Banks' bail-out and a conditionality clause on SMEs support

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Abstract

Despite the discount factor for SMEs lending introduced in the CRR directive, SMEs access to credit may still not be sufficiently enhanced. Also, this preferential weight may even raise a potential distortion of the risk profile of SMEs. This Q&A section discusses the alternative measures undertaken by EU member states to alleviate the funding constraints to SME lending by banks. More specifically, it investigates the role on Small Business Lending of a conditionality clause in granting State aid.

Introduction

Small and medium-sized enterprises (SMEs) are the backbone of the European economy. They are seen to provide the lion share of the added value and employment and they are the drivers of economic growth and innovation. Usually, many SMEs perceive getting finance as their most pressing problem to grow. They are in turn perceived by banks as opaque and risky, which in most of the cases justify higher risk premiums if they are granted loans. This is a direct consequence of the asymmetry of information that usually governs SMEs and banks relationship. The global financial crisis has put further strain

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on on-going and new activities of all types of enterprises (small, medium or large) and raised serious doubts on the health of the European banking sector, which were not adequately capitalised when the financial crisis erupted. Most SMEs suffered dangerous dry ups of funds necessary to maintain their operations and essential cash-flow running and hence became even riskier than before. The reduced availability of bank loans, credit lines and overdrafts was one of the channels through which the financial crisis hit especially SMEs, which have been for long largely reliant on bank financing. During the crises, several policy and regulatory measures were deployed to alleviate funding shortage to SMEs.

Questions on the impact of the financial crises on SME funding and the role of public intervention

What has driven the decline to SME funding during the financial crisis?

As was evidenced in a recent research work I directed for the European Parliament in 2014[38], the deterioration of the financial health of European banks and the subsequent macro-economic woes in several EU countries have been largely detrimental to SMEs. The 2007-2009 global financial crises and the consecutive 2010-2012 euro area sovereign debt crisis exposed the banking sector to heavy losses and resulted in higher capital requirements making their business seemingly more expensive in a period where it was difficult to access capital. Such situation hampered their capacity to take risk and particularly risk to SMEs. The more prudent behaviour and restructuring plans imposed on banks by regulators that followed to help banks return to soundness led to a reduction of the loan volumes in general and more specifically to SMEs. In particular, the bank loan volumes decreased and the interest rates increased most in countries that applied for financial assistance from other EU Member States during the euro area debt crisis. In turn, the adverse economic conditions have also led to a reduction in demand for bank loans; but the reduction in available lending volumes seems to outweigh the shrinkage in demand.

38. Ayadi R., W.P. De Groen and P. Thyri (2015) “State aid to banks and credit to SMEs: Is there a need for conditionnality”, European Parliament, 2015 (thereafter Ayadi et al (2015)).

What are the policy measures taken during the crisis to alleviate SMEs funding constraints?

I will emphasise the measures undertaken by EU member states to alleviate the funding constraints to SME lending by banks. The capital requirements regulation (CRR) 2012/648/EU[39] introduced a preferential risk weight for SMEs (Article 501) aimed at reducing the regulatory costs for SMEs. However, this might not be sufficient for banks to enhance access to credit to this category of enterprises and might even raise a potential distortion of the risk profile of SMEs. Indeed, as a result of the financial crisis, banks have largely suffered losses because of excessive risk taking in previous years on the so-called "toxic" assets, which has curtailed their capacity to lend to the real economy and hence motivated several governments to provide them with financial support in form of State aid.

Between 2008 and 2012, the financial sector has benefited from large amounts of State aid, amounting respectively to 39 % of the European Union's (EU) 2012 gross domestic product (GDP).[40]

Questions on the role of State aid in avoiding funding disruptions to SMEs

What is State aid and how does it work to save EU banks and avoid disruptions in SME funding by banks?

State aid is defined under Article 107 (1) Treaty on the Functioning of the European Union (TFEU)[41] and thus follows the legal assessment made by the Commission. It is assumed that the elements of the concept of State aid, i.e. (i) granting of an economic advantage, (ii) transfer of State resources, (iii) favouring of a certain undertaking (selectivity), (iv) distortion of competition as well as an (v) adverse effect on trade between Member States are present.[42]

39. Article 501, OJ L 176 of 27.6.2013.
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:FULL:EN:PDF

40. See Ayadi et al (2015).

41. Article 107 (1) TFEU, OJ C 115 of 09.05.2008, pp. 91-92, '*1. Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.*'

42. Vademecum (2008), *Community law on State aid*, European Commission Directorate-General for Competition pp 6-7.

Therefore, the State measures applied to EU banks fall under the realm of application of Article 107 (3) (b) TFEU[43], empowering the Commission to determine whether an aid can be seen as compatible with the Common Market or not. To that end, the first sentence of Article 108 TFEU envisages a system of obligatory *ex ante* notification to the Commission, further laid out and specified in the recently amended procedural regulation Nr. 659/1999.[44] In applying Article 107 (3) (b) TFEU, the Commission enjoys substantial discretion. Such discretion will allow the publications of communications to govern the application of State aid.

In the autumn of 2008, the Commission issued its '*banking package*' which was originally intended to give guidance to the Commission's temporary policy approach towards State aid in to the banking sector.[45] In July 2013, the Commission published the Banking Communication[46], which consolidates most of the

43. Article 107 (3) TFEU, OJ C 115 of 09.05.2008, pp. 91-92,
'3. The following may be considered to be compatible with the internal market:
(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation;
(b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;
(c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;
(d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common interest;
(e) such other categories of aid as may be specified by decision of the Council on a proposal from the Commission.'
Visual emphasis introduced by the authors.

44. Council Regulation (EU) No 734/2013, amending Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ 2013 L 204/15, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:204:FULL:EN:PDF.

45. Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ('2008 Banking Communication') (OJ C 270, 25.10.2008, p. 8, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:270:0008:0014:EN:PDF); Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('Recapitalisation Communication') (OJ C 10, 15.1.2009, p. 2, http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52009XC0115%2801%29); Communication from the Commission on the treatment of impaired assets in the Community financial sector ('Impaired Assets Communication') (OJ C 72, 26.3.2009, p. 1, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:072:0001:0022:EN:PDF); Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ('Restructuring Communication') (OJ C 195, 19.8.2009, p. 9, http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52009XC0819%2803%29); Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2010 Prolongation Communication') (OJ C 329, 7.12.2010, p. 7, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:329:0004:0005:EN:PDF) and Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2011 Prolongation Communication') (OJ C 356, 6.12.2011, p. 7, http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52011XC1206%2802%29).

46. Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), OJ C 216, 30.7.2013, p. 1, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:216:FULL:EN:PDF.

previous ones and sets out the up-dated EU crisis rules for State aid to banks during the crisis from 1 August 2013. It replaces the 2008 Banking Communication and supplements the remaining crisis rules. Together, they define the common EU conditions under which Member States can support banks with capital, asset relief measures, guarantees and other liquidity facilities. The main objective of the Commission is to safeguard the financial stability, meaning the prevention of negative spill-over's to other banks as well as ensuring that the lending to the real economy continues and hence avoid any funding disruptions to SMEs in Europe. In addition, the Commission sought to limit the distortion of the competitive environment, minimize the required tax payers' money and retain the single market.

When a financial institution receives State aid, the Member State has to submit a viability- or restructuring-plan for the bank. This plan sets out the conditions that the bank has to respect during the restructuring process. The Commission examines the plan based on five broad criteria entailed in the 2009 Restructuring Communication:[47]

The 2007-2009 global financial crises and the subsequent 2010-2012 euro area sovereign debt crisis forced EU Member States to undertake bold actions. After a long period with barely any bank rescues,[48] EU Member States committed between 2008 and 2012 in total EUR 5.1 trillion (equal to almost 40 % of 2012 EU GDP) of State aid. The State aid granted to European banks during the crises can be divided across four broad types; recapitalisation, asset relief measures, guarantees and other liquidity measures.

1. The first form of State aid is the **recapitalisation** of banks. Governments provide funds to banks in exchange for equity instruments, including normal shares, preferred shares and hybrid capital. This measure strengthens the capital position of banks. In addition, the recapitalisation can deliver the government the control over the bank. A public body obtaining control over a bank itself is not considered State aid.

47. Community guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 244, 01.10.2004, p 2-17; Latest prolongation OJ C 296, 02.10.2012, p. 3, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:296:FULL:EN:PDF.

48. *'The most well-known ones are the Crédit Lyonnais case and the German regional banks [resp. Landesbanken] ruling. In the case of Crédit Lyonnais, the European Commission decided in 1995 that Crédit Lyonnais, in return for the green light on the EUR 6.9 billion (FF 45 billion) in State aid, had to reduce its commercial operations abroad, including a substantial part of its European banking network, by at least 35 % by the end of 1998. In the German Landesbanken case, the European Commission agreed with the German government in 2001 to phase out the system of State guarantees for the regional savings banks in 2005 ('Landesbanken') and distinguish between the public policy and purely commercial tasks of these institutions'*, Lannoo and Napoli, 2010.

2. Second, governments also carve out impaired and toxic bank assets. The provided **asset relief** can help banks to reduce the uncertainty about the value of their assets and limit the impact of temporary losses due to illiquid markets. The asset relief measures contribute to re-gaining access to liquidity, deleveraging and reducing the capital consumption. Moreover the schemes must be justified to taxpayers when public money is used to guarantee the bad assets.[49]
3. Third, governments **guarantee bank liabilities**. Besides the deposits covered under deposit guarantee schemes**,** governments can also specifically guarantee newly issued bonds. The guaranteeing of newly issued bonds allows banks to raise new funds or rollover old liability instruments.
4. Fourth, besides guarantees some Member States also provide **direct liquidity** to ailing banks and other systemic financial institutions that faced problems obtaining funding. The direct short-term facilities mostly contained loans.

Besides through State aid European Banks also received liquidity assistance from central banks. Although the central banks are public institutions most of their funding of the banking sector is exempted from State aid requirements. Hence, instruments related to monetary policy are exempted, while support for a specific institution can be considered State aid (e.g. Emergency liquidity assistance - ELA). Though, in most cases this liquidity support is also exempted, as long as the bank is solvent, the liquidity support is fully collateralised, a penalty interest rate is charged and the initiative for the measure stems from the central bank.[50]

Through which channels could in general granting State aid to banks influence the access of SMEs to finance?

Not all banks managed to absorb the losses and fulfil the higher capital requirements. The EU Member States intervened, providing capital, asset reliefs, guarantees and liquidity measures to ailing banks to safeguard financial stability and avoid the consequences of the breakup of the lending chain,

49. OJ C 72 of 26.3.2009,
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:072:0001:0022:EN:PDF.
50. OJ C 270, 25.10.2008, p. 8,
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:270:0008:0014:EN:PDF

which can be detrimental to the real economy and to SMEs. In exchange for State support the aided banks had to fulfil certain conditions. Albeit the (below-market price) remuneration for the obtained support, the banks that received State aid were also obliged to restructure to limit distortions to competition and to become long-term viable. The case-specific restructuring plans could, for instance, include conditions to sell or cease parts of the activities, to merge with other healthier banks but also to apply lending targets (in particular to SMEs) and bans on acquisitions, price- leadership (price setter) coupon-, dividend- and bonus payments and to abide by other types of restrictions such as advertising.

Did State aid to financial institutions actually impact the SMEs' access to finance?

As was evidenced in our research, in countries experiencing economic woes and where the financial sector needed more State aid SMEs access to finance took the largest hit, both in terms of volumes and interest rates. In addition, the bank intermediation in countries where banks had relatively higher risk costs and less capital were significantly less performing, while the opposite is true for countries with better economic conditions. On the other hand, loan guarantees, which are loans guaranteed by national guarantee schemes did not seem to lead to a better bank loan intermediation towards SMEs during the crisis years. In fact, loan guarantees under national schemes are too limited and concentrated in just a few countries (e.g. France and Italy) to allow a comprehensive assessment. Therefore more research on this topic is needed.

What role did credit to SMEs play in the decisions to grant State aid?

When looking at State aid decisions on 46 banks in 15 Member States during the crisis years (2007-2012), we found that on the one hand, lending to SMEs played a role in the decision to grant State aid. Indeed, avoiding that the bank-lending channel would be broken was one of the motivations to grant State aid. This is a key dimension to avoid disruptions of funding the real economy. On the other hand, many restructuring plans had an impact on lending to SMEs either directly via imposing hard or soft lending targets and price leadership bans or indirectly via general bans on price leadership and restrictions on new or dismantling of existing activities.

Would a conditionality clause for granting State aid to banks subject to providing access to credit be legally possible?

Lending to SMEs could be legally justified as a condition to State aid under the existing legislation. Article 107 (3) (b) of the Treaty on the Functioning of the European Union (TFEU) allows for the assessment of the compatibility of State aid with the Internal Market and provides the European Commission with sufficient possibilities to approve SME lending targets to prevent a credit crunch and disturbance to the real economy.

Would a conditionality clause for granting State aid to banks subject to providing access to credit be economically justified?

Based on our research, when applied conditionality can have a significant impact on the lending activities of banks, but seems not to contribute to more lending to SMEs by banks. Generally, the ailing banks that received State aid on the condition that they restructured, liquidated or to be nationalised, displayed lower SMEs loan growth compared to other banks that did not benefit from State aid. More specifically, the analysis displayed in our research focuses on conditions, both on the relative price levels and lending volumes, which are the two channels to directly influence lending to SMEs. Hence, aid recipient banks that had to abide to minimum SME-lending targets recorded significantly lower growth in total customer loans than banks that did not have to fulfil any lending target or for which maximum targets are applied. These banks are most probably suffering the restructuring plan internally and hence were incapable of adding further risk into their balance sheet. SMEs are by definition more opaque entities and display generally a higher risk profile than other asset classes. The results for banks that had to comply with general lending targets are ambiguous and not significant. Moreover, the banks that were not allowed to be price leader in standard products in general quoted lower loan growth rates. While for banks with price-leadership bans in SMEs products the results were ambiguous, but also not significant. These results show that ailing banks recipient of State aid fail to maintain and/or increase funding to SMEs. In contrast, State aid to banks could have achieved lesser financial instability and disruption on the system level. This hypothesis was not tested in our research. Finally, we showed that sounder banks that are more retail-oriented, that generally display more liquid funds, higher regulatory capital and lower market funding are expected to sustain lending to the real economy[51]. In addition, higher economic growth and liquidity provisioning by central banks contribute to higher loan growth, which confirms that the action of the ECB were beneficial to sustain lending to SMEs.

References

Ayadi R., De Groen, W.P., and Thyri, P., 2015. State aid to banks and credit to SMEs: Is there a need for conditionality, European Parliament, 2015

51. See Ayadi, R. Et al (2015), "Business Models Monitor in Banking, Europe 2015", International Research Centre on Cooperative Finance (IRCCF), HEC Montreal, Forthcoming.