conseil d'analyse
économique
French Council of Economic Analysis

Jacques Cailloux[a], Augustin Landier[b]
and Guillaume Plantin[c]

Lending to SMEs: Identifying Difficulties and Recommending Targeted Measures

Les notes du conseil d'analyse économique, no 18, November 2014

In the context of major change in regulation in the banking world, the future financing of small and medium-sized companies (SMEs) is a legitimate concern. Faced with demanding new requirements for equity capital and liquidity, are banks' appetites for financing the development of such companies likely to fall? So far, the recapitalisation of French banks has not been achieved at the expense of SMEs. In addition, the development of new financial instruments for financing larger SMEs and mid-market companies, along with two reforms in the insurance sector, should enable banks to continue to take on the risk of lending to smaller SMEs and micro-enterprises. Moreover, the French banking sector appears to be able to respond to increased demand for credit, estimated here at EUR10-15 billion per additional point of growth in nominal GDP. In this context, the authors do not view the securitisation of loans to SMEs and micro-enterprises to be particularly positive for France. Rather, they would favour securitising household debt or debt issued by larger entities (large SMEs and mid-market companies), as it is less costly and should be encouraged whenever it achieves a real transfer of portfolio risk to long-term investors. Such securitisation will indirectly facilitate lending to smaller SMEs by 'freeing up' banks' risk-taking capacity, while leaving equity levels unchanged.

For the authors of this Note, French SMEs' credit problems are relatively well defined –they mainly concern financing cash-flows, and particular problems faced by smaller companies and the construction and public works sector. It is thus appropriate to focus on targeted measures that will contribute to smoothing out the loans market for SMEs and micro-enterprises and to overcoming its information shortage.

As SMEs' cash-flow problems are largely caused by excessive payment delays by customers, the authors recommend encouraging factoring and, in particular, 'reverse factoring', in which the instructing party (rather than the supplier) becomes the factor's customer. To solve problems of information asymmetry that hamper lending, the authors suggest opening access to the Bank of France's company information database (FIBEN) to all market players and developing 'positive listing' for credit (along the lines of the American FICO model) while, naturally, guaranteeing the confidentiality of any personal information, a loan to a micro-enterprise being very close to a loan to its manager. It is in the area of deepening relationships between lenders and borrowers and in the support given to borrowers that solutions should be sought. The authors also propose that banks and chambers of commerce work together to develop training tools for financial management and basic accounting principles for micro-enterprises. Certification in this area could be taken into account by the banks and encourage them to offer more favourable financing terms.

[a] Nomura International, associated member of the CAE.
[b] Toulouse School of Economics (TSE), Toulouse 1 University, IDEI.
[c] Sciences Po Paris, member of the CAE.

Introduction

Since the beginning of the financial crisis in autumn 2008, the number of companies in France going out of business –mainly small and medium-sized companies (SMEs)– has been around 60,000 per year, compared with around 48,000 before the crisis.[1] It is tempting to attribute such a large increase in failures to SMEs having difficulties in their access to finance and, in particular, to credit from their banks. However, the financial crisis rapidly became an economic crisis, so that many failures have been owing to a lack of orders rather than financing problems.

It is thus important to differentiate between a company with financial difficulties and one that is not economically viable. A company ceases to be economically viable when the discounted value of flows of its forecast revenue become less than its projected costs. Of course, by its very nature, such a calculation is uncertain. But when it has been established that a company is no longer viable, financing its requirements can only be done at a loss. The public authorities may well wish to postpone shutting down the company,[2] but this enters the realm of public subsidies with no expectations of the sums provided ever being recovered.

The situation is very different for an economically viable company that sees the creation or continuation of its business threatened by financial constraints associated with a dysfunctional credit market. A viable company can be temporarily 'cash strapped' or illiquid, if its business activity requires immediate external financing even if it would be able to reimburse in a few months' time. If the financial system is unable to provide such financing, the company will get into financial difficulty. A viable company may also become insolvent if the value of its assets falls below that of its liabilities. In this case there is a need to restructure the company's balance sheet (that is, renegotiate its debt), so that creditors and shareholders 'take their losses' through significant and rapid coordinated action. In both cases –illiquidity and insolvency– the company is viable but may cease to be so if, for example, temporary financial difficulties lead to losing customers.

The distinction between financial difficulty and economic difficulty is essential: bailing out companies that are not economically viable amounts to wasting tax-payers' money; allowing viable companies to fail because the financial system is incapable of responding when needed would be an economic mess. In practice however, the distinction between the two situations is not always easy to ascertain and the businessman is, of course, more likely to highlight his financing difficulties than question the viability of his company. The public authorities can seek to soften the effect of dysfunctional credit markets by for example improving information exchange mechanisms. However, they need to be aware that, when public authorities choose to lend directly, they are subject to the same imperfect information as the private sector: credit that is deemed to be too risky to be profitable by a private bank is just as risky for a public financing source.[3]

Because of this distinction, we present an overview of the situation, before broaching three key issues –loan securitisation, cash-flow credit lines and information.

The current state of financing for SMEs

At end-2012, the amount of outstanding external financing for non-financial French companies (all sizes combined) stood at EUR4,130 billion (i.e. twice the French GDP), made up of 59% in quoted or non-quoted shares, 29% in loans and 12% in bonds and marketable debt instruments (consolidated data, Eurostat). Although the granting of loans to companies in France has significantly slowed since the start of the crisis, the outstanding amount has only fallen slightly, while at the same time bond financing for large companies has flourished.

Overall, French SMEs do not seem to lack equity capital compared with their European counterparts.[4] According to the Bank of France,[5] shareholder equity amounts to roughly 40% of SMEs' balance sheets and has grown by an average 5% per year since 2008. The problems with equity capital arise at certain points of the business life cycle –when launching the company, when small innovative companies go

Several interviews with both public and private institutions were conducted for the preparation of this *Note*. The authors wish to thank those organisations who made time available to give their views, and in particular the CGPME (the French association of SMEs) and KPMG (the French arm of the audit, consultancy and accounting firm) for making available its "barometer of SME's access to finance and credit", as well as BPI for sharing the information in its SME 2013 report. They are particularly grateful to Jézabel Couppey-Soubeyran, scientific advisor at the CAE, for the quality of her assistance and contributions throughout their work.

[1] See *L'Observatoire des entreprises*, Bank of France. A small or medium-sized company (SME) is a company employing less than 250 people, with less than EUR50 million in annual turnover and with less than EUR 43 million in total assets.

[2] Such subsidies could be justified by negative (ensuing unemployment) or positive (innovation) externalities.

[3] Modern corporate finance develops further the analysis by taking into account the fact that the economic viability of a project does not depend solely on its capacity for generating profits, but also on the incentives that the businessman has to make his project succeed, something which can reduce the level of external financing that can be provided to the company. See, for example, Tirole J. (2010): *The Theory of Corporate Finance*, Princeton University Press. In this case, the imperfection in the credit market is structural –it is caused by a problem of information with which any public organisation would also be confronted.

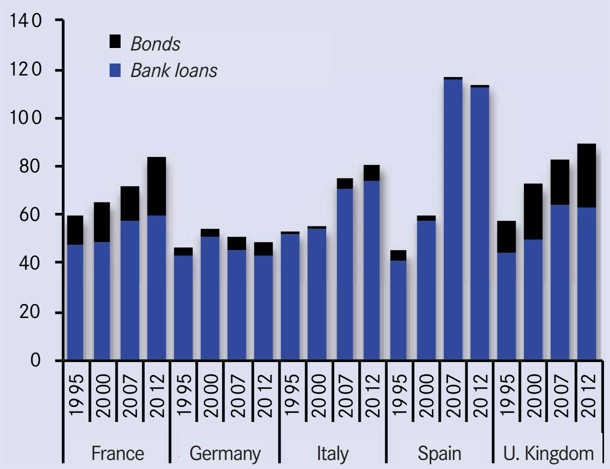
[4] Banque de France (2012): " Les PME en Europe: les disparités sont plus fortes en 2010 qu'avant la crise ", *Bulletin de la Banque de France*, no 188, 2nd quarter.

[5] Banque de France (2014): " Le recul de la rentabilité pèse sur l'investissement des PME ", *Bulletin de la Banque de France*, no 197, 3rd quarter.

[6] Here estimated from the "securities other than shares with the exception of product derivatives" in the national financial accounts.

for their 'second round' of fund-raising, or when handing over to the next generation, for example. These questions, which concern the possible under-development of investment funds in France and also the shortage of high-return projects in the country, will be the subject of a future *Note* from the CAE. We concentrate here on the question of lending, which is at the core of the 2008 financial crisis and the concerns over the re-regulation of the banking sector put in place since that time.

1. Financing non-financial companies using bank credit and bonds, stocks in % of GDP

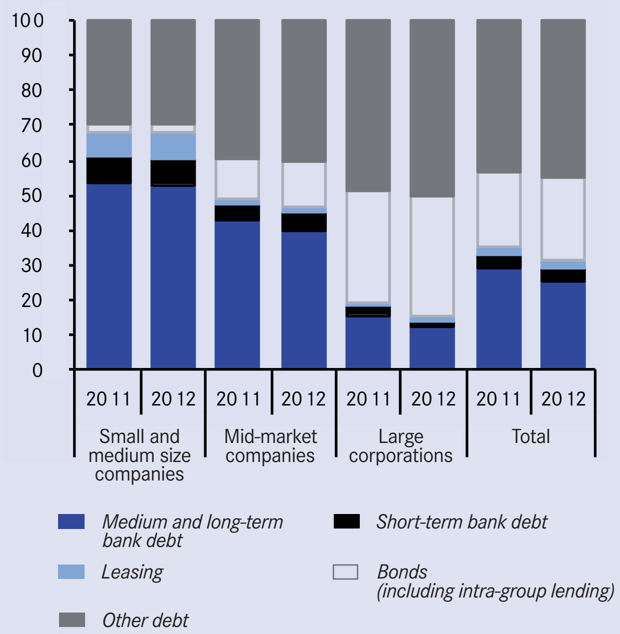


Source: Consolidated national financial accounts, Eurostat.

Non-financial French companies' (all sizes combined) financing from bank loans increased by 10 points of GDP between 1995 and 2012, reaching the equivalent of 60% of GDP in 2012. The preliminary data for 2013 and 2014 suggest a similar ratio for these years. This is less than in the United Kingdom, Spain and Italy (see Graph 1), but more than in Germany, where the ratio has hardly changed over the past 20 years and remains around 40% of GDP.

The proportion of funding derived from bond issuance[6] has more than doubled since 1995, reaching almost 25% of GDP in 2012, just behind that in the United Kingdom. Of the large eurozone countries, France is the one where sources of company funding appear the most diversified. However, this reflects the position of large corporations more than that of SMEs. Graph 2 shows that bond-derived funding made up just 2% of SMEs' debt in 2012, compared with 34% for large corporations.[7] SMEs and micro-enterprises are thus structurally more dependent on bank funds, largely owing to the small size of the loans required for their financing.

2. Breakdown of financial debt by size of company, in %



Source: Banque de France (2013): «Les entreprises en France en 2012 : dégradations des performances mais consolidation des équilibres financiers», *Bulletin de la Banque de France*, no 194.

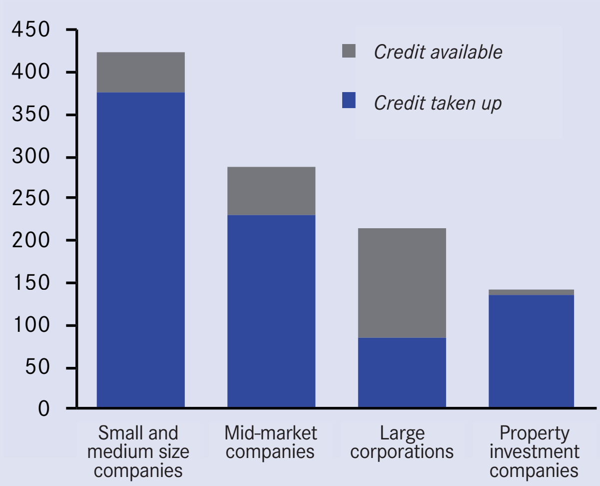
Even though SME and micro-enterprise funding could become more diversified, banking credit will probably remain their main source of external funding, if only because information problems are best overcome by the personalised relationship between the bank and the entrepreneur.

If one looks at the outstanding stock of loans in banks' assets (Graph 3), the contrast between small and large companies is striking. In July 2014, about 45% of the EUR820 billion in outstanding loans to non-financial companies –some EUR377 billion– went to SMEs,[8] twice the volume destined for large corporations.

[7] In 2013, the proportion of debt in the aggregated balance sheets of SMEs was estimated at 29%, of which less than 1% was in the form of bonds. See Banque de France, FIBEN data.

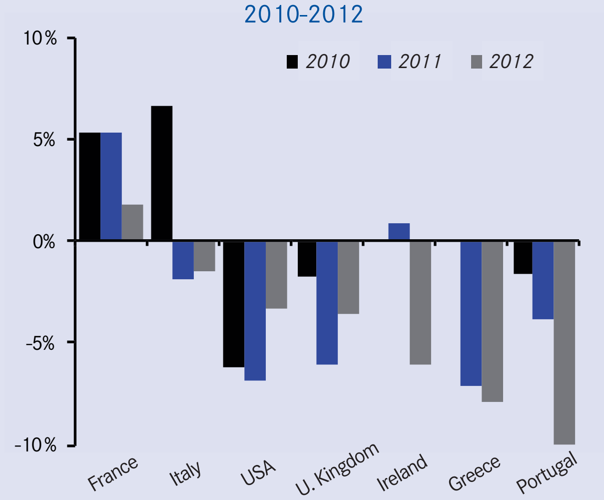
[8] At the end of Q2 2014, outstanding credit granted to micro-enterprises (defined as companies having an annual turnover of less than EUR2 million) amounted to some EUR230 billion. See Banque de France (2014): " Financement des micro-entreprises ", *Stat Info*, June.

3. Outstanding bank credit by size of company, in billions of euros, July 2014



Source: Banque de France.

4. Growth rate for outstanding loans to SMEs, 2010-2012



Note : Data is not available for Germany and Spain..

Sources: OCDE (2014): *Financing SMEs and Entrepreneurs 2014: An OECD Scoreboard*, July.

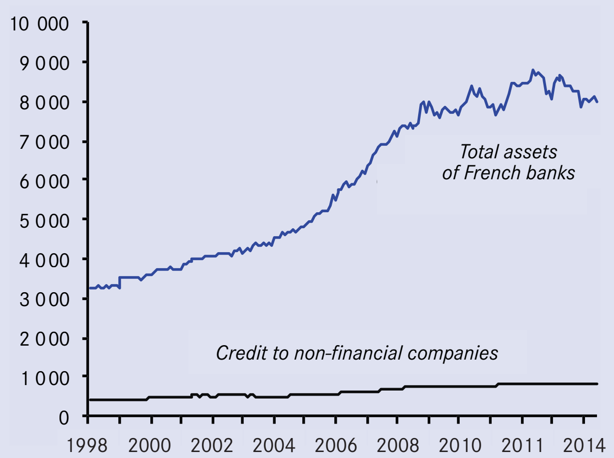
Because definitions vary, direct international comparisons of the evolution of bank loans to SMEs (and even more so to micro-enterprises) are very difficult.[9] If we limit ourselves to comparing growth rates (partly sidestepping the comparability problem), France was in a relatively favourable position between 2010 and 2012: outstanding loans to SMEs increased during this period, whereas they diminished in several countries, including both the United Kingdom and the United States, two countries where pre-crisis growth was stronger than in France (Graph 4). If we focus exclusively on new loans of under EUR250,000, which are generally taken up by small SMEs and micro-enterprises, the volume was stable in 2013 and 2014 in France, whereas it dropped significantly in Italy (data from the ECB, the European Central Bank).

Are banks in a position to meet increased demand for credit?

The sluggish rate of increase in loans to SMEs can be largely explained by perceptions of fairly limited economic growth, which reduces the tendency to invest. It is perhaps useful to estimate what SME demand for credit would be if GDP growth were more dynamic. The calculations shown in Box 1 suggest that, for each additional point of nominal growth, there would be additional credit demand of around EUR10 to 15 billion. Yet Graph 5 shows that credit granted to companies amounts to only a small proportion of French banks' balance sheets, a proportion which has not followed the growth curves enjoyed by these institutions. In June 2014, total outstanding corporate loans amounted to less than 10% of French banks' balance sheets, while the equivalent figure for SMEs totalled less than 5%. The noughties were a decade during which market-trading activities expanded and proved far more profitable for banks than lending to companies.

Thus, the EUR10 to 15 billion additional credit demand in the scenario of a significant improvement in GDP growth would only make up some 0.1% to 0.2% of the banks' combined

5. Bank credit to non-financial companies and total bank assets, in billions of euros



Source: Authors, from Banque de France data.

[9] The September 2014 *scoreboard* from the OECD concerning financing SMEs emphasised the problem of comparability of data. For example, the smaller the company, the greater the difficulty in distinguishing between personal and commercial loans. In addition, practices differ by country: in the United Kingdom, 70% of financing for individual companies is handled through credit cards; in other countries, the loan is granted after mortgaging some personal asset, in which case the loan can be classified as part of real estate loans.

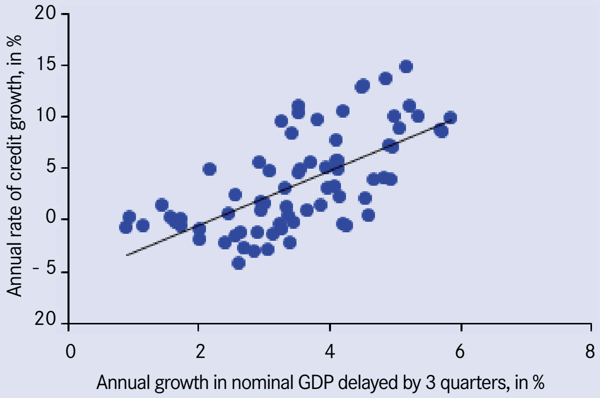
1. What level of credit for which growth rate?

What is the «normal» amount of corporate credit for a given level of business activity? Such an estimate is never easy to put forward and even less so in times of crisis. Supply and demand factors are not always apparent and tend to overlap. In addition, certain structural problems can complicate matters further, such as the increase in the proportion of external financing by debt bonds or the trends in the prudential environment.

Recent studies[a] have focused on credit rationing and have tried to identify the credit supply factors that could slow the granting of credit in the marketplace. The conclusion is that weak credit growth, as evident in France in the past few years, is related more to demand, rather than supply, factors.

Here we study the relationship between nominal GDP growth and the growth in corporate credit, with a view to establishing an order of magnitude of the increase in credit needed in the case of a clear upsurge in the economy. As can be seen from the accompanying graph, there is a clear relationship in the long term. Ordinary least squares regression analysis for the period 1994-2014 (with a dummy variable introduced to cover the financial crisis between third quarter 2008 and third quarter 2009) suggests that an increase in nominal growth of 1 percentage point would produce 1.7 points of growth in the demand for credit.

Nominal GDP growth and the growth in corporate credit
1994-2014



Note: The 2008 crisis has been removed from the Graph.
Sources: INSEE, Banque de France and Nomura.

[a] See, for example, Kremp E. and P. Sevestre (2012): «La crise a-t-elle entraîné un rationnement du crédit pour les PME ?», *Document de Travail de la Banque de France*, no 405, November and Kremp E. and P. Sevestre (2014): «Le crédit bancaire aux PME en France : d'abord la persistance d'une faible demande» in *Les entreprises en France*, INSEE Références.

balance sheets, which is less than that required by the adjustments under the new prudential regulations. Surveys carried out by the ECB and the Bank of France confirm that the balance sheet constraints imposed on banks have up to now had practically no effect on the terms of banks' credit offerings. The results of the ECB's comprehensive assessment of the balance sheets of the eurozone's banks (stress tests and asset quality review) published on 26 October 2014 would also seem to confirm that French banks are sufficiently capitalised to be able to respond to an upsurge in demand for credit from SMEs.

As for the demand for credit, the available surveys from banks and from companies[10] do not suggest a significant problem in SMEs' access to finance in 2014, except with regard to cash-flow credit lines, for which the rejection rate has been significantly higher than for financing investments. According to the Bank of France survey, 90% of SMEs which requested investment credits say they obtained the full amount or more than 75%, but only 75% of SMEs were as successful in applying for cash-flow credit lines. Besides, an international comparison borne out from data in the ECB's half-yearly SAFE survey suggests that access to finance could, in some cases, be more difficult in France than in Germany.[11] According to the results, French SMEs see their bank loan applications approved, either entirely or almost entirely, in 77% of cases (70% of cases for micro-enterprises). Although quite low, the approval rate for micro-enterprises' loan applications remains higher in France than in Germany, Spain or Italy, where it stands at only 43%. However, for other types of loans (commercial credit, overdrafts, etc.), the approval rate is higher, on average, in Germany. Yet, even then, the situation of French companies continues to surpass that of their Italian or Spanish competitors (see table). This somewhat mixed situation is backed up by the results of a survey run jointly by KPMG and the French Federation for SMEs published under the banner '*Baromètre sur le financement et l'accès au crédit des PME*' (The Barometer of Access to Finance and Credit

[10] See Banque de France: *Enquête mensuelle auprès des banques sur la distribution du crédit en France*, (Monthly survey of banks concerning credit distribution in France), available at www.banque-france.fr/economie-et-statistiques/stats-info/detail/enquete-mensuelle-aupres-des-banques-sur-la-distribution-du-credit-en-france.html; *Enquête trimestrielle de la Banque de France auprès des entreprises* (Quarterly survey of companies by the Bank of France) (3,500 SMEs and 400 mid-market companies, in the industrial, services and construction sectors) available at www.banque-france.fr/economie-et-statistiques/stats-info/detail/acces-des-entreprises-au-credit.html

[11] See Survey on Access to Finance of Enterprises (SAFE), available at www.ecb.europa.eu/stats/money/surveys/sme/html/index.en.html

Share of credit requests fully granted or financed to close the full amount
between April and September 2014, in %

	France	Germany	Italy	Spain
SMEs				
• Bank loans	77	76	56	62
• Trade receivables	70	87	70	71
• Overdrafts, lines of credit, credit card limits exceeded	69	75	56	69
Micro-enterprises				
• Bank loans	70	63	43	57
• Trade receivables	72	88	58	65
• Overdrafts, lines of credit, credit card limits exceeded	66	72	45	70

Note: Answers S1 ("amount requested was fully granted") and S5 ("close to full amount requested was granted") to question 7B of the survey are summed up together.

Sources: *Survey on the Access to Finance of Enterprises* (SAFE, question Q7B), BCE and Nomura.

for SMEs). This is a survey carried out among a sample of 401 entrepreneurs, representative of French companies with between 10 and 500 employees. In September 2014, 34% of those surveyed highlighted cash-flow or financing problems, compared with 26% to 29% in 2010. The problem would appear to be most acute in the construction and public works sector (46%), in the North East region (35%) and in rural areas (38%).

A noticeable problem with financing cash-flow

Although companies would highlight financing as a problem far more than would the banks, both agree that there is a persistent issue with finance for tackling cash-flow difficulties. Cash-flow is a particularly difficult problem in the construction and public works sector, where micro-enterprises predominate,[12] and which appear to suffer from both large payment delays and cash-flow problems as acute as those in the mid-1990s.[13] Several factors can be advanced to explain the recent deterioration –the sluggish demand in the construction sector, budget restrictions at both central government and local authority levels and an unprecedented lengthening of payment delays. Although the construction and public works sector is not the only sector affected by late payments, late payments significantly contribute to the cash-flow problems prevalent in this sector.

Observation. The French banking sector appears able to absorb more sustained demand for credit from SMEs if more favourable economic conditions emerge. Gaining access to cash-flow credit lines does seem however to be difficult compared with Germany. Increased payment delays weigh heavily on companies in certain sectors.

Diversify financing sources for SMEs?

Even though the banking sector remains the major player, one might ask whether alternative sources can be found for financing SMEs, especially in the light of an ever more prudent banking sector, and the significantly cyclical, not to say unstable, nature of the availability of banking credit.[14]

The European financial markets were very quick to act in response to the uncertainty surrounding bank loans. One such response was private placements, where medium- and long-term debt is placed with a small number of institutional investors, without recourse to public funding. Since 2013, private placements by mid-market companies and larger SMEs have seen unprecedented growth in the eurozone. In 2013, it enabled some 40 French companies to borrow more than EUR3.3 billion, of which some EUR1.2 billion was accounted for by 20 mid-market companies.[15] This expansion has been accompanied by the publication in March 2014 of the charter concerning *Euro Private Placements*, or *Euro PP*, drawn up by the Paris Financial Centre under the aegis of the Bank of France and the Paris-Île-de-France Chamber of Commerce. This charter sets standards of practice in the private placement market.[16] In parallel with these market trends, the public authorities have embarked on reforms that are likely to divert life insurance funds towards industry financing.

Life insurance reforms

In March 2014, the sums lodged in life insurance policies exceeded EUR1,400 billion. These include EUR240 billion in unit-linked contracts, usually invested in UCITS (Undertakings for Collective Investment in Transferable Securities), where the policy holders accept the risk of fluctuations in the value of the units. The remainder of the outstanding amount, i.e. more

[12] According to the National Federation of Public Works (FNTP), 90% of companies in the sector have less than 50 employees, with a combined annual turnover of EUR11 billion. See Fédération nationale des travaux publics (FNTP) (2013): " Recueil de statistiques ", *TP Informations*, no 71, November, available at www.fntp.fr/upload/docs/application/pdf/2013-12/recueil_statistiques_2012.pdf

[13] See INSEE (2014): *Enquête mensuelle de conjoncture dans l'industrie du bâtiment* (Monthly business survey in the construction industry), October.

[14] See International Monetary Fund (IMF) (2014): *Global Financial Stability Report*, Chap. 1, October.

[15] See Observatoire du financement des entreprises par le marché (2013): *Annual report*.

[16] We hasten to point out that the strong growth in private placement is partly explained by the historically low level of long-term interest rates. Future trends are therefore unpredictable given their high dependence on American monetary policy.

than EUR1,100 billion, is placed essentially in so-called "euro denominated" contracts. Such contracts offer considerable advantages to policy holders. First, their value is guaranteed and they can be liquidated by policy holders at any moment, upon payment of a small administrative charge and, second, policy holders must benefit from a portion equal to at least 85% of the net performance of the insurance company's assets. Such liability commitments mean the insurance companies adopt a very cautious investment policy, focusing on reliable and liquid assets. Until the August 2013 reforms, the prudential regulations concerning insurance companies incorporated such cautious behaviour by limiting the ability of life insurance companies to invest in debt issued by SMEs and mid-market companies.

Two recent reforms, which concern both the asset and the liability sides of life insurance companies, aim to facilitate financing of mid-market companies and larger SMEs:

– On the liabilities' side: New types of life insurance policies known as "*euro-croissance*" and "*vie-génération*" were introduced in 2014. The euro-croissance policies maintain all the essential characteristics of euro-denominated contracts, particularly their tax treatment, but the insurance company is no longer obliged to guarantee policy holders that, eight years after it was taken out, the contract will still hold its original value. The *vie-génération* policies are unit-linked contracts that offer a 20% allowance on the capital passed upon the subscriber's death, in return for an investment of a minimum of 33% in SMEs or in the solidarity economy;
– On the assets' side: Decree no 2013-717 of 2 August 2013 modified the regulations governing insurance to allow insurance companies to invest up to 5% of their clients' savings, i.e. around EUR60 billion, either directly by granting loans to companies or by investing in 'loan funds for the economy' with such funds then issuing bonds covering loans to SMEs and mid-market companies.

These two reforms are steps in the right direction. Guaranteeing at all times the surrender value of existing euro-denominated life insurance policies makes them de facto equivalent to a bank savings account in terms of liquidity. Clearly there are risks associated with offering insurance companies the chance to expose themselves to a greater extent to the uncertainties of mid-market and large SME assets with which they are less familiar. As a result, the regulatory qualitative provisions imposed on any insurance company wishing to invest in this type of product are significant, in particular that they possess appropriate in-house expertise.

Should loans to micro-enterprises be securitised?

The current initiatives for diversifying financing sources for companies are mainly targeted at mid-market companies and larger SMEs. As private placements generally involve far too high fixed costs for micro-enterprises and the majority of SMEs, one wonders whether it would be appropriate to develop a market for securitised loans for this latter category of company.

Securitisation consists of transferring a portfolio of loans or debt from the balance sheet of the financial institution which initially granted it to another company that will refinance it by issuing bonds. Bondholders have rights over future revenue flows generated by the portfolio. The bond issue may be split into various risk 'layers'. The so-called 'equity' layer, which bears the highest risk, would take the first losses. Each subsequent layer would in turn absorb losses until all their value had been dissipated. The final layer, known as the 'senior' layer, only supports losses once all the preceding layers have lost all of their value. Such a structure makes it possible to adapt the risk profile of each layer to a given set of clients (hedge funds, insurers, etc.), thereby creating better overall value for the portfolio. However, this is at the cost of a much more complex financial instrument. In addition, despite its deceptively reassuring name, the 'senior' layer could well be relatively risky in certain circumstances.

Developing securitisation of SME loans would require huge portfolios consisting of a sufficiently large number of relatively low-value individual loans to diversify the risk. These portfolios would then be securitised and sold as such, or by layer, with the bank that originally granted the loans having to retain a certain portion of the risk on its balance sheet as a means of maintaining the right incentives (see Box 2).[17] By selling such securitised loans, the bank would create space on its own balance sheet, effectively enabling it to take on new risks and thus grant new loans to market participants. The ECB's determination to promote the market for securitised loans to SMEs emanates from this logic, with the ECB having the possibility to buy the 'senior' layers of such assets on the markets.

However, small companies are very heterogeneous –more so even than private individuals. The loans all come with their various differing clauses and are difficult to group together into large generalised categories of borrowings that would lend themselves to statistical analysis. In addition, small companies are precisely those where information asymmetry between banks and markets are the most acute. Loan

[17] The retention of an 'equity' layer by the bank is equivalent to the deductible in an insurance policy. The deductible encourages the insured party to control his risk. But such an incentive has a cost –the transfer of an imperfect risk to the insurer.

2. Securitisation aberrations and the 2008 crisis

The risks associated with securitisation are linked to the behavioural changes that it induces. If a bank knows upfront that it will transfer the future cash flows associated with its loans, it knows it will no longer suffer the full force of a default. Therefore it will not only be less diligent in its selection of borrowers, but it will also be less concerned about engaging effective recovery mechanisms in the case of a credit event. Such problems were particularly evident in the case of American mortgage loans during the 2008 crisis.[a] In practice, retaining some risk provides incentives for the 'credit-originating' bank. By keeping a part of the 'equity' layer –in effect a part of the first losses incurred by the portfolio– the bank has some incentive to ensure a minimum quality for its portfolio.

The securitisation operations that played such a central role in the 2008 crisis were delinquent forms of the securitisation as described above, used to get around the prudential regulations applied to the banks. The securitised loans were not transferred to non-banking investment concerns –they were refinanced either within the banking system, or by organisations in the 'shadow banking' sector, i.e. institutions that refinance by issuing quasi-deposits, such as money market funds, thereby being *de facto* unregulated banks. In the United States, before 2008, securitisation had become a regulatory arbitrage tool allowing banks to escape prudential regulations, rather than a transfer of a bank's risks to institutions with less fragile balance sheets.

[a] Keys B.J., T.K. Mukherjee, A. Seru and V. Vig (2010): «Did Securitization Lead to Lax Screening? Evidence from Subprime Loans», *Quarterly Journal of Economics*, vol. 125, no 1, pp. 307-362 and Piskorski T., A. Seru and V. Vig (2010): «Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis», *Journal of Financial Economics*, vol. 97, no 3, pp. 369-397.

decisions are based on the local bank manager's judgement, given his knowledge of the immediate context of the firm's commercial situation and of the competence, energy and even personal financial position of the company's owners. The costs incurred by the loss of information associated with securitisation would therefore appear to be particularly high for small SMEs and micro-enterprises. Even in the American financial system, the most innovative in this area, this particular type of securitisation is seldom used.[18]

It is therefore important to identify the particular benefits that this type of securitisation could bring compared with those associated with the private placements mentioned earlier (destined for mid-market companies and larger SMEs) and securitisation of personal loans, which is easier to put in place (especially when based on mortgage loans) than loans to small SMEs and micro-enterprises. When a bank 'frees up' one euro of capital (by transferring the risk of this euro to the market), it is expected to use this euro to allocate funds in the most profitable manner, irrespective of the source of this euro (securitisation, share issuance, retained profits, etc.). In other words, there is no reason to suppose that the loosening of banks' equity capital constraints, which could be achieved by private placements of loans granted to mid-market companies or securitisation of mortgage loans, would not benefit - at least to some extent- those micro-enterprises and SMEs with profitable projects. The fungibility of banks' balance sheets, even if only partial, indicates that trying to securitise banks' most illiquid assets to loosen their financial constraints is not an effective mechanism.

Ultimately, the recent life insurance reforms are there to bridge the shortcomings in bank lending to SMEs which would likely appear in the event of a significant upsurge in investment financing. For example, the reform concerning insurance company placement has created the potential for investing in SMEs to the value of some EUR60 billion, far greater than our estimates of the likely increase in credit demand from SMEs were the economy to take off. The fact that *Novo*, the loan funds for the economy launched by the *Caisse des dépôts et consignations* in July 2013, has only committed to date some EUR500 million, out of a capacity of EUR1 billion suggests that the new financing capacity created by these reforms will not be taken up very quickly.

Although it is essential to ensure that international regulation changes (in particular Basel III for the banking sector and Solvency II for the insurance sector), and their incorporation into French law, do not excessively interfere with securitisation in France in the next few years, the benefits expected from securitising loans to SMEs would appear to us to be less than obvious in France in the short term.[19]

[18] By contrast, small American entrepreneurs frequently use consumer or mortgage-type credit to finance their activity. Securitisation of this type of outstanding credit is thus highly developed in the United States and plays an important role in financing micro-enterprises.

[19] The situation is different in Spain, and even more so in Italy, where banks do not appear to be in a position to take on additional risks onto their balance sheets.

Recommendation 1. The development of securitization should target loans to individuals and to larger SMEs and mid-market companies, rather than loans to smaller SMEs and micro-enterprises.

Financing SMEs' cash-flow requirements. As we saw above, the case that there is a dearth of investment financing has not been clearly made. Yet there is no doubt that French SMEs are frequently confronted with cash-flow problems. However, these often arise when the solvency of the firm is at stake, suggesting the need to restructure its debt or to simply close down the company. "Cash-flow difficulties", blamed by companies on banks for being overly cautious, may well be an advance warning that a business is not in a position to cover its liabilities. It is therefore important to keep in mind the obvious difference between the optimistic businessman, who would have everyone believe that his business will recover,[20] and the banker, who knows he will never see his money again if the business becomes insolvent.

In fact, as the *Observatoire du financement des entreprises* highlights in its June 2014 report (see Box 3), the rate of cash-flow-based credit default is on average greater than that of investment loans. One way to overcome the bank's reticence is for the company to anticipate any cash-flow problems. Upfront discussions about financial risks can give rise to sensible loan negotiations, prior to experiencing any financial difficulties, with such loans acting as a cushion to soften the blow from any liquidity issues. This could limit the number of situations where the company goes to the bank cap in hand, faced with credit requirements the bank can only cover at a high cost as, statistically, bailing out companies with a loan *in extremis* has a high probability of default. We shall return later to the issues surrounding this capacity for anticipation.

Payment delays by major contractors

Companies' cash-flow requirements are largely determined by the difference in payment delays from that of their customers paying their bills to that of paying their suppliers. The French economy has tended to have significant business-to-business payment delays compared for example with countries such as Germany. The 2008 law on modernising the economy, or LME (for *'Loi de modernisation de l'économie*') aimed to reduce such delays by introducing deadlines for supplier payments at 60 or 45 days from the end of the month, as well as penalties for not respecting such deadlines. The LME prompted a significant reduction in payment delays, up until 2011, with the impact subsiding thereafter. Moreover, a parliamentary report dated from 2013[21] showed that the length of payment delays imposed on suppliers was clearly proportional to the size of the contractor, whereas customers' due-dates were fairly independent of size. SMEs have therefore been subjected to extended delays in payment by large contractors, potentially generating cash-flow problems in a difficult economic context.[22] Overall,

3. Financing cash-flows: the findings of the *Observatoire du financement des entreprises*

The report on financing micro-enterprises published by the *Observatoire du financement des entreprises* in June 2014[a] specifically focuses on the difficulties, raised by micro-enterprises, encountered in financing cash-flows and includes detailed minutes arising from the interviews carried out on the subject.

According to this report, the default rate on loans to micro-enterprises was on average around 6%, but 'significantly higher' for credits designed to help with cash-flow. Banks are therefore more reticent about financing cash shortages than they are investments –an urgent need for cash is logically interpreted as an advance warning of a business problem that is more than a simple issue of liquidity.

A useful course of action is to anticipate cash-flow problems before they arise. In this respect, the report mentions a certain lack of professionalism within micro-enterprises: "It transpired *a posteriori* that, in numerous cases, a loan with predetermined repayments would have been less costly for the company than using an overdraft facility. But the entrepreneur does not always see it this way when asking for credit facilities. It would be advisable to put actions in place to educate small business entrepreneurs in the area of cash credit lines" (p. 44).

In that one of the specifics of the French market is a significant use of overdrafts to overcome liquidity issues, a more informed and effective financial management would be extremely beneficial to small companies. 60% of the outstanding short-term financing of micro-enterprises is through authorised overdraft facilities. Financing through overdrafts is costly for a company (roughly three times more expensive than an equivalent credit with due-date payments), especially in those cases where no overdraft facilities have been authorised (interest premiums, fixed charges for refusal of cheque and direct debit payments, particularly high commission charges for handling such events).

[a] Observatoire du financement des entreprises (2014): *Rapport sur le financement des TPE en France*, June.

[20] Landier A. and D. Thesmar (2009): "Financial Contracting with Optimistic Entrepreneurs", *Review of Financial Studies*, vol. 22, no 1, pp. 117-150.

[21] Bourquin M. (2013): *Les relations entre donneurs d'ordres et sous-traitants dans le domaine de l'industrie*, Report for the Prime Minister by Senator Martial Bourquin, May.

[22] See for example, Souquet C. (2014): " Forte hétérogénéité des délais de paiement entre entreprises " in *Les entreprises en France*, INSEE Références.

the central government has reduced its payment delays for public procurement orders, while those from local authorities have tended to increase since 2011.

In its annual report for 2013, the *Observatoire des délais de paiement*[22] published simulations showing that, were all non-complying participants –including those in the public sector– to adhere to the maximum payment delay set out by law, significant amounts of cash-flow, financed by large contractors, would be freed-up in favour of SMEs (EUR15 billion) and mid-market companies (EUR6 billion). Consumer law no 2013-244 of 17 March 2013 introduced two mechanisms designed to improve the implementation of the LME. Thus, auditors must now draw up a certified statement relating to payment delays for suppliers and customers. This certified statement must be lodged with the Ministry of Economic Affairs; penalties for late payments have been strengthened.

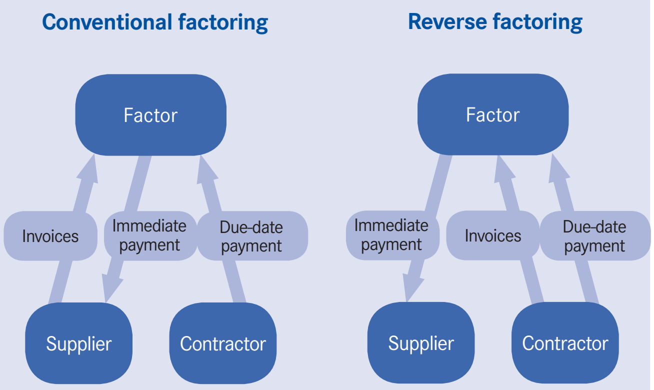
The fact that a number of large contractors have in this manner reduced their working capital needs at the expense of their small suppliers would appear to be a classic example of a lopsided business relationship, one in which the (small) supplier loses all his negotiating power from the moment the balance of his activity depends on a commercial relationship with a single (large) customer. The use of reverse factoring by contractors would seem to be a perfectly appropriate contractual means of overcoming this problem. As we explain below, reverse factoring allows contractors to credibly commit to not using their market power against their suppliers.

Using reverse factoring to insure against the risk of payment delays

Factoring is a financial operation, whereby a company transfers its trade receivables to a financial institution (the factor) against upfront payment of the associated invoices. Factoring can be done without recourse, in which case the factor does not refer back to the assignee of the creditor's rights in case of credit events, or with recourse, where the factor can refer back to the assignee of the creditor's rights in the event of non-payment.

In reverse factoring, it is the contractor placing the order who becomes the factor's customer, not the contractor's supplier. The business customer, with the permission of the contractor, transfers the supplier's invoices to the factor, along with any information relevant for the monitoring of any associated risks (see diagram). The factoring firm immediately settles the invoices with the supplier and deducts a discount for cash payment; it channels back this discount to its business customer, who then compensates the factor. The business customer then pays the factor according to a pre-established payment schedule comprising the value of the supplier's invoices.

Conventional factoring and reverse factoring



Source: Authors.

Reverse factoring would appear to be perfectly suitable to the situation, where a major contractor (mid-market company, large firm or local authority) places orders with many SME suppliers. Such reverse factoring grew rapidly in the United States after the 2008 crisis had considerably soured other sources of cash-flow financing. But it is significantly less developed in France than in other eurozone countries. This is likely related to the structure of the factoring market in France, which is much more concentrated than in the United States. The participants in the French factoring market are essentially subsidiaries of large banking groups, which are themselves highly concentrated. By contrast, in the United States, the factoring market is much more fragmented and consists of companies that do not, for the most part, have capital links with the banking sector. We propose that the public authorities encourage the development of this type of contractual solution. The rules for public procurement could include the obligation, for companies whose debt levels towards suppliers exceed a certain threshold, to meet the following conditions:

- the tendering company is in a position to provide detailed information concerning the spread of payment delays for its sub-contractors in recent years;
- it proposes a reverse factoring solution to carry out the contract.

Recommendation 2. Encourage the development of reverse factoring to insure SMEs against the risk of excessive payment delays when dealing with major contractors.

[22] Observatoire des délais de paiement (ODP) (2014): *Une double nécessité: stabiliser la loi, aménager les procédures de vérification pour les acteurs publics locaux*, ODP Report 2013, January.

Reducing information asymmetries in the credit market

Information friction is at the heart of the problem of financing small companies:[23] an entrepreneur has great difficulty in demonstrating the quality of his project, his ability to drive it to conclusion, or even to credibly commit to undertaking the effort necessary to achieve success. Since the founding seminal work by Grossman and Stiglitz (1976 and 1980),[24] economic literature has shown that privately produced information (particularly financial) is likely to be sub-optimal whenever the producer of the information bears the cost of production, yet cannot reap the benefits. Government intervention in this area is thus fully justified.

Access to FIBEN data to free up the secondary market for credit to SMEs

The Bank of France produces financial data for all French companies with an annual turnover in excess of EUR750,000. This information is assembled in the Bank's company information database (FIBEN) and comprises information on the company's liabilities and any history of payment problems. The Bank issues company ratings designed to measure their ability to honour financial commitments over the next three years. This rating is based on the company's balance sheet, but also takes into account a qualitative assessment derived from the Bank's discussions with the company.

Currently, such information is made available to all credit organisations and to credit and suretyship insurance companies. Information in FIBEN is confidential and carefully protected and cannot be divulged to any unauthorised third party. Thanks to this confidentiality, the Bank of France, which produces the data, avoids being considered as a credit rating agency and being regulated as such.

Standardising and improving the flow of information concerning the financial risk involved with companies, without giving an information advantage to any particular category of participant, would however have a certain social value. This could help to promote the emergence of a secondary market for credit and encourage innovation in this sector. Wider access to FIBEN data could, for example, facilitate the sale of some of the larger SMEs' individual loans, to refinance trade receivables, etc. This would open up the analysis of securitised products to a wider audience of interested professionals –not just credit companies, but also other potential buyers or data-analytics consultants. More generally, this would widen the circle for economic analysis of the market for credit to SMEs. The people likely to be in a position to affect price formation in the credit marketplace are not all employees of credit issuers or insurance companies. Produced by the Bank of France, this information could either be sold to all participants in the economy or put into the public domain as 'open data'. The draft law on simplifying company procedures had considered making the FIBEN database available to insurers, on account of their credit activity, to crowdfunding platforms and to loan funds management firms. However, the Senate, after examining the draft law in November 2014, decided to delete Article 30, upon which this provision was based, citing the "cost", the "feasibility" of FIBEN and the risk that it would end up making life more complicated for firms. It is unfortunate to see this topic disregarded without justification, insofar as the FIBEN database already exists and has already proven its usefulness to those in the banking sector who can benefit from it. Much could be gained from opening up access to these data –to the largest possible audience– to see new funding relationships outside of the banking sector develop.

Recommendation 3. Extend access to FIBEN information to all participants in the economy.

Financial education and the bank/SME ecosystem

Financial difficulties faced by micro-enterprises are largely owing to the lack of financial training of those who manage them, as even the representatives of SME associations have pointed out.[25] The inability to foresee and prepare for cash-flow issues and capital requirements is a prime factor in entrepreneurial failure and should be prevented. In particular, it is important that the manager of a micro-enterprise is aware of the potential risks of financial difficulties and of the importance of being in a position to manage them. Developing training opportunities in conjunction with banks or chambers of commerce would at least enable managers to recognise the benefits of being coached on financial matters. Such training should include the basic principles of accountancy and cash-flow management, as well as the essential elements of taxation and labour law, all of which are part and parcel of assessing the solvency of a company. Although interesting initiatives are to be found in this area, they are unlikely to become widespread without external support, partly because entrepreneurs often fail to recognise the value of such training in advance. Public authorities thus have an important role to play, in addition to offering entrepreneurial support. Digital developments –the use of online courses and examinations– mean that such training need not be expensive to deliver.

[23] Stiglitz J.E. and A. Weiss (1981): "Credit Rationing in Markets with Imperfect Information", *American Economic Review*, vol. 71, no 3, pp. 393-410 June.

[24] Grossman S.J. and J.E. Stiglitz (1976): "Information and Competitive Price Systems", *American Economic Review*, vol. 66, no 2, pp. 246-253 and Grossman S.J. and J.E. Stiglitz (1980): "On the Impossibility of Informationally Efficient Markets", *American Economic Review*, vol. 70, no 3, June, pp. 393-408.

[25] Academic studies confirm the widespread problem of the lack of financial. See, for example, Lusardi A. and O.S. Mitchell (2013): "The Economic Importance of Financial Literacy: Theory and Evidence", *NBER Working Papers*, no 18952.

Here we fully agree with the conclusions of the *Observatoire du financement des entreprises* which recommends strengthening the financial knowledge and understanding of those who run micro-enterprises.

Recommendation 4. Develop a training tool for micro-enterprise managers covering financial issues and basic accounting. Such training could be evaluated by an online examination and participating banks could offer (with full transparency) favourable treatment to businessmen who participate in the programme.

Personal information

Micro-enterprise turnover means that they do not feature on the radar screen of the FIBEN database (>EUR750,000), a situation that renders their default risks difficult to evaluate for any potential lenders. Extending the FIBEN system to such companies is not an appropriate route to take as scores based on the company's accounts are not good indicators of the probability that very small companies will pay back their debts. In addition, the financial health of a small firm is closely linked with the personal financial situation of the entrepreneur –credit granted to micro-enterprises resembles personal loans rather than credit extended to SMEs. In addition to the business project, other variables need to be evaluated, such as those associated with the behaviour of the company's manager or his personal situation (Has he already borrowed a lot personally? Has he successfully paid back sizeable loans? Does he tend to pay his bills on time? Etc.). In the United States a large proportion of credit to micro-enterprises is financed through the founder's personal credit card. This is made possible by the existence of a "FICO score", which assesses an individual's ability to repay a loan based on his credit history.[26] This type of positive rating file does not exist in France, which is probably one of the obstacles to the development of credit to micro-enterprises. A positive score on the credit register would constitute non-financial collateral, which the businessman could pledge upon borrowing, giving some level of guarantee that he intends to repay the loan. France singularly distinguishes itself by being opposed to the idea of positive listing, citing the country's privacy protection principles. But such protection causes a disservice to those individuals, particularly the founders of small companies, who have the greatest need to demonstrate their financial reliability to potential credit providers. Equally, one should expect opposition to such positive listings from some of the large banking networks, which would see their captive market undermined by giving the borrower the possibility to set out his credentials to credit organisations with which he has no client history.

Recommendation 5. Develop a "positive listing" for individual's credit-worthiness (along the lines of the American FICO system) which would loosen the credit constraints for micro-enterprises with no history and no collateral.

Conclusion

In the face of widespread economic difficulties since 2007, both bank and bond financing of SMEs have grown only slightly. There have been no indications that financing conditions for SMEs have got significantly worse in general, but this masks problems in the particular cases of micro-enterprises and in financing to meet cash-flow difficulties. We believe that the most appropriate responses to these difficulties would be highly focused, specific measures designed to improve the operation of the credit markets in these particular cases. Specifically, we recommend the reduction of the risks associated with payment delays by large contractors to help overcome cash-flow difficulties, including by the use of reverse factoring; the development of better quality public credit information; and the improvement of training opportunities in financial management for micro-enterprises.

[26] FICO (Fair Isaac Corporation), creators of the main credit scoring in the United States. See www.myfico.com/CreditEducation/WhatsInYourScore.aspx

conseil d'analyse économique

The French Conseil d'analyse économique (Council of Economic Analysis) is an independent, non partisan advisory body reporting to the French Prime Minister. This Council is meant to shed light upon economic policy issues, especially at an early stage, before government policy is defined.

Publisher Agnès Bénassy-Quéré
Editor Hélène Paris
Electronic publishing Christine Carl

Contact Press Christine Carl
Ph: +33(0)1 42 75 77 47
christine.carl@cae-eco.fr

113 rue de Grenelle 75007 PARIS (France) **Ph: +33(0)1 42 75 53 00** **Fax: +33(0)1 42 75 51 27** **@CAEinfo** **www.cae-eco.fr**