POSITION PAPER

EIB Consultation on the Transfer of Financial Advantage to SMEs under its "Loan for SME" product

Response by ESBG

16 September 2011

ESBG

1. Introduction

ESBG welcomes the opportunity provided by the European Investment Bank (EIB) to respond to its consultation with European banking associations on the transfer of financial advantage to small and medium-sized enterprises (SMEs) associated with its "Loan for SME" product. Due to the timing of the consultation in August, it has not been possible to collect a response from all ESBG members that are acting as an EIB intermediary for the on-lending of such loans to SMEs. This response represents the views expressed by ESBG member in six European countries: Austria, the Czech Republic, Germany, Portugal, Slovakia and the United Kingdom. This feedback is summarised below.

2. Overarching comments

EIB loans for SMEs have been introduced in 2008 as a result of a consultation with the financial services industry and are thus welcomed by the industry. They provide refinancing means (liquidity) and relatively long maturities-even if there is a view that these maturities could usefully be extended- but no risk sharing so far.

The financial value added – "FVA" or discount provided by EIB, i.e. the difference between the cost of an EIB loan and of other forms of refinancing for the same intermediary, is beneficial to customers:

- ✓ It allows customers to reduce the direct cost of investing in their businesses

- ✓ Improves the affordability of lending, effectively supporting lenders in extending facilities to customers who may otherwise be unable to afford the investment (pre-discount)

The funding benefit is attractive to lenders:

- ✓ Enabling lenders to further support SME's with discounted lending
- ✓ Product structuring is simple, allowing lenders to utilise current debt instruments

The Scheme is viewed externally as a positive collaboration between EIB and Lenders.

3. Issues which limit the scope to increase the transfer of financial advantage to SMEs

- The cost of EIB funding is increasing in certain markets against a current backdrop of a decreasing cost of funding on capital markets. This may make this latter source of funding more attractive than that of the EIB. It should also be noted that EIB loans for SMEs as a refinancing offer to financial intermediaries may be competing with other attractive sources of funding available on domestic markets, including promotional finance.

- In the light of the above developments, some ESBG members have suggested that the margin achieved on EIB refinancing will almost disappear. This is particularly relevant for savings banks that usually benefit from a strong level of customer deposits and are not dependent on refinancing on the capital markets. In effect, one ESBG member has not signed the contract with the EIB for the SME Loan product despite being chosen as a financial intermediary. The main issue was the price of financial sources from the EIB.

- Accordingly there may not be any space for the suggested increase of the financial benefit transferred to the SME unless the EIB pricing reflects this situation. This would involve a decrease in the EIB margin as well as a reduction in collateral requirements.

- Owing to the profile of the funding advantage, the product currently best supports those customers with borrowing terms of less than 7 years, even though commercial businesses often need access to longer term borrowing (up to 25 years). The consultation paper mentions the possibilities of longer maturities and a development in this sense can only be encouraged.

- The financial value added- FVA- of the EIB "Loan for SME" may decrease over the duration of the agreement due to changing conditions on the capital markets. It should therefore be possible to review this as the tranches are being drawn down.

- In its current form, EIB best supports relatively mature SME businesses that have the security to enable access to EIB borrowing. EIB doesn't support those businesses in start up stages, or those lacking the required security.

- Certainty around future tranche availability – this makes it difficult managing customer (and internal) expectations around product availability beyond the current tranche.

- Depth of tranche – each tranche of EIB funds is relatively small (less than 10% of a typical years lending), this makes it difficult for large lenders, in particular, to be certain around future availability and to have the confidence to build the product into core system/process architecture - therefore relying upon manual (bespoke) administration and processes.

- There are extra handling costs related to EIB loans for SMEs, due to the higher administration costs as well as risks involved with such loans. There are administrative costs associated with the loan application as well as the subsequent reporting and processing obligations. These administrative costs are often higher than those related to other funding sources. Where possible, EIB funding sources should be combined with national schemes in order to reduce administrative burden.

- The time period between funds being made available from the EIB and on lent to final beneficiaries can be restrictive

- The eligibility criteria can be vague, often further clarification is required via the EIB on the definition of eligible and ineligible projects.

- There are contractual risks resulting a) from a “rating trigger” which may cause an increased demand for collateral by EIB during the term of the loan, and b) from EIB’s rights of withdrawal.

- Collateralisation is an issue, as financial intermediaries have to fund the cost of using ECB eligible collateral.

- There are costs of providing collateral for tranches drawn from EIB before these can be covered by outstanding receivables.

- The regulation governing the transfer of the financial benefit to the SME is not very flexible. This is a problem, as the agreed financial advantage is not always in line with prevailing capital market conditions.

- Scheme legal agreements are complex, this leads to lengthy negotiations and can delay the ability of financial intermediaries to begin on-lending to final beneficiaries.

- Seeking amendment or variation to the scheme can be a lengthy process.

- Specific to a tranche of EIB funds (provided against a securitisation):

    - The funding advantage is linked to the amortisation of the underlying securitisation; this creates uncertainty for lenders around the profile of receipt of funding advantage.

    - Lenders carry the risk of an underlying note downgrade. This (market) risk exposes lenders to the liability for SME loans already agreed with final beneficiaries.

- The EIB’s involvement is a real selling point of the scheme; however centralised marketing/awareness of the scheme is minimal. This would help build awareness and increase customer demand.

Some additional country specific remarks on this topic can be found in annex.

4. Proposals for improving the attractiveness of EIB Loans for SMEs

These proposals have been made by individual ESBG members. It should however be noted that they are not necessarily all shared by all of the respondents, due to different national situations and bank profiles.

- EIB should consider improving the financial advantage of this instrument. This would involve a decrease of the margin, a reduction of the collateral required as well as a more flexible regulation for the transfer of the financial benefit to the SME.

- Some ideas on making the regulation for the transfer of the financial benefit to the SME more flexible include the following: the minimum financial advantage should not be fixed for all financial intermediaries in the same range; the amount of the benefit should be discussed and agreed between EIB and the intermediary in function of the current situation on the capital market before each single tranche is drawn down.

- Another suggestion was that the EIB should consider a maximum margin for a financial intermediary to cover its financing costs rather than a minimum financial advantage to be passed on to beneficiaries. This is the general practice of promotional banks in Germany for example.

- Longer maturities than the current average maturity of 8 years would be most welcome. These should be associated with improved matching of tenors of EIB lending and sub-loans to SMEs.

- Support businesses in start-up stages, or those lacking the required security

- EIB should provide explicit guidance on the definition of eligible and ineligible projects so that financial intermediaries can be clearer with customers on this topic

- Given that in future banks will need most of their capital for Basel III, EIB capital should not be collateralised or at most the collateralisation should not exceed 50%.

- Consider possibilities for reducing or offsetting the extra handling costs related to EIB loans for SMEs. One proposal from a member in central and eastern Europe was to consider providing grants to cover part of the additional administration costs. This could apply in particular to portfolios with very small loans, or to priority investments such as the environment, energy efficiency measures, etc.

- Where possible, EIB funding sources should be combined with national schemes in order to reduce administrative burden and allow the possibility of providing assistance to SMEs in a smooth manner.

- The EIB is encouraged to engage in more risk sharing with financial intermediaries and to explore funded and unfunded risk sharing instruments as suggested in the consultation document.

Annex

Country specific remarks

Germany

Re: Liquidity

EIB loans for SMEs as a refinancing offer to financial intermediaries have to compete against alternatives which are rather manifold in the German context:

- In terms of the pure liquidity, intermediaries have alternatives such as clients' deposits or covered bonds ("Pfandbriefe") whose availability is especially wide for Sparkassen.

- When it comes to promotional finance - including interest advantage, risk sharing and/or other improved loan conditions - there are easily and widely accessible offers from German public sources such as KfW and the promotional banks of the Federal States (a much wider offer than in many other EU countries).

Re: Financial advantage

In Germany, at present, the FVA of EIB refinancing is not as high as in many other European countries. Thus, practitioners do not see much scope in Germany for an increase in the minimum financial advantage passed on to SMEs.

On the level of Landesbanken, the existing FVA of EIB refinancing is partly offset by extra effort and costs related specifically to EIB loans - compared to other refinancing sources:

Re Administrative cost and processing.

Although EIB loans for SMEs can be used in a rather lean way (the "allocation request" is acknowledged to be easy and short) its application process is not incorporated into the usual and well-known IT platforms used for German programmes; this fact increases the processing effort for EIB loans which - according to some practitioners - also have risen in recent years.

The EIB product compared to German offers is "exotic" to a certain extent and has to demonstrate an extra advantage to offset the additional effort in processing.

In the specific German context the EIB's target group of (small) SMEs would best be reached by making use of the established system of cooperation between Landesbanken and Sparkassen (or equivalent between central and local cooperative banks). Landesbanken themselves are serving mid-caps rather than SMEs, but they are able to achieve the "critical mass" in loan volume suitable for EIB refinancing, and on the other side - as their business partners - the Sparkassen are close to the target group of (small) SMEs. In this system, if it were to be used for the disbursement of EIB loans for SMEs, there are additional handling costs for passing on the loans from Landesbank to Sparkasse.

Portugal

1 – In the present economic conjuncture, which affects all Portuguese banks and to which ESBG's Portuguese member, Caixa Geral de Depósitos (CGD) is also particularly sensitive, CGD does not see any real possibility of lowering spreads on SME financing, even if this would be a very desirable action under present circumstances.

Compared to real market rates, including the real cost of funding for CGD, all the loans, under the protocol signed with the EIB, already have significantly lower spreads, which reflect the lower cost of funding, as agreed with the EIB;

2 – The administrative costs of loans that involve EIB funding are also much higher than the ones directly offered by CGD, given the higher amount of paperwork involved, be it in actually placing a request, or in the following reporting duties that CGD feels to be excessive.

That translates in more man hours spent and besides being time consuming, it is also expensive.

About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6.000 billion, non-bank deposits of € 3.100 billion and non-bank loans of € 3.300 billion (all figures on 1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

European Savings Banks Group - aisbl
Rue Marie-Thérèse, 11 ▪ B-1000 Brussels ▪ Tel: +32 2 211 11 11 ▪ Fax : +32 2 211 11 99
Info@savings-banks.eu ▪ www.esbg.eu

Published by ESBG. September 2011