High Level Principles of Long-Term Investment

The case for SME financings

Fostering long-term investment by institutional investors with a view to bringing about economic growth and employment could come into conflict with the principles that are guiding the Basel Committee on Banking Supervision (BCBS).

Reviewing the business of lending to SMEs will expose why this conflict may inevitably unfold, even if unintentionally: it is about the risks of lending versus the risks of entrepreneurship.

Financial risk versus entrepreneurial risk

Lending to SMEs is the business of banks close enough to small companies to be able to judge whether the small corporate represents an acceptable credit risk. This will typically be a smallish savings bank or the local branch of a major bank where the bank manager and the entrepreneur personally know each other, perhaps have even known each other for years. The entrepreneur will have some sort of standing in the local community and the bank manager will, to a major extent, rely on this informal standing and, as a rule, ask for collateral as security for a loan because he knows that he does not understand the business of the entrepreneur well enough for permitting unsecured lending. In other words, the promise of a loan is not based on an appraisal of the corporate risk proper but on the liquidation risk of the granted collateral, which is a much narrower financial consideration.

With growing size of the company its financing needs will increase as will the competition from lending institutions seeking its business. Credit decisions will then be based more formally on measures of the financial strength of the borrower like debt leverage or interest coverage ratios. And unsecured lending will commence when the pool of unencumbered assets looks large, tangible and liquid enough for satisfactory recourse in case of an eventual distress. Even then, the intrinsic entrepreneurial risk will rarely receive focused attention.

From the entrepreneur's point of view, different and mostly contrary to the above, financial risk is of secondary importance only, a relatively inconvenient constraint that needs to be observed, but not what ultimately drives the business nor even investment decisions. The typical entrepreneur/business owner, by personality mostly some blend between a techie and a sales person, will aim at creating, conquering and defending market share for his company's products or services. In order to be successful, the entrepreneur needs to take risks and will be comfortable with taking risks.

The salaried CEO of a large public corporation who depends on shareholder approval for an extension of his management contract will typically behave more like the prudent banker and will therefore weigh entrepreneurial risk more systematically against financial risks.

Schumpeter, more than 70 years ago, in his rather pessimistic "Capitalism, Socialism and Democracy" stylized this difference as the transition from capitalism ("the perennial gale of creative destruction") to bureaucracy in both public sector administration and businesses.

The fundamental lack of regard which some entrepreneurs show for financial risk certainly deserves no sympathy from a regulatory body in charge of banking supervision. But totally dismissing the need for entrepreneurial risk taking on the part of financial market regulators must hurt the real economy. And entrepreneurial risk rarely comes without financial risk.

The communication challenge between public policies which, on the one hand, want to stop recklessness and irresponsibility in banking and, on the other hand, wish to stimulate long-term financing for economic growth and more jobs may take a while before gaining positive recognition from financial market regulators. And during that interval Basel III, Solvency II and the various CRDs may inflict considerable damage on long-term financing. But the disinclination to listen to pleas for allowing more leeway in risk taking also has to be seen against the background of excessive financial risk still in the system.

The basic regulatory predicament is that all risk measurement and control systems are predicated on financial default probabilities which cannot differentiate between (possibly constructive) entrepreneurial risk and (bad speculative) financial risk. But there is a substantial difference in that probabilities of default are based on time series of the past whereas the entrepreneur will adopt the long view and act to actively shape the course of future events in ways favoring his company.

Rating agencies do also try to take into account "qualitative" aspects when awarding their ratings. But even in doing so, unsurprisingly, they have not always been infallible and sometimes have even been compliant with the views of the issuers paying for their rating. So one of the declared aims of financial regulators is "to mitigate mechanistic reliance on external credit ratings."

Why would any investment manager mechanistically rely on an external credit rating? Well, if it is an AAA, the manager can't be blamed when things turn sour subsequently. But it is an open question whether he will make a more educated, enlightened, responsible choice when coerced by stringent, but arbitrary capital requirements imposed by the financial regulator.

Consequences of current regulatory approach for SME financings

With increased pressures on more prudent and risk sensitive capital requirements, the resulting investment pattern, including institutional investors with long-term liabilities, is away from longer and towards shorter term assets and away from illiquid towards more fungible assets. This, obviously, is not helpful for the financing of corporate capital expenditures and there is a discussion going on whether the current emphasis does not, in reality, augment financial market volatility and cliff effects. With regard to SME financings additional aspects impede a stronger involvement of institutional investors which, in principle, could provide perfect and welcome relief from the deleveraging pressure on banks (as a result of increased capital requirements) by agreeing with them on the transfer of swathes of corporate loan portfolios.

But as institutional investors will not bend for individual small-ticket loans there is the issue of pooling or bundling hundreds and thousands of SME deals in a shape and form acceptable for and attractive to big-ticket investors. One practical solution to this challenge is securitization, i.e. the pooling and subsequent tranching into risk layers attractive to institutionals. But the BCBS simply and strongly dislikes securitization and is suggesting to penalize securitized portfolio risk – regardless of asset class or securitization structure - with a prohibitively higher capital charge when compared to the capital charge for the same portfolio risk in unsecuritized form. This certainly comes across as arbitrary and has already been strongly challenged by numerous market participants from banking and securitization institutions.

But even if the BCBS were to grant exemption from prohibitive capital charges for SME loan securitizations, the particulars of the risk transfer from the originator to the final investor are another set of issues remaining conceptually unresolved as yet.

Suggestion for safeguarding the integrity of the risk transfer

It is remarkable that among the forty-two comments[1] that the BIS shows on its website in response to the consultative document of the BCBS on securitization of December 19th 2012[2], none, so far, came from an institutional investor, i.e. an insurance company, a pension fund or a sovereign wealth fund. This may simply be so as long as a capital charge of 1250% for securitized risk is still on the table. But even without such a punitive charge institutionals may not be prepared to get involved unless they are being offered full, reliable transparency and continuous monitoring on all underlying assets.

The originating institutions may not be willing or able neither to provide this extent of disclosure nor to shoulder its initial and ongoing costs. The SMEs which typically like to keep to themselves what they see as their competitive advantage will not sympathize with disclosure either. So detailed information for investors would need to remain confidential like in M&A constellations where interested parties obtain access only upon signing a confidentiality agreement.

One step in the right direction is the concept of Datawarehouse GmbH[3], a central clearing platform for securitization structures between originators and investors that was set up at the end of 2012. This is a private initiative that offers relevant information against a user's fee. For simple, homogeneous asset classes like mortgage and car sale securitizations this approach should turn out as useful and sufficient. But in connection with the much more complex and heterogeneous asset class of SME loans substantially more input would need to be provided, including the financing of the build-up and warehousing of deal-flow prior to securitization and distribution.

Given the significance of the SME sector in many European countries for innovation and employment, consideration should be given to regard the build-up, maintenance and funding of such a comprehensive *SME data and deal warehousing platform as a collective good* which society should provide to resolve the inherent conflict of economic interest between the seller and the buyer of entrepreneurial risk. Data information would be provided on a

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[1] www.bis.org/publ/bcbs236/comments.htm
[2] www.bis.org/publ/bcbs236.htm
[3] www.eurodw.eu

continuous basis with conclusions not in definitive, but in tentative, dialogical form from more than one expert source on individual risk aspects in order to escape “mechanical reliance” on formal ratings or abstract model assumptions. The SME data and deal warehousing platform would need to draw on the know-how and experience of industry sector and private investment experts, but would be directed and managed by a public sector institution to guarantee its impartiality and objectivity. The EIB could be the possible host of such a platform which, over time, could assume an important role in overcoming the fragmentation of the various national European credit markets.

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Michael Altenburg

MAF Group