

Box 5

THE EXTERNAL FINANCING CONDITIONS OF SMALL AND MEDIUM-SIZED ENTERPRISES IN THE EURO AREA

In raising external funding, small and medium-sized enterprises (SMEs) frequently face financing conditions that differ to those confronting larger enterprises. This is often due to the fact that enterprises of a different size tend to be exposed to different sources of economic risk. SMEs normally rely on just one or a few business lines, and are thus less diversified in their activities, and they are typically less well diversified geographically than larger firms. This means that SMEs are often more exposed to domestic demand developments. Moreover, without access to the capital markets, SMEs typically face more constraints in accessing external finance, as they are often limited to bank credit.¹ To the extent that some euro area banks, especially smaller ones, may be particularly exposed to the SME sector, both directly through loans to these firms and indirectly through their credit exposure to households that have family members employed by SMEs, it is important from a financial stability perspective to analyse and assess the financing conditions facing SMEs. This Box examines the external financing situation of SMEs in the euro area and draws comparisons with the conditions facing larger enterprises.

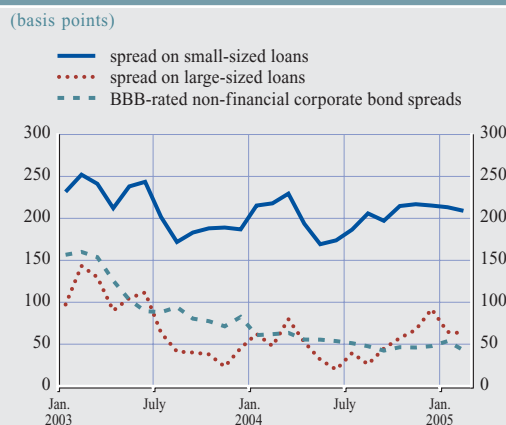
Chart B5.1 Changes in the credit standards applied to the approval of loans or credit lines to enterprises



Source: ECB Bank Lending Survey.
 Note: The net percentages refer to the difference between the sum of the percentages for “tightened considerably” and “tightened somewhat” and the sum of the percentages for “eased somewhat” and “eased considerably”

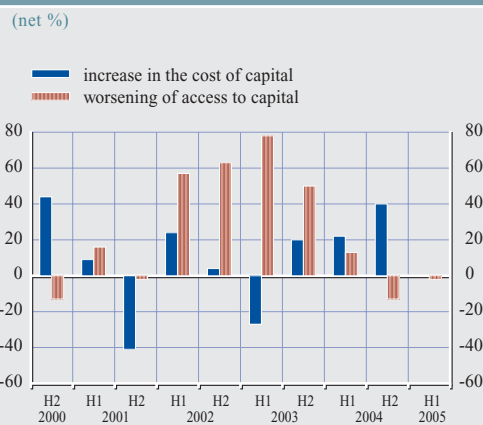
¹ See also Box 4 in the 2004 ECB Annual Report entitled “Were euro area small and medium-sized enterprises subject to less favourable financing conditions than large enterprises in 2004?”.

Chart B5.2 Spreads of MFI interest rates on new business loans to non-financial corporations and BBB-rated non-financial corporate bond spreads



Sources: ECB and Merrill Lynch.
 Note: The spread between the rate on new business loans to non-financial corporations with one and up to five years' initial rate fixation below (small) and above (large) EUR 1 million and the three-year government bond yield.

Chart B5.3 Changes in the cost of, and access to, capital for small and medium-sized enterprises



Source: UNICE.
 Note: The net percentage is calculated as the percentage of firms that reported an increase in the cost of capital (a worsening of their access to capital) minus the percentage of firms that reported a decrease in the cost of capital (an improvement in their access to capital) compared with the previous observation period.

Towards the end of 2004, the bank financing conditions of euro area SMEs began to show signs of improvement as reflected, for example, in the April 2005 Bank Lending Survey (see also Box 10), which showed that in Q1 2005, for the fourth quarter in a row, more banks eased than tightened credit standards on the approval of loans to SMEs (see Chart B5.1). This may indicate that underlying the strength of growth in MFI loans to non-financial corporations after mid-2004 was an improvement in SMEs' access to bank credit. One factor driving this easing of credit standards vis-à-vis SMEs might have been a perceived improvement in the sector's profitability, although the lack of comprehensive and timely data on SME profitability makes it difficult to assess whether a marked improvement did indeed take place.

The easing of credit standards applied to SME loans may to some extent reflect the fact that banks, in seeking to boost profitability, have tended to take on more risk in an environment of squeezed margins. The perception that credit to SMEs involves relatively more risk than lending to larger companies is, for example, reflected in the higher credit spreads of MFI interest rates on small-sized new business loans than similar spreads on larger-sized loans (see Chart B5.2).² Since mid-2004, bank interest rate spreads on small-sized loans (and more recently also on large-sized loans) over comparable market rates increased by around 40 basis points, thus indicating that while banks may have eased credit standards towards SMEs, they also appear to have priced in higher risk by demanding higher premia. Moreover, a survey by UNICE, an employer's association, confirms that banks have recently been relaxing access to capital while, at the same time, raising the relative cost of bank financing (see Chart B5.3).

All in all, if domestic demand growth in the euro area were to prove weaker than expected, this could entail some risks for the credit quality of the SME sector. Banks have been raising spreads on loans to the SME sector, and there are indications that banks have also been responding to intense competition from other banks and hunting for yield in an environment of

² This assumes that loans up to EUR 1 million are predominantly granted to small-sized firms, while loans over EUR 1 million are mostly granted to large companies.

low interest rates. However, it remains unclear whether risks are being priced appropriately. In other words, it cannot be excluded that banks may have taken on more risk by supplying more credit to the SME sector on easier terms.