Non-bank finance in Spain: A growing alternative in response to tougher bank funding channels

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Vol. 3, N.º 6 (November 2014)

Default risk in commercial relationships between Spanish companies is among the highest in Europe, resulting in tighter restrictions by banks on lending and consequently reducing companies´ opportunities to tap commercial discounting. In this context, non-bank financing is emerging as an alternative, albeit not yet a true opportunity for Spanish SMEs.

Prevailing economic uncertainty and historical experience with defaults have led a large share of companies to be much more selective when granting commercial loans to their clients. In addition, companies have been facing more and more roadblocks to discounting commercial notes in traditional banking channels. Although bank financing still plays a much more dominant role in the capital structure of Spanish companies than for their European peers, there is growing room for other SME financing alternatives to take hold. While non-bank financing sources are emerging as a viable alternative for Spanish companies, reliance on this type of capital remains limited within the Spanish productive fabric, and especially in the case of SMEs.

B2B default in Spain

Non-payment, or delays in settling commercial obligations, result in a series of distortions in the administrative and operational activities of companies. Firstly, it means companies have to fund their defaulted working capital by using capital generated in the company or externally, the latter either through banking channels or by "passing on" the delay or non-payment to suppliers. This second option is especially damaging, in that it moves the culture of delayed or defaulted payments along the value chain of the activity in question (spreading the "default culture"). Secondly, it entails opportunity costs for the company granting the financing, which are not necessarily offset by the costs saved in default with third parties. In addition, although it is difficult to estimate actual figures, legal costs and penalties also arise in the event of default, as do reputational and brand-image costs derived from improper payment practices, both for the company in question and for the country at large.

According to the Business Financing and Default Gazette (*Boletín de Morosidad y Financiación Empresarial*),[2] in the second quarter of 2014, the annual cost of commercial debt in arrears was 993 million euros (0.1% of GDP). This cost results from applying the legal interest rate to the commercial

[1] A.F.I. - Analistas Financieros Internacionales, S.A.

[2] Published by CEPYME (http://www.cepyme.es/es/documentos/boletin-de-morosidad-y-financiacion-empresarial_23.html).

Table 1
Cost of default
(€ million)

	2Q11	2Q12	2Q13	1Q14	2Q14
Financial cost of commercial debt	2,631.3	2,174.5	1,850.4	1,690.1	1,572.3
Commercial debt in arrears	307,145.1	274,161.7	221,766.8	216,699.4	211,146.3
Cost of debt in arrears	1,891.7	1,475.4	1,115.5	1,092.3	992.7
Legal interest rate (%)	4.0	4.0	4.0	4.0	4.0
Legal delay interest rate (%)	8.0	8.1	8.5	8.3	8.3
Weighted legal interest rate (%)	6.9	6.9	7.0	7.0	7.0

Sources: Boletín de Morosidad y Financiación Empresarial.

loan balance in arrears, and is equal to two-thirds of the cost attributed to commercial loans granted by companies. The costs companies incur upon definitive default of notes they issue must also be taken into account.

According to the European Payment Index published by Intrum Justitia, Spain, Greece, Portugal and the Balkan countries are far from keeping with good collection and payment practices, which are more respected in certain Nordic countries. In effect, the likelihood of default in Spain is very high. This finding is backed by the *Business Financing and Default Survey (Encuesta de Morosidad y Financiación Empresarial, EMFE).* Nearly one-quarter of companies believe they will never recover 10% or more of their outstanding billings; this rises to over 20% in the case of companies with less than 50 employees.

Nevertheless, the most recent analyses point to a trend in Spain, a priori a counter-intuitive one, whereby during the economic downturn, corporate default has actually decreased from the high levels seen when the crisis first hit.

Spain is among the European countries with the highest risk of default. Companies and banks have tightened selection criteria when approving operations.

In effect, the most representative aggregate default indicators (average payment period and the percentage of commercial loans in arrears) have fallen steadily since the onset of the downturn. Although this trend responds to a more

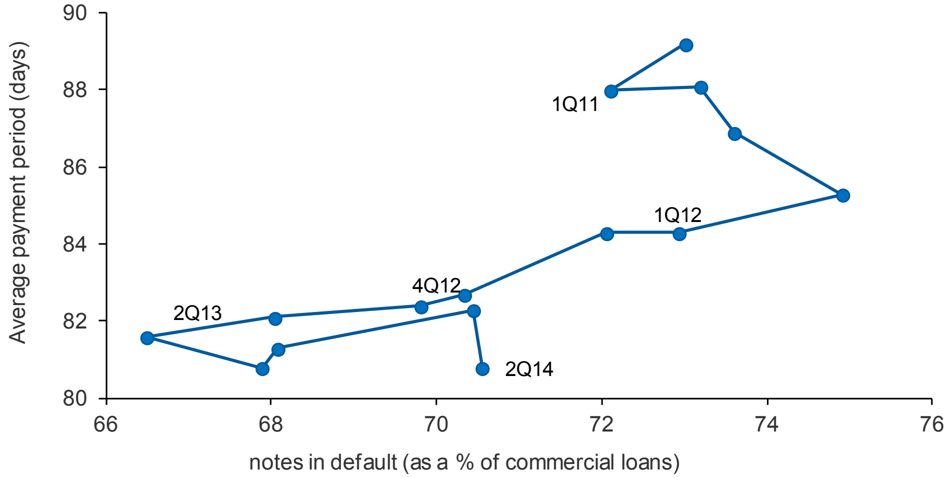
Table 2
Likelihood of default [(1)] by size of creditor
(% of replies) June 2014

	Less than 1%	1%-2%	2%-4%	4%-10%	Over 10%
1-9 employees	32.1	19.3	14.8	9.7	24.1
10-49 employees	41.9	14.9	9.5	8.1	25.7
50-249 employees	52.9	11.8	11.8	11.8	11.8
TOTAL	33.7	18.6	14.1	9.6	24.0

Note: [(1)] Proportion of the value of outstanding invoices that will never be collected.
Sources: Boletín de Morosidad y Financiación Empresarial.

Exhibit 1

Amounts and duration of corporate default in Spain



Sources: Boletín de Morosidad y Financiación Empresarial.

complex process and not necessarily because of improved behaviour, the fact that regulations governing payment periods have become more strict and that agents have adapted to these regulations (albeit to varying degrees) has indeed had an influence.

During the financial crisis, companies and banks began applying much more demanding criteria when approving loan operations (financial and commercial). Banks – first and foremost in response to the need to restructure their balance sheets and to make allowances to cover potential defaults – raised their requirements for granting new loans. Yet they also tightened their requirements for commercial discounting, based, among other indicators, on default indicators which, when all is said and done, are a proxy for the credit risk of companies. Businesses, finding it more difficult to secure funding by discounting receivables from other companies, also tightened their selection criteria for clients and/or required higher cash payments, down payments, etc. These new trends also responded to the climate of uncertainty in which asymmetrical information problems became more prevalent, such as the adverse selection of customers.

Another experience observed (and one in line with what economic theory would suggest) is that the size of the company is a determining factor. Normally, the smaller the company, the smaller its negotiating power and its capacity to access credit, and the higher the costs it must bear in the case of default.

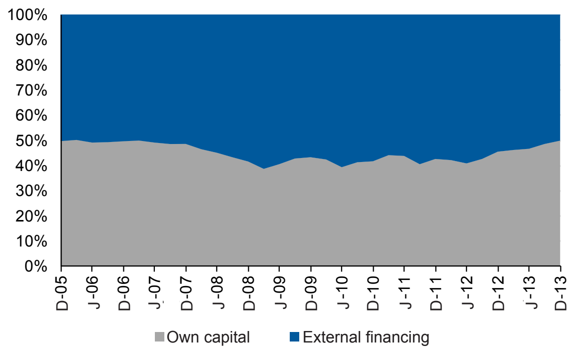
Financing profile of productive activities

SMEs are the cornerstone of the Spanish productive fabric. According to DIRCE, Spain's central business directory, of the 3.11 million companies in Spain, 99.6% are SMEs. This structure is highly fragmented: 96% have fewer than 10 salaried workers, or none at all. Moreover, one of the most characteristic features of the capital structure of Spanish companies, as reflected in the accompanying charts, is their high dependence on bank financing compared to their European peers. External financing accounts for 50% of total capital of Spanish non-financial companies.

Despite the lengthy restructuring process carried out in the Spanish banking sector, new loan

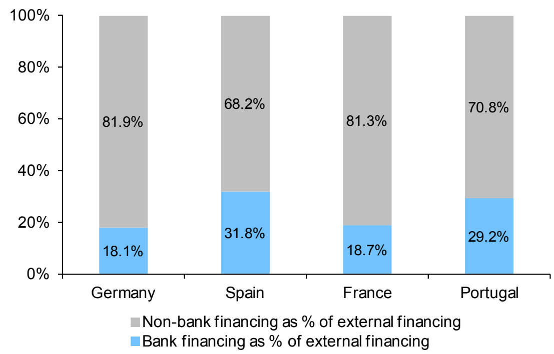
Exhibit 2

2.a - Capital structure of non-financial companies in Spain 2013



Sources: Bank of Spain and AFI.

2.b - Distribution of external financing in certain European countries (% total)



Sources: Bank of Spain and AFI.

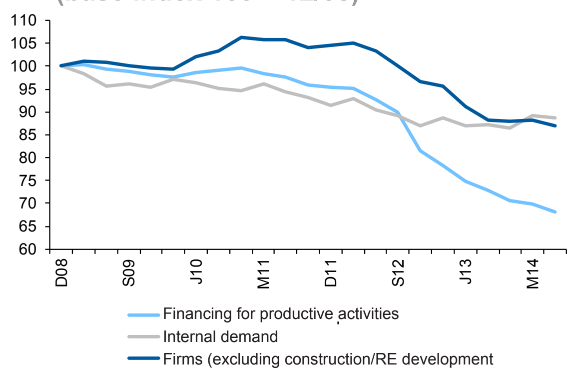
approval indicators continue to show a deep weakness. In all of 2013, new loans granted totalled only one-third of the amount extended in 2007.

SMEs comprise the bulk of the productive fabric, and are highly dependent on bank loans for funding their activities.

According to the *Business Financing and Default Survey,* 26% of companies have attempted to access financing facilities from credit institutions in the past six months. This percentage is similar to that reported in the survey on access to financing among Eurozone SMEs, published by the European Central Bank (ECB). The report places Spain among the countries whose companies have the greatest funding needs, behind only France (31%) and Italy (29%). The following charts show how loan approval for productive activities has decreased, especially since mid-2012. By way of a benchmark, the figures also show that internal demand had been falling until the third quarter of 2013.

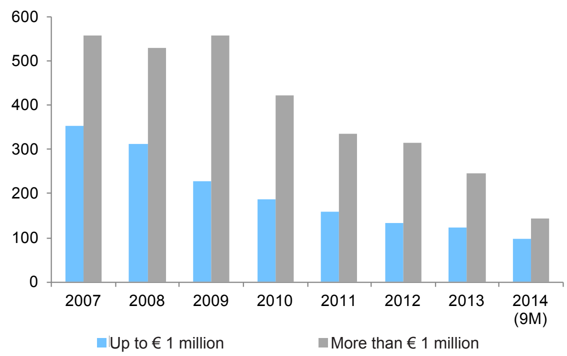
Exhibit 3

3.a - Domestic demand and bank loans for companies (base index 100 = 12/08)



Sources: Bank of Spain and AFI.

3.b - New loans granted to companies in Spain (€ thousand million)



Sources: Bank of Spain and AFI.

The role of non-bank financing and SMEs

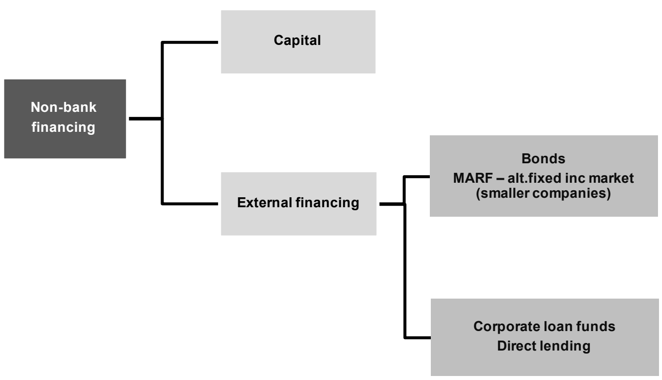
In the context described above, companies have started to turn to alternative funding sources. Nevertheless, in Spain the scope of these financing sources – whether carried out through debt or through own capital – is very limited. This contrasts with the situation in the US, where companies tap capital markets for funding to a much higher degree.

According to the EMFE, financing channels other than own capital and bank financing still play a discreet role, as reflected in the table below. One funding mechanism that is relatively significant in Spain is the Instituto de Crédito Oficial (ICO, Spain's state finance agency). Funds from the remaining channels, however, such as loans from non-banking entities and guarantees from mutual guarantee companies, are still negligible.

Although non-financial entities stepped up their issues of bonds and debentures in 2013 and

Exhibit 4

Non-bank financing channels



Source: *AFI.*

Table 3

Financing channels June 2014

	No. of responses	%
Capital (contributions, regulated markets, alternative markets (MAB))	438	49.1
Bank financing	278	31.2
Instituto de Crédito Oficial (ICO) funding	94	10.5
Other	40	4.5
Supplier payment programme	21	2.4
Loans from non-bank entities (shadow banking)	10	1.1
Guarantee from a mutual guarantee company	10	1.1
Securitise collection rights in alternative markets	1	0.1

Sources: Boletín de Morosidad y Financiación Empresarial.

2014, non-bank financing is still not an effective alternative for smaller-sized companies. Funding through organised markets (non-bank external funding) is designed for investment undertakings, not to fund working capital. Accordingly, small and micro-companies are, due to their size, less likely to rely on these funding instruments. This is essentially because the costs entailed in accessing this type of financing (such as issue costs) represent a considerable portion of the business margin. Small and medium-sized companies are therefore obliged to carry out capital increases against own funds for CapEx operations of a certain size or to fund their working capital through suppliers.

Although non-bank financing has begun to take off, small and micro-companies have yet to tap these disintermediation instruments.

Conclusions

Default in commercial relationships between companies curbs growth in their activity. In Spain, this problem directly and indirectly affects the funding capacity of companies and has a considerable knock-on effect on the business fabric. In addition, default entails costs that must be borne above and beyond those already inherent in productive activity. This added cost directly erodes the competitive edge of the business fabric, as well as the reputation of companies and of the country at large, when establishing new business relationships. Another effect derived from default is the mistrust it generates between lending institutions and companies, given that the lenders, against a backdrop such as the current economic downturn, find it difficult to correctly screen potential borrowers and to optimally assign their services. In other words, banks have rolled out tighter loan criteria, to streamline their already high costs. Spanish companies, which are highly dependent on bank financing, have fewer opportunities to access commercial discounting, and therefore have also become more selective when extending credit to their customers. Spain´s regulatory bodies must design incentive systems in order to minimise or, to the extent possible, eradicate default in commercial relationships. Otherwise, default will continue to impede a healthy flow in economic activity between financial institutions and companies, and between companies themselves.

Consequently, given the more difficult climate for financing through banking channels, the conditions are present for non-bank financing to emerge, covering the needs not met by the traditional channel. Nevertheless, the presence of these banking desintermediation instruments is still only modest, and has had limited acceptance among large and medium-sized companies. Funds secured through this channel are used for CapEx projects and not to fund companies' working capital. In that regard, it does not pose a true opportunity for small and micro-companies, which continue to be in a vicious cycle of default and dependence on commercial loan funding, resorting to funding through suppliers and/or using commercial discounting or own capital.

SEFO - Spanish Economic and Financial Outlook Vol. 3, N.º 6 (November 2014)