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The changing face of Germany's financial system – an opportunity for SME financing

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Summary and conclusions

Both the German financial system in general and SME financing as a key component of this system have been undergoing a considerable structural transformation since the beginning of the 21st century. This process is being driven by several trends simultaneously: the transformation process has recently picked up speed. This development means **that markets and valuations in line with market conditions are becoming increasingly important**. Traditional financing instruments that previously characterized the German SME segment, such as loan and supplier financing, have developed by leaps and bounds due to the increased risk requirements of the international capital markets and the greater emphasis placed on the individual risk profiles of banks. In practice, we are seeing an increase in the number of capital market-based financing options and new financial market institutions for the broad SME segment. Although this development has been sluggish to date, the trend is starting to accelerate. Size-based restrictions as a reason for the strong SME reliance on bank loans are becoming less of an issue as the volumes required for capital market products decrease.

Although there is proof that direct market relationships between companies and lenders – such as households and institutional asset managers - are becoming increasingly important, intermediaries such as banks, insurance companies and private equity funds – which use third-party funds in order to acquire receivables from third parties, in turn – are not set to see their role in the process decline. The misleading use of the term “disintermediation” often promotes this assumption. Nevertheless, **effective market access still requires relationship-based intermediation**, and banks will continue to use their most important informational asset, namely their customer knowledge and ties, in the interest of the latter.

The structural change in the German financial system will not jeopardize the partnership between the financial sector and SMEs. Long-term contractual relationships will continue to form the basis for relationship-based banking business in the future. After all, the fact that banks are using ABS techniques, for example, to exploit the international capital market to the benefit of the German SME sector shows that, if anything, they are *increasingly* acting as a financing bridge between SMEs and the capital market. This means that there is more of a trend towards a situation in which market-based financing instruments complement traditional debt financing methods, as opposed to a situation in which one method poses a hurdle to the other. **A financial system with a truly comprehensive offering, i.e. one that offers the entire range of financing products, offers a comparative advantage from a macroeconomic point of view and increases growth opportunities at the microeconomic level.** Banks have improved their ability to bear risk thanks to enhanced risk management and risk assessment instruments. ABS-based securitization techniques can optimize both the use of bank capital for the SME business and bank balance sheet structures, which ultimately benefits SMEs. It is a well-known fact that SMEs, in particular, face the problem (when it comes to financing) of producing detailed, transparent information. When risks are securitized and then placed on the capital market, the risk buyer is barely affected by this information asymmetry between borrower and lender. Mezzanine financing and private equity are

also relationship-based, meaning that they can overcome **information-related barriers**. According to the rules of the information economy, the latter arise whenever the financer has insufficient information on the borrower prior to the granting of financing, and whenever the borrower assumes excessive risks after receiving the external funds. The informational barriers support the argument for **intermediation**, such as is provided by banks and private equity funds. This is because these organizations have developed techniques to reduce the risk posed by insufficient information. The formation of a portfolio can allow an intermediary to reduce the costs resulting from the information asymmetry. What makes securitization techniques particularly attractive is that they combine traditional relationship-based financing with modern market-based financing transactions.

SME practice has shown for some time that relationship/Hausbank-based financing does not necessarily oppose market-based/"anonymous" financing some time ago, although capital market and financing theory still asserts the contrary in many cases. Quite the opposite: In the strategy of many SMEs, a diversified financial approach is extremely closely linked to the respective SME shareholder structure and the equally diversified SME product portfolios and markets. As far as the SME business is concerned, too, banks are increasingly moving away from a purely product-based approach to targeting clients in a solution-oriented manner by means of a relationship-based approach. **It only by means of the synthesis of these financing forms, true to the motto "Together we are stronger", that the typical SME problems can be solved** – from the lack of equity to succession planning, the diversification of borrowing, risk management and the challenges posed by globalization. **This study shows that not only traditional financial intermediaries such as banks and insurance companies, but also the new types of financial intermediaries such as private equity companies, are striking a happy medium between the stereotypes of capital market-oriented and bank-oriented financing.**

Comprehensive financial planning, which is becoming more and more of an issue among SMEs, partly due to the change on the financial markets, is creating a growing demand for comprehensive financial advice. This has created a challenge for financial services providers. Their task is to allocate financing risks, in an efficient manner, to those investors that really want to assume them at prices in line with market conditions. These investors may be the banks themselves, but could also be third parties. This means that banks become risk bearers and risk agents at the same time. **The transformation of the financial market, which is prompting a more market-based assessment of financial risks, is improving the division of labor within the financial system.** A changed financing structure and enhanced transparency can allow SMEs to boost their own growth and that of the economy as a whole. SMEs are increasingly looking at the transformation of the financial system and the new financing rules as a restructuring program for their own company, as opposed to an intervention. **Confronting the new financial market rules will make both SMEs and banks more competitive.**

1. The status quo: The liable capital resources of SMEs are still unable to perform key equity functions

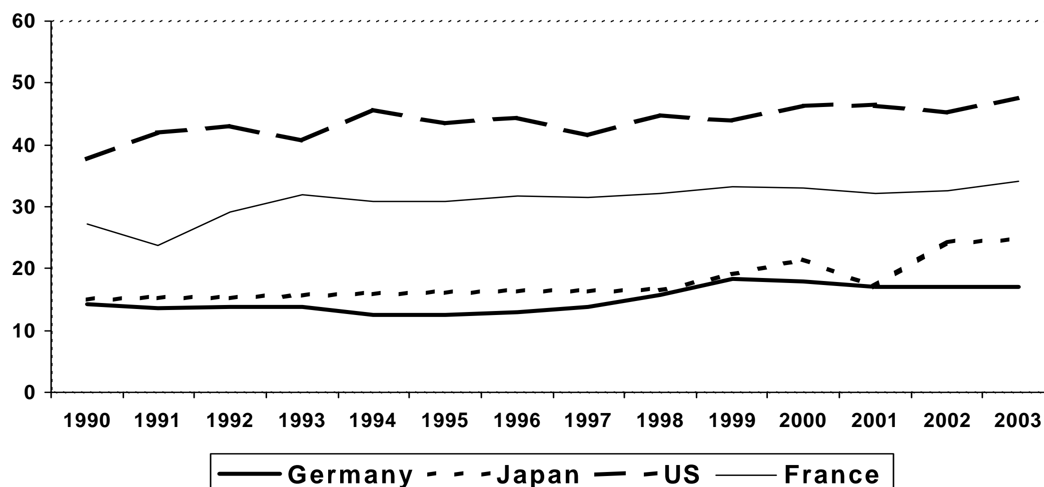
Pronounced information asymmetries increase the information and monitoring costs for external lenders, particularly with respect to the financing of SMEs. Here in Germany, this has led to a preference for financing that is based primarily on internal self-financing and external loan financing. For a long time, many Germans were adamant that the unequal distribution of information between lenders and the SME borrowers virtually ruled out access to the capital market. These voices believed that it would be virtually impossible for SMEs to borrow on the anonymous capital market, because it would simply be far too expensive to inform all potential investors. Furthermore, valuable internal company data could find its way into the hands of competitors. Instead, the transaction costs involved in external financing and the co-decision rights of third parties could be reduced by using relationships with bank intermediaries (the motto here being, “Just inform your bank advisor and conclude a loan agreement with him”). The particular features of the German financial system also have historical roots. The Second World War resulted in a considerable loss of financial assets, and many companies were destroyed. As a result, the remaining companies were particularly reliant on debt capital, a development that was accounted for by creating tax advantages for the use of debt capital as opposed to equity, and the fundamental creditor focus of the German insolvency system.

As a result, the capital structure of German SMEs is occasionally referred to as being “optimum” in the sense of the “rational” considerations of market participants against the backdrop of the existing institutional framework.

Chart 1

SME equity ratios in an international comparison

- Figures in % of total assets -



Sources: BACH Database, Creditreform, Ernst & Young.

This assessment fails, however, to recognize the fact that, even considering that there is ultimately no uniform definition of an “optimum” capital structure, an equity situation that is considered as being optimum or rational given the institutional framework can be sub-optimum from a company-specific or overall economic point of view.
The fact that smaller companies account for a high percentage of total insolvencies highlights the fact that the equity ratios of these companies are obviously insufficient with respect to insolvency protection. **The current small equity base of many SMEs is also unable, from the point of view of most financial market players, to fulfill its function as a basis for acquisitions, creditworthiness and confidence.** From an overall economic point of view, this is compounded by the fact that the SME sector is extremely important from a growth, competition and structural point of view. In order to be able to perform these overall economic functions, the numerous SME non-incorporated companies also need a stronger equity base than at present.

Any assessment of companies’ financial situation based on their equity ratio is hindered here in Germany by the fact that there is no central company register, unlike in France, for example. The comparability of the data prepared by institutions such as the Bundesbank, KfW Bankengruppe, Verband der Vereine Creditreform and the German Savings Bank Association (*Deutscher Sparkassen- und Giroverband* - DSGV) as an ancillary service only is limited due to the differences in the parent population and calculation methods, as well as the different weightings given to small and large companies. Fundamentally, there is no way of calculating *the* equity ratio for German SMEs. Nevertheless, the following general statements can be made

- Around ten years of weak domestic demand have left their mark on the equity resources of German SMEs. Before the SME economy started to pick up in 2003, the equity ratios of small and medium-sized German companies were considerably lower than in other key Western countries in an international comparison.
- In Germany, the larger the company, the significantly larger the equity base. On average, the equity ratio of companies with revenues of between EUR 2.5 million and EUR 50 million was around three times as high as that of companies with annual revenues of less than EUR 2.5 million in 2003. The gap between the equity ratio of larger SMEs and that of large companies with annual revenues of more than EUR 50 million has narrowed. Furthermore, it is noteworthy that, according to the financial statements data pool of the Bundesbank, non-incorporated SMEs (equity ratio in 2004: 8¾ %) are almost exclusively responsible for the weaker SME equity base, whereas there is virtually no difference, following a rapid catch-up process between 1997 and 2004, between the equity resources of the small and medium-sized incorporated companies (23½ %) and those of large companies (28¾ %).
- Increased earnings retention and the settlement of bank loans have prompted a considerable increase in the equity ratio of German SMEs across the board over the past eight years.

- Nevertheless, according to Vereine Creditreform, only one fifth of all German SMEs had sufficient equity in the fall of 2006 (more than 30% of total assets).

In addition to the relatively weak equity base, the liabilities structure of German SMEs reveals another distinctive feature, namely the rather insignificant role played by provisions. In 2003, provisions stood at a good 10 % (companies with revenues of less than EUR 2.5 million) and 13 % (companies with revenues of between EUR 2.5 million and less than EUR 50 million) of total assets, far lower than at large companies, where provisions stood at a good 26 % of total assets. The differences between the SMEs and large companies with respect to equity resources and provisions are mirrored with respect to liabilities. The latter accounted for a far larger proportion of total assets at the very smallest, and at small and medium-sized companies (namely 80 % and almost 62 % respectively) than at the large companies (45%), despite a downward trend. The very smallest companies proved to be particularly reliant on short and long-term bank loans, which accounted for a good 40 % of their total liabilities. Bank loans accounted for around 22 % of the total assets of small and medium-sized companies, while the same financing instrument accounted for only 7 % of the total assets of large companies.

Table 1

Structure of external corporate financing in Germany and the US

- 1970 - 2000; figures in % -

	Germany	USA
Long-term bank loan	76	18
Long-term loan from a non-bank intermediary	10	38
Bonds	7	32
Equities	8	11
External financing via intermediary	86	56
Direct external financing	15	43

Sources: Hackethal/Schmidt, 2004; Jäger, 2006.

In the first instance, international long-term comparisons also confirm the **assertion that the financing of German companies is remarkably bank-based – a trend that has proven to be a stable one.** This is highlighted in table 1, for example, in a comparison with the US. On the one hand, the table shows that banks were the most important source of external financing between 1970 and 2000 in Germany. On the other hand, non-bank financial intermediaries (such as

insurance companies, investment funds and finance companies) contributed almost forty percent to external corporate financing in the US, as against only a tenth in Germany. At the same time, securitized instruments such as equities and bonds accounted for almost 45 % of US corporate financing, compared with only a very low proportion of 15 % in Germany.

2. The three levels of change on the financial market

The past few years, however, have heralded fundamental changes on the German financial market and, as a result, with respect to corporate financing, too. This change is having an impact at three levels. Firstly, taking a bird's eye view of things, there has been a shift in the overall economic **financing structure**. Secondly, traditional financing instruments, such as the bedrock of loan financing for German SMEs, have been developed considerably in the **banking sector** itself, i.e. on a key financial market supply side. Last but not least, there have been changes on the **SME demand side** itself, prompting a growing convergence between supply and demand for SME financing, thanks, among other things, to the closer coordination of loan products and securitization techniques.

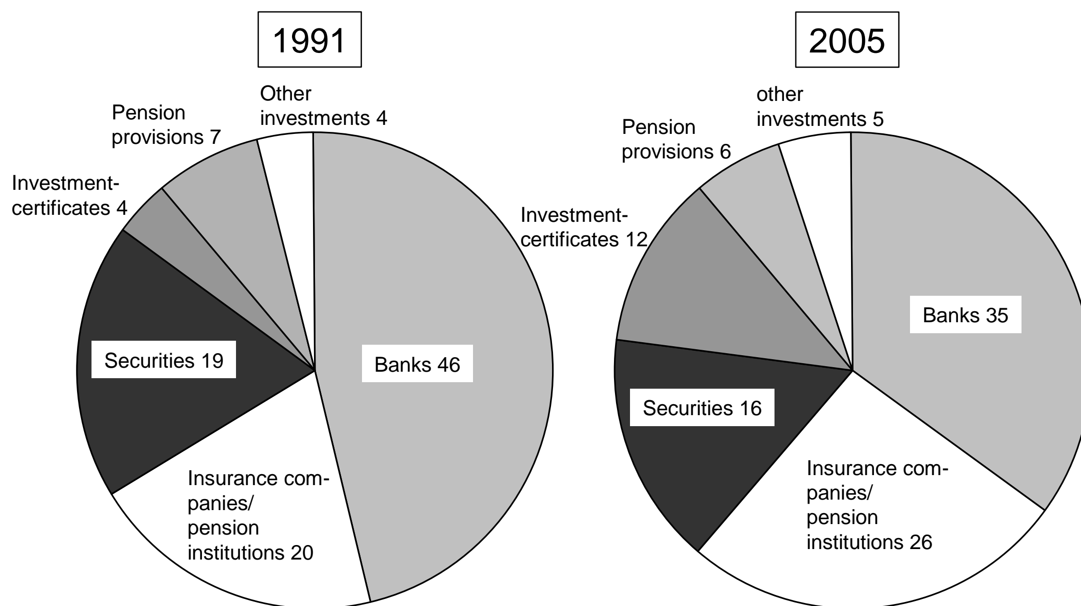
2.1 The overall economic financing structure: growing trend towards financial relationships reaching the market via intermediaries

The Bundesbank publishes trends in asset generation and the financing of asset generation once a year on the basis of the latest results of the national accounts data and the financial accounts data. If we examine the development in the structure of the financial assets of private households (which are, after all, the largest financer) over the past fifteen years, the first thing that stands out is that there has been virtually no change in the extent to which private households turn to intermediaries in order to invest their assets. This means that, in direct terms, there is no trend towards disintermediation (in the sense of a growing proportion of funds that do not reach the economy via intermediaries) among private households. Nevertheless, private households are promoting a trend towards disintermediation in indirect terms by investing increasingly, and for some time now, with intermediaries that tend to hold tradable assets, as is the case with insurance companies and investment funds. Between 1991 and 2005, for example, the proportion of private household receivables from banks fell considerably from 46 % to 35 % of their total gross financial assets. By contrast, there is a growing trend among private households towards investing with insurance policies and in investment certificates. These intermediaries recently accounted for 37 % of financial assets, as against only 23 % in 1991.

Chart 2

Structure of financial assets of private households in Germany 1991 and 2005

- Figures in % -



Source: Deutsche Bundesbank, 2006.

A trend towards disintermediation can also be observed if we consider that the group of intermediaries increasingly holds tradable assets and that the role played by those sectors that grant loans is on the decline. The proportion of the loan receivables of the entire financial sector of the German economy as a percentage of its financial assets fell from 60 % in 1991 to 54 % in 1995 and then to as little as just under 39 % in 2005. As far as the banks themselves are concerned, only just under 52 % of their financial assets were attributable to loans, compared with 70 % in 1991 and still almost 66 % in 1995. This trend is reflected on the production company side. The proportion of long and short-term loans as a percentage of the total liabilities of non-financial corporations dropped from 43 % (1991) to 40 % (1995) to as little as just under 35 % in 2005. **On the whole, it can be said that, although the direct financial relationships that bypass intermediaries have remained relatively constant, financial relationships that run directly from the intermediary to the company are being increasingly replaced by financial relationships that run from the intermediary to the market, and then on to the company.**

Table 2

The three levels of „disintermediation“

- Figures in % -

	1991	1995	2005
Loans as % of financial assets of domestic financial sectors	60	54	39
Loans as % of financial assets of monetarv financial Institutions	70	66	52
Loans as % of liabilities of non-financial corporations	43	40	35

Source: Deutsche Bundesbank, 2006.

Need to improve risk management and risk assessment methods

The discussion on the overall economic financing structure, together with the findings on the declining role played by loans as a financial instrument and the increased importance of tradable receivables at intermediaries, has, from a bird's-eye view, so as to speak, provided an initial, key indication as to the extent and quality of the change on the financial market that started to emerge several years ago. The two sections below now aim to describe the change on the financial market from a mesoeconomic point of view (change within the banking sector) and a microeconomic point of view (change in the typical SME entrepreneur).

The main factor explaining the relatively high importance of loan financing is quoted by banks time and again as being what are known as "**agency costs**". This refers to the costs incurred in order to limit the potential for abuse by the company's management, which results from information asymmetries and has a negative impact on external lenders. As far as bank-based financing is concerned, these agency costs are actually relatively low, because banks are in a better position to assess a company's financial situation and outlook than lenders with a more distanced business relationship to the respective company, thanks their long-term relationship with companies and the fact that they both receive, and generate information on the financed companies on an ongoing basis. In Germany, this has resulted in a particularly high concentration of risks with banks. In the first instance, banks were unable to pass their credit risks on to the capital market, and other intermediaries such as private equity lenders were available to a more limited extent than abroad. Furthermore, direct corporate financing via equities and bonds was largely restricted to large companies and standardized capital market-compatible mezzanine financing was initially seen as a niche market. This means that low agency costs, together with a partial disregard for credit risks and a high level of creditor protection in Germany, have led to the well-known preference for external loan financing and to favorable loan conditions.

The overall conditions on the financial markets have been undergoing considerable change since as early as the mid-1990s.

A single European currency was introduced, accounting standards were harmonized and new supervisory law guidelines such as Basel II were passed and implemented.

Competitive pressure has increased, shareholders of private banks are demanding higher yields such as those that are common at international level, and the abolition and modification, respectively, of the “Gewährträgerhaftung“ and “Anstaltslast” liability regimes is posing a challenge to public-sector banks. In the period between 1994 and 2000, write-downs due to a sharp increase in insolvencies ate into the operating result before risk provisions of German banks by an average of more than four-tenths. In 2002, the write-downs even reached the same level as the operating result before risk provisions. And while the write-downs were halved between 2003 and 2005, they still stood at 38 % of the operating result before risk provisions in 2005. In terms of the gross lending volume, at least 4 % of loans were non-performing in 2005, meaning that there was a need for specific allowances. Non-performing loans reached their peak in 2003, when they accounted for 5¼ % of the gross lending volume. The very smallest and smaller SMEs made less of a contribution to the improvement of portfolio quality within the German banking system in 2004, and in particular in 2005, than larger companies did. High loan defaults and increasing competitive pressure pushed the interest rate margin down from around 2 % to 1.2 % between 1994 and 2000, and it has merely stagnated at this level ever since. The interest rate margins have been the victims of an erosion process for some time now, driven in particular by the key lending side. After all, the return on equity of German banks declined almost consistently from the mid-1990s onwards, reaching a low of 0.7 % before taxes in 2003. There was a considerable improvement in 2004 and 2005 (to 12.7 % in the year before last). Nevertheless, the domestic banking industry still has some way to go because, according to the data most recently available, the return on capital of

Table 3

ROCE of European banks 2005

- Average pre-tax profit as % of tier 1 capital -

UK	26,8
Sweden	26,8
Belgium	23,4
France	22,2
Spain	22,2
Netherlands	16,9
Germany	12,9
EU-25	**20,9**
World	**22,7**

Basis: all national institutions in the top 1,000 in each case.

Sources: The Banker, Die Bank 10/2006.

German banks (pre-tax profit in relation to the tier 1 capital in accordance with the definition of the Bank for International Settlements), at 13 %, is well below the European average (21 %) and further still below the global average of 23 % (see table 3).

In addition to ongoing consolidation, the streamlining of organizations, process industrialization and strategic focusing, the change on the financial market is characterized in particular by improved risk management and the expansion of the range of tools available in order to measure the credit risk of new exposures. Now, the granting of loans to any company is examined on an individual basis and assessed in terms of both risk and return. The fundamental idea behind the banking supervisory provisions is to ensure that capital charges are based more on the individual risk profile of the banks, and to demand lower capital requirements where progressive risk assessment methods are employed. This means that, in principle, the package of supervisory law measures introduced under the “Basel II” umbrella have merely implemented what the banks had already been forced to introduce, or what would have prevailed anyway, namely the more precise assessment of risk, more risk-oriented conditions and the tying of the granting of loans to a rating. As a result, the requirements with respect to borrower creditworthiness, the transparency of corporate business processes, the informational value of the documentation and plans to be submitted and the collateral provided have increased considerably.

2.3 SMEs themselves promoted the change on the financial market by breaking with tradition

The change on the financial market can also be described and explained from the point of view of the SMEs. For a long time, for example, high volumes for structured financial products and a relatively low financing requirement meant that almost all SMEs either had no access to, or did not exploit financing options other than traditional bank loans. Since, up until 2000, the profits that corporations distributed were taxed at a higher rate than those that they distributed, this, together with the tax deductibility of interest on liabilities, resulted in tax advantages for borrowing. **The change on the financial market means that SMEs are now being encouraged to prepare their balance sheets with an increased focus on rating optimization, as opposed to merely on the basis of tax, information and monitoring cost optimization criteria. This means that even back in 2004, despite what was still an unfavorable overall economic environment at the time, the change on the financial markets played a role in improving SME earnings and financing, as is shown in the Bundesbank’s financial statements data pool.** In 2005 and 2006, SMEs are likely to have participated in the further considerable improvement in the earnings and financing situation of German companies, especially since the economy has been boosted increasingly by the domestic demand over the past two years. **This positive development is due primarily to improved communication and exchange processes between SMEs and banks, which focus on solid corporate planning, improved management accounting and greater transparency.** This enables a relationship with the *Hausbanks* that is based on trust, and a strategic partnership between SMEs and banks.

German SMEs themselves have facilitated, and even promoted the change on the financial markets due to a gradual break with tradition. In the 1970s, the traditional SME model started to come under pressure due to a combination of structural economic and socio-economic reasons. Microelectronics and digital technologies devalued qualifications that had matured over a long period of time and increased capital requirements. Competition intensified considerably as trade barriers were removed, new competitors from countries further afield entered the market and transportation costs declined. Development and marketing cycles were shortened substantially. This was compounded by the fact that traditional SME virtues such as abstention from consumption in favor of business investments were called into question by the emergence of the "pleasure-driven society". The interests of the family shifted in the direction of the interests of the individual. **Successful SMEs saw these environmental changes as an opportunity and exploited them.** In many cases, the dominance of the family was eased and decision-makers and advisors from outside of the family found their way into company management. It became evident that SMEs that are managed by non-family members communicate with lenders in a more offensive manner than owner-run businesses. A market emerged for the "corporate control" of SMEs, facilitating mergers and acquisitions and making investments in these companies considerably more attractive. **In the new SME segment, factors relating to certain individuals no longer have the same impact on the selection of financing instruments as in the past.** The "new SME segment" will continue to tread this path in the future, meaning that it will have a less distinct identity than its traditional predecessor. It will be far more open to alternative forms of financing, will focus more on the short term, will conduct its activities in a more yield-oriented manner and will pay less attention to the interests of individual families. German family-run companies plan their management succession earlier than their European counterparts and more frequently consider external solutions. They differentiate relatively clearly between corporate and management succession, which will increase the demand among these companies for alternative external forms of financing in the future. **In the future, a large section of the SME segment will no longer be recognizable as such in a positive sense, and this is the very reason why SMEs will continue to play a key role in the corporate sector.**

3. Quality and range of financial services offering key to macroeconomic and microeconomic growth

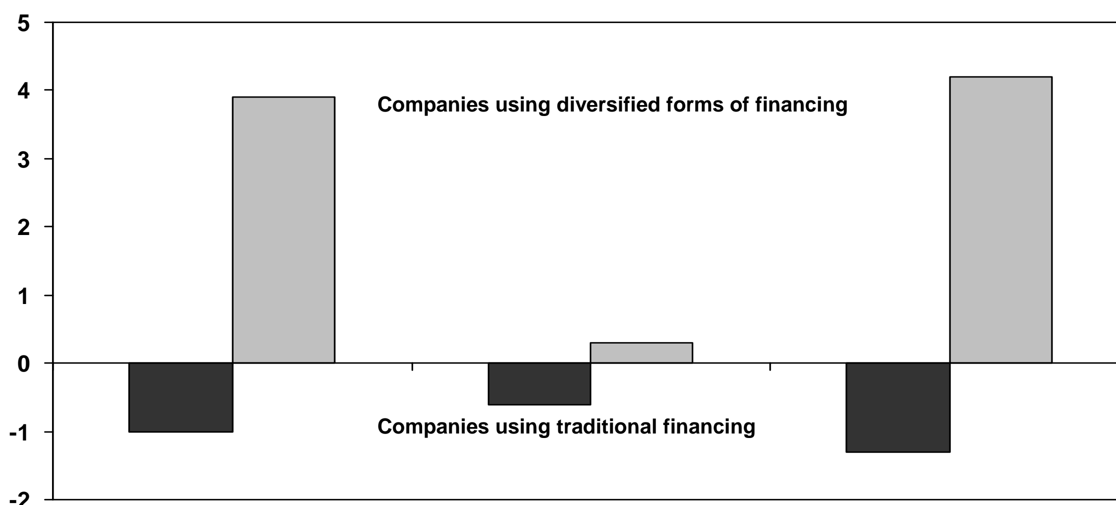
The described changes in the development of SMEs will continue to break down financing barriers and help these companies make the necessary move away from the preponderant bank and supplier loan-oriented financing they have relied upon to date. SMEs have begun looking at their refinancing base through an increasingly wider lens and are becoming more open to diversifying their refinancing structure. By modifying their financing structure, taking a more open approach to innovative capital-market financing instruments, and making themselves more transparent vis-à-vis capital providers, they will be able to boost their own growth, as well as that of the economy as a whole. From a macroeconomic perspective, it is essential that, in the future, SMEs have capital market-based products at their disposal in addition to the traditional bank-based forms of financing.

The majority of empirical economic studies show that economic growth hinges less on the structure of the financial system (bank or capital market-oriented) than on the quality and range of financial services offered. It is therefore not the system that is the key factor, but rather the financial products and depth of the financial sector. Microeconomic studies conducted by Ernst & Young have also shown that SMEs with annual revenues of between EUR 10 million and EUR 100 million that chose to diversify their financing structure increased their revenues by an annual average of almost 3 % between 2001 and 2004, whereas those companies that relied solely on traditional instruments such as bank loans experienced an average drop in revenues of just under 1 %. Although the causality underlying this analysis is not clear – it could be possible, for example, that growing SMEs are more likely to use the capital market as an external source of financing – practical financing experience shows that **a diversified financing base and the resulting distribution of risk among capital providers allows companies to exploit growth opportunities more easily**.

Chart 3

Revenue development - companies using traditional and diversified forms of financing

- Growth in % -



Sources: Ernst & Young (2005), own calculations.

Macro and microeconomic opinions thus concur: **the capital market and capital market-based products are not in competition with traditional bank loans; they are a necessary compliment in the sense that they drive growth.** SMEs and banks alike have already responded to this. The growing aim of SMEs – as can be seen in the significant demand for equity and mezzanine capital, as well as ABS financing – is to establish a broad-based financing structure with the help of a competent banking partner. In turn, banks are also continuing to expand their range of financial engineering and corporate finance advisory services for SMEs so that more and more

volume-reduced capital market-based elements can be used for SME financing and a demand-based tranching of capital-market products is possible for individual SMEs.

This increase in the depth and breadth of financing options is a key characteristic of the advantageous (from an overall economic point of view) shift in the financial markets. This shift signifies market share gains for new products and new institutions that have emerged alongside established forms of financing and financial market transactions, but also, a phenomenon referred to occasionally as “disintermediation” or the purported loss of significance of relationship-based financiers. As the analysis of the overall economic financing structure has already shown, however, this finding is misleading. **As the most important relationship-based financiers, banks are not playing a passive role in this change on the financial market**. **They are the main proponents of these changes. The shift would not be taking place at all if it were not for the groundwork carried out by banks, because the latter use their informational assets – customer knowledge and ties – to offer SMEs effective access to the market**.

In conclusion, the sections regarding securitization (chapter 4) and private equity (chapter 5) aim to sketch out techniques linking the use of markets with the advantages of relationship-based financing.

4. Combination of relationship-based financing and progressive market orientation: Securitization

Due to the rising return demands of institutional investors, banks themselves use ABS products in a variety of ways to optimize equity use and thereby their return on equity with regard to SME financing. In principle, securitization involves the use of a pool of receivables that form an illiquid component of the balance sheet of a financial intermediary or a company as a basis for issuing securities that are then sold to investors. On the capital market, the economic interest in the receivables is liquid, which means that risks can be allocated efficiently. This is because the securitization process entails determining the market value of the receivables, which are then transferred to those parties who expect to achieve the highest return and who can best manage the associated risks.

There are two main types of securitization. **Synthetic securitizations** involve the placement of credit risks on the capital market, thereby easing the burden on the lending bank’s regulatory capital and providing it with scope to issue new loans. **True-sale securitizations**, on the other hand, not only involve the transfer of credit default risks but also an actual sale of the loans, which provides not only capital relief but also additional liquidity. According to the rating agency Moody’s Investors Service, the German market for long-term securitizations achieved record growth in 2006, the risk transfer volume almost doubling from EUR 35 billion to EUR 67 billion. True-sale structures accounted for just under EUR 44 billion (2005: a good EUR 23 billion) and pure risk transfers

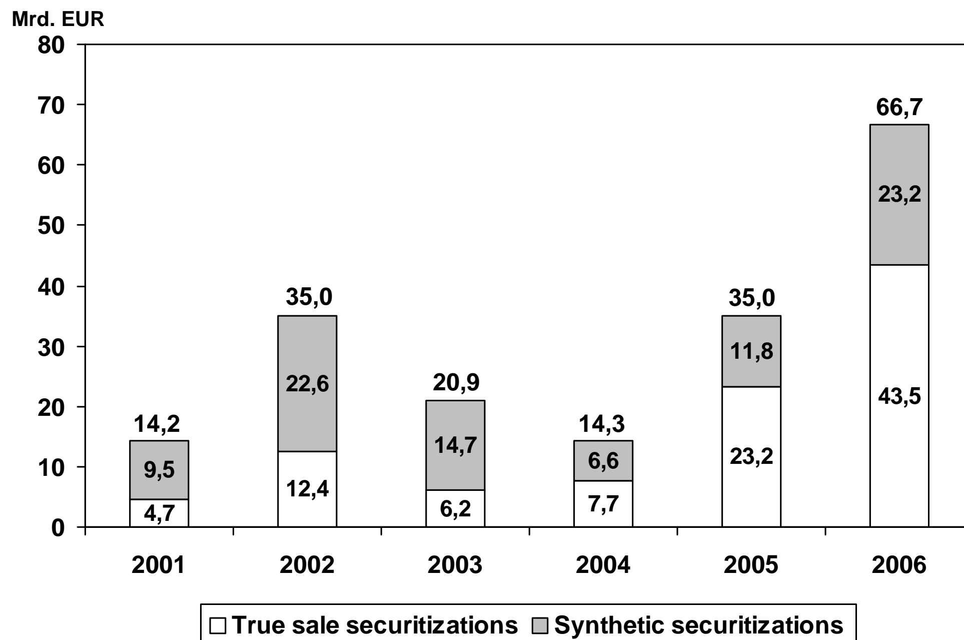
(synthetic securitizations) for a good EUR 23 billion (2005: just under EUR 12 billion). The number of transactions doubled in 2006 to 54.

In terms of SME financing, Germany ranks number one in Europe, with a share of around 30 % of the total long-term securitization market. SME ("Mittelstand" in German) has now become an accepted term among international ABS investors. Preliminary figures for 2006 show Germany with a share of just under 13 % of the European securitization market, which rose by around a third last year to a record volume of approximately EUR 550 billion.

Chart 4

The German securitization market 2001 to 2006

- Figures in EUR bn -

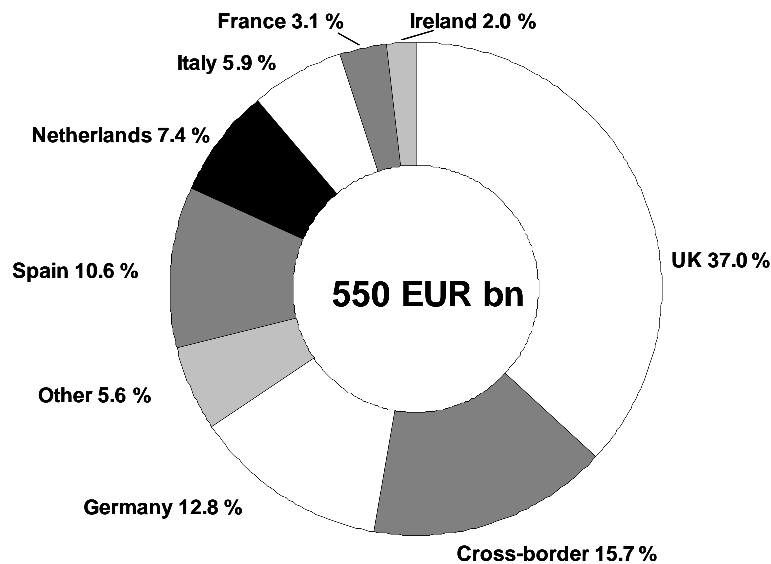


Source: Moody's, own calculations.

In principle, securitizations are a way of bringing receivables directly to the capital market. In this respect, they are similar to corporate bonds. However, whereas bonds are only really an option for larger companies due to the more symmetrical distribution of information and larger issue volumes, the smallest of loans can in principle be securitized and placed on the capital market as long as it is of a similar quality to those securitized receivables in the respective pool.

Chart 5

Structure of European securitization market[1)]2006
- figures in percent -



1) Including Middle East and Africa.
Source: Moody‘s.

The most important advantage of securitization is its ability to improve the division of labor in the financial system. The various steps in the value chain for financing via intermediaries can be described as follows: screening, origination, monitoring, funding and risk transfer. **Through securitizations, the funding and risk transfer steps are shifted onto the market. This is highly efficient, as the market has a comparative advantage in that it can absorb risk and provide funds, while the intermediary’s core competence is to produce information, as well as to establish and cultivate relationships.** Particularly in view of the German tradition, this **combination of established relationship-based banking and progressive market orientation** seems very appropriate. Loan financing arrangements undergo a **“sniff test” by the capital market** and **risks are assumed by those who are willing and able to bear them**. The price at which another market participant would be willing to assume a risk becomes key information for a bank’s risk management unit. This **market-based assessment of financial risks** is superior to the internal model-based analysis which forms the core of the framework for risk-sensitive bank management in accordance with Basel II. The market allows risks not only to be assessed independently of a model but also – via hedging and risk transfer – to be tailored to a bank’s desired risk profile. This provides banks with additional scope to assume new risks, including exposures to SMEs. An optimized use of and return on equity puts banks in a better position to issue loans to SMEs. Through this function, banks also serve SMEs as a “transmission channel” onto the capital market. **Particularly in the current economic climate – in which German SMEs are experiencing the longest period of recovery since reunification and the gap between them and large corporations has closed – this more professional approach to capital**

procurement is enabling SMEs and banks alike to remain successful on the market and fully exploit their growth opportunities.

The improved options for the securitization and transfer of financial instruments have boosted the **market for mezzanine financing products**. Based on a recently recorded market volume of around EUR 4 billion, mezzanine financing is only just beginning to make its mark on the market for SME financing. Although there are signs of a trend toward smaller volumes, most of the transactions are still focused on the upper end of the SME segment. Furthermore, mezzanine financing is, in most cases, not the only financing instrument used but rather forms part of a recapitalization package together with other instruments. It is a particularly suitable option when substantial earnings are forecasted for the future but the company lacks senior-status debt and equity capital. The term “mezzanine” (“mezzanino” in Italian) originates in architecture and describes an intermediate floor situated between two main floors. In financing theory, “mezzanine” is used as **collective term for hybrid financing instruments** lying somewhere between pure equity capital and pure debt capital. As such, mezzanine financing instruments can come in a whole variety of forms as regards their capital characteristics and the associated participation rights; their structure can be equity-based (**equity mezzanine**) or debt-based (**debt mezzanine**). The possibilities include equity-related measures such as capital reductions and increases, traditional debt capital instruments such as bank loans and bonds, and typical mezzanine financing instruments such as participation certificates, silent partnerships, convertible bonds or options. The financing arrangement can also be extended to include various types of subordination, deferral, waiver and conversion. In practice, the remuneration for such financing comprises combinations of fixed and performance-related regular remuneration, and in a few seldom cases bullet remuneration. From a company perspective, the flexibility in the use of funds resulting directly from the subordination of, for example, participation certificates and the retention of controlling rights is of prime importance. From a banking perspective, the three criteria – longer-term capital provision, termination rights and subordination – play a decisive role in determining whether or not mezzanine capital is included as economic capital in individual loan assessments.

5. Key relationship-oriented complement to bank-based financing for SMEs: private equity

Globalization and accelerated structural change mean that the majority of companies are having to make considerable adjustments. Larger established companies use **internal** capital markets (mainly retained profits) to finance their restructuring programs and have **direct** access to the **external** capital markets for equity and debt capital if they so desire and provided that they have clear and communicable development prospects. The large majority of businesses rely on relationship-based financing offered by banks and increasingly by off-exchange private equity companies.

In particular in cases where traditional business practices are realigned, there is a very large degree of informational asymmetry between outsiders and company insiders. It is therefore very difficult to assuage the doubts harbored by these outsiders as to whether or not companies with an established management really want to part with their trusted business strategies. As a result, outsiders are generally discouraged from making a financial commitment by way of direct lending through the capital market. And this is where not only banks but also private equity companies have identified an opportunity. These companies also act as intermediaries in the financial market by managing the pension assets entrusted to them by insurance companies and pension funds, for example. Like banks, they produce key information on companies that generally do not have direct access to the capital market. It is thus a sign of distinction for banks if a company has undergone due diligence by a private equity investor. However, private equity capital lenders and banks are now also increasingly in competition with each other, for example with respect to succession financing arrangements, as well as in the growth and turnaround financing business. In particular, the mezzanine capital programs that banks have since developed themselves are becoming an increasingly competitive alternative to the private equity business. The latter is not really “private” at all any more. With just under 6,000 financed companies in Germany, employing around 1 million people and contributing an estimated six percent to overall economic output, the private equity sector no longer needs – and is no longer able - to hide it lights under a bushel.

As a whole, the **private equity** sector in Germany comprises the buyout and venture capital financing segments. Whereas **buyouts** involve target companies that are already established but not exploiting their full economic potential, the target companies of **venture capital** investors are those that are in the process of researching and developing a new business plan (seed phase), bringing their product on to market (start-up phase) or striving to reach the break-even point (expansion phase). Since 2001, the buy-out segment has been the main focus of investments by private equity companies operating in Germany, recently accounting for almost three quarters of the total volume compared with only one fifth in the nineties. Just under 20% of the investments made in 2006 constituted expansion financing, and at least 6% were used for start-ups. Seed phase financing increased five-fold last year, yet in terms of volume – accounting for less than 1% of total investments – this area is of minimal significance. The main players in this small-scale segment are currently business angels (private investors who invest in start-ups and fledgling companies with which they have no family ties). Only in later phases do venture capital funds jump on board.

The figures published for Germany by the Association of German Equity Investment Companies (*Bundesverband Deutscher Kapitalbeteiligungssgesellschaften* (BVK)) only provide a rough outline of the development of the private equity sector. The EUR 3.6 billion in investments disclosed for 2006, for example, contain neither the amount of debt capital raised nor the investments made by private equity funds based abroad. If the target country is taken into account as a criterion, the private equity investments made in Germany in 2005 were almost twice as high as the investment volume calculated according to where the fund management company is based. This reveals a

weakness in the tax and legal framework for private equity on the German financial market, which is also highlighted by the fact that private equity investments by German and foreign funds in Germany recently accounted for only around 0.25 % of overall economic output, compared with the European average of over 0.4 %.

Especially in cases where companies want to completely realign their operations, private equity companies can contribute something very important in addition to the capital necessary for the restructuring and refocusing process – namely entrepreneurial and strategic expertise. In this respect, they distinguish themselves from banks, which are unable to provide business consultancy services as they are understood in this context. A strategic realignment has similar characteristics to the start-up phase of a company: in both phases, the company ideally needs decision-making support and a basis for decisions. The information-related barriers that spring up between lender and borrower in this context are usually very high, which generally leads to prohibitively high financing costs. This is where private equity companies step in and assume important functions in the financial system which other financial intermediaries are unable to fulfill in the same way and with the same level of efficiency. As a result, they **fill the gaps in the financial market** – barring a few lamentable cases. **By planning their exit from an investment as early on as when they make it – capital-market oriented strategy – on the one hand, and having an influence on the business policies of the shareholding – relationship oriented strategy – on the other, private equity capital lenders offer a combination of capital-market and bank-oriented financing.**

The business concept of private equity companies comprises four basic steps. First, the companies perform what is known as **fundraising**. According to the industry association, German private equity companies raised EUR 2.8 billion in funds in 2006 – a vast improvement on the consolidation years of 2002 to 2004 but not a patch on the volumes raised in the boom years 2000 and 2001 (average EUR 4.4 billion). Key investors in this field are increasingly funds of funds and private investors, together receiving 37% of the funds last year. In order to mitigate risk, foreign investors with German subsidiaries, which account for a third of the new funds raised, initially look toward funds of funds if they want to make an alternative, return-oriented investment in Germany. Banks and insurance companies each accounted for around 13% of the new funds, and a further 10% originated in the public sector. What is worth noting is the fact that independent private equity companies are particularly reliant on foreign capital due to the persistent reticence of German investors.

The three other steps can be appropriately labeled **"buy", "fix" and "sell".** First, the private equity company acquires a stake in the target company which generally confers a controlling influence over the latter. By doing so, these companies act differently to hedge funds, which usually only acquire small share packages – although this distinction is now increasingly on the decline. The reason for this is that private equity companies and hedge funds are competing more and more against each other in the field of SME and restructuring financing. Last year, more than three quarters of the **investment volume** of German private equity companies was financed with "real"

equity, the rest being attributable to equity-like financing such as silent partnerships, shareholder loans and other forms of mezzanine financing. Accounting for three quarters of the investment volume, independent funds, which raise capital through external investors, are the main contributors. Just under one fifth of the investments are made by private equity companies of banks, insurance companies and industrial companies. 2001, these equity capital lenders have mainly channeled their investments into traditional sectors such as “other services” (including, for example, business service providers, temporary employment agencies and media companies), as well as mechanical and plant engineering, iron, steel, light metal and IT companies. In 2006, these sectors received a total of at least 70% of fund inflows. In the future, these private equity capital lenders are expected to focus more on other sectors such as healthcare, hospitals and logistics.

Once the target company has been restructured and modernized (**fix**), the private equity company usually sells its exposure within four to seven years (**sell**). The favorable climate on the organized capital markets and the booming M&A market have meant that the sales volumes of private equity companies in Germany – at just under EUR 2.1 billion - have almost reached the record level seen in 2002. The key **exit channel** in this regard has been the sale of interests to other private equity companies (known as secondaries – 29 % of the sales volume), followed by trade sales (25 %), share sales following an IPO (19 %) and the redemption of silent partnerships and shareholder loans (8 %). Now that the first generation of buyouts from the turn of the millennium and subsequent years is coming on to the market, secondaries are likely to play an even greater role in years to come.

As the amount of “mega deals” on offer is limited and the returns in this field are already low due to the tough competitive environment, **private equity companies are increasingly turning their attention to SMEs.** Many private equity capital lenders have realized that they can generate higher returns on investments in SMEs in relative terms. SMEs are expected to see a large influx of private equity capital, with the largest flow of funds currently being channeled into companies with annual revenues of between EUR 20 million and EUR 100 million. In 2006 alone, around 30% of the **investments** were made in companies with less than 1,000 employees and annual revenues of less than EUR 500 million, respectively. More than three quarters of the **financed companies** last year had less than 100 employees, and more than 70 % revenues of less than EUR 10 million. Even international funds, which for a long time had tended to focus on large-scale transactions, are now shifting increasing attention to German SMEs. The considerable interest of foreign funds in German SMEs is testimony to the maturity of this segment, as well as to the attractiveness of these companies as target investments. In the fall of last year, for example, the UK private equity company 3i launched the largest private equity fund for European SMEs to date (EUR 5 billion), which plans to invest 15 % and 20 % of its funds in companies from the German-speaking world. Nowadays, SMEs are increasingly inclined to sell their business to a financial investor than to a competitor or a group. Particularly with regard to the maintenance of confidentiality regarding internal trade secrets, the reputation of private equity companies has increased significantly compared to that of strategic investors. **The younger generation of SMEs is far less cautious**

when it comes to transactions with private equity companies than SMEs have been in the past. The removal of this apprehension has been aided by the fact that many financial investors attach considerable importance to the involvement of the existing management and former shareholders.

Contrary to what the term “private equity” suggests, equity investments are in practice mostly financed by loans and only to a limited extent by own funds. In the case of LBOs in Europe, for example, two thirds of the purchase price are nowadays attributable to loans. This – together with the rising prices for target companies and the growing risk appetite of funds due to the high level of capital available – is the subject of increasing criticism. The more leveraged a fund is, the higher its return on equity, provided that the return on the overall capital is higher than the interest charged on the debt capital (financial leverage). Furthermore, the absolute loss risk of an investor drops the lower his/her use of equity capital. On the one hand, this **condensation of risk** is intentional. The more risks and thus the more opportunities focused on the equity, the greater the **incentive** to increase the enterprise value for the owners, who often also include fund managers with a participating interest, as well as to utilize the company’s assets in the most efficient way possible. The profits remaining after debt capital has been serviced are allocated to a relatively low amount of equity, which gives rise to high returns. On the other hand, it is very important for the private equity sector and its debt capital lenders to minimize the **false incentives** associated with a high leverage rate. Investors or fund managers, for example, could be encouraged to adopt particularly risky strategies, as they are afforded enhanced participation in the success of high-risk measures, but are only liable to a proportionately lesser extent for any losses due to their low capital commitment (“**gambling**”). A very critical form of misconduct is also made by equity security holders who attempt to milk companies of their assets before other stakeholders have secured their claims (“**cash-in and run**”). In 2006, a number of such transactions came to light where dividends were to be paid to financial investors using new liabilities. The temptation to act in this incorrect way is substantial when there is a growing influx of capital waiting to be invested and a declining number of attractive acquisition opportunities, which pushes up purchase prices. **Nonetheless, together with its debt capital lenders, this sector has instruments at its disposal to largely eradicate or limit such misconduct, which contradicts established practice and undermines the positive incentives of private equity, and ultimately prevent any potential market failure.**

Economic logic, experience from abroad, and many examples of successful exposures of private equity companies in Germany speak strongly in favor of private equity companies as financial intermediaries with a longer-term investment horizon that manage risk in an expedient manner on the whole. Both at macro and microeconomic level, it has been proved time and again that **a strong relationship has developed between the various levels of private equity, on the one hand, and economic growth and corporate revenue and employment growth on the other.** In the short term, the boom in this sector looks set to continue as the number of transactions is likely to rise further and the level of liquidity likely to continue outweighing the demand for financing. Although there are now calls for financial investors to be cautious, there is no need to be **overly**

concerned that this **business will overheat**. The moderate slowdown in overall economic growth, broad risk diversification, and flexible lending instruments all **tend** to point **instead** toward a **soft landing** for the industry. Moreover, it should be noted that German target companies – given the comparatively low penetration of private equity in this country mentioned above – often have lower price tags than their counterparts in other European countries. After all, based on the ratio of purchase price to EBITDA, German companies were recently estimated as being undervalued by almost 10%.

This also reflects the fact that **taxes and rules and regulations for private equity in Germany** are unfortunately still comparatively high. The **Private Equity Act (*Private-Equity- Gesetz*)** set to come into force in early 2008 should therefore improve the tax situation in this sector, in particular, removing the disadvantages compared with fund structures that exist in countries such as the UK and Luxembourg and also providing SMEs with easier access to equity capital. The new bill should therefore ensure that the tax loss carryforwards of an acquired company can continue to be utilized following a change in the majority shareholder, and that, in addition to “asset-managing” funds, “commercial” funds that actively influence the strategy of their portfolio companies will also retain their tax-free status in general.

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