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*Research Report:*

# Fairer Finance for Germany

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This research report outlines the opportunities and potential for trade receivables securitization in Germany, from the perspective of corporates and financial institutions.

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## Key findings

- In the last two years, the average cost of funds for both large and small German companies, is estimated by banking organisations in Germany to have risen by 12.5%, on account of factors such as economic slowdown, tightening credit policies and the withdrawal of state guarantees for corporate lending.

- German Banking Institutions believe that the securitization of trade receivables (invoices issued by the borrower to third parties in the normal course of business) is an increasingly attractive method of raising reasonably-priced finance, with the bank acting as an arranger between the corporates and the capital markets. Trade receivables securitization is predicted by these organisations to grow by 39% over the next two years.

- 71% of banking organisations in Germany believe that the increased financial transparency resulting from factors such as Basel II risk management by banks and the stringent, granular and timely reporting required by the rating agencies for trade receivables securitization transactions, would provide a body of information on mid-sized companies that will lead to fairer credit decisions.

- Just 12% of German banks surveyed rated themselves as being adequately prepared for Basel II, raising the spectre of a competitive threat from foreign banks moving in on the increasingly attractive German corporate finance market.

## Introduction

The financing of medium-sized corporates in Germany, known as the "Mittelstand",[1] is undergoing a transformation. In the past, state guarantees for Landesbanks (of which there are 11) meant that artificially low rates of interest could be offered to mid-sized companies. The Sparkassen and Landesbanks could therefore lend cheaply, as could the Volks and Raiffeisen banks, whose primary motivation has not always been profit maximisation. Consequently, the commercial banks were faced with the choice of following the pricing down or exiting the market. These guarantees for Landesbanks have been removed since 18th July 2005, due to complaints to the European Commission relating to unfair competition. Whilst no actual crisis is looming, any impact of this removal for German banks is bound to be widely felt as the large private sector banks only have a 20% domestic market share. According to the Financial Times,[2] Germany's Sparkassen "command market shares of between 50 and 60 per cent both among retail customers and small and medium-sized corporate clients."

Furthermore, Germany is heavily overbanked and inefficient when compared with its international peers, doubling the pressure on lending criteria that the current slow economic state of the country has produced. According to rating agency Fitch,[3] "German banks had accumulated bad debt on their balance sheets due to the country's ongoing economic slowdown, the decline in real estate values and inadequate risk management." Fitch follows on to say, "The banking sector is facing fresh challenges arising from increasing international competition, more sophisticated customers and tougher regulation. To remain profitable in a faster-moving environment, German banks are being forced to undergo cultural changes, and take a more proactive approach to marketing their products. For banks such as Deutsche Bank and Commerzbank, this process is largely complete, however for the majority like Bayerische Hypo-und Vereinsbank (HVB) and WestLB AG, there remains a long way to go. Unless German banks can act quickly to improve their revenue generation, it is unlikely that they will catch up with their international peers. For a significant improvement in profitability, Germany's banks need the domestic economy to pick up, and require further support from the German political establishment to enable structural reform, both within and beyond the banking system." There has been a degree of consolidation initiatives between Landesbanks and the Sparkassen in an attempt to address this "overbanking" problem, however there remains a lot of work to do.

In simple terms, the Mittelstand is witnessing the fact that banks are increasing their rates and reducing the funding lines they offer.[4] In a recent keynote speech,[5] the Deutsche Bundesbank said, "German banks, on the whole, have pursued an increasingly more restrictive lending policy. For example, results until the end of 2004 indicated that the German Banks were applying a more "risk-sensitive" approach to interest rate margins and loan covenants. This has been reflected through higher margins for riskier loans and in more stringent collateral requirements for riskier loans." This situation prevails in what is continuing to be a slow German economy,[6] where corporates still need to borrow funds.

Our research (conducted June 2005) focused on major banking institutions active in the German corporate finance market and revealed that on average, the cost of finance for German companies large and small has risen 12.5% over the last two years.

There are a number of reasons contributing to this situation and Fitch summarises the situation thus: "Some banks (like Dresdner Bank and ING BHF-Bank) started a few years ago separating their non-performing and non-strategic assets from their core business. Portfolio restructuring and sizeable loan loss provisions over the last few years have helped these banks to improve their asset quality and average costs and provisions went down in 2004. Other banks (especially various Landesbanks) are only now focusing on using their economic capital efficiently." In 2005, the German Landesbanks and the Sparkassen will lose the benefit of two strong support mechanisms offered by the German state, namely: *"Anstaltslast"* (maintenance obligation); and *"Gewaehrtraegerhaftung"* (statutory guarantee of full payment of principal and interest, including post insolvency interest). As a result of losing these benefits, ratings on the Landesbanks and Savings Banks have been lowered.[7] These mechanisms are now being phased out

(since July 18 2005), however *Gewaehrtraegerhaftung* will be "grandfathered", or continued, for obligations entered into before this date, as long as the obligations mature before 31st December 2015. Nevertheless, the overall result is an increased cost of capital for affected banking institutions, especially with the Landesbank's reliance on the interbank market for liquidity and funding provision.

Secondly, Basel II is expected to either encourage lending rate rises or require a significant increase in the capital that banks must allocate against the risk of lending to certain corporates, unless that risk can be accurately measured and closely monitored.[8] Borrowers are used to operating on low-cost credit lines (below BBB equivalent), yet the cost of providing that credit is rising. As ratings are set to fall, the requirements for setting aside capital are becoming more stringent. Thirdly, the German banks are increasingly comparing their low return on capital with that of their international peers and realising they are perhaps undercharging, which is undermining their own efforts to develop a viable commercial model that will produce a reasonable return.[9] The bad loan market is also being driven by Basel II: loans over 90 days past due, net of provisions, can carry a 150% risk weighting. In an attempt to improve their financial performance, more banks are now looking to sell their bad loan portfolios. According to Fitch, "Until now, it has mainly been the big commercial banks that have been selling their bad loan portfolios whereas savings banks, having close ties to their local communities, have been reluctant to sell loans to outside investors for fear of alienating their customers." There has also been a degree of unrealistic or overly optimistic provisioning. Nevertheless, both bad debt sales and outsourcing of collections are increasingly common, as banks move away from relationship lending towards more information-driven products that accurately and systematically assess risk. This is an imperative point as overall, Basel II will favour retail business and penalise banks with wholesale lumpy risks and underprovided non-performing loans.

For both banks and their corporate customers these problems are serious and both parties are increasingly seeking capital and funding solutions that deal with the balance sheet and credit issues that will emerge as a result of Basel ll.

## Accessing the Capital Markets

The most obvious solution is to use the capital markets to provide the financing shortfall, disintermediating the banks' balance sheets. If assets such as trade receivables are securitised (asset based lending) then the bank becomes a finance arranger rather than a direct lender. Capital requirements arereduced, as the bank has demonstrable access to comprehensive and sensitive payment data, allowing it to show greater control over the asset status and therefore improved risk management. However, securitization transactions have historically only been available to the larger corporates for several reasons:

- Execution costs were viewed as being excessively high – legal fees, complexity, and control and information issues.
- There were administration, collections and fraud risks that banks were only prepared to accept from larger companies.
- Only the largest banks have fully developed structuring capabilities.

This "exclusivity" aspect of securitization is evidently shifting, especially in the German market a solution is required to solve the Mittelstand financing dilemma. Reporting solutions are now playing a significant role as bankers seek to find ways to "commoditise" their complex product offerings so that they can be offered economically to smaller clients. The investment banking community is also strongly focused on broadening their product application as their traditional market place (the large deals) has become very competitive with foreign banks, particularly the American Banks, beginning to focus on the larger domestic clients, under-cutting fee levels.

The provision of finance to medium-sized companies is typically dominated by the commercial financing arms of large banks. Many medium-sized companies have a range of working capital facilities costing upwards of EURIBOR plus 300 basis points. Lending decisions are based upon a relationship built up over time with the borrower. Wherever possible, lending is secured on trade receivables and utilising these trade receivables as collateral reduces the risk of loss by diversifying the potential sources of repayment on a borrower default.

In a paper published earlier this year,[10] Andreas Jobst of the London School of Economics summarized the advantages

of securitization, specifically in the context of German Mittelstand finance: “From an issuer perspective, securitization registers as an alternative source of funds for profitable economic activity at most resourceful factor input and efficient cost of capital, which is reflected in one or more of the following key motivations:

**Points Pertinent to Financial Institutions**

- To curtail balance sheet growth and realise certain accounting objectives and balance sheet patterns,
- to reduce economic cost of capital as a proportion of asset exposure associated with asset based lending,
- to ease regulatory capital requirements in order to manage risk more efficiently.

**Points Pertinent to Corporate Issuers**

- To efficiently access capital markets in lieu of [intermediated] debt finance at a cost of funds, which would not be possible on account of the issuer's own credit rating, and
- to overcome agency costs of asymmetric information in external finance (e.g. “underinvestment” and “asset substitution”).”

## Making securitization work for the Mittelstand

However, there are two main problems in running this kind of transaction for a medium-sized company: Generally these corporates do not possess sufficiently high volumes of receivables to make a large enough transaction. There are commercial banking risks that make the transactions unattractive for medium-sized companies. With a larger company, these issues are dealt with on the basis of trust – so should a problem arise, the corporate will be substantial enough to provide compensation to the financier. There are three significant risks that also require consideration:

- **Administration risk** – the risk that the corporate does not perform adequately the servicing and collection actions required for the transaction (these can be quite complicated and labour intensive).
- **Collections risk** – the risk that the money is paid by the debtor on the invoice but is not received by the financier – e.g. it gets lost, is incorrectly posted or the corporate itself gets into financial difficulties and holds the cash. The main risk here is that the debtor has discharged his obligations, although the true owner (the financier) has not received the payment.
- **Fraud risk** – the receivables do not exist or the cash relating to them is misappropriated.

To reduce overall cost, receivables are taken from multiple companies and pooled together, allowing the set up costs for the transaction to be absorbed across multiple clients. Although the receivables are amalgamated into a single large pool, the transaction must be structured in such a manner that ensures that each corporate is only exposed to the credit risk of its own receivables and not cross exposed.

Collections risk is mitigated by either:

- Ensuring that cash is paid by debtors into a blocked account, to which the corporate has no access. Unless settlement is executed daily, this is secure for the lender, but less attractive for the corporate, as it will be paying for funds which it cannot use.
- Running a daily settlement report of receivables and cash, where the financier has the ability to reduce collections risks to a manageable level. This level of detail will support good financial controls around the transaction and detect any fraudulent or unusual transactions.

Technology advances in the last two to three years have played a significant role in overcoming these obstacles to Mittelstand trade receivables securitization. Multi-company, multi-currency, and multi-jurisdictional receivables pools can be facilitated with ease and rigorous reporting functions fully automated.

So what is the current state of play in German Mittelstand trade receivables securitization? Certainly the market has an established, if currently small, base. Moody’s[11] tells us that “German conduits financed 21 trade receivables transactions in 2004 totalling approximately ¢1.7 billion. In Germany, this would represent some 9% of German sponsored conduit issuance. However, a report from the European Business School[12] opines that approximately 5,500 firms in Germany… are potential candidates for securitization. This contrasts with Moody's figure of 30,000. This number appears to be too optimistic and cannot be supported by our analysis. The total stock of securitisable trade receivables is c. ¢126 billion.” Tables in this same

report estimate that there are approximately ¢44 billion of Mittelstand trade receivables that the European Business School believes are securitisable. Whatever the exact figures, these estimates give us an idea of the scale of the financing opportunity for the Mittelstand and the banking community.

Whereas mortgage backed securitizations are expected to decline somewhat, even in the UK, Moody's states that it "expects to see further growth in the volume of German trade receivable transactions in 2005… In 2004, there were signs that this form of financing would develop further, with more involvement from credit insurers and other institutions in Germany. Several conduits, including Atradius's European Receivables Funding, Dresdner Bank's Silver Tower Funding and IKB's Rhineland have focused on financing these companies, with typical deal sizes of between ¢10 million and ¢50 million. We expect a further increase in the number of German SME transactions as awareness of ABCP grows." Demica's June 2005 research amongst banking organisations active in Germany helped to quantify the short-term growth picture for trade receivables securitization in Germany. Respondents on average felt that the next two years would see 39% growth over the current market issuance.

## Fairer Finance

A side-effect of trade receivables securitizations is up-to-date transparent view on how efficiently a company is being paid by its debtors. This payment performance information is a regulatory rating requirement for such securitizations, in order to monitor the assets on behalf of investors; however, it also provides the securitization arranger and administrator (the bank) with a powerful indicator of cashflow health amongst a receivable pool's participants. Mittelstand lending by banks cannot afford to conduct such in-depth analysis. 71% of our research respondents felt additional transparency would lead to fairer lending rates for healthy Mittelstand companies. In other words, good risks would be more accurately assessed, meaning that well managed firms would be rewarded and poorly managed firms would be penalised. This marks a mind-shift radically away from the one-rate-fits-all mentality of post-war German banking. In short, the bank is able to view (and act upon) daily information about at least a part of the borrower's balance sheet, rather than just relying on historical information in audited or management accounts, with trade receivables behaviour being a leading indicator of corporate credit status and ongoing health.

Any process which efficiently enables credit transparency at low cost will also have an impact on Basel II preparations by banking organisations operating in Germany. However, we are still in the early stages of take-up in the country. Our research indicated that only 12% of respondents thought that German banking organisations were "well prepared" for Basel II requirements. A further 65% were only "adequately prepared". This may be taken as an indicator of the urgency with which banks need to revolutionise their operations if they are to fight off the threat from foreign banks moving into their territory.

## Conclusion

In summary, there is evidently a growing appetite, both from borrowers and financiers, to utilise trade receivables securitization to offer economically priced finance to the Mittelstand. Growth is expected to be almost 40% over two years – reflecting the general move away from relationship lending to corporates. The Landesbanks and Sparkassen may well consolidate to address the problems of overbanking in the German system. Trade receivable securitization will be important for the German economy in smoothing the path between traditional Mittelstand financing, which was artificially cheap, due in part to state guarantees of Landesbanks and Sparkassen and free market pricing. Reporting solutions are are set to play a role in providing a low-administration method for admitting SME receivables portfolios into a securitised pool. Standardisation of process, documentation, and information flow are critical to the success of such initiatives.

Offering this alternative form of finance to the Mittelstand is both a necessity and an opportunity for German banks in general, and the Landesbanks in particular. As principal central bank service providers to the Savings Banks, which deal with the larger proportion of direct Mittelstand customers, there is a relationship asset to be capitalised upon. Another advantageous fact is that Landesbanks currently account for 20% of the value of European conduit outstandings. Thus Sparkassen have the customer base, and

Landesbanks can offer structuring ability and funding via conduits. However, in terms of competitive threat, global banks (many of them foreign) have spotted this financing opportunity and are already actively marketing their offers to the marketplace. In addition, there are non-bank finance providers also entering the market, in the form of credit insurers and invoice discounting companies. As a handful of Landesbanks have placed themselves in a premium competitive position, the remainder will have to act fast or risk losing ground to their more proactive counterparts.

## Methodology

The methodology deployed for this study embraced both primary and secondary market research and included telephone interviews. The survey period ran from late May to early June 2005 and was carried out by MarketingUK **on behalf of Demica.**

Primary research was conducted amongst the 30 top banking organisations active in the German corporate market in order to ascertain:

- Increase in cost of finance for corporate borrowers over the last two years
- Predicted growth in German trade receivables securitization market
- Impact of increased transparency on corporate finance
- German banks' readiness for Basel II

**Third party research sources included:**

- The International Securitisation Forum
- AltAssets
- Mayer, Brown, Rowe and Maw
- JP Morgan
- Commerzbank
- Deutsche Bundesbank
- Ifo Institute
- London School of Economics
- AMR Research
- KPMG
- PricewaterhouseCoopers
- TowerGroup
- Bloomberg
- Fitch Rating
- Standard and Poors
- Moodys

1 Definition from the Institut für Mittelstandforschung Bonn, *Mittelstand in der Gesamtwirtschaft – Anstelle einer Definition*, puts the maximum turnover of a Mittelstand company at €50m.

2 Financial Times, *Loss of state support will cut bond issuance*, 15th July 2005.

3 Fitch Ratings, *The German Banking System*, February 2005.

4 German banks are actively reducing their exposure to 'vanilla' credit for SMEs. See Commerzbank's 2004 Annual report which states that "The overall conditions in corporate activities were difficult again in 2004. Due to permanently weak business investment, demand for credit was quite subdued… We felt obliged more often than in the past to reject requests for credit if we could not ensure an adequate risk premium." Also see a report from Mercer Oliver Wyman – *Business as Usual? The Future of Business Banking in Europe*, January 2004 – which notes that banks have the opportunity to convert their relationship lending customers to alternative financing instruments if they are sufficiently nimble.

5 Deutsche Bundesbank, *Bank Relationships, Financial Integration, and Monetary Policy*, June 2005.

6 Ifo Institute, *The State of the World Economy and the German Economy in Spring* 2005 – "In the first half of 2005, the underlying growth momentum will remain limited. The order inflow to industry which had increased strongly around the turn of the year due to large scale orders have declined again more recently. Latest sentiment indicators suggest that the economy may still have to find bottom; business expectations continued to tend downwards. An important reason for the increasing pessimism may be the rise in oil prices which dents into corporate profits and reduces real incomes of private households. All in all, domestic demand is expected to increase only modestly for the time being. Exports will also lack momentum, as growth abroad will be dampened by higher energy prices as well."

7 Financial Times, *Loss of state support will cut bond issuance*, 15th July 2005, states that "Standard and Poor's, the credit rating agency, has cut the Landesbanken's guaranteed long-term ratings, all in AA or AAA territory, to unguaranteed levels of A+ at best and BBB+ at worst."

8 Bank for International Settlements, *Overview of the new Basel Capital Accord*, 2003, states that "Under the proposed New Accord, the regulations that define the numerator of the capital ratio (i.e. the definition of regulatory capital) remain unchanged. Similarly, the minimum required ratio of 8% is not changing. The modifications, therefore, are occurring in the definition of risk-weighted assets, that is in the methods used to measure the risks faced by banks. The new approaches for calculating risk-weighted assets are intended to provide improved bank assessments of risk and thus to make the resulting capital ratios more meaningful."

9 Fitch Ratings, *The German Banking System*, February 2005.

10 Andreas Jobst, *Asset securitisation as a risk management and funding tool: what does it hold in store for SMEs?* 2005.

11 Moody's, 2004 *Review and* 2005 *Outlook – German/Austrian/Swiss Structured Finance: Growth Potential and New Challenges.*

12 European Business School, *Verbriefung von Unternehmens-, Factoring- und Leasingforderungen in Deutschland*, 2005.

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