The growth of non-bank and alternative financing sources in Spain

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Despite the continued predominance of bank finance in Spain, in recent years, there has been a notable improvement in the array of funding sources available to firms, including alternative finance. While these new, innovative funding channels are still at a very early stage of their development, their attractiveness relative to traditional finance translates to expectations of considerable growth in the coming years.

Alternative finance is generated significant interest in many economies. This is in part due to the realization that diversification of funding sources may alleviate firms´ financial pressures during a credit crunch, particularly in the case of SMEs. While the Spanish private sector still depends to a large extent on bank funding, there has been a relative improvement in the array of funding sources accessible to firms (including SMEs) in recent years. The latest regulations in Spain further aim to diversify the types of available funding as well as to incentivize banks to pay more attention to SME lending. Some of these sources ̶such as debt financing, the alternative stock market and venture capital̶ are showing promise. At the same time, it is still too soon to assess the evolution of newer, more innovative channels ̶such as crowdfunding or Peer-to-peer (P2P) business lending, which are at a very incipient stage of development. Although total funding from these sources amounted to only 62 million euros in 2014, their growth over the coming years is expected to be considerable.

Banking and alternative finance

The realization that diversification of funding sources helps alleviate financial tensions at times of crisis has elevated the importance alternative funding sources. That said, the novelty of the topic has generated some confusion as to what the term alternative finance really means. Traditionally, it described the funding of firms and individuals beyond banks and standard debt and equity markets. In the current business environment, there are more restrictive definitions that just refer to financial activities that are developed through entirely new channels, such as business-to-business (B2B) online lending or crowdfunding.

This article defines alternative finance as the non-bank funding alternatives for individuals and SMEs. These are the economic agents that depend to a larger extent on bank financing

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in a country like Spain. This definition thus makes alternative financing synonymous with disintermediation. At the beginning of the 1990s, the concept of disintermediation became popular in a business environment in which US banks faced increasing competition from mutual and pension funds, insurance companies and other non-bank financial competitors. There was even concern that banks would rapidly lose their predominant role in the financial system as other intermediaries gained importance. However, the repeal of the Glass–Steagall Act and the approval of the Gramm-Leach-Bliley Act in the US permitted commercial banks to get involved in many activities that had been forbidden or restricted before (*i.e.* securities trading, industrial stakes). As a result, banks maintained their position as leading intermediaries in the US financial system.

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In countries like Spain (and also Germany and Japan), banks have been allowed to offer a wider range of services under what is called a "universal banking model." Therefore, rather than disintermediation, Spanish banks have enjoyed a "reoriented intermediation." In particular, instead of facing increasing competition from other intermediaries, they became big players in insurance, pension funds and other related businesses. This increased the dependence of the private sector on bank financing. Twenty years later, the Spanish private sector still depends to a significant extent on bank funding. Analysts and policy makers have traditionally advocated for a wider array of funding sources for households and firms, in particular in private equity and debt markets.

The restructuring of the Spanish banking system during the recent crisis has also focused attention on alternative finance. The surveillance of the Spanish financial sector under the financial aid program to Spanish banks includes some recommendations from the European Commission, the IMF and the ECB on this front. A recent example is given in the IMF report "Spain: Concluding Statement of the 2015 Article IV Mission" where one of the statements reads: "efforts should continue to strengthen SMEs´ access to market-based financing. Bank lending will remain dominant, and initiatives such as the Juncker plan [a pan-European plan for investment] will be helpful in this regard. However, non-bank financing should be developed further, including via alternative exchanges, venture capital, and securitization, while improving transparency and accuracy of financial reporting."

In line with the IMF´s recommendations, from the demand perspective, alternative financing refers to the availability of non-standard funding channels for firms. These channels are connected to a new environment in the services industry where marginal costs are rapidly falling, and where digitalization and social interaction are dominating the transformation of many sectors. In this sense, Allen *et al.* (2012) suggest that financing from non-market, non-bank external sources will likely become as important as bank funding globally. Moreover, alternative finance appears to be the dominant source of funds for firms in fast-growing economies.

Considering this emphasis from private and public sources on the growing importance of alternative financing channels, it could be argued that banks will have a diminishing role in the economy in the near future. However, this is not necessarily true. Alternative financing may emerge as a complement rather than a substitute for bank lending. A revealing reference is Berger and Udell (2006), which suggest that lending relies on different technologies and that the structure of these technologies is often oversimplified. A common oversimplification is the treatment of some of these bank lending technologies as a homogeneous group, unsuitable for lending to less transparent SMEs. A frequent misleading conclusion is that large institutions are at a disadvantage in lending to SMEs. The anecdotal evidence suggest that banks have been finding new ways of building lending relationships with firms and also that the same banks have developed technologies such as factoring, leasing and other forms of financing that are not frequently attributed to them.

Given the growing importance of alternative finance, it could be argued that banks will have a diminishing role in the economy in the near future. However, this is not necessarily true. Alternative financing may emerge as a complement rather than a substitute for bank lending.

If we reinterpret these lessons from Berger and Udell (2006) in the post-crisis context of the Spanish financial system, we observe that new forms of non-bank funding are emerging in the country but also that there is now a challenge for Spanish banks to find new and more specialized ways of providing financing to SMEs. In this sense, alternative finance also presents a challenge for banks to transform the way they do business.

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In this note, we analyse some of the recent regulations that aim to promote new funding sources in Spain as well as the evolution of some of these new channels.

The regulatory environment

There are various regulatory initiatives related to the promotion of alternative funding sources in Spain. Most of them were approved in 2014 and are being implemented in 2015. The main one is the Law on Promoting Business Finance, which was approved in April 2014. The law is both directly and indirectly related to bank business as it aims to make bank financing more flexible and more accessible, and, at the same time, to strengthen other sources of non-bank financing. It also seeks to reinforce the supervisory powers of the Spanish Securities Market Commission. The law tries to address the fact that, according to the government, 75% of SME financing in Spain comes from banks. The law states that any bank or credit institution wishing to reduce the financing it provides to an SME –that is fully up-to-date with its payment obligations– will be required to notify the SME three months in advance. Additionally, the SME is entitled to request its payment history from the bank, including a credit score.

Furthermore, regulation governing securitisations has been reformed to simplify them and make them more transparent. Importantly, banks are encouraged to securitize not only mortgages and large corporate loans but also loans to SMEs.

The Law on Promoting Business Finance also aims at fostering new financing instruments. In particular, the Alternative Stock Market (Mercado Alternativo Bursátil, MAB) is strengthened. Specifically, the law adds flexibility to the requirements for companies wishing to move from the MAB to the official Spanish Stock Market. For instance, when the share capital of a company listed on the MAB reaches a threshold of 500 million euros.

The law also seeks to help limited liability companies issue fixed-income securities by simplifying the mechanisms and the requirements to do so. Moreover, it strengthens the supervisory, inspection and penalization powers assigned to the National Securities Market Commission (Comisión Nacional del Mercado de Valores, CNMV).

A particularly innovative feature of the Law on Promoting Business Finance is its first time ever attempt at introducing regulation of crowdfunding[3] in Spain. The idea is to ensure these platforms are transparent, and to provide and/or facilitate a connection between investors and the investment projects in such a way for them to require authorization and supervision by the CNMV with support –especially in terms of loan activity– from the Bank of Spain. Two different types of investors for crowdfunding are defined: accredited and non-accredited. Accredited investors are institutions, companies with over 1 million euros of assets, a turnover of 2 million euros or 300,000 euros of equity and any individual or legal entity whose income level exceeds 50,000 euros per annum or have an asset value in excess of 100,000 euros and expressly request to be treated as such. The rest are non-accredited investors and will not be permitted to globally invest more than 10 billion euros per year.

From the supervision side, crowdfunding platforms fall under the authorisation, supervision, inspection and sanction of the CNMV. The Law restricts the range of services that these platforms may provide. In particular, they are not allowed to offer investment advice or process payments (unless they apply for a license as hybrid payment institutions). An important aspect of the crowdfunding regulation is that it protects non-professional investors. Platforms are required to publish certain information on applicants and their projects.

Another representative aspect of alternative funding sources is venture capital, the funds created to pool resources to finance investments in newly created projects and start-ups. On November 12th, 2014, the Spanish Parliament enacted new law 22/2014, regulating venture capital and private equity entities, other closed-ended investment entities and investment managers for closed-ended investment entities (Law 22/2014). This law harmonizes the Spanish regulation with Directive 2011/61/EU, of the European Parliament on alternative investments fund managers (AIFMD).

Law 22/2014 derogates former law 25/2005, which until now regulated Spanish venture capital and private equity and establishes a new legal framework for venture capital and investment managers and other closed-ended investment entities. It introduces important measures to promote fundraising among investors (including tax advantages) and provides alternatives to bank financing. With this law, closed-ended investment entities are distinguished from open-ended entities in two ways. First, in closed-ended investment entities, the divestment takes place simultaneously with respect to all of the investors. Second, in closed-ended entities, each investor will be remunerated on an individualized basis, in accordance with the regulations and by-laws applicable to each class of shares. In this sense, venture capital and private equity entities are deemed to be closed-ended investment entities. These entities may either be incorporated as companies ("sociedades de capital riesgo") or funds ("fondos de capital riesgo)."

Recent evolution

Considering the new regulatory initiatives, to what extent is the Spanish financial system

[3] The activity of the Internet platforms that promote so-called participatory funding.

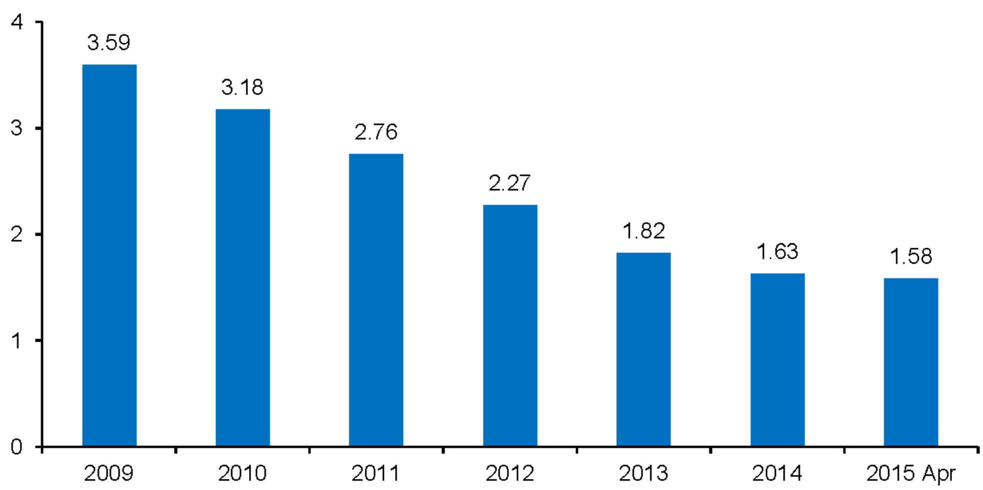
internalizing alternative finance and how are the perceptions changing in Spain compared to other European countries? The consulting company Allen and Overy (2014) undertook a survey among top financial executives at Western European companies and found some interesting answers at the European level on perceptions about the current and future penetration of alternative finance. The findings show that while bank lending remains the single biggest source of funding on average, alternative finance accounts for an average 41% of their total funding mix, slightly more than in 2009 (39%) and just behind bank lending (43% in 2014 and 44% in 2009). Public capital markets represent 16% (17% in 2009). The survey was biased towards large firms and this may make non-bank funding sources look more representative but the figures are quite illustrative as regards the ongoing changes.

As for Spain, a first interesting analysis refers to the relative size of bank funding compared to equity funding. A simple —although not necessarily comprehensive— measure is the ratio of credit institutions´ lending to the private sector to the market capitalization of the Madrid Stock Exchange. As shown in Exhibit 1, this ratio has considerably fallen from 2009 (3.59) to April 2015 (1.58). This does not necessarily mean that equity markets have taken the lead in financing the private sector in Spain because bank lending has been particularly negatively affected during the crisis. However, it looks like the Spanish financial markets are becoming more balanced in securing financing from markets and institutions.

The Bank of Spain publishes a monthly analysis on the evolution of financing to the private sector that offers a closer look at bank lending *versus* other funding alternatives. Exhibit 2 shows the annual change in loans and in securities (other than shares) as sources of financing for Spanish households and firms. Bank lending growth rates remained negative during the crisis years. The annual change in loans was -5.8% in 2012 and it reached -7.1% in 2013. It has been slowly improving since then and, in April 2015, the rate was -3.8%. The year-on-year growth of loans is expected to be positive by the end of 2015. In any event, as described in previous issues of *Spanish Economic and Financial Outlook*, these figures refer to outstanding amounts and it is worth

Exhibit 1

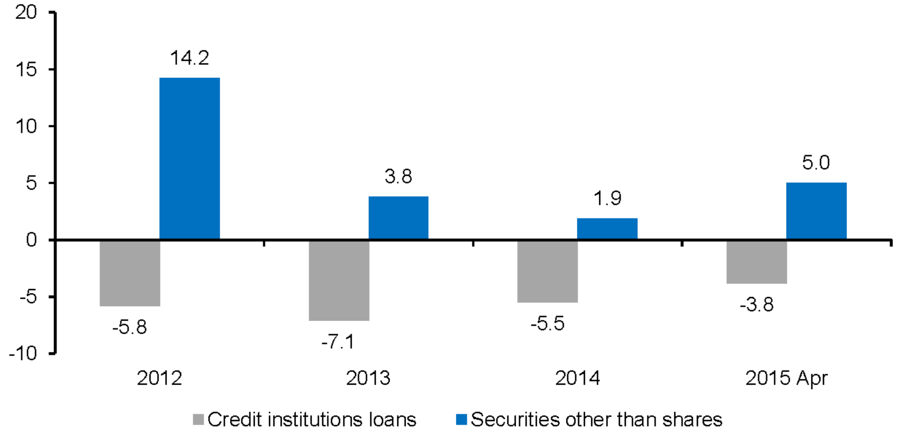
Credit institutions´ lending/market capitalization of the Madrid Stock Exchange



Source: Bank of Spain and own elaboration.

Exhibit 2

Sources of financing for the private sector. Credit institutions loans and securities other than shares. Annual growth rates



Source: Bank of Spain and own elaboration.

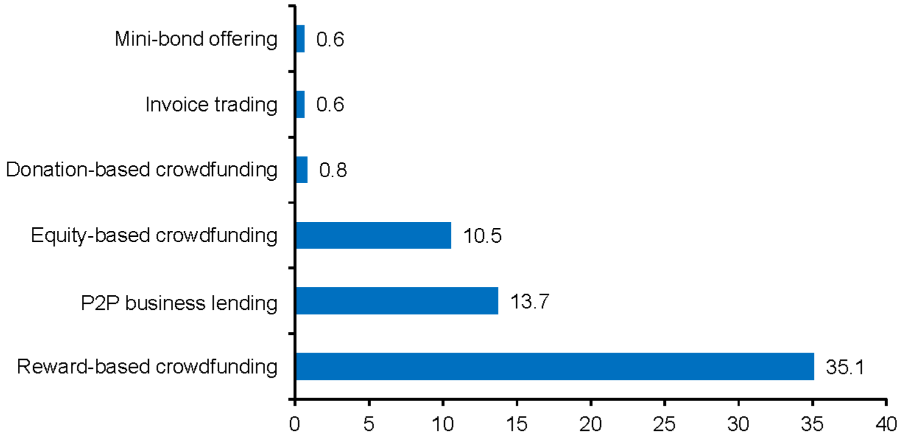
noting that the growth rate of new loans has been increasing since the beginning of 2015.

As for securities other than shares (mostly debt), they grew by 14.2% in 2009. Although their growth has been more modest in recent years, it has always been positive and was 5.0% in April 2015.

The figures in Exhibits 1 and 2 suggest that sources of funding other than loans may be gaining importance in the Spanish corporate sector. However, it is difficult to determine if these new sources represent the most innovative ways of alternative finance available today. Some figures from Statista suggest that the new alternative finance markets are still underdeveloped in Spain

Exhibit 3

New alternative finance market in Spain. 2014
(€ millions)



Source: Statista and own elaboration (http://www.statista.com/).

(Exhibit 3). The outstanding amount of reward (product reward-related) crowdfunding and equity (share participation-related) crowdfunding together reached 45.6 million euros in Spain in 2014. Peer-to-peer (P2P) online business lending reached 13.7 million euros. Other sources of new alternative finance are much more limited. Donation-based crowdfunding, invoice trading and mini-bond offering amounts were below 1 million euros in 2014. These numbers reveal that the most innovative ways of alternative financing are still very limited in their quantitative scope in Spain.

Sources of funding other than loans may be gaining importance in the Spanish corporate sector. However, the most innovative ways of alternative financing are still very limited in Spain.

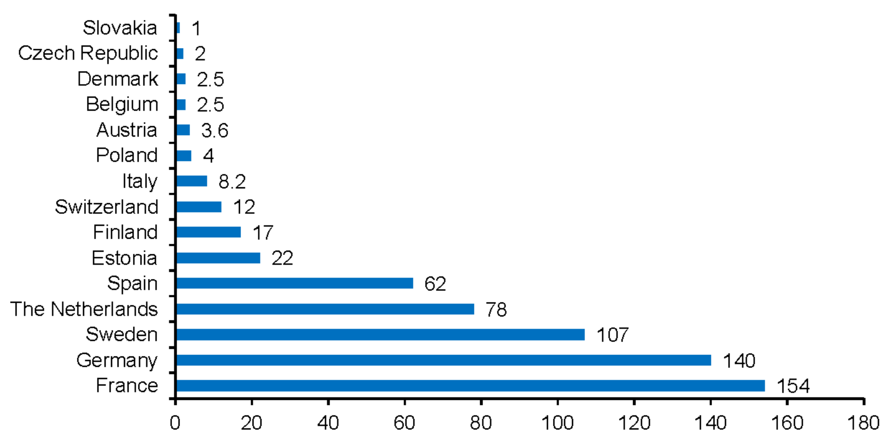
Cambridge University and Ernst and Young provide a similar estimate of the new alternative finance channels in Spain, totalling 62 million euros in 2014. This figure is still low compared to the UK (2.3 billion euros, not shown in the exhibit given the much larger comparative size), and also lower than in France (154 million euros) Germany (140 million euros), Sweden (107 millions euros) or the Netherlands (78 million euros). However, it is larger than in Finland (17 million euros) or Italy (8.2 million euros).

Considering the relatively low size of the newer funding channels, we relax the definition of alternative finance to include possibilities of funding for firms (in particular, for SMEs) beyond bank lending and trade credit. Exhibit 5 shows the evolution of market funding by non-Ibex 35 firms in the Spanish stock markets. Evolution has been irregular over the last few years. It grew from 2008 to 2011, when it reached 4 billion euros. It then fell amid the market tensions related to the sovereign debt crisis, but it has grown again in 2014 to 3.1 billion euros.

The funding in Exhibit 5 refers mainly to large firms as SMEs have no access to the main stock markets. Exhibit 6 shows the evolution of the

Exhibit 4

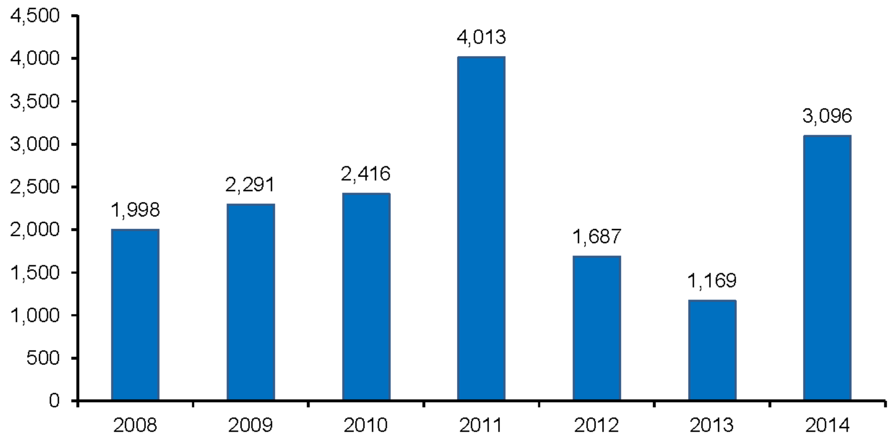
European online alternative finance market. 2014
(€ millions)



Source: The European Alternative Finance Benchmarking Report (Robert Wardrop, Bryan Zhang, Raghavendra Rau and Mia Gray), February 2015, Cambridge University and Ernst and Young.

Exhibit 5

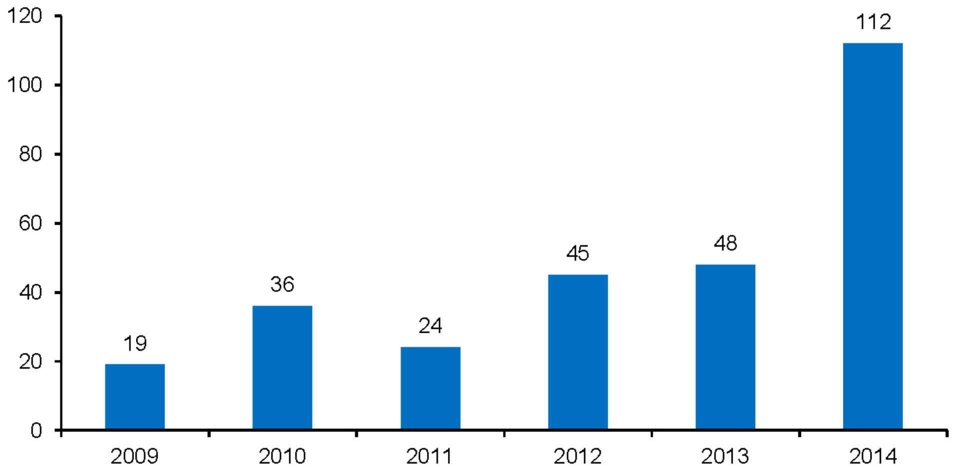
Market funding of non-Ibex 35 firms
(€ millions)



Source: Bolsas y Mercados Españoles (BME) and own elaboration.

Exhibit 6

Funding for the alternative stock market (MAB) firms
(€ millions)



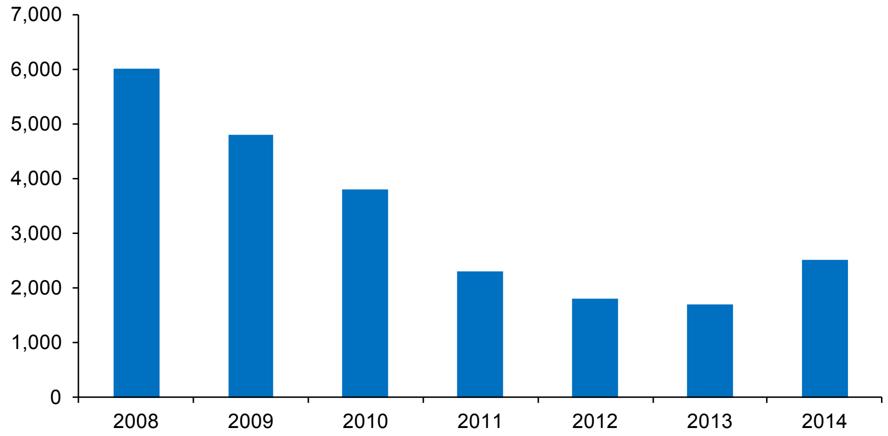
Source: Bolsas y Mercados Españoles (BME) and own elaboration.

financing in the Spanish alternative stock market MAB. It has been growing since 2009, with the exception of 2011. The growth was particularly substantial in 2014, where MAB funding increased to 112 million euros.

As for venture capital, this market has been operating in Spain for some time and the new regulations are aimed at fostering this channel. As shown in Exhibit 7, the funds available (the so-called "dry powder") for investment from venture capital funding fell from 6 billion euros in 2008 to 1.7 billion euros in 2013. However, funding started to grow again in 2014, when it reached 2.5 billion euros.

Exhibit 7

Funds available for investment from Spanish national venture capital firms



Source: ASCRI and own elaboration.

Conclusions

The assessment of the situation as well as the prospects for alternative finance in Spain depend on its definition. If we refer to the more restrictive concept which only accounts for the newer funding channels (*i.e.* crowdfunding, P2P) the development has been quite limited. This does not mean the outlook is poor, as these sources are expected to grow considerably in the coming years.

A broader definition of alternative finance, which includes non-bank funding and market access for SMEs, reveals that there has been a relative improvement in the array of funding sources in recent years. The alternative stock market (MAB) and venture capital represent particularly promising alternatives for Spanish firms in the near future. The recently approved regulations promoting these alternative channels should help increase the heterogeneity of financing sources available for firms in Spain. Importantly, this will not necessarily mean a diminishing role for banks, as they will also have to find new ways of servicing SMEs, exploiting their informational advantages in the intermediation business.

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