Credit Crunch and Late Payments

Minutes of Lunch-Time Meeting

27 November 2008

Payment uncertainties are one of the primary problems impairing the cash flows of corporations around the world. Disadvantaged by their relative bargaining power, small and medium-sized enterprises (SMEs) are often put in a position to accept late payments in their business-to-business transactions, regularly exposing them to liquidity shortages. To make things worse, the current credit crisis has reduced availability of funding to such enterprises. The consequence of both developments is an increased pressure on SMEs.

On 27 November 2008, a day after the publication of European Commission's Economic Recovery Plan[1], representatives of financial institutions, trade federations, and officials gathered at the Centre for European Policy Studies (CEPS) to discuss the credit crunch, late payments and their impact on SMEs.

The panel started with the general introductory remarks of the chairman, **Frederik C. Musch**, former Secretary General of the Basel Committee on Banking Supervision and former Chairman Global Financial Services, PriceWaterhousCoopers. Mr. Musch highlighted three issues that deepened the current crisis. First, since banking is pro-cyclical, the current crisis is pushing banks to lend less, which further undermines the economic conditions. Second, banks have become detached from their borrowers due to the rapid development of securitization, which is threatening the very existence of relationship lending that smaller firms principally depend on. Third, tightening of cash management practices around the world have increased the fragility of supply-chains due to payment uncertainties.

Looking for solutions, policy-makers around the world need to decide between using the banks as active policy instruments and letting them survive – or perish – on their own accounts as private entities. According to the chairman, the latter approach is preferable as long as due precautions to minimize collateral damage are taken. However, this is not the approach that seems to be taken by the governments currently. Moreover, "easy money", one of the triggers of the crisis, is now being paradoxically embraced as a promising solution. Governments around the world are attempting to "live beyond their means" by offering generous bail-out plans amidst deteriorating fiscal conditions. This could have unintended consequences by costing future tax-payers amounts that they have not signed up for.

The ensuing panel discussions included **Gert-Jan Koopman**, Director of Economic Service and Structural Reforms, European Commission, DG Economic and Financial

[1] For more details on the Commission's detailed Recovery Plan, see COM(2008) 800 final, 26 November 2007.

Affairs; **Rudiger Ahrend**, Senior Economist, OECD; and **Michael Wolf**, President and CEO of Intrum Justitia Group.

In addition to issues that relate directly to SMEs and address payment uncertainties, the discussions also addressed broader concerns relating to the current crisis and its handling by the governments. Several key points have emerged from the discussions.

1. For late payments and the state of SMEs, there are a number of promising structural reforms that could have a quick impact;

2. Despite a growing sense of unease in the credit markets, politically-motivated or unfair policies are unlikely to yield positive results;

3. Incentive structures need to be re-aligned to ensure that financial institutions are responsible for the risks they take.

Structural reforms

Taking the stage after Mr. Musch's introductory remarks, Mr. Koopman acknowledged that payment uncertainties were an important concern for SMEs for which trade credits were one of the most common forms of financing. The Commission's Recovery Plan puts forth several actions that would address directly the problems faced by SMEs. The idea is to tackle not only the problems on the aggregate supply side, but also the fall-out of demand that is currently being observed. According to the plan, EU governments are encouraged to offer guarantees and loan subsidies to compensate the high borrowing costs faced by corporations. Additionally, the plan pushes for the prioritization of large infrastructure projects, especially those that could benefit SMEs. More specifically, the European Investment Bank (EIB) is to increase its usual lending to SMEs. Building on the Small Business Act[2], the plan pushes for the reduction of administrative burdens of enterprises. In particular, public authorities are compelled to settle their unpaid invoices within one month and start accepting electronic invoices to speed up the process. Lastly, the implementation of the Payment Services Directive (2007/64/EC) and the ongoing work on the Late Payments Directive (2000/35/EC) would also address the late payments problem.

In order the highlight the need for reforms, Mr. Wolf underlined that according to the findings of Intrum Justititia's survey late payments generated around €25 billion of annual costs for companies. The requirement for public bodies to settle payments within 30 days would be a significant step. According to the survey's 2006 findings, payments by public authorities were 70 days late on average. This was significantly greater than the average payment time for businesses (60 days) and consumers (42 days).[3]

Pointing to the positive aspects of the Nordic system, Mr. Wolf noted that other potential improvements on general payment procedures could include increased transparency, limits on maximum late payment charges and a legal mechanism for ensuring the quick resolution of payments disputes. These improvements would not only mitigate payments uncertainties but also enable the growth of an external debt collection market. In turn,

[2] See COM(2008) 394 final.

[3] Retrieved from Intrum Justitia's website, http://www.intrum.com/1033_ENG_R.asp, on 27 November 2008.

the existence of such firms would provide scale benefits by enabling lenders across the EU to outsource their debt collection activities.

Political or unfair responses

All four speakers have warned against excessive government meddling with the market. Voicing his personal opinions, Mr. Ahrend noted that the current crisis did not appear to be significantly worse than previous ones, at least up until now. This is particularly the case for European SMEs. Recent data shows that aggregate bank loans to non-financial firms and households are growing despite evidence of rapid tightening of lending standards. Also, while the bailouts have effectively created “walking corpses”, it appears that these responses have been successful in averting a deeper crisis so far. Unlike the Japanese experience of the 1990s, the governments have acted promptly. Further political pressure to ease lending practices, however, would be tantamount to repeating the US government’s questionable approach of establishing large government sponsored establishments, i.e. Fannie Mae and Freddie Mac, to provide liquidity to mortgage markets.

One of the participants, **Antonio Hilario Garcia del Riego**, from Banco Santander remarked that the bail outs meant that not all institutions are in the same pack. In particular, the push to ail only the bigger banks was unfair. Mr. Garcia del Riego expressed concern that by not letting such institutions fail, the governments might have allowed them to gain market power in the expense of healthier firms, leading to unfair competition.

Incentive structures

One of the key problems identified in the system is the incentive structures provided to banks and their managers. Mr. Musch noted that Bank of International Settlements (BIS) has been warning about the coming crisis for a long time. However, such warnings were not taken seriously at a time when the financial institutions were concentrated on making two digit yields. The institutions’ owners, managers, their consumers and investors at large have all participated in massive herd behaviour. Repeating his opening remarks, Mr. Musch insisted that the banks had to be allowed to fail, only to ensure that they claim the responsibility of their actions. Also, regulators cannot be the saviours, as they are “always running behind”.

Mr. Ahrend reminded the audience that the current price-earning model, which rewarded a bank’s managers for short-term gains, was at the root of the problem and was not sustainable. The incentive schemes need to be modified in order to incorporate long-term objectives of the bank, not only annual performance. Banks that were deemed “too big to fail” had to be regulated differently, more strictly than others simply because of the externalities they impose on the public budget.

Mr. Wolf observed that the current system has so far led to excessive greed and risk-taking. Banks did not know or care for the characteristics of their lenders, given that they not only could get rid of the resulting assets but also would be rewarded to do so. He then predicted that the ultimate re-aligning of the incentive structures will result in the revival of relationship lending.