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European Small Business Finance Outlook

June 2016

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Executive summary¹

This European Small Business Finance Outlook (ESBFO) provides an overview of the main markets relevant to EIF (equity², guarantees, securitisation, microfinance). It is an update of the ESBFO December 2015.

We start by discussing the general market environment, then look at the main aspects of equity finance and the guarantees/SME Securitisation (SMESec)³ market. Finally, before we conclude, we briefly highlight important aspects of microfinance in Europe.

Market Environment:

- The general economic environment continues to improve, although the recovery remains fragile: the investment contribution to economic growth is still relatively limited and recently, growth estimates have been revised downwards.
- The expressed will of the British people to leave the European Union increases the uncertainty regarding the economic environment and it can be expected that the decision will have a negative impact on the recovery process.
- Driven by the European Central Bank (ECB)'s QE program, NFC's cost of borrowing continues to decline and has currently reached record lows, but Euro-aggregates mask significant country-level differences in the costs of finance.
- In line with the general economic environment the SME business climate also improved, however, policy uncertainty continues to weigh on SMEs' investment decisions.
- Although aggregate borrowing costs remain low, SMEs face higher costs than large firms – a phenomenon which is persistent over time and observed in nearly all European countries.
- According to the latest ECB SAFE survey a significant portion of European SMEs continues to consider access to finance to be an important problem, although the situation improved marginally over the second half of 2015.
- In line with the spirit of the European Commission's plan to establish a Capital Markets Union, the financing landscape for SMEs is changing. Although banks remain to be the main external financing sources for SMEs, alternative financing instruments - often but not exclusively driven by Fintechs - are gaining importance (including crowdfunding, debt funds, etc.).

¹ This paper benefited from comments and inputs by many EIF colleagues, for which we are very grateful; we would like to express particular thanks to Francesco Battazzi, Alicia Boudeau, Laurent Braun, Rémi Charrier, Per-Erik Eriksson, Daniela Francoviccio, Ulrich Grabenwarter, Giovanni Inglisa, Carsten Just, Marco Natoli, Silvia Manca, Pablo Millan Cantero, George Passaris, Dario Prencipe, Angelo Salvatore, Simone Signore, Matteo Squilloni, Tanja Tanayama and Arnaud Vanbellingen. We would also like to thank colleagues from AECM, Collier Capital, the ECB, EMN, Euler Hermes, Eurochambers, the Invest Europe research team, Go4Venture Advisers, Leaseurope and the UEAPME study unit for their support. All errors are of the authors.

² We are using the term "equity finance" to combine semantically the areas of Venture Capital and Private Equity. However, if we refer here to equity activities, we only consider those of EIF's investment focus, which includes neither Leveraged Buyouts (LBOs) nor Public Equity. The reader is also referred to the Private Equity glossary in Annex 1.

³ The term SME Securitisation (SMESec) comprises transactions backed by SME loans, leases, etc.

Private equity:

- Following the severe crash of European private equity (PE) investment in 2008/2009, it had partially rebounded over 2010-2011. Following a setback in 2012, the recovery continued in 2013 and 2014, albeit at lower levels. In 2015, investments by PE funds located in Europe increased by 13%, compared to the year before, to EUR 47.4bn, according to Invest Europe data. At the same time, venture capital (VC) investments increased by 11% to EUR 4.0bn.
- Some of the gap left by the slump in VC investment after 2008 has been filled in by business angel activity in recent years; their proximity to the market has been beneficial during this difficult period.
- In 2015 total funds raised by PE firms located in Europe slightly decreased by 1% to EUR 47.6bn, compared to the year before and according to Invest Europe data. However, they are well above the levels of the crisis years 2009-2012. In the VC segment, fundraising increased by 8% to EUR 5.3bn
- The exit markets have remained remarkably strong in 2015. In the previous two years, Invest Europe statistics had already recorded the highest PE divestment amounts ever. In 2015, total divestments by PE firms located in Europe recorded another increase, i.e. by 3% to EUR 41.0bn. However, there are warning voices of potential overheating, and downward adjustments have already been observed in some market segments.
- Despite the recent generally positive developments, as mentioned above, PE and VC investment and fundraising activity as well as the number of PE and VC funds are still far below the levels that were reached in the pre-crisis years. According to the Invest Europe figures, government agencies accounted for 31% of total VC fundraising in 2015, thereby continuing to support the market recovery.

SME Guarantees:

- Credit guarantees continue to be “the most widely used instrument [...] to ease SME access to finance” and to alleviate related market failures (OECD, 2016).
- AECM statistics show that Italy and France exhibit the largest volume and number of outstanding SME guarantees. Related to GDP, Italy and Portugal have the largest markets. According to the OECD (2013), guarantees are particularly relevant “in those countries where a network of local or sectoral guarantee institutions is well established”.
- For 2015, AECM preliminary data reports a considerable increase in total guarantee issuance. The new guarantee activity was strongest, related to GDP, in Hungary, Portugal, Italy, Poland and Turkey.

SME Securitisation:

- Despite the financial and sovereign crisis, the European securitisation market has performed relatively well so far, with the SME segment showing low default rates.
- In terms of new issuances, the SMESec market is still relatively weak. The issued volume of SME deals in 2015 was only EUR 27bn, representing 13% of the overall securitisation issuance. Retention rates remained very high (for SMESec 94% in 2015).

- Overall, the SMESec market in Europe is underdeveloped and strengthening this market can be an effective way to facilitate the flow of funds to the real economy, while not creating too much distortion.
- The reputation of the SME securitisation market segment is improving; a de-stigmatisation is happening, and the general perception is shifting towards a means that could help overcome negative effects of the crisis.
- Although the fog is slowly lifting, regulatory uncertainty is still to be seen as the main impediment and negative spill-overs from a non-holistic regulation approach lead to unintended consequence that hinder market development.
- Reasonably defined criteria for high quality securitisations might be a way out of the current dilemma. However, at the earliest, new securitisation regulation can only be expected towards the end of 2017 and first 'quality-labelled' transactions will not happen before 2018.

Microfinance:

- Microenterprises are important contributors to employment. Especially in countries with high unemployment rates, microenterprises act as a driving force fostering job creation. However, their overall business environment remains relatively unfavorable compared to their larger peers.
- According to the data from the latest ECB SAFE survey, microenterprises have perceived an increase in the external financing gap indicator. Moreover, the share of enterprises which see access to finance as their most important problem remained higher among microenterprises than among their larger peers.
- Access to finance is crucial not only for existing microenterprises, but also for those who are eager to create a business in order to escape poverty or unemployment and contribute to job creation. Aside the financial support, unemployed people are often in need of acquiring the necessary skills for success through coaching and mentoring.
- Microfinance is an important tool to overcome the effects of the crisis for some specific groups and in particular to support inclusive growth. Aside from these financial products and services, many European MFIs provide non-financial services as well.
- The recent EMN-MFC survey reports a remarkable growth both in the overall total value and the number of microloans provided by the surveyed Microfinance Institutions.

Table of contents

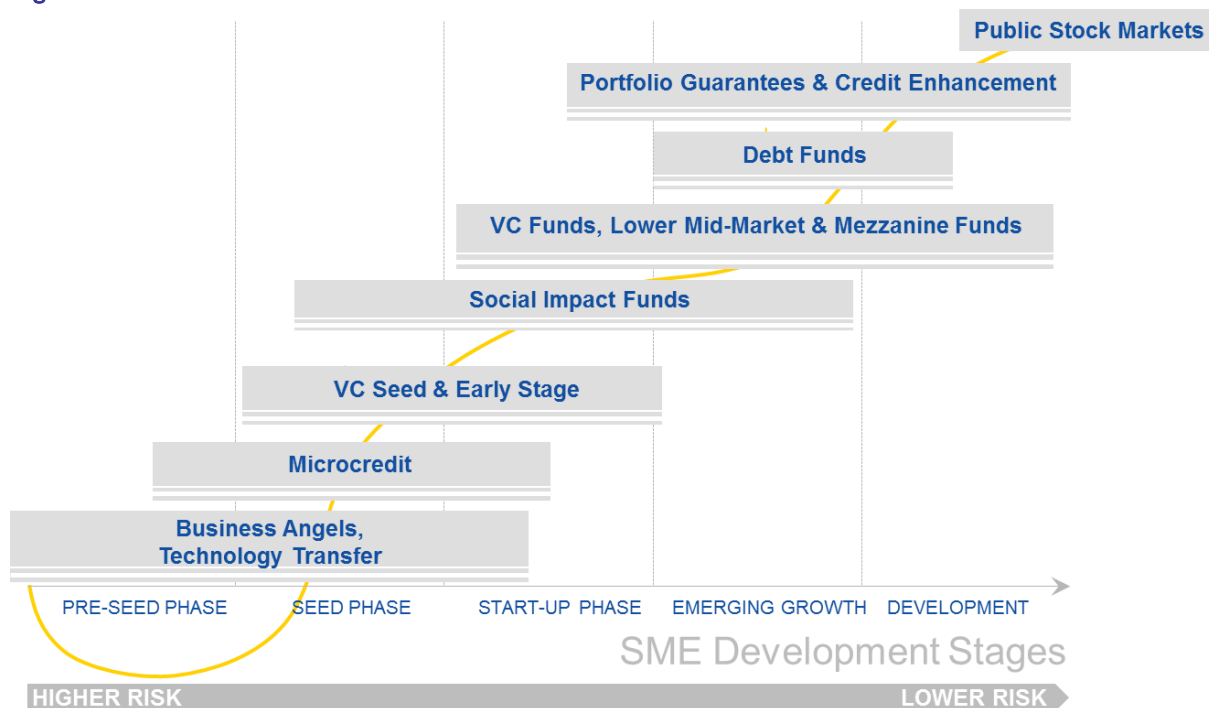


<i>Executive summary</i>	iii
<i>Table of contents</i>	vi
1 Introduction	1
2 General economic environment	2
2.1 Economic outlook	2
2.2 Financial environment	3
3 Small business economic environment	5
3.1 SME's economic outlook.....	5
3.2 SME's financial environment	8
3.2.1 Borrowing costs	11
3.2.2 SME financing from a supply perspective	14
3.2.3 SME financing from a demand perspective.....	20
4 Private equity	28
4.1 Investment activity	28
4.1.1 Private equity funds	28
4.1.2 Business angels	31
4.2 Fundraising activity.....	33
4.3 Divestment activity.....	38
4.4 Lower mid-market and hybrid debt/equity finance: An important market segment.....	39
4.5 PE prospects.....	40
5 SME guarantees and SME Securitisation in Europe	46
5.1 SME guarantees.....	46
5.1.1 Market failure and policy response	46
5.1.2 Market size and activity in 2015.....	49
5.2 SME Securitisation.....	52
5.2.1 SMESec market activity.....	54
5.2.2 SMESec prospects.....	61
6 Microfinance market	67
6.1 Microfinance and social inclusion.....	67
6.1.1 What is Microfinance?	67
6.1.2 A support tool for necessity-driven business creation	68
6.2 The demand for microfinance: microenterprises and their finance decisions	74
6.3 The supply of microfinance: a sector characterised by significant diversity.....	76
6.4 The microenterprise financing gap.....	78
6.5 Microfinance prospects	81
7 Concluding remarks	83
ANNEX	88
Annex 1: Private Equity Glossary	88
Annex 2: Securitisation Glossary	91
Annex 3: List of acronyms.....	92
References	96
About	103
... the European Investment Fund	103
... EIF's Research & Market Analysis	103
... this Working Paper series	103
EIF Working Papers.....	104

1 Introduction

The European Investment Fund (EIF) is the European Investment Bank (EIB) Group’s specialist provider of risk financing for entrepreneurship and innovation across Europe, delivering a full spectrum of financing solutions through financial intermediaries (i.e. equity instruments, guarantee and credit enhancement instruments, as well as microfinance). Figure 1 illustrates the range of EIF’s activities:

Figure 1: EIF tool kit for SMEs



Source: EIF

The EIF focuses on the whole range of micro to medium-sized enterprises, starting from the pre-seed, seed-, and start-up-phase (technology transfer, business angel financing, microfinance, early stage VC) to the growth and development segment (formal VC funds, mezzanine funds, portfolio guarantees/credit enhancement).

Against this background, the European Small Business Finance Outlook (ESBFO) provides an overview of the main markets relevant to EIF (equity⁴, guarantees, securitisation, microfinance). The present edition is an update of the ESBFO December 2015.

We start by discussing the general market environment, then look at the main aspects of equity finance and the SME guarantees, specifically the SME Securitisation (SMESec) markets. Finally, we briefly highlight important aspects of microfinance in Europe.

⁴ Please see footnote 2 concerning the term “equity finance”.

2 General economic environment

2.1 Economic outlook

Since the publication of the previous ESBFO in December 2015, the global economic outlook has worsened slightly. For 2016, the IMF (2016) revised its predictions for global growth downwards by 0.2 percentage points to 3.2%. The European Commission (EC) on the other hand marginally updated its EU growth projections for 2015 upwards (Table 1), expecting a positive growth rate of 2% for 2015 (revised upwards from 1.9%). Economic growth is expected to slightly weaken over the following two years. The expressed will of the British people to leave the European Union increases the uncertainty regarding the economic environment and it can be expected that the decision will have negative consequences for the recovery process. These effects are not yet fully considered in the forecasts, shown here.

The European labour market continues to perform strongly. After entering single-digit territory in 2015, the unemployment rate is expected to decline further to 8.5% in 2017. Also other macro-aggregates are performing well: in 2015 government debt levels reversed their increasing trend and budget deficits shrank, trends which are expected to continue in 2016 and 2017. Investment levels have risen in 2015. Inflation however remains very low, as price levels are forecasted to remain constant throughout 2015 and increase only marginally in 2016. The ECB's policies are expected to trickle down to the real economy only in 2017, when the rate of inflation is expected to pick up significantly to 1.5%.

Table 1: European Commission spring 2016 forecast for the EU

(Real annual percentage change, unless otherwise stated)				Spring 2016 estimates / forecasts		
	2012	2013	2014	2015	2016	2017
GDP	-0.5	0.2	1.4	2.0	1.8	1.9
Private consumption	-0.6	-0.1	1.2	2.0	2.1	1.8
Public consumption	0.1	0.3	1.2	1.4	1.5	1.2
Gross fixed capital formation	-2.5	-1.7	2.7	3.4	3.0	3.8
Employment	-0.6	-0.4	1.0	1.1	1.0	0.9
Unemployment rate (a)	10.5	10.9	10.2	9.4	8.9	8.5
Inflation (b)	2.6	1.4	0.5	0.0	0.3	1.5
Government balance (% GDP)	-4.2	-3.2	-3.0	-2.4	-2.1	-1.8
Government debt (% GDP)	85.1	87.3	88.5	86.8	86.4	85.5
	Contribution to change in GDP					
Private and Public Consumption	-0.3	0.1	0.9	1.4	1.5	1.2
Investment and Inventories	-1.3	-0.1	0.5	0.7	0.7	0.8
Net exports	1.1	0.3	-0.1	-0.1	-0.3	0.0

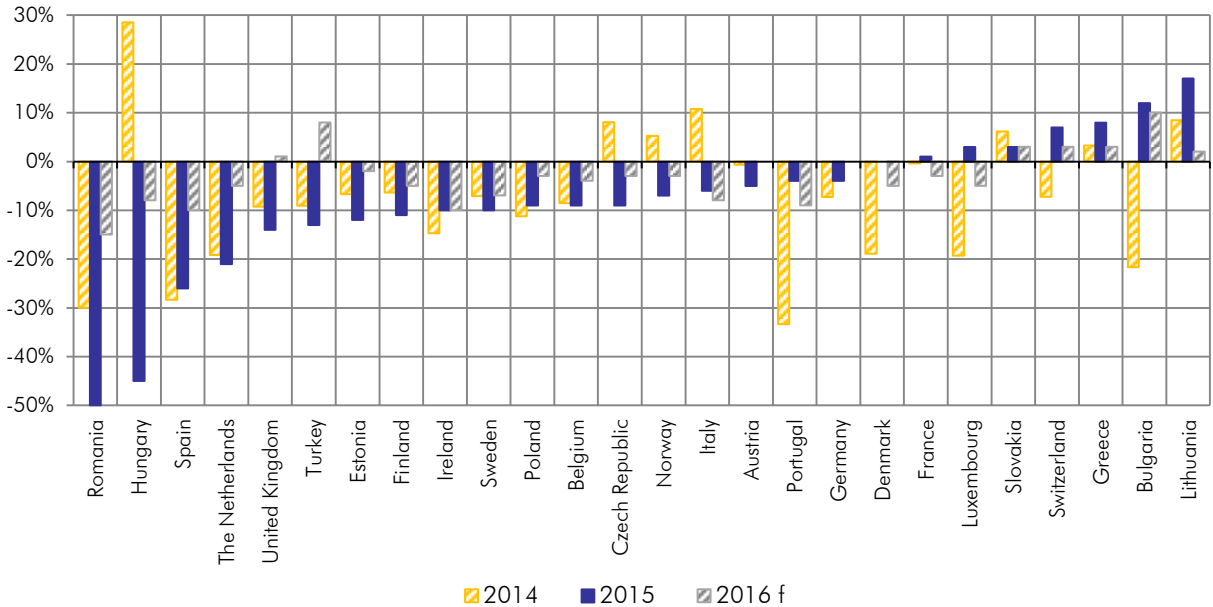
(a) Percentage of the labour force.

(b) Harmonised index of consumer prices (HICP), annual percentage change.

Source: European Commission (2016b)

European insolvencies further decreased in 2015. The Euler-Hermes Insolvency Index (Euler Hermes, 2016), which measures the year-to-year percentage change in the number of insolvencies, registered a decrease in the number of Western European insolvencies by 13%. Also in Central and Eastern Europe insolvencies declined further (-11%). Figure 2 plots the index for different European countries and shows how the regional aggregates conceal a significant amount of spatial heterogeneity. Within most of the Eurozone, the number of insolvencies either dropped significantly or stabilised in 2015, but not all Eurozone countries recovered equally well. Greece recorded an increase in the number of insolvencies by 8%, but also Luxembourg experienced a marginal increase. Apart from Greece, the worst performers in the EU were Bulgaria and Lithuania. Interestingly, also Switzerland did not perform well, a likely consequence of the removal of their currency cap vis-à-vis the Euro which led to a deterioration in the competitive position of their export sector.

Figure 2: Rate of change in insolvency, 2014-2016



Note: 2016 f = forecast for 2016

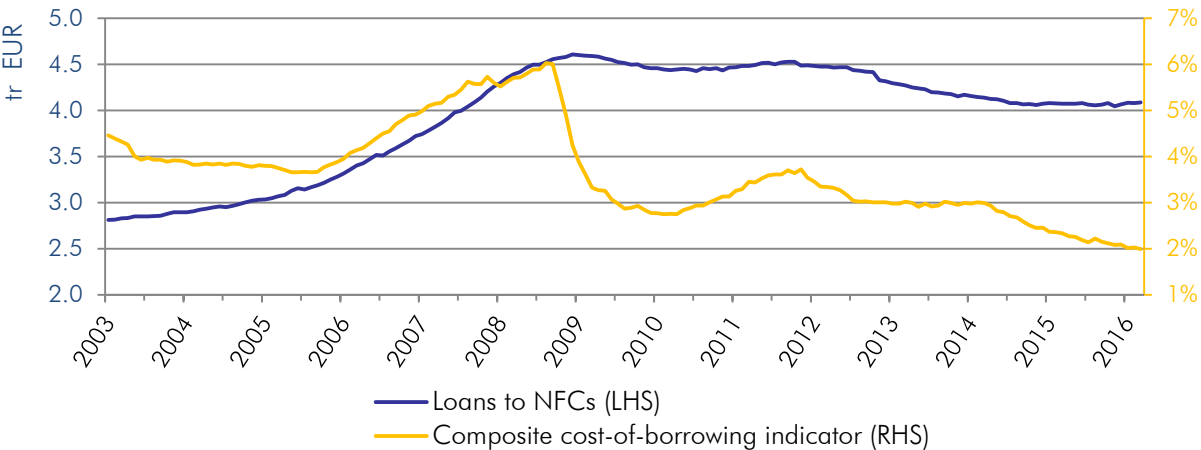
Source: Euler Hermes (2016)

2.2 Financial environment

Figure 3 illustrates the borrowing costs and evolution of outstanding loans to NFCs. Borrowing costs have continued to decline: by March 2016, the cost indicator reached a record low, dropping an additional 32 basis points from its year-to-year 2015 level. The continuous decline in borrowing cost did not get reflected in a definite trend reversal in the evolution of the amount of outstanding loans to NFCs, which remained stagnant and has been hovering right above the EUR 4 trillion thresholds for the past two years. It is clear that, even though the decline in outstanding loans that set in after the crisis has found a bottom, any conclusions about a definite trend reversal are still premature.

The aggregate cost-of-borrowing indicator illustrated in Figure 3 masks a significant amount of underlying country heterogeneity within the Euro Area. The between-country divergence in NFCs borrowing costs was triggered by the financial crisis (European Commission, 2013). Figure 4 illustrates this country heterogeneity and shows the evolution of national borrowing costs between April 2015 and April 2016. In line with the European trend, NFCs in most European countries experienced a decrease in the cost of borrowing during that period. This decrease was particularly pronounced in Slovenia and Portugal. Against the European trend, the cost of borrowing to NFCs increased in three countries: two Baltic states (Lithuania and Estonia) and Malta, which resulted in the latter surpassing Greece and Cyprus to lead the European ranking. The higher cost of borrowing implies countries like Malta, Greece, Cyprus and Portugal face a competitive disadvantage on export-markets, compared to countries in which SMEs have access to cheaper credit, like Luxembourg, the Netherlands, Finland or Austria.

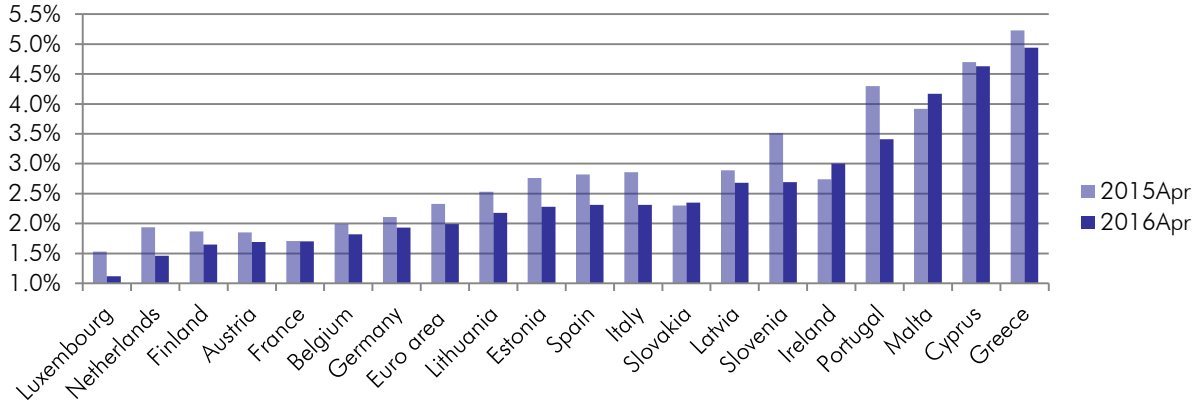
Figure 3: Outstanding loans and composite cost-of-borrowing indicator for non-financial corporations in the Euro Area (until April 2016)



*The composite cost indicator is a volume-weighted average of interest rates on new loans with different maturities. For an elaborate overview of the methodology, see ECB (2013)

Source: ECB Data Warehouse

Figure 4: Cross-country heterogeneity in borrowing costs of NFCs



Source: ECB Data Warehouse

3 Small business economic environment

3.1 SME's economic outlook

SMEs are defined by the European Commission⁵ as having fewer than 250 employees. In addition, they are required to have an annual turnover that does not exceed EUR 50m, or a balance sheet total of no more than EUR 43m:

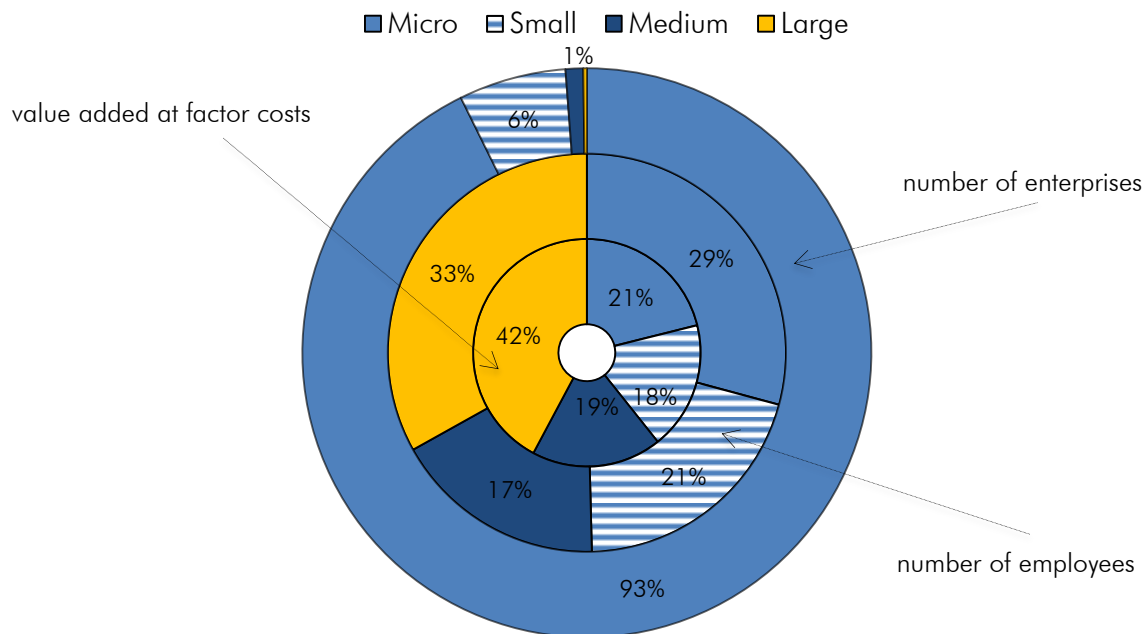
Table 2: EU definition of SMEs⁶

	Employees	Turnover	Balance sheet total
Micro	<10	≤ EUR 2m	≤ EUR 2m
Small	<50	≤ EUR 10m	≤ EUR 10m
Medium-sized	<250	≤ EUR 50m	≤ EUR 43m

Source: European Commission (2015a)

Small and medium-sized enterprises contribute significantly to job creation and economic growth. In 2014, more than 22.3 million SMEs in the European Union made up 99.8% of all non-financial enterprises, employed 90 million people (66.9% of total employment) and generated 57.8% of total added value (EUR 3,700bn), (see Figure 5).

Figure 5: SMEs, employment and value added in the EU, 2014



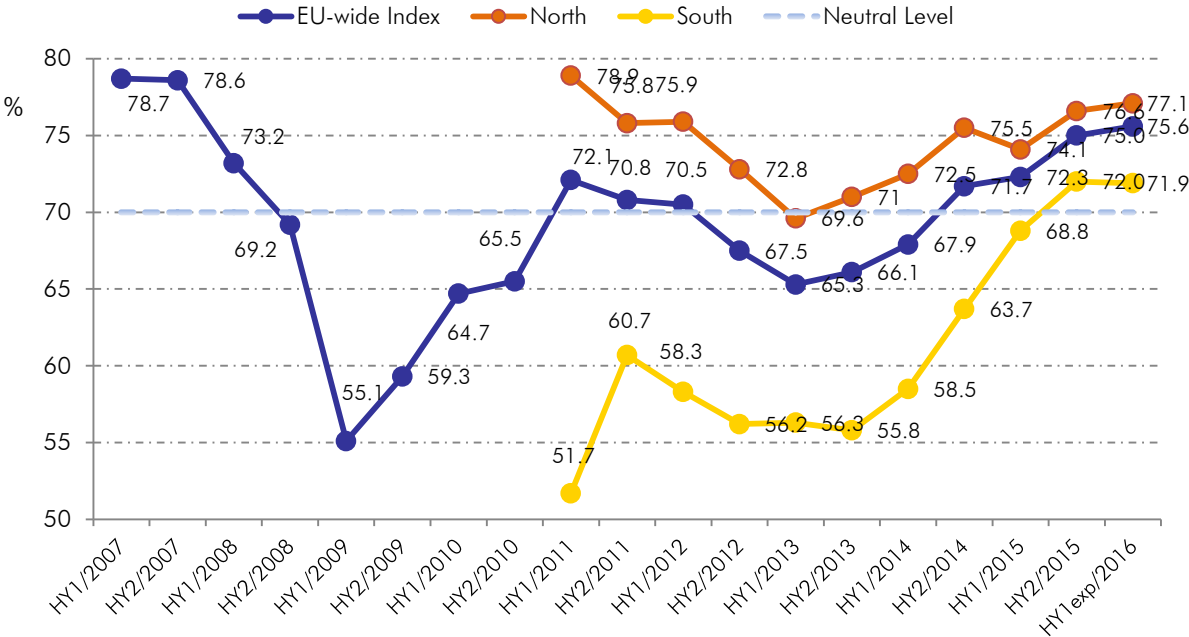
Source: European Commission (2015a)

⁵ Commission Recommendation of 6 May 2003.

⁶ In the context of defining enterprise categories, often also the category of mid-caps is mentioned in between the categories of SMEs and corporates. We define mid-caps as enterprises with a minimum of 250 and a maximum of 2,999 employees; moreover, there is the sub-category of small mid-caps, with a maximum of 500 employees.

In line with the general economic predictions of the EC, the UEAPME study unit (2016) concludes that the SME business climate continues its gradual path to recovery. The upward trend in the EU-wide SME business climate index⁷ (Figure 6) is mainly driven by evolutions in the North/Centre⁸ of Europe. In the Southern/Peripheral⁹ countries the recovery in the SME business climate stagnated during the first half of 2016, after a strong improvement in the previous semester. This implies the convergence between North and South that set in begin 2013 has come to a halt.

Figure 6: SME Business Climate Index



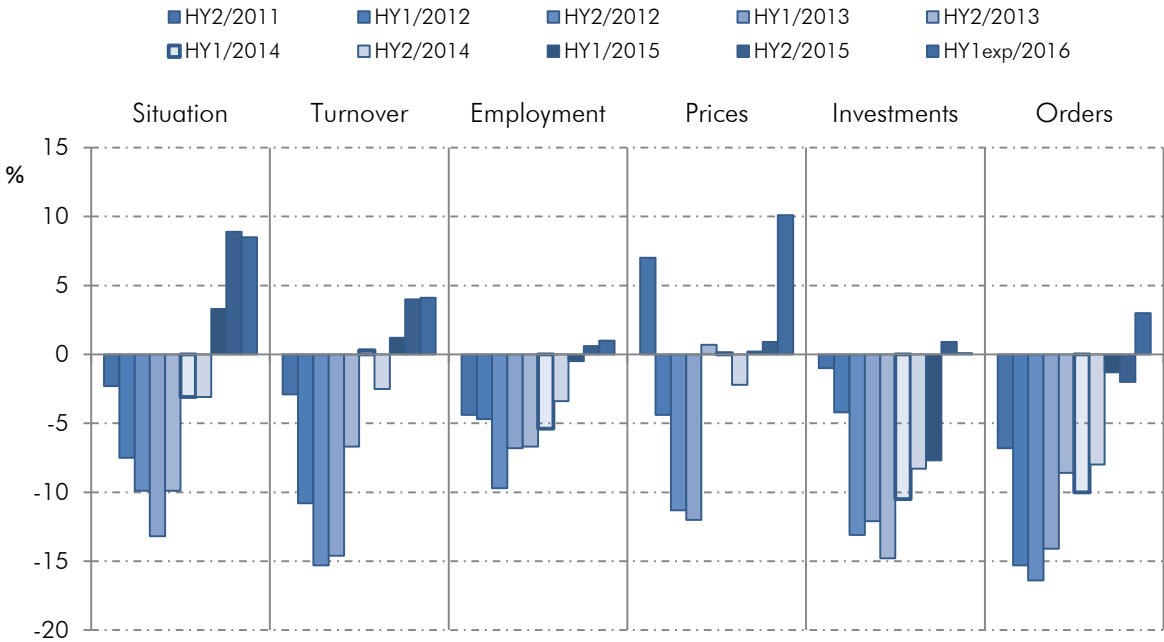
Source: UEAPME Study Unit (2016)

Based on surveys conducted by member organisations, UEAPME constructs the semi-annual EU Craft and SME Barometer. The Barometer provides information on SMEs’ perception on the current and future economic environment. Figure 7 plots net responses¹⁰ for a number of different economic indicators, such as the overall economic situation, turnover, employment, prices, investments and orders. During the second half of 2015, SMEs were generally positive about the overall economic situation they were facing, in line with their expectations during the previous semester. This optimism seems primarily driven by strong turnover figures. The negative expectations for the investment climate during the second half of 2015 did not materialise: SMEs actually reported a net positive improvement. SMEs are carefully optimistic about the near economic future. Interestingly, for the first half of 2016 SMEs expect that the ECB’s renewed QE efforts will be reflected in an improvement of the general economic situation and the price level, while remaining neutral on the anticipated investment climate.

⁷ The UEAPME SME Business Climate Index is calculated as the sum of positive and neutral answers with regards to the overall situation for the business, averaged over the current situation and the expectations for the next period.
⁸ Austria, Belgium, Bulgaria, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Romania, Slovakia, Sweden and UK.
⁹ Croatia, Cyprus, Greece, Ireland, Italy, Malta, Portugal, Slovenia and Spain.
¹⁰ The net response is calculated as the share of positive minus negative responses.

The results of the recent Eurochambres (2016) Economic Survey¹¹ largely confirm the conclusions of the UEAPME survey. According to this study domestic demand, employment and exports all show signs of improvement during 2016. General business confidence and investments, however, are expected to decline. Both the UEAPME survey as well the Eurochambres survey reveal a general sense of scepticism with regards to the investment climate SMEs are currently facing. A possible cause of this could be the current political climate in the European Union. A recent study by Gulen and Ion (2015) showed how policy uncertainty can depress corporate investment by inducing precautionary delays due to investment irreversibility. The pending Brexit and continued woes about Greece’s financial situation continue to cast doubt on the future composition of the European Union, which is likely to negatively affect firms’ investment behaviour. This is confirmed by the results of a Deloitte survey among British companies, whose finance directors reported to postpone investment decisions given the possibility of Britain leaving the European Union (Deloitte, 2016). The outcome of the British referendum significantly adds to this uncertainty and hence is likely to affect employer’s investment behaviour further.

Figure 7: Main Results of the EU Craft and SME Barometer HY2/2015



Source: UEAPME Study Unit (2016)

¹¹ The Eurochambres Economic Survey is a European qualitative survey of business expectations for the year ahead. Conducted annually by the Chambers of Commerce and Industry, and coordinated by Eurochambres, the survey records the expectations of approximately 59,000 businesses in EU Member States and EU Candidate Countries on six economic indicators: business confidence, domestic sales, export sales, employment & investment. The Eurochambres Economic Survey has been conducted since 1993. For details on the methodology see Eurochambres (2016).

3.2 SME's financial environment

Box 1: A new composite indicator for SME financing in Europe

Over recent years, composite indicators have become a popular monitoring tool for policy makers. Composite indicators summarise large amounts of information related to different dimensions of a single economic phenomenon in one single statistic. This makes it easy to perform cross-country benchmarking or track time evolution and to communicate this complex information to the public (OECD, 2005). However, composite indicators have to be interpreted with a certain degree of caution, thereby always taking into account the underlying data and methodologies in order to avoid misinterpretations.

Under the framework of a Capstone project, five students from the London School of Economics' (LSE) Master of Public Administration program investigated the strengths and weaknesses of current composite indicators for SMEs.¹² Three major composite indicators/studies on SMEs' access to finance were evaluated: the SME Access to Finance Index (SMAF), the Perceived External Financing Gap Indicator for SMEs (Gap), and the OECD Scoreboard "Financing SMEs and Entrepreneurs".

Based on their assessment, the LSE students, in close cooperation with the Research and Market Analysis team of the EIF, produced a comprehensive report in which they propose the construction of a new SME financing indicator. The team leveraged on an extensive literature review in order to determine an optimal approach to improve upon the existing finance indicators. Three key decisions were made pertaining to (1) selection of sub-indicators, (2) a normalization method, and (3) allocation of weights and aggregation method for the respective sub-indicators.

(1) Selection of sub-indicators. This is a defining step as it determines the building blocks of the composite indicator. Sub-indicators must first and foremost have significant explanatory power vis-à-vis the measured phenomenon. Furthermore, the underlying data sources should meet a number of criteria pertaining to timeliness, accessibility, and data quality. The EIF composite indicator is built on three "building blocks" of SME finance, for which there is a sufficient amount of quality data available. Three sub-indicators related to three financing instruments were included: loans, credit and leasing, and equity finance. These are the most important sources of finance for SMEs in terms of volume and reach. In addition, a sub-indicator was added reflecting macro-economic conditions. Ultimately, a set of 19 time series were included and grouped into four sub-indices: loans, credit and leasing, equity and macro factors:

Loans:

- Percentage of SMEs using bank loans in last 6 months
- Percentage of SMEs using grants or subsidised bank loans in last 6 months
- Percentage of SMEs with rejected loan applications or unacceptable offers
- Percentage of SMEs not applying for a bank loan because of possible rejection in last 6 months
- Interest rate for loans under EUR 250k (floating rate with interest rate fixation (IRF) up to 1 year)
- Interest rate spread (under EUR 250k vs over EUR 1m for floating rate with IRF up to 1 year)
- Percentage of SMEs that "applied for bank loans, and received less than 75% of the amount"

¹² More information about Capstone projects is available on the LSE website: <http://www.lse.ac.uk/IPA/MPA/capstones/CapstoneProjects.aspx>. We thank the LSE team members Bonggyu Chae, Chavi Meattle, Jacob Simunovic, Li He and Mari Landsem and supervisor professor Stephen Jenkins.

Box 1 continued:

Equity:

- Venture Capital Investments / GDP
- Venture capital availability index
- Value of IPO market / GDP
- Percentage of SMEs using equity capital in last 6 months

Credit and Leasing:

- Percentage of SMEs using bank overdraft, credit line, or credit card overdraft in last 6 months
- Percentage of SMEs with rejected overdraft, credit line or card overdraft applications in last 6 months
- Percentage of SMEs not applying for the above because of possible rejection in last six months
- Percentage of SMEs using leasing or hire-purchase in the last 6 months
- Median interest rate charged to SMEs for credit line or bank overdraft application in last 6 months
- Percentage of SMEs that applied for the above but received less than 75% of the requested funds

Macro Factors:

- Gap between actual and potential GDP
- Strength of legal rights index
- Depth of credit information index
- Availability of financial services index
- Bank non-performing loans to total gross loans
- Percentage of SMEs "feeling that there are no financing obstacles"

(2) Determining a normalisation method. Normalisation puts sub-indicators on a comparable scale, to avoid adding up apples and oranges. This step tends to have only a small first-order impact on the composite indicator. Nevertheless, weighting is inherently subjective. Hence, transparency about the chosen methodology is warranted. The type of selected sub-indicators, data analysis, and specific needs of the composite indicator led to the selection of the "distance from the minimum and maximum" method to proceed with the normalisation of the sub-indicators.

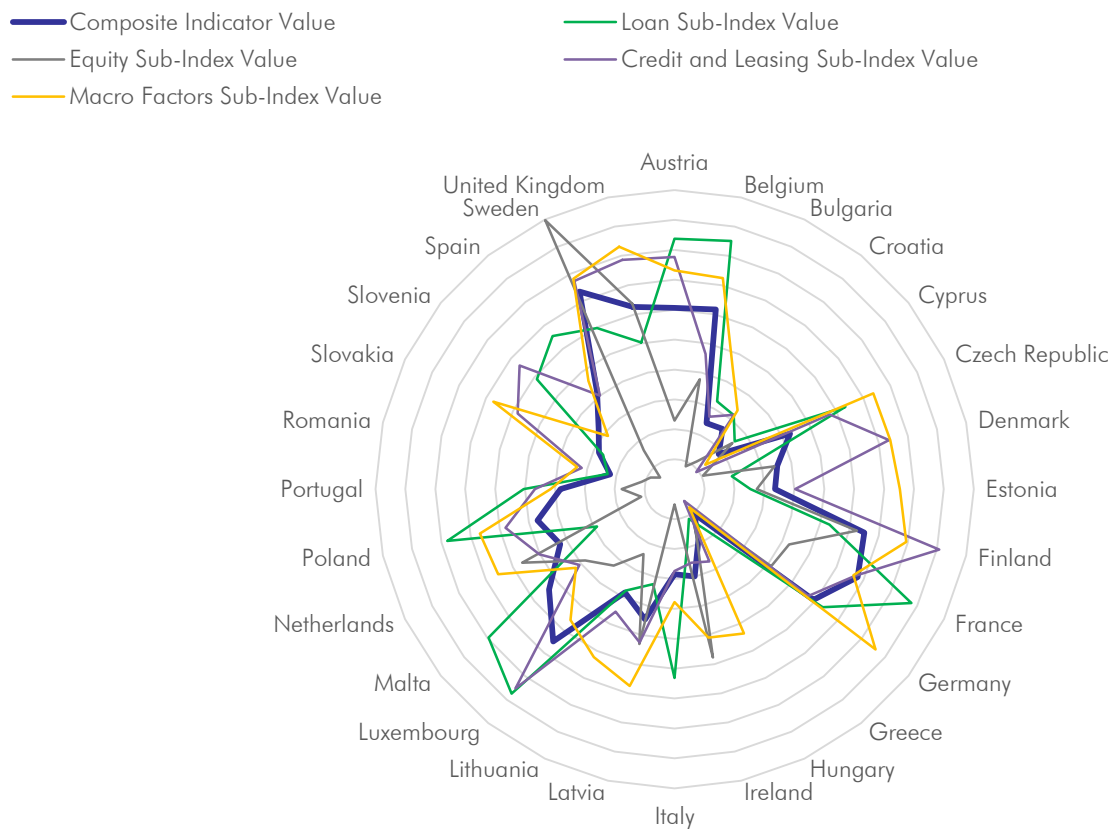
(3) Allocating sub-indicator weights to proceed with aggregation of the sub-indicators. The team identified three categories of weighting methods: equal weighting, participatory weighting, and statistical weighting. The choice was made to rely on participatory weighting methods, leveraging on EIF's in-house expertise with respect to SME financing to determine the appropriate weights for each of the four sub-indicators. Geometric aggregation was applied as the baseline aggregation methodology. This relatively straightforward method ensures that countries that score well on the composite indicator do so by performing broadly well on multiple sub-indicators simultaneously, instead of just performing exceptionally well on a single sub-indicator. Figure B.1 illustrates the results of this exercise.

Box 1 continued:

Overall, the results are in line with intuition. For example, those countries that have been intensely affected by the recent European debt crisis, score relatively poorly in the index. However, the results also reveal some outcomes that are at first glance somewhat unexpected. In such cases, a closer look at the underlying data can provide helpful explanation. To provide some additional insight into the drivers of the composite index, Figure B.1 also illustrates the outcomes for the different subindicators. This reveals for example that the ranking of Sweden is to a large extent driven by a very high score on the equity subindex, while the country scores less high on other subindices. The new composite indicator has undergone a series of sensitivity analyses (with regard to changes in aggregation, normalisation, weighting and sub-indicators), the results of which are largely encouraging (for example, the rankings created by the adjusted composite indicators are broadly in line with the baseline indicator).

While the static result of 2015 is interesting in its own right, EIF's primary intention is to develop an indicator which will allow to track the financing conditions for SMEs in the different European countries over time. Figure B.2 illustrates the results of this exercise as it graphs the evolution of the SME financing index over the years 2013, 2014 and 2015 for the EU-28 countries.

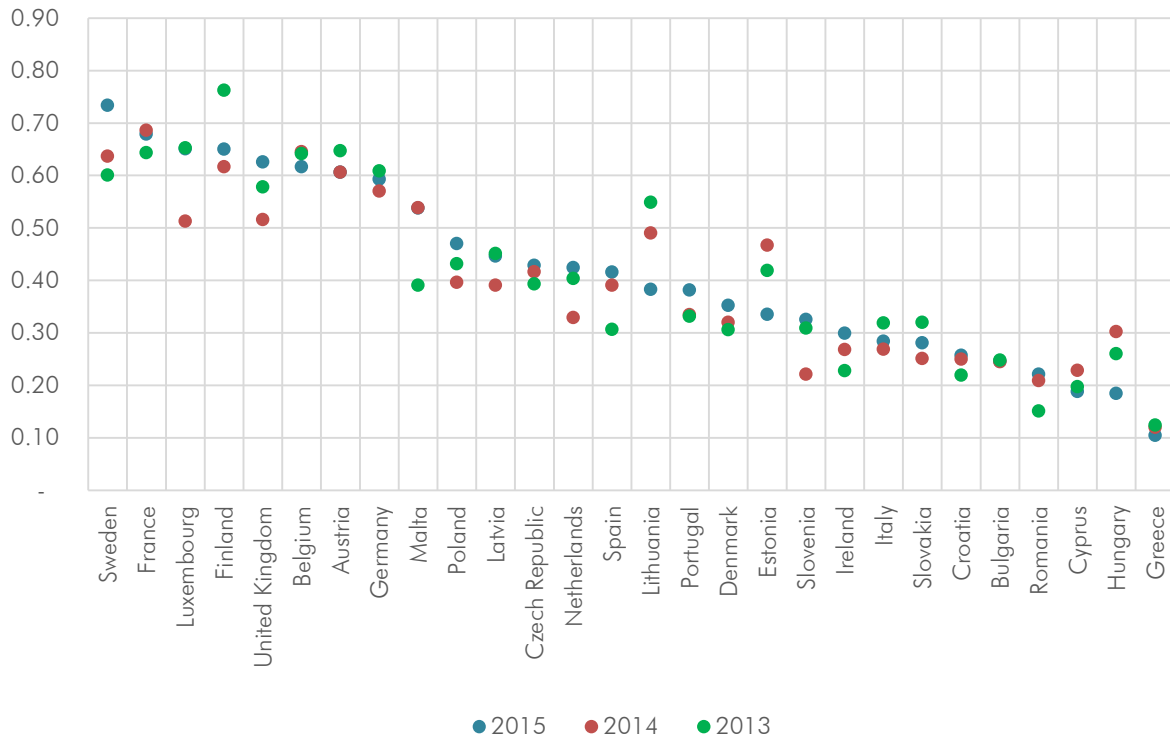
Figure B.1: The SME Finance Index:



Source: Capstone project SME financing indicator

Box 1 continued:

Figure B.2: The SME Finance Index: evolution over time

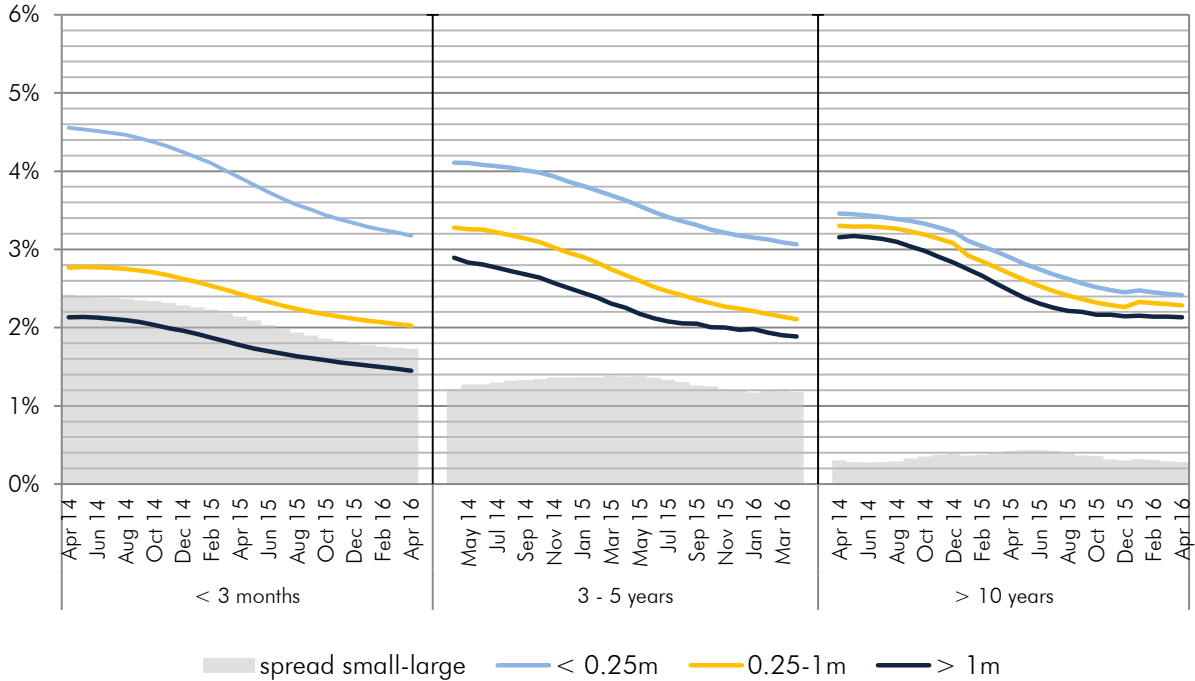


Source: Capstone project SME financing indicator

3.2.1 Borrowing costs

The interest rate is an important determinant of loan demand, as it determines investment financing costs. Figure 3 and Figure 4 illustrated that overall borrowing costs have been declining over the past few years, but large country-level heterogeneity exists. This section takes an in depth look at borrowing costs by using ECB information on interest rate levels and newly euro-denominated loan volumes to investigate in depth the financing conditions faced by SMEs. Although this information is not made available by firm-size, it is published for three distinct loan size categories: small loans (<EUR 0.25m), medium-sized loans (EUR 0.25m – EUR 1m) and large loans (>EUR 1m). Interest rate data is further subdivided according to loan maturity. Assuming smaller loans are predominantly used by smaller firms, one can use this information to defer some conclusions on the different lending conditions faced by firms from different size classes.

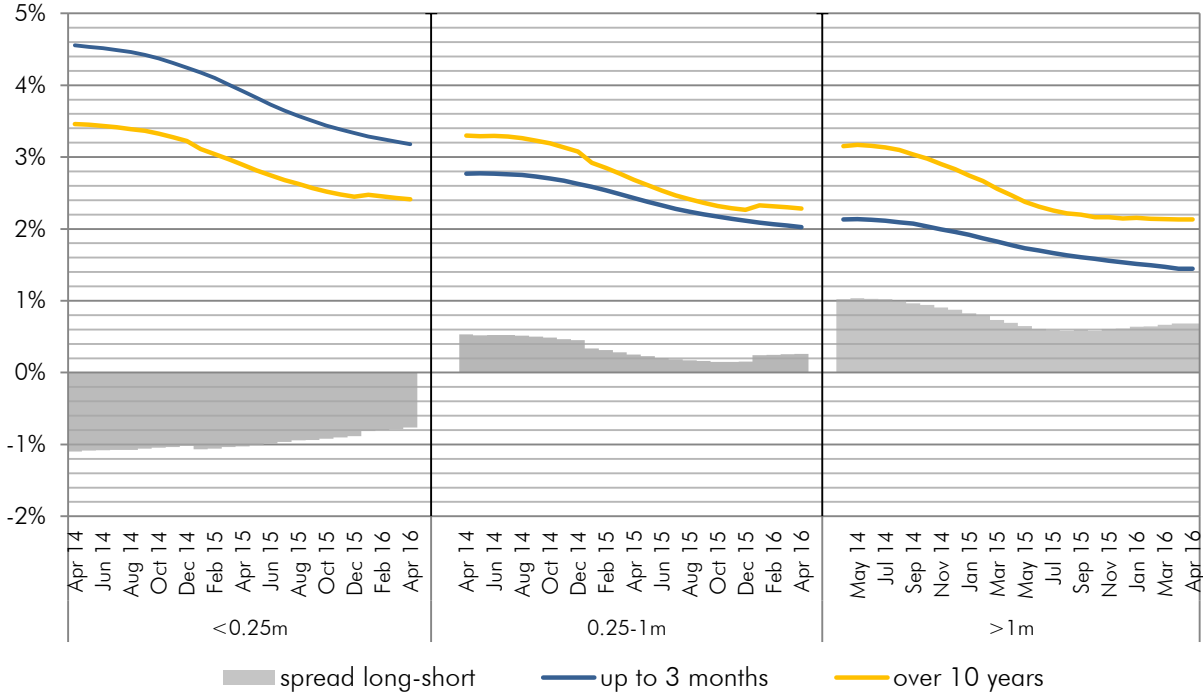
Figure 8: Interest rates by loan size and maturity, and the interest rate size spread – March 2014 to March 2016



*The graph depicts the 12 month backward moving average floating interest rates charged by banks on loans to NFCs (other than revolving loans and overdraft)
 Source: ECB Data Warehouse, authors' calculations

Figure 8 illustrates the evolution of interest rate levels for different loan sizes, by maturity, over the past two years. The graph highlights several interesting findings: First, over all maturities, small loans are burdened with a higher interest rate. This is somewhat surprising, as traditional finance theory suggests that, *ceteris paribus*, the risk of default increases with loan size (Stiglitz, 1972). Two factors could explain why the inverse relationship between loan size and the interest rate breaks down in the case of bank lending to NFCs. In the presence of fixed screening costs, small loans will carry a higher interest rate. Alternatively, smaller lenders could possess different characteristics (Moore and Craigwell, 2003), or use the borrowed funds for different, riskier, financing purposes, such as funding working capital, instead of long term investment projects. In particular loans with short maturities come with a large loan size spread, although this spread has been steadily declining. Since the publication of the previous Outlook (Kraemer-Eis et al, 2015b), interest rates for loans of all size classes have continued to decline. The decline was strongest for loans under EUR 0.25m. Third, Figure 8 exposes an anomaly in the maturity spread of small loans (see also Figure 9). As a general rule, liquidity decreases with loan maturity. Long term loans will therefore carry higher interest rates. This reasoning indeed holds for medium-sized and large loans. For small loans however, short term lending is actually most expensive. This could be explained by the presence of a fixed lending costs element, related to screening, or the specific characteristics of small lenders. This negative maturity spread is depicted in greater detail in Figure 9, which compares short term (<3 months) to long term (>10 years), for different loan sizes. The negative maturity spread for small loans has been normalising further over the past 6 months, however, further converging towards 0.

Figure 9: Interest rates by maturity and loan size and the interest rate maturity spread - March 2014 to March 2016

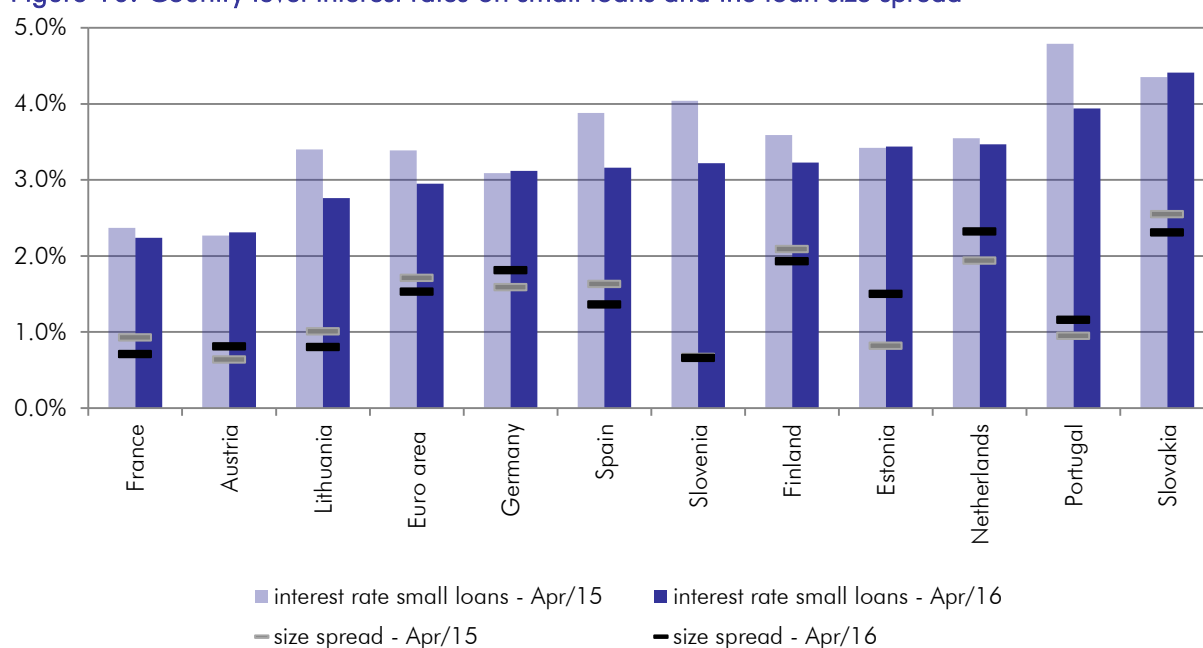


*The graph depicts the 12 month backward moving average of the floating interest rate charged by banks on loans to NFCs (other than revolving loans and overdraft)

Source: ECB Data Warehouse, authors' calculations

While overall financing costs for NFCs might be decreasing, Figure 10 indicates that the aggregates hide a significant amount of country-level heterogeneity. It plots the interest rate charged to NFCs on loans not exceeding EUR 0.25m for the selection of countries for which data was available, as well as the size spread, defined as the excess interest rate charged on loans smaller than EUR 0.25m compared to loans with a value exceeding EUR 1m. Between April 2015 and April 2016, the interest rates charged on small loans has decreased or stagnated in all countries for which data was available, but Austria. The interest rate increase in Austria was not an aggregate occurrence: in The Netherlands and Estonia the size spread increased significantly, and to a lesser extent in Austria, Germany and Portugal. Per April 2016, small borrowers have access to the cheapest credit in France and Austria, while small loans are most expensive in Slovakia and Portugal. The size spread is lowest in Slovenia, France and Lithuania, and highest in Slovakia and the Netherlands. In line with the observations made in the previous edition of the Outlook (Kraemer-Eis et al, 2015b), the interest rate size spread continues to increase in the Netherlands, further deteriorating Dutch SMEs' relative financing conditions.

Figure 10: Country level interest rates on small loans and the loan size spread*



* The spread is calculated as the percentage point difference between loans exceeding EUR 1m and loans smaller than EUR 0.25m. Countries for which there was no sufficient data are omitted.

Source: ECB Data Warehouse, authors' calculations

In conclusion, while overall borrowing costs continue to decline, the financial environment faced by firms differs significantly between countries. This holds especially true for small firms, as evidenced by diverging financing costs for SMEs, who often need access to smaller loans, and large differences in the size spread of borrowing costs.

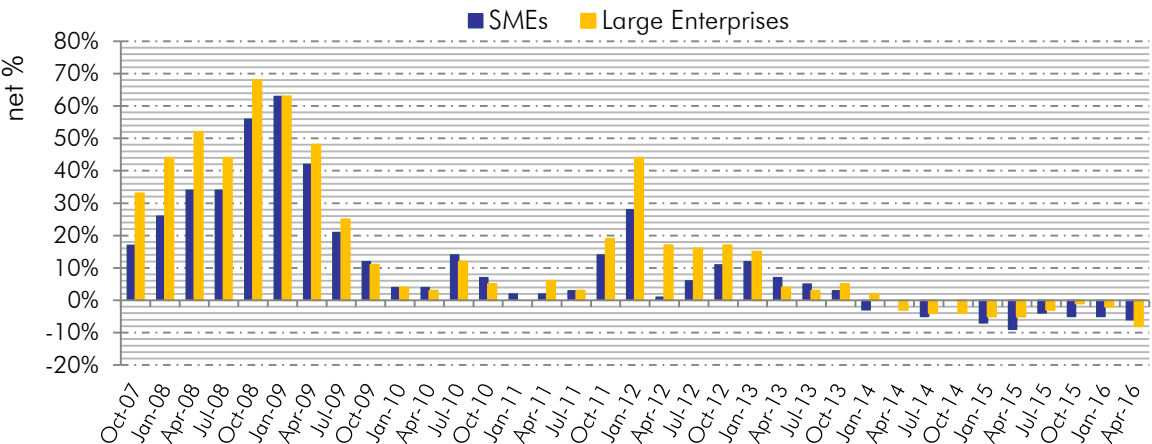
3.2.2 SME financing from a supply perspective

The ECB's latest Bank Lending Survey (ECB, 2016b)¹³ allows analysing the current state of the SME lending market from the perspective of the banks. This supply-side survey informs about banks' perception on credit standards applied to NFC-lending. This information is reported for different firm-size classes. Figure 11 illustrates how banks perceive the change in credit standards they uphold for NFCs applying for a loan.¹⁴ It plots the quarterly net change in credit standards, calculated as the difference between the sum of the percentages of banks responding "tightened considerably" and "tightened somewhat", and the sum of the percentages of banks responding "eased somewhat" and "eased considerably". Over the last quarter of 2015 and the first quarter of 2016, credit standards continued to ease for both large and small firms for the ninth consecutive quarter. Credit standards loosened somewhat more for large firms than for SMEs in the first quarter of 2016.

¹³ This survey was conducted on 141 Euro Area banks and reports changes during the first quarter of 2016 (Q1/2016) and expectations of changes in the second quarter of 2016 (Q2/2016).

¹⁴ Banks are requested to answer the following question: 'Over the past three months how have your bank's credit standards as applied to the approval of loans or credit lines to enterprises changed?'

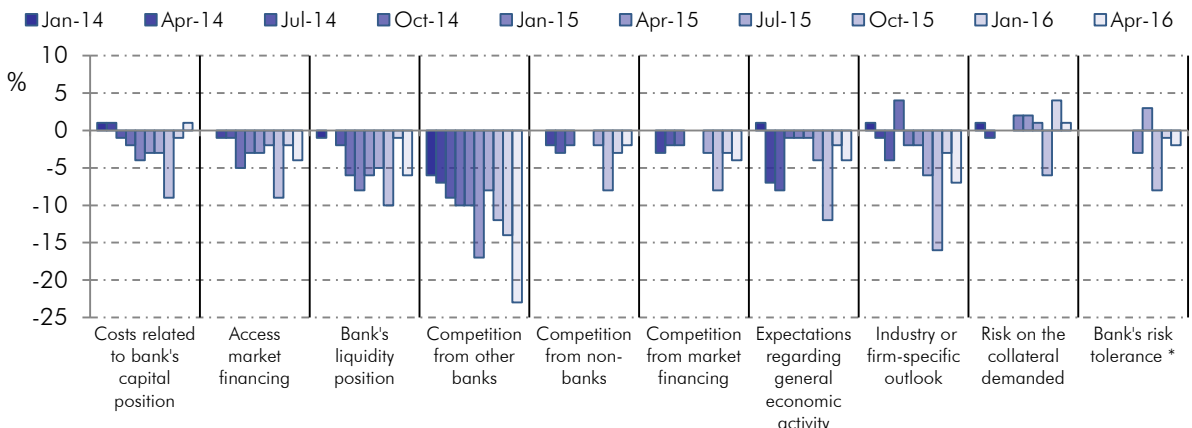
Figure 11: Net changes in credit standards applied to the approval of loans or credit lines to enterprises (SMEs versus large enterprises)



Source: ECB Bank lending survey (ECB, 2016b)

Figure 12 illustrates the factors that drove the change in credit standards for SME lending. For Q4/2015 and Q1/2016, nearly all factors contributed to the easing of credit standards. Only the factors ‘costs related to bank’s capital position’ and ‘risk on collateral demanded’ induced banks to tighten credit conditions. Interestingly, expectations of reduced competition from other banks have contributed significantly to the easing of credit standards. Positivity with respect to the evolution of the economic outlook also contributed to a further easing, but to a lesser extent than was the case during the previous two quarters. This is consistent with the growth projections of the EC, which were recently revised downwards.

Figure 12: Factors contributing to tightening credit standards for SMEs¹⁵



*Note: “Bank’s risk tolerance” was only introduced to question 2 of the BLS in Q2/2015

Source: ECB Bank lending survey (ECB, 2016b)

¹⁵ Banks were requested to answer the following question: Over the past three months, how have the following factors affected your bank's credit standards as applied to the approval of loans or credit lines to enterprises? The graph reports net percentage contribution of each factor to the tightening or easing of credit standards. The net percentage is defined as the difference between the percentage of banks reporting that the given factor contributed to a tightening and the percentage reporting that it contributed to an easing.

In times of deleveraging by banks, alternative financing solutions have started to play a more prominent role in supplying credit to SMEs. Debt funds are an important part of these instruments. While such non-bank lending institutions are quite common in more market-based economies such as the United States, little is known about these alternative debt providers in traditionally largely bank-based European countries. Box 2 elaborates on debt funds by discussing, inter alia, a recent study undertaken by Will (2016) in cooperation with RMA.

Box 2: Debt Funds and their Role in SME Financing in Europe

In 2014, EIF published an overview of “Institutional on-bank lending and the role of Debt Funds” (Kraemer-Eis, 2014). In cooperation with EIF, Will (2016) had a more recent look at this market. The purpose of his empirical research was twofold. In the first instance, the European SME debt fund market was analysed based on a comprehensive internet research. Based on the compiled market overview, a qualitative research approach via expert interviews was conducted in order to examine the functioning of debt funds. The research focuses on two different debt fund types: Selective and Diversified Funds. This differentiation follows the approach of the related EIF financing instrument, “EREM Loan Funds”, which is implemented by EIF under the EIB Group Risk Enhancement Mandate (EREM).

The findings of this research provide information with regard to general characteristics, selection criteria and their handling of asymmetric information between the fund and SMEs. While selective funds use a private equity-like investment approach via an in-depth due diligence process, diversified funds typically invest in a diversified loan portfolio and apply a credit metrics-based approach. Furthermore, as the result of the interviews show, both investment approaches differ in a variety of characteristics such as their provided debt instruments, investment horizon, fund- and loan sizes as well as target returns.

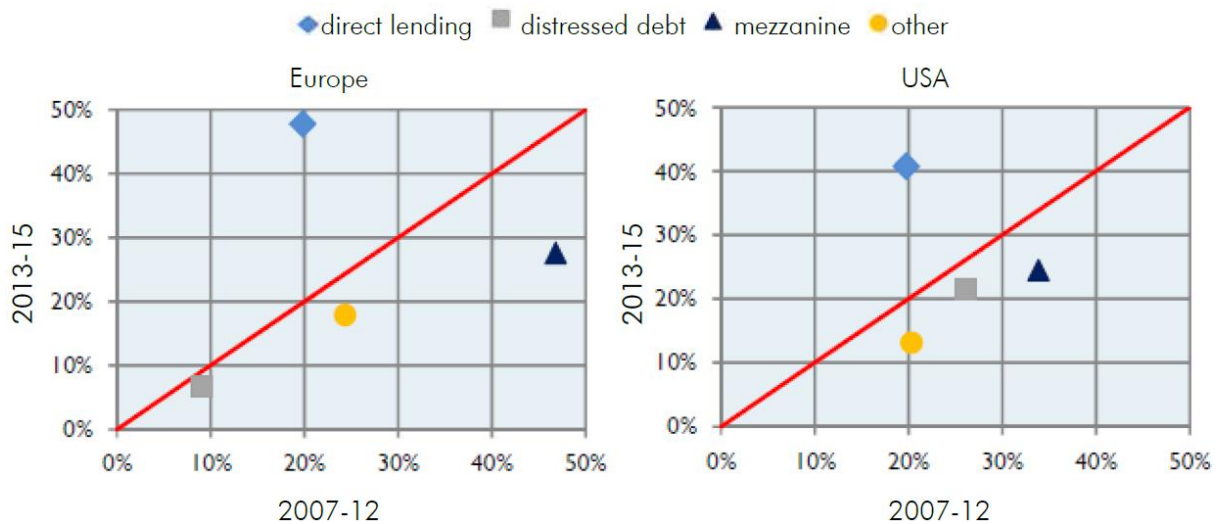
The vast majority of loan funds focus on regions where first regulatory developments towards market-based financing are in progress or already implemented, such as the UK, Italy, France or Germany. EIF has so far detected c. 119 initiatives, out of which 75 follow a selective approach and 44 follow a diversified approach. There is more information and data available on selective funds than on diversified funds (e.g. with regard to performance and actual number of funds), as the latter is a relatively new approach. However, there are some arguments why this approach could become more popular (Will, 2016): Against the background of a current low interest rate environment, institutional investors such as large global insurance companies and pension funds are hunting for higher-yield investment alternatives in order to fulfil their return promises. Therefore, diversified funds could develop into an attractive alternative in the fixed income allocation pocket of insurance companies, as they promise target returns above the current yield level of government bonds and an adequate risk profile because of a broader portfolio diversification. There are also debt funds with an ambiguous characteristic, i.e. being a hybrid between selective and diversified funds, which could already constitute a movement towards a more diversified investment approach in order to attract additional investors with a large reservoir of dry powder. Moreover, recent AIMA findings show that an increasing number of funds that work in cooperation with a bank are currently fundraising (Will, 2016, based on AIMA, 2015).

However, it is yet too soon to finally assess the ability of loan funds to become a serious alternative to bank lending, as they are a quite new phenomenon on European capital markets and the performance of these funds has not been “tested” through an entire credit cycle. (Will, 2016). Most of the players are first time teams/funds, which clearly shows the early stage of the private debt market in Europe.

Box 2 continued:

When looking at the importance of different investment strategies of debt funds, those funds with a focus on direct lending have increased in relative importance, from a share of 20% of all private debt funds in the years 2007-2012 to 48% in the 2013-15 period (Creditreform, 2015). At the same time, the share of mezzanine funds and distressed debt funds decreased from 47% to 28% and 9% to 7%, respectively (see Figure B.3).

Figure B.3: European and US fund managers' investment strategies



Source: Creditreform (2015).

With regard to the geographic focus, Creditreform (2015) found evidence for a home bias among fund managers: 91% of the funds which were launched by a fund manager based in Europe, target European borrowers, while 88% of US funds also focus on US borrowers (see Table B.1).

Creditreform (2015) found a strong increase in the number and cumulated loan volumes of direct lending funds, which represent approximately half of all private debt funds in Europe. Until 2011, this financing form had been hardly used in Europe. Following an already strong increase in 2012, the direct lending fund market skyrocketed from 2013 onwards (Figure B.4). Between 2012 and June 2015 (the closing date for the Creditreform analysis), 71 funds with a focus on direct lending to enterprises were launched, comprising a total fund volume of EUR 38.2bn. Taking into account the amounts reached before 2012, the total cumulated direct lending fund volume was at EUR 43.1bn in Europe at the end of June 2015. At that time, the US' cumulated direct lending fund volume was at EUR 87.0bn.¹⁶ Within the European market segment, the UK currently represents the pioneer market with a market share of 41%, next to other important countries such as France, Switzerland and Germany (Will, 2016, based on Preqin, 2016a, 2015).

¹⁶ For the full year 2015, Preqin (2016a) shows an annual (non-cumulated) direct lending fundraising volume of EUR 18.8bn for funds with a primary geographic focus on Europe, EUR 12.9bn for funds with a focus on North America and EUR 1.1bn for funds with a focus on the rest of the world. This was the first year, for which Preqin recorded higher amounts for Europe than for North America (for example, the figures for 2014 are: Europe 12.7bn, North America: EUR 19.8bn, rest of the world: EUR 1.5bn).

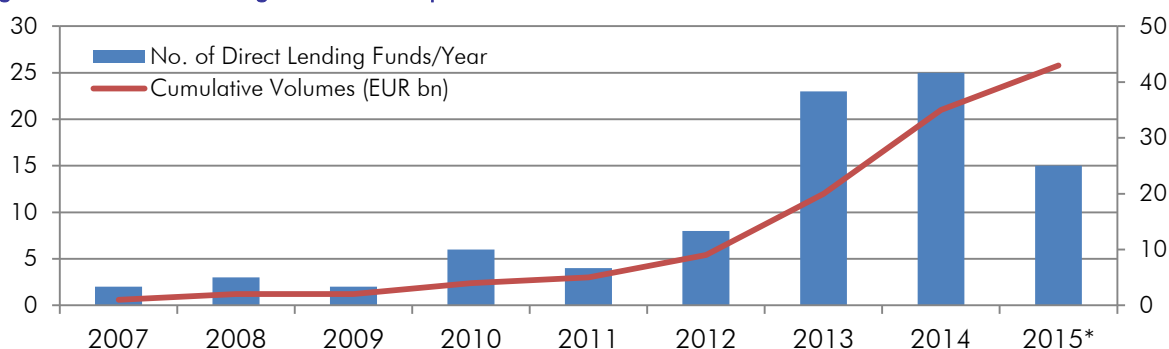
Box 2 continued:

Table B.1: Geographic focus of direct lending funds

		fund managers	
		Europe	USA
geographic focus	Europe	91	7
	USA	3	88
	diversified, multi-regional	6	5

Source: Creditreform (2015).

Figure B.4: Direct Lending Funds in Europe



Sources: Will (2016), Creditreform (2015).

For the coming years, Creditreform (2015) expects a further strong market development, spurred by investors' search for returns, the deleveraging of banks and several initiatives at European and national level to improve the regulatory framework for lending activities of debt funds. This is in line with a recent Preqin survey, according to which the majority of institutional investors named Europe to be the region which currently presents the best opportunities for alternative debt investments. With regard to potential reasons, the research stated the relative underdevelopment of the private debt market in Europe in comparison to the US and significant deal opportunities in the course of regulatory developments and deleveraging processes of banks (Will, 2016, based on Preqin, 2016a, 2015).

The launch of the Capital Market Union initiative and other regulatory measures, which aim, inter alia, at broadening the range of accessible financing sources for SMEs, could be a starting point for a further improvement in the framework environment of debt funds and contribute to a positive market development. As for venture capital, the reduction of barriers for cross-country activities for funds and investors would be an important part of such a strategy. The approach of the EREM Loan Funds instrument, i.e. to provide financial support at a European level and, at the same time, to help spreading best market practice is another building block to help creating a sustainable eco-system for these new market players in order to further enhance the access to finance of SMEs and mid-caps.

As the existing financial gap for SMEs is not expected to disappear in the near future, debt funds could become a viable financing alternative to these smaller companies in Europe (Will, 2016). Current fundraising numbers and the objected growth of this new market segment support this view.

Another supplier of SME financing that has attracted renewed attention in the aftermath of the economic crisis are cooperative banks and smaller institutions (CBSI). In this context, Box 3 elaborates on a new dedicated EIB Group product, implemented by EIF, which is discussed at length in a forthcoming EIF Working Paper:

Box 3: The role of cooperative banks and smaller institutions for the financing of SMEs and small mid-caps in Europe

The EIB Group is currently in the final phases of preparing a new instrument to support SMEs through Cooperative Banks and Smaller Institutions (CBSI). The CBSI instrument will be implemented by EIF as a new window under the EIB Group Risk Enhancement Mandate (EREM). EREM CBSI shall contribute to the EIB Group's intention to increase lending (and leasing) to SMEs and to broaden the range of intermediaries through which it operates, in particular by targeting small cooperative banks and other smaller institutions that have a particular focus on smaller SMEs and start-ups. EIF's Research & Market Analysis (RMA) is preparing an EIF Working Paper "The role of cooperative banks and smaller institutions for the financing of SMEs and small mid-caps in Europe", which is related to CBSI. In that paper, we provide background information on cooperative banks and other smaller institutions in Europe. However, we focus on the cooperative banking segment, for which more information is available. In the following, we present some highlights of the paper.

Banks' business models strongly differ by the size of the banks. For example, smaller institutions' share of trading assets over total assets is, on average, very low. ECB indicators also show that smaller banks have higher solvency and asset quality, as well as lower leverage and loans-to-deposit ratios, when compared to larger banks.

These characteristics broadly hold for the more specific group of cooperative banks too. Statistics of the European Association of Cooperative Banks (EACB) show more than 4,000 regional/local cooperative banks among the EACB members in the EU. Despite the large differences (e.g. by country/legal environment, size, independence/integration of the individual local/regional institutions, and relevance of certain target groups including SMEs) between the cooperative banking structures in Europe, their common feature is a usually more conservative business model than that of "shareholder banks". Cooperative banks typically concentrate to a large extent on lending-based retail banking. Individual local institutions are key intermediaries for SME loans, with a relatively strong focus on smaller SMEs. Cooperative banks' funding policy, but also capital base, is regarded as being comparably stable. Their main funding source is deposits from customers, who are to a large extent identical with their members/owners. In addition to the membership contribution of their owner-members, usually their almost exclusive capital source is retained profits.

The local cooperative banks have generally been less impacted by the financial crisis, compared to their peers. However, not surprisingly, they suffered more in those countries that were more intensively hit by the crisis, and some of the central institutions have been strongly affected, in particular when they had deviated from the traditional model of cooperative banking in the domestic market.

Box 3 continued:

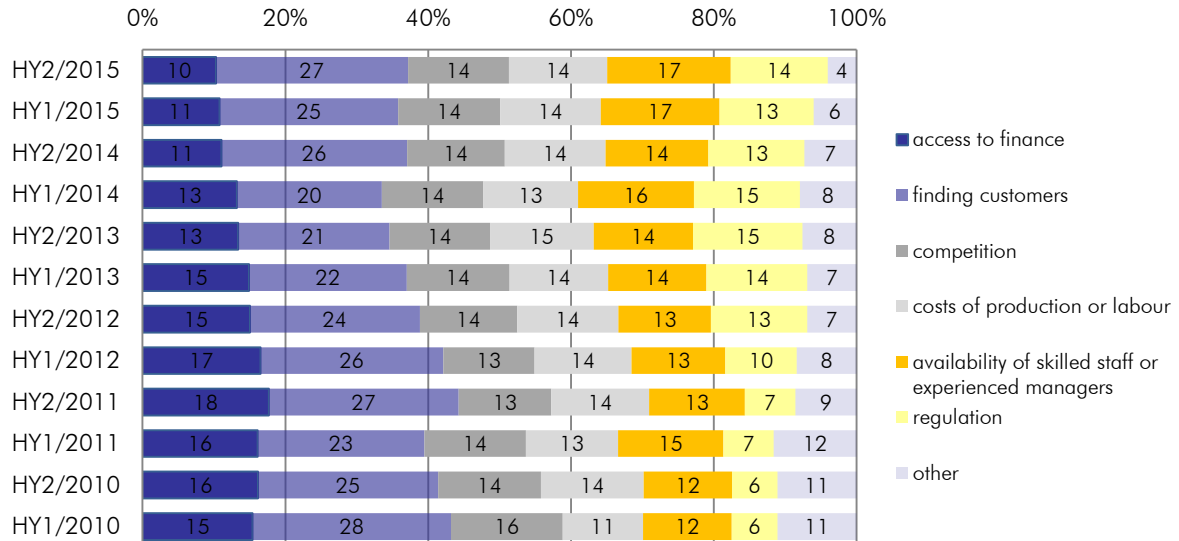
Looking forward, there is a risk that a more intensified competition for retail deposits, driven by Basel III and challenging wholesale markets, could slightly erode the deposit market shares of cooperative banks. As this might lead to an increase in the relative price of deposits, there could be a stronger tendency to look for alternative funding sources. The provision of additional and attractive funding opportunities could then help the cooperative banks to offer better support to the economy, in particular when growth picks up again.

Source: EIF

3.2.3 SME financing from a demand perspective

Having discussed the bank’s supply side perspective of the lending market, this section turns to the demand side and reports the most important results of the latest Survey on the Access to Finance of Enterprises (SAFE). Figure 13 shows the most important problems faced by SMEs in the Euro Area and illustrates that the SMEs perceive their situation to have remained relatively stable over the last six months of 2015. About ten percent of SMEs reported access to finance as their most important problem, down one percentage point since the first semester of 2015. For the majority of SMEs, finding costumers remains the most pressing problem, with 27 percent of SMEs ranking it to be their biggest issue, the highest level since 2011.

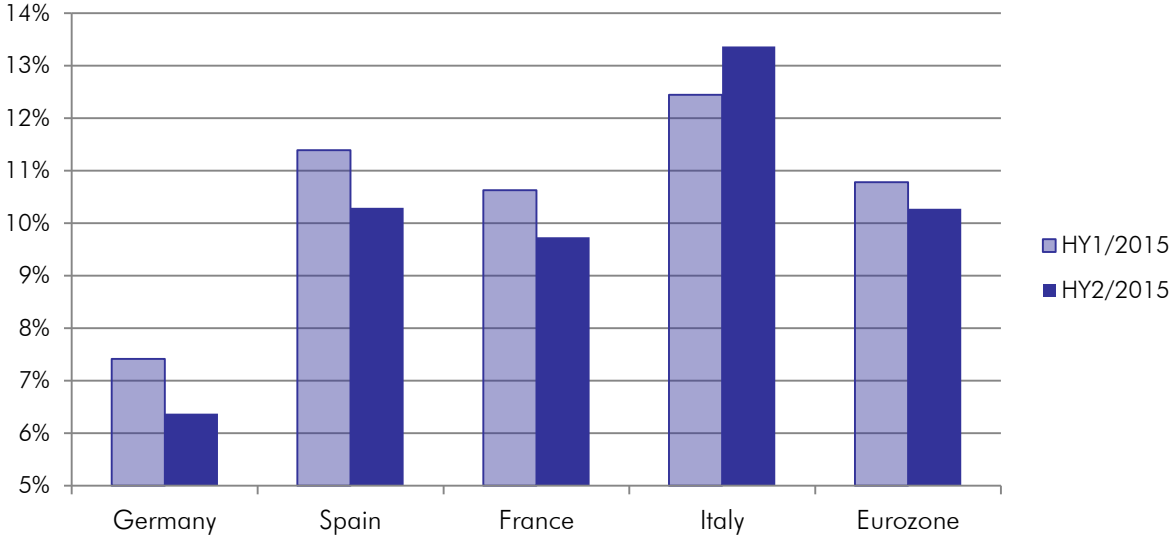
Figure 13: The most important problems facing Euro Area SMEs



Source: ECB SAFE (ECB, 2016a)

Figure 14 illustrates how the share of SMEs ranking access to finance to be their most important problem evolved between the first and second half of 2015, for the Euro Area and the four largest economies. Germany, Spain and France follow the Eurozone trend. In Italy however, the share of SMEs ranking access to finance as their main problem increased by one percentage point to 13.4 percent.

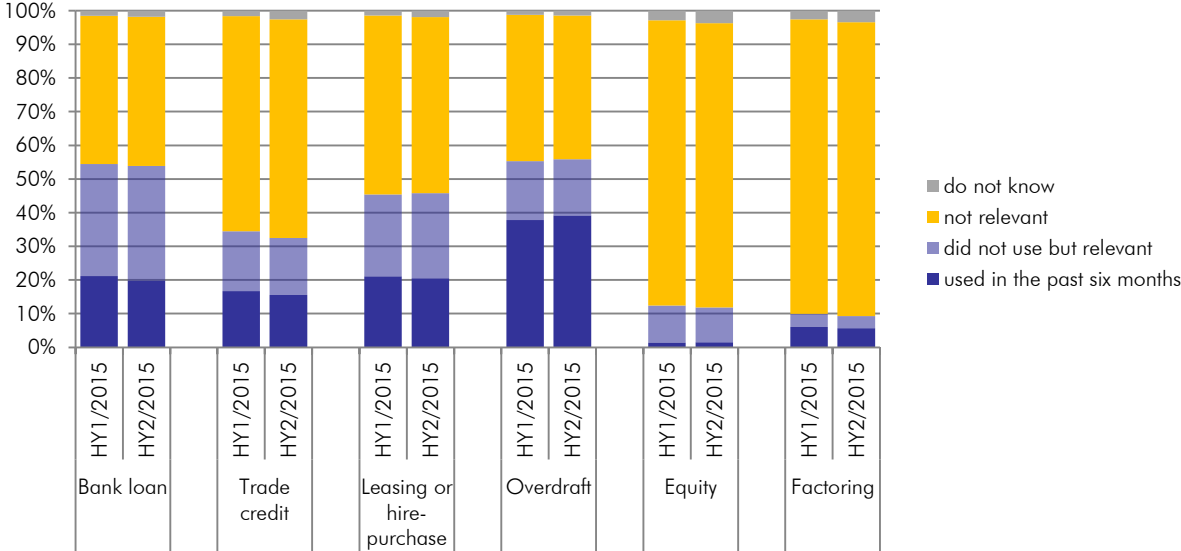
Figure 14: Percentage of SMEs ranking access to finance as their most important problem in four big Euro countries and the Euro Area



Source: ECB SAFE (ECB, 2016a)

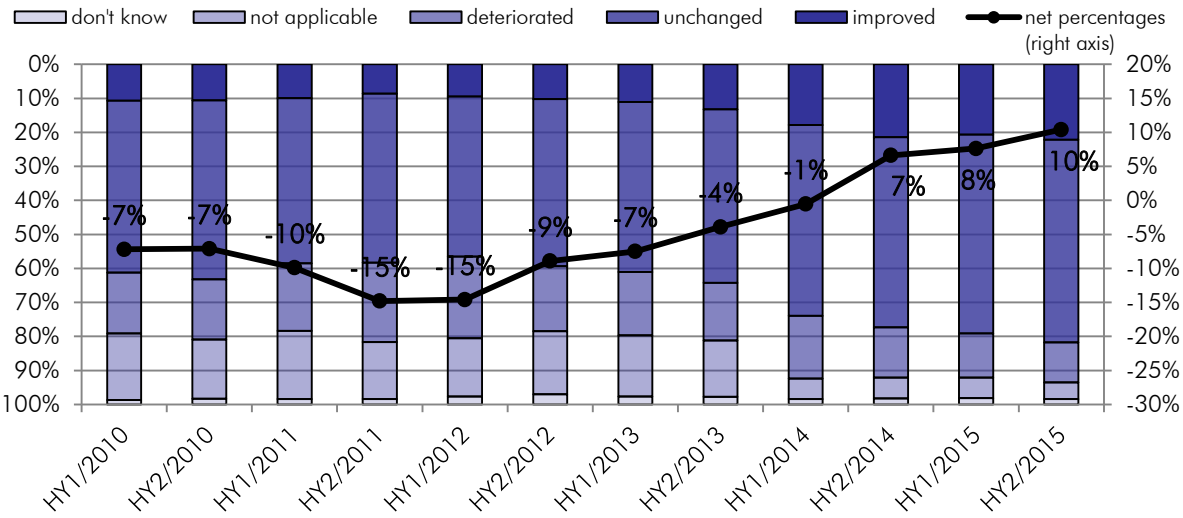
Over the first half of 2015, no significant changes occurred with respect to the relative importance of the different funding sources used by Euro Area SMEs (Figure 15). Bank products (loans and overdraft) remained the most popular financing products for SMEs in HY2/2015. The bank products were followed by Leasing and hire-purchase (see Box 4 below). The availability of bank loans for Euro Area SMEs improved marginally compared to the previous period (Figure 16): as indicated by the net-percentage evolution, more firms reported an improvement in the situation. This net percentage increased 2 percentage points since HY1/2015.

Figure 15: Sources of external financing of Euro Area SMEs



Source: ECB SAFE (ECB, 2016a)

Figure 16: Change in the availability of bank loans for Euro Area SMEs



Source: ECB SAFE (ECB, 2016a)

Box 4: SME leasing in Europe¹⁷

In the EC/ECB SAFE survey for Europe¹⁸, leasing and hire-purchase rank as the third most relevant source of finance for SMEs in the EU. More importantly, in the six months preceding the survey, it was the second most often used type of SME financing (i.e. used by 23%), after credit line/overdraft and before internal funds and bank loans. Germany, Poland, Latvia and the UK are among the countries with the highest proportion of SMEs using leasing or hire-purchase, followed by the Scandinavian region. In contrast, Spain, Italy, Greece, Malta and Cyprus are at the other side of the spectrum with the lowest proportion of SMEs.

The use of leasing or hire-purchase grows with the firm size. High-growth, exporting and innovative SMEs tend to use leasing or hire-purchase more often than non-exporters or non-innovative firms. Fifteen percent of EU SMEs are high-growth firms (average annualised growth of 20% p.a. over a three-year period), according to the SAFE survey, and 28% of these are lessees.

Survey respondents stated that the availability of leasing or hire-purchase improved the most in the past six months compared to other financing sources. Moreover, SMEs expected that the availability of leasing would continue to improve the most among all external financing sources in the coming 6 months. Leasing is also the source of finance with the largest proportion of SMEs signalling an increased need for it. The same holds true across SMEs of various characteristics, especially for innovative, exporting, high-growth firms and gazelles (high-growth firms that are up to five years old).

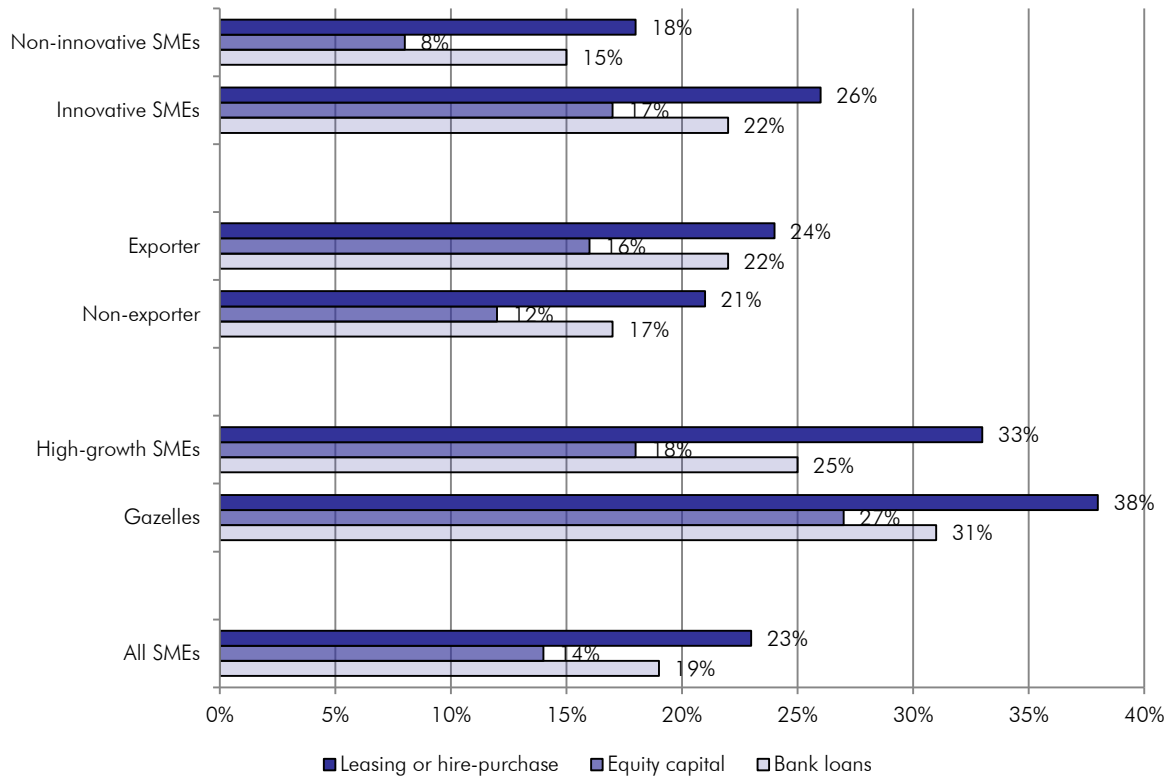
According to the survey, 25% of SMEs in the EU need financing amounts between EUR 25k and EUR 100k to materialize their growth ambitions. Given that the average lease contract size for equipment was about EUR 30k in 2014 (Leaseurope, 2015), leasing is well placed to address these SME needs (see Figure B.5).

¹⁷ This text box is based on Leaseurope (2016), and we would like to thank our Leaseurope colleagues for their support. Many of EIF’s guarantee products for the benefit of SMEs are also available for leasing providers. Leaseurope and EIF compiled an overview of EIF’s guarantee instruments in a fact sheet for the European leasing industry, which is available here: [http://www.leaseurope.org/uploads/EIF_2015%20factsheet_WEB\(singlepage\).pdf](http://www.leaseurope.org/uploads/EIF_2015%20factsheet_WEB(singlepage).pdf).

¹⁸ Information based on the latest joint EC/ECB SAFE survey wave (April-Sept. 2015). In contrast, the latest ECB SAFE survey wave for the Euro area was conducted for the period Oct.2015 – Mar. 2016.

Box 4 continued:

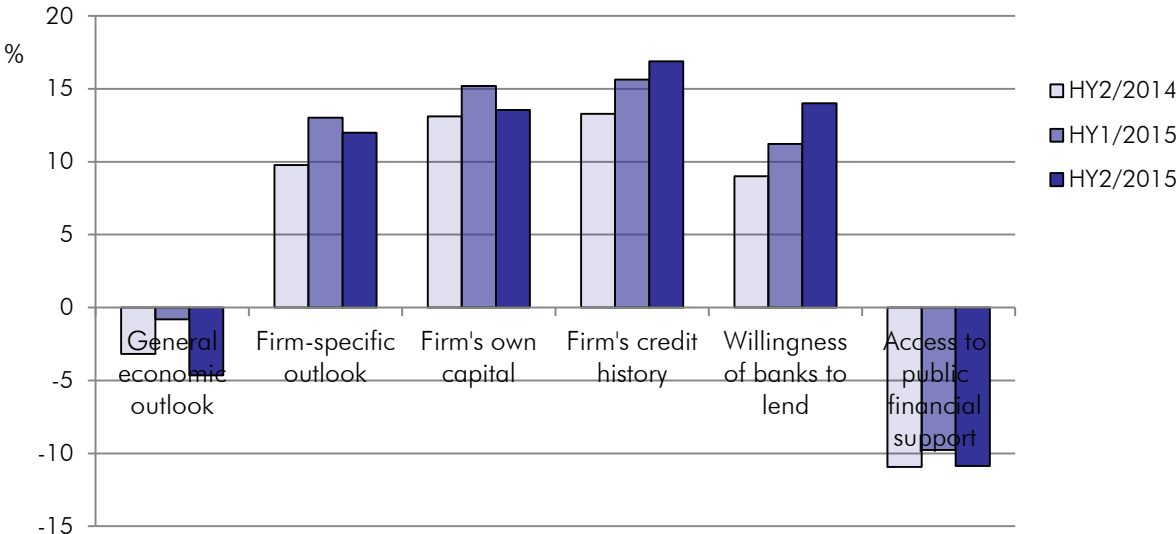
Figure B.5: SMEs reporting an increased need for different external financing products in the past 6 months (Apr. – Sept. 2015) in the EU, by firm characteristics



Source: Leaseurope.

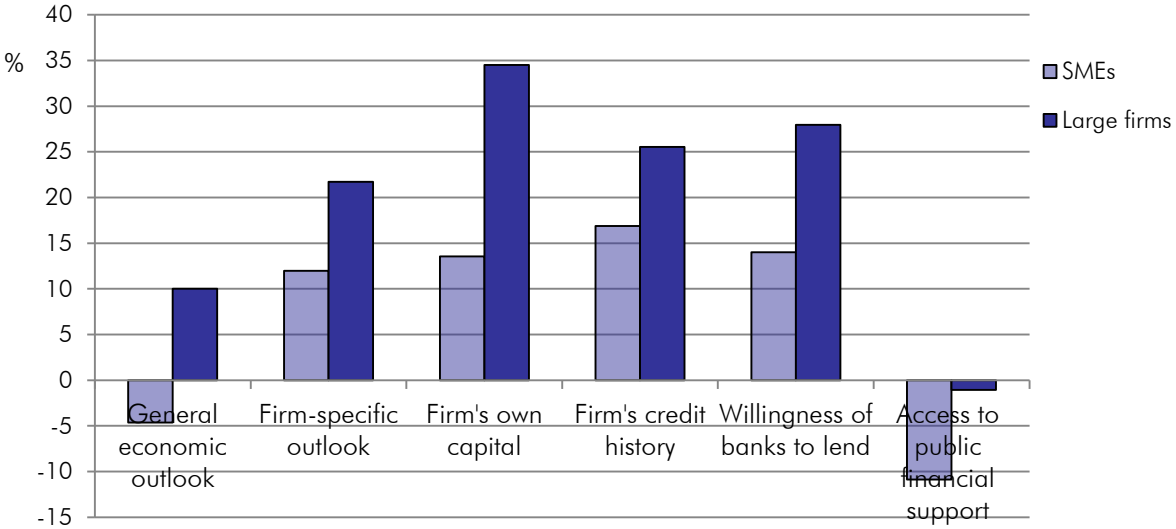
The SAFE survey also informs on the factors which SMEs believe to drive the availability of external financing. Figure 17 illustrates their responses for the last three semesters. Since HY2/2014, SMEs perceive their favourable credit-history to be an increasingly important driver behind the improved availability of bank loans. Likewise, SMEs believe the willingness of banks to lend them money was an important contributor as well. As was already the case in HY1/2015, SMEs continue to believe lack of access to public financial support negatively impacted the availability of external financing in HY2/2015. Figure 18 adds the responses of large firms and reveals that lack of public finance support was only a concern for SMEs. In addition, while large enterprises were still generally positive about the economic outlook, SMEs reported the economic outlook to contribute negatively to the availability of external finance.

Figure 17: Change in factors driving the availability of external financing to Euro Area SMEs



Source: ECB SAFE (ECB, 2016a)

Figure 18: Change in factors driving the availability of external financing to Euro Area SMEs (SMEs vs large firms – HY2/2015)

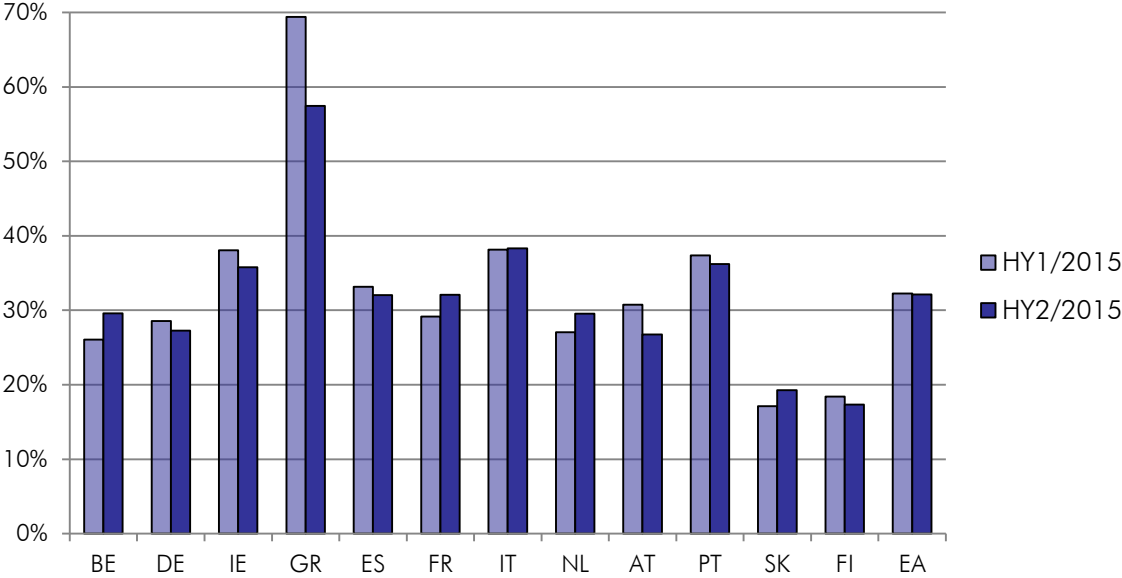


Source: ECB SAFE (ECB, 2016a)

Figure 19 provides more insight into the within-Euro Area heterogeneity in the perceived importance of financing. It plots per country the percentage of SMEs that considers access to finance as *highly* important.¹⁹ In HY2/2015 and for the aggregate Euro Area, 32 percent of SMEs report access to finance as a highly important issue, a number which stayed constant compared to HY1/2015. This percentage varies significantly by country, with Greece still heading the ranking (57%), although this number improved significant over the last half semester, dropping down from 70 percent. The situation in other European countries remained relatively stable.

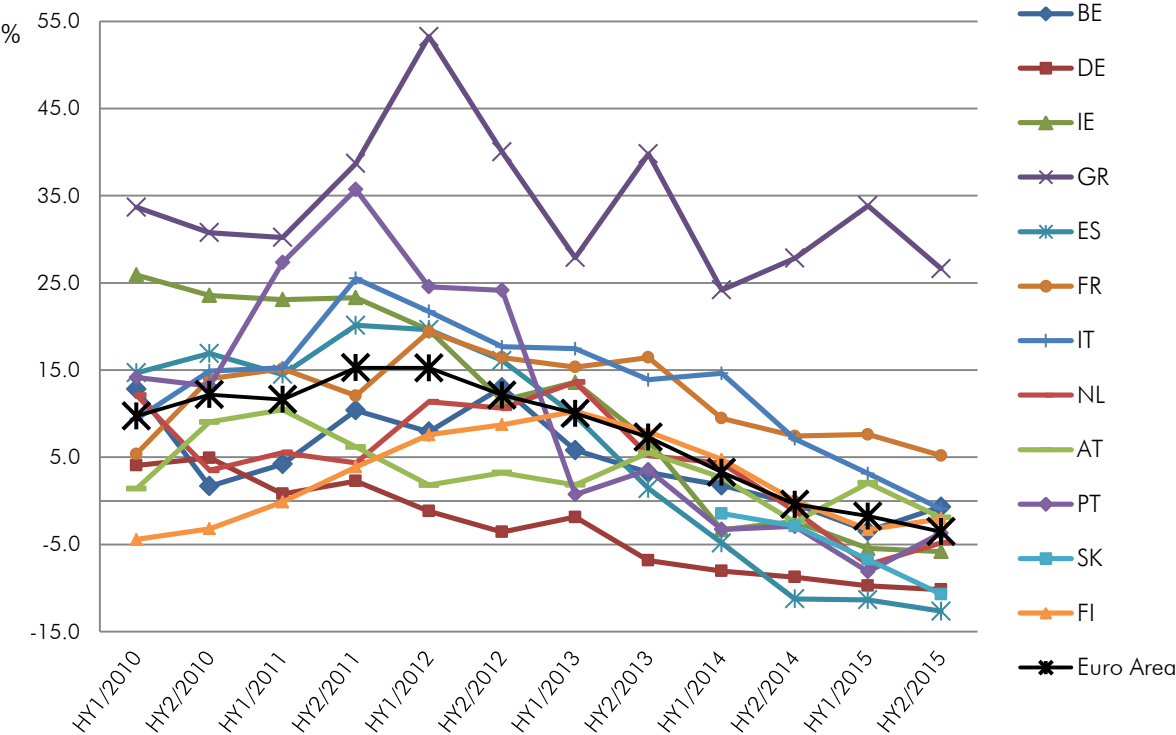
¹⁹ Rating it 7 or higher on a scale of 10.

Figure 19: Percentage of SMEs ranking access to finance as highly important



Source: ECB SAFE (ECB, 2016a)

Figure 20: The change in SMEs' perceived external financing gap

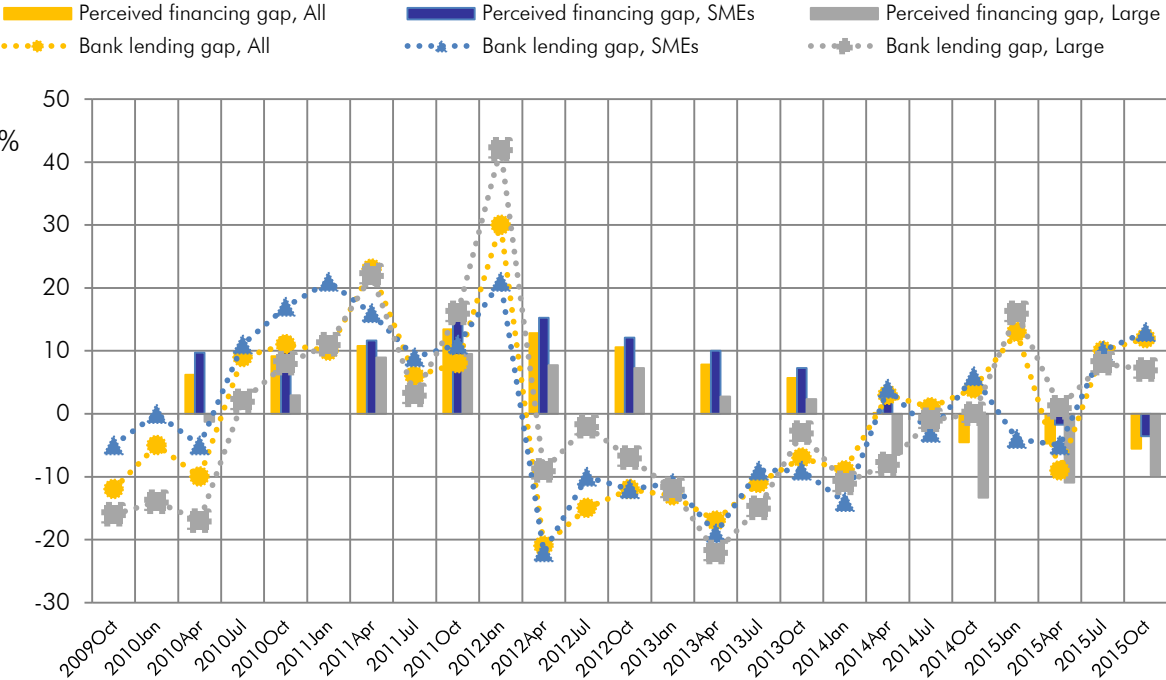


Source: ECB SAFE (ECB, 2016a)

The evolution of changes in SMEs’ perceived external financing gaps, as illustrated by Figure 20, shows a somewhat more optimistic picture.²⁰ Euro Area SMEs believed the financing gap further shrank during HY2/2015. This Euro average hides large country disparities.

Although the situation in Greece improved marginally compared to HY1/2015, Greek SMEs still perceive an increasing financing gap, as the country ranks well above the European average with a net percentage of 26.6 percent. Together with France, Greece is the only country in which SMEs perceived the financing gap to have increased further during the second semester of 2015.

Figure 21: Perceived change in the external financing gap, reported by borrowers and lenders²¹



Note: Weighted net balance for enterprises and net percentage for banks. The number of banks responding to questions about all enterprises is different from the number of banks responding to questions about large enterprises or SMEs. Hence, the bank lending gap line for “all” does not necessarily lie between the lines for “SMEs” and “Large”.

Source: Authors, based on SAFE, BLS and own calculations

Combining supply side data from the ECB’s bank lending survey with demand side survey results from the SAFE allows us to compare the perception of the financing gap by SMEs to what banks are reporting. Figure 21 graphs the perception of the change in the financing gap by Euro Area SMEs, as well as a measure for a bank lending gap, using data reported by European banks. The BLS bank lending gap is defined as the difference between the net percentage of banks reporting an increase in the demand for bank loans and the net percentage of banks reporting an easing in

²⁰ For each of the five financing instruments (bank loans, trade credit, equity, debt securities, bank overdraft), an indicator change in a perceived financing gap takes the value of 1 (-1) if the need increases (decreases) and availability decreases (increases). If firms perceive only a one-sided increase (decrease) in the financing gap, the variable is assigned a value of 0.5 (-0.5). The composite indicator is the weighted average of the financing gap related to the five instruments. A positive value of the indicator suggests an increasing financing gap. Values are multiplied by 100 to obtain weighted net balances in percentages.

²¹ On this figure the distinction between large enterprises and SMEs is based on annual sales as defined by the BLS.

credit standards. The positive value of this gap indicator during the second half of 2015 implies that more banks were experiencing an increase in the demand for bank lending, than there are banks easing their credit standards. Arguably, this implies an increase in the financing gap, derived from demand side survey results. Interestingly, this contrast with the perception of SMEs (and large firms), who perceived the financing gap to be shrinking.

Overall, the outlook about the general economic environment remained relatively stable since the publication of the previous European Small Business Financing Outlook in December 2015. While financing costs further declined, loan volumes have still not picked up. Aggregate European financing cost measures continue to mask large country level disparities. Looking specifically at SMEs, similar conclusions are reached. However, the current uncertainty in the European political arena is likely to put strains on the fragile recovery of SMEs' investment climate. While access to finance is still perceived to be a major problem for a significant portion of European SMEs, this issue has become slightly less important over the past half semester. However, also here there are large country-level differences, with Greek SMEs still reporting large and growing difficulties in accessing external finance.

4 Private equity

4.1 Investment activity

4.1.1 Private equity funds

Box 5: Introductory information on Invest Europe data

In this chapter, numbers, diagrams and statements are to a large extent built on statistics from Invest Europe (formerly EVCA, the European Private Equity & Venture Capital Association), and we would like to thank our colleagues from the Invest Europe research team for their support.

Please do also note that Invest Europe private equity (PE) statistics do not include infrastructure funds, real estate funds, distressed debt funds, primary funds-of-funds, secondary funds-of-funds and PE/VC-type activities that are not conducted by PE funds. Further, activities of business angels and hedge funds as well as corporate acquisitions outside of dedicated corporate venture programmes are not included in the statistics. Invest Europe statistics can differ from the numbers reported by other data providers for the reasons just mentioned and due to, e.g., differences in methodology, definitions and interpretations of the PE fund and investment stages and geographical definitions (e.g. of “Europe”).

Invest Europe activity statistics are based on the PEREP_Analytics database, which monitors a total of 2,029 eligible PE firms representing EUR 564bn of capital under management, as of 31.12.2015. For 2015 the database recorded 1,200 PE firms, covering 91% of the total capital under management in Europe, that were active in fundraising, investments or divestments in Europe.

See, also for more details, Invest Europe (2016a) and the Invest Europe website (www.investeurope.eu).

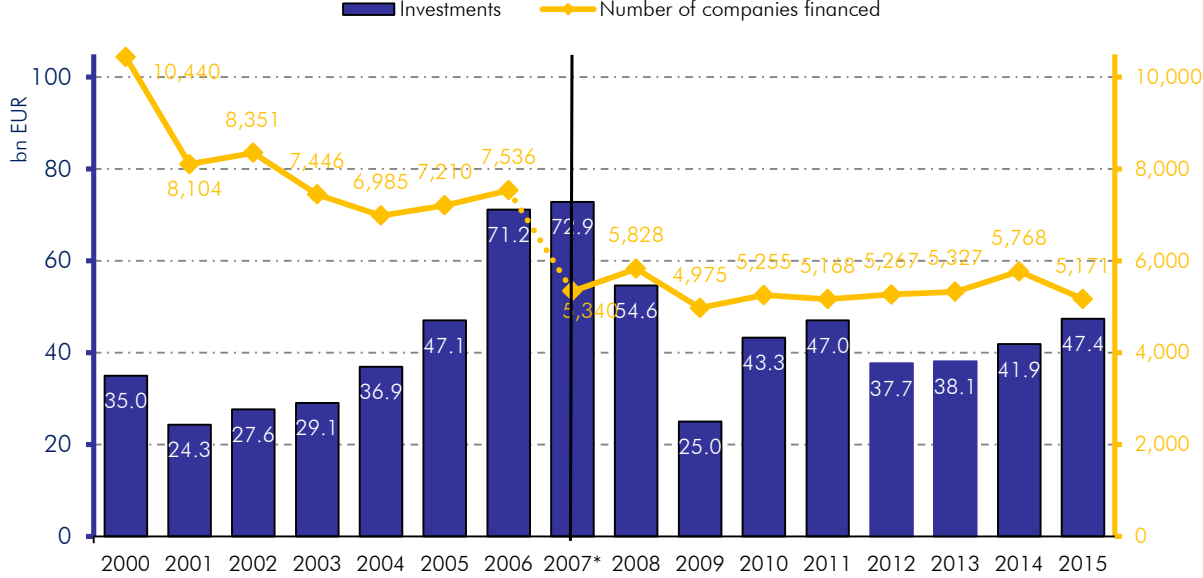
Following the severe crash of European private equity (PE) investment in 2008/2009, it had partially rebounded over 2010-2011. Following a setback in 2012, the recovery continued in 2013 and 2014, albeit at lower levels. In 2015, investments by PE funds located in Europe increased by 13%, compared to the year before, to EUR 47.4bn, according to Invest Europe data (see Figure 21; for more information on the Invest Europe data, see Box 5). In contrast, the number of companies financed decreased by 10% to 5,171 in 2015.

In terms of amounts invested, strong positive growth rates were recorded in the buyout (+15% to EUR 36.5bn) and growth capital (+11% to EUR 6.1bn) segments of the PE market. Venture Capital (VC) investments increased by 11% to EUR 4.0bn.

Within the VC market segment, investments with a focus on the start-up (+9% to EUR 2.1bn) and later stage (+11% to EUR 1.8bn) increased, but also the relatively tiny sector of seed investments²² recorded a strong upswing (+26% to EUR 0.13bn); see Figure 23.

²² With regard to seed investments, equity investments in Technology Transfer (TT) activities can effectively reduce early-stage (pre-seed, seed and post-seed) funding gaps and sustain viable TT structures while generating over time financial returns for investors (EIF, 2016). TT activities encourage collaboration between research organisations and industry, the licensing of intellectual property rights, and the creation of start-up businesses and university spin-out companies. As a part of its TT activities, EIF supports business incubators. In the context of a cooperation with the University of Trier, EIF also contributed to a recent research project on incubator business models in Europe; an overview is provided in the previous ESBFO issue (see Kraemer-Eis, Lang, Torfs and Gvetadze, 2015).

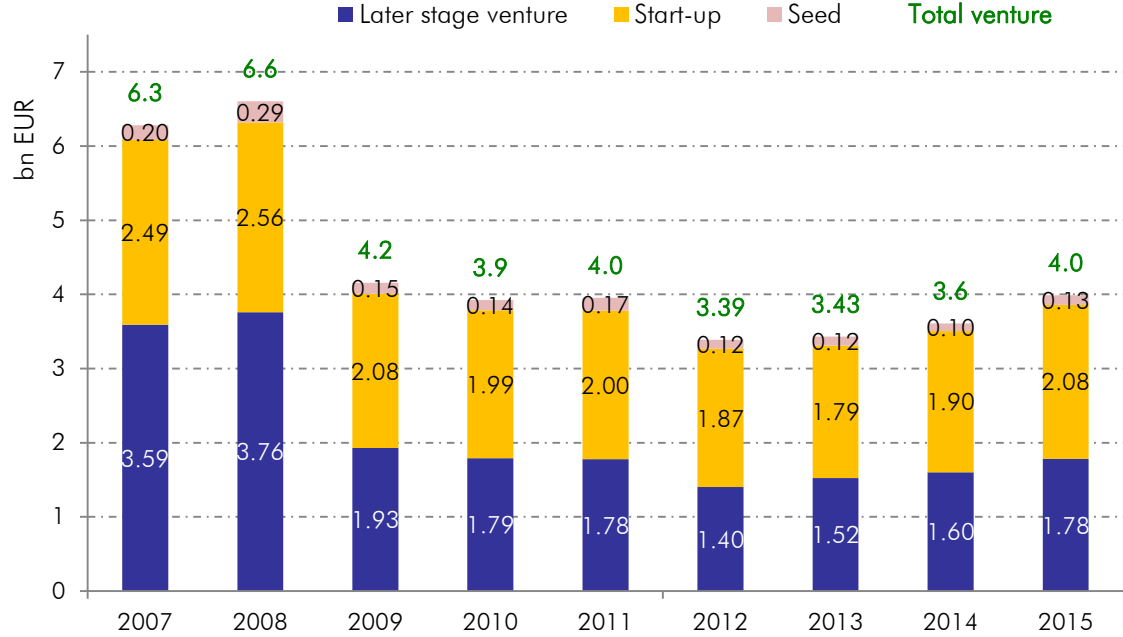
Figure 22: Investment activity by private equity firms located in Europe²³



*Invest Europe changed the data provider with effect from 2007 on. Since then, the activity statistics are based on data from PEREP Analytics.

Source: Authors, based on data from Invest Europe.

Figure 23: Venture Capital investment activity evolution in Europe



Source: Authors, based on data from Invest Europe.

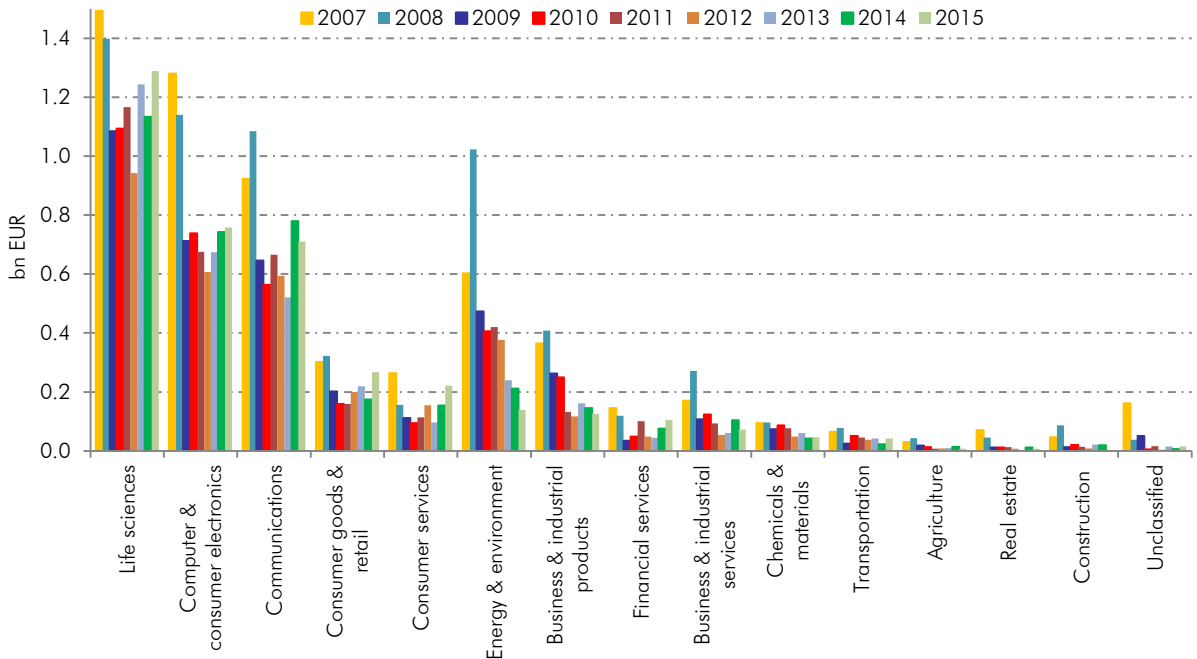
²³ The Invest Europe figures mentioned in this chapter show investment activity by PE firms located in Europe (“industry approach” or “office approach”). All investment figures are equity value, i.e. excluding leverage.

These developments were at least partially driven by the improved general economic situation and very favourable monetary and credit conditions, from which private equity – and in particular the buyout sector being the biggest segment of the market – has benefited.

(Please note that the investment activities of Business Angels are not included in the Invest Europe statistics, see Box 5. As business angel financing is important for the financing of SMEs and innovation, we present more information in Chapter 4.1.2).

Recent developments in venture investment by sector are shown in Figure 24. In the Invest Europe statistics, the relative importance of sectors shows certain stability over time: life sciences, computer/consumer electronics and communications remained by far the most relevant industries for venture investment. The *share* of life science in total VC investment activity even increased from 25% in 2007 to 34% in 2015. However, in particular the developments in the IT sphere have had a substantial impact on *structural* developments in the VC market. See Chapter 4.4 on PE prospects for a more detailed elaboration. Moreover, according to Invest Europe, market participants have observed more and more growth stage investments as follow-on investments in venture backed companies, which mean additional contributions from the PE industry that are not shown in VC investment statistics, but contribute to the growth stage investment statistics. In 2015 about EUR 1.5bn in growth stage investments was received by venture-backed companies, according to Invest Europe.

Figure 24: Venture investment in Europe by sector, 2007-2015²⁴



Source: Authors, based on data from Invest Europe

²⁴ This diagram and the related text are based on market approach (i.e. by country of portfolio company), due to data availability.

4.1.2 Business angels

As already mentioned, the Invest Europe activity data cover fundraising, investment and divestment from PE and VC firms in Europe. Certain segments outside the definition that Invest Europe applies for the collection of its activity statistics are not covered, e.g. business angels' activities. However, business angel financing has gained importance in recent years.

Business Angels (BAs) represent an important class of private equity investors, primarily consisting of high-net-worth individuals, usually with business or managerial experience. They tend to invest their own money, either individually or in formal or informal syndicates, in businesses which are not publicly traded. (See, also for a general description of BA financing, Kraemer-Eis and Schillo, 2011; OECD, 2016; OECD, 2011; BAND, 2016.)

BAs differ from VC funds, which primarily invest third parties' funds (e.g. institutional investors'). Angel-financed companies are typically in earlier stages of their development and the holding periods of BA investments are typically shorter than the corresponding periods in VC funds (Kraemer-Eis and Schillo, 2011). BAs' transaction costs are relatively low, which allows them to invest on a lower scale. They are geographically more dispersed than VCs and often invest in local markets. Moreover, BAs tend to be very 'hands-on' investors, providing also services beyond financing (e.g. mentoring, business advice and access to networks), hence they can play a central role in the start-up ecosystem, in particular for innovative firms (OECD, 2016). According to several studies, BAs have a positive impact on the growth of the firms they invest in, their performance, and survival (Lerner et al., 2015; OECD, 2016). The success of the investees seems to be strongly based on the services beyond financing that BAs provide (Kerr et al., 2011). There is evidence that BAs are relatively resilient to changing market cycles (OECD, 2016), and angel investments in early-stage high-growth companies tended to increase during the crisis, as VC funds migrated to less risky later-stage investments (Kraemer-Eis, Lang and Gvetadze, 2013).

An increasing majority of BAs co-invest with other early stage investors in order to diversify risks (OECD, 2016) and/or to improve their skillset and experience (Capizzi, 2015). Moreover, vehicles like crowdfunding platforms are used more often by BAs – in particular by younger and less experienced ones – as tools to find investment opportunities, thereby allowing them to make investments in a wider geographical area (OECD, 2016).

However, there are difficulties in measuring the size of the business angel community, the main ones being identification and definition. BAs often stay anonymous and the details on their investments are rarely disclosed. Further, nothing can prevent an individual from identifying oneself as a 'virgin' angel, although he/she may have never actually invested. Others may have occasionally acted as angels, but are no longer looking for investment opportunities. Moreover, the so called "invisible market" makes a precise estimation of the angel market difficult. There are studies that the invisible part of the market is up to seven times greater than the visible part (CSES, 2012), while others estimate even a multiplier of around ten (EBAN, 2014, 2016). Such difficulties must be borne in mind when describing the market.

Currently there is no robust and consistent data available on the Business Angel market in Europe; published data is typically imprecise and can only be used as indication or very rough estimate. For the visible market segment, data is collected by angel associations from angel groups and networks. In the following, we use these statistics, as currently no better information is available. However, it is important to note the shortcomings of these statistics, which we take from the related EBAN disclaimer that we show in Box 6.

Box 6: Introductory information on EBAN data

Due to its nature, the early stage investment market and especially the BA segment is difficult to quantify. An important percentage of the total investments are informal and not publicly reported. The estimate of the percentage of the invisible market is based on a study commissioned by European Commission to CSES about the Business Angels market in Europe. In some countries, the deals done through the 'visible market' (BANs, Federations) are not published, so in some cases the estimates may not correspond to the exact amounts invested by BAs. However, EBAN matched information from different sources, to validate the estimates for each particular market in order to have a higher degree of confidence on the data that is published.

Knowing the underlying limitations, the main objective of the EBAN statistics is to provide a better understanding of the European early stage market. The EBAN publication comprises information collected through direct surveys from BA networks, national federations and other early stage investors.

Source: EBAN (2016).

At a European level, the European Business Angel Network (EBAN), reports an increase in BA investment by 5%, compared to the year before, to EUR 6.1bn in Europe in 2015 (EBAN, 2016). However, this number is based on the assumption that the visible market, for which EBAN reports investments of EUR 607m, represents 10% of the whole market. The number of BAs is estimated at 310k (comprising 30k angels organised in networks and an estimated 280k "invisible" BAs), which represents an increase by 7% compared to 2014. While the market has been growing in terms of total amount invested as well as number of BAs, the number of deals decreased, which could be due to increased BA co-investment funds and syndication among angels. The number of BA networks (BANs) in Europe has been relatively stable at around 470 over the past three years. However, compared to 2003 the number increased by 17%.

Most of the BA activity within the EU is happening in the UK, Spain, Germany, France and Finland. When compared to GDP, total BA investment amounts are relatively high in Estonia, Finland and Portugal. In 2015, only 6% of BA deals targeted companies outside their home country; in some countries BA co-investment funds, tax break or grant schemes do not support or not even allow investment abroad (EBAN, 2016).

The average amount invested by a single BA per company increased by 6% to EUR 184k in 2015. This is well in line with the results of other studies (e.g. CSES (2012)), which estimated that BAs provided on average around EUR 100k to 200k per deal. According to EBAN (2016), investments per individual angel vary between EUR 9k and EUR 100k; the average investment per BA has remained relatively stable at EUR 20.0k in 2015 (EBAN, 2016).

ICT has continued to be by far the most attractive target sector for BA deals, both in terms of investment amounts (with a share of 22% of the total investment amount) and number of deals (37%), followed by mobile (13% of total amount, 7% of deals), biotech/life sciences (11%, 9%) and finance/business services (10%, 6%). Early stage and start-up phase companies have received the largest share of BA investments (40%), but also seed investments (32%) account for a considerable part of the market.

While co-investments with other BAs are still the most common deal form, the relevance of investments alongside early-stage funds has increased in the recent past. In some countries, governments created such funds with favourable terms for BAs' co-investment, inter alia supported by the European Angel Fund, an initiative advised by the EIF, which provides equity to BAs and other non-institutional investors for financing innovative companies in the form of co-investments.²⁵ Syndication among angels has also increased, inter alia due to co-investment schemes, in which the threshold amounts are relatively high for a single BA (EBAN, 2016).

As explained, the invisible part of the market is dominant – therefore, data availability for general statements is limited. However, it can be assumed that BAs behavior did not move in the same direction like bank lending or venture capital supply during the crisis. Mason and Harrison (2013), e.g., showed for the UK that angel investment activity has held up since the onset of the crisis and they emphasise the economic significance of this market segment. Moreover, they underline the need for ongoing government support. Recent findings by Hellmann, Schure and Vo (2015) also suggest that public support for start-up financing should go beyond an exclusive support of (formal) venture capital, because additional policy measures for angel investors “would reach a different set of entrepreneurial companies that develop outside of the reach of venture capitalists”. Hence, “the central role of BAs is increasingly recognised by policy makers [...], and initiatives to support angel activities have expanded in recent years as part of a broader shift towards policies that aim to make equity-type instruments more widely available for start-ups and SMEs” (OECD, 2015b). According to the OECD (2016), public-private co-investment schemes are able to catalyse the private market, “but only if the existing angel market is sufficiently well developed, so that a sufficient number of investor-ready deals can be financed and the government does not have to be overly engaged in matching supply and demand for early-stage equity”.

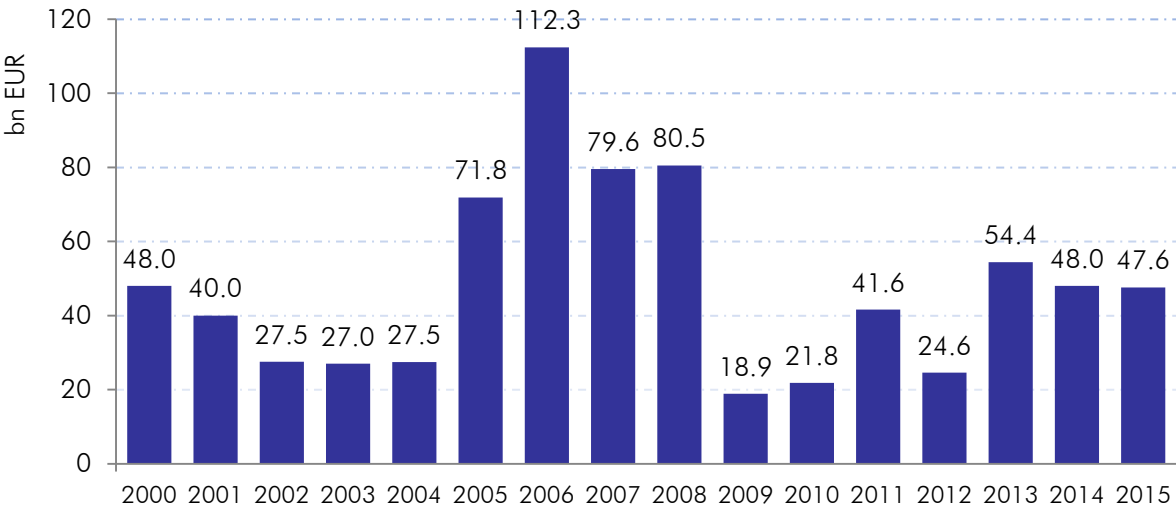
4.2 Fundraising activity

In 2015, total funds raised by PE firms located in Europe slightly decreased by 1% to EUR 47.6bn, compared to the year before and according to Invest Europe data (see Figure 25).²⁶ However, they are well above the levels of the crisis years 2009-2012.

²⁵ See www.eif.org/eaf for more information about the EAF.

²⁶ Figures show fundraising activity (incremental amounts raised during the year) by private equity firms located in Europe (“industry approach” or “office approach”), except where otherwise stated.

Figure 25: Funds raised by private equity funds located in Europe (incremental amounts raised during year)

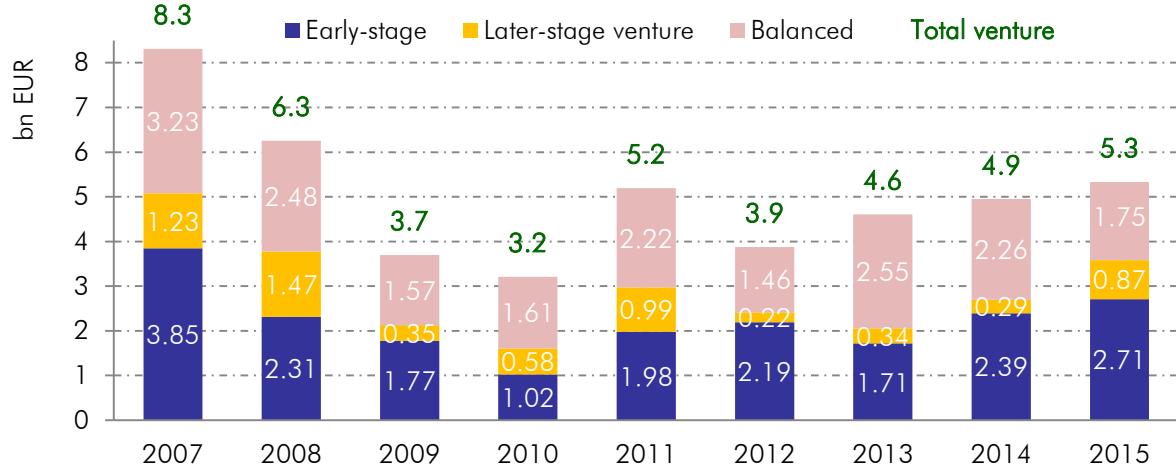


Invest Europe changed the data provider with effect from 2007 on. Since then, Invest Europe PE activity statistics are based on data from PEREP Analytics.

Source: Authors, based on data from Invest Europe

In the venture capital segment, fundraising increased by 8% to EUR 5.3bn (see Figure 25). This is the highest amount since the start of the crisis in 2008. While funds with a focus on early stage (+13% to EUR 2.7bn) and later stage venture (+195% to EUR 0.9bn) raised remarkably higher volumes, funds with a balanced stage focus performed worse (-22% to EUR 1.8bn).

Figure 26: Funds raised by VC funds located in Europe (incremental amounts raised during year)

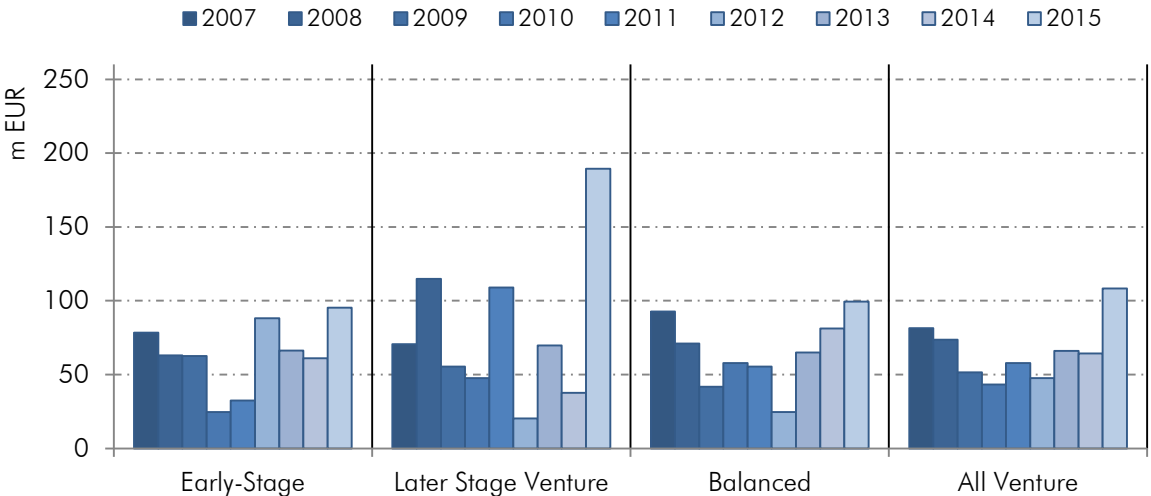


Source: Authors, based on data from Invest Europe

The average VC fund size has substantially increased to EUR 119m (see Figure 26). This is the highest level ever reached in the Invest Europe statistics, which started to record VC fund sizes in 2007; moreover, this statement is true for all three reported stage foci. Given the evidence in previous studies, which indicated that small fund size was one of the reasons for poor European VC performance (Kelly, 2011), the current finding might mean positive news.

However, EIF internal analysis suggests that larger funds are often managed by teams that previously had smaller funds that performed well. Thus, the size would be a consequence rather than a cause. Larger fund size would be a sign of more successful GPs and more careful due diligence by LPs. Moreover, further EIF internal analysis suggests a positive relation between relative fund size compared to peers of a same vintage and performance. Together with the former argument, this may indicate that achieving a larger fund size is associated to a certain market validation. Helping promising teams in demonstrating their investment skills and getting market validation in a smaller first time fund is consequently a way to help with the next fundraising of such manager, and hence the VC ecosystem.

Figure 27: Average VC fund size²⁷ (based on final closings, cumulative amounts raised since inception)



Source: Authors, based on data from Invest Europe

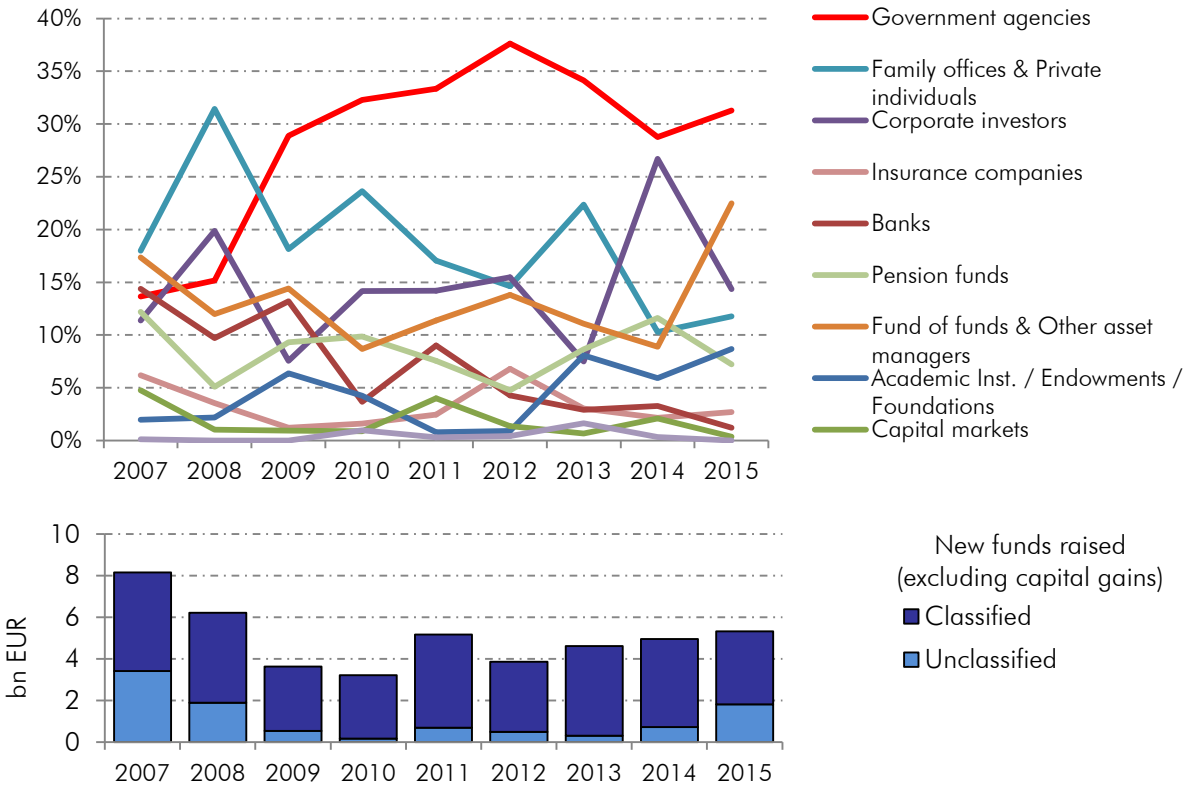
A sign of investors’ cautious sentiment for VC as a consequence of the crisis has been the shift in the investor base, which went on during the past years (see Figure 28). According to Invest Europe figures, government agencies accounted for 31% of total investors into VC funds in 2015. However, even if the importance of government agencies is still unsatisfyingly high for the long term, it is noteworthy that government agencies continue to play their role and support the market in a counter-cyclical way, in particular in the times of an economic and financial crisis when total VC fundraising levels came down from EUR 8.3bn in 2007 to EUR 3.2bn in 2010 and EUR 3.9bn in 2012, respectively. This led almost “naturally” to an increased share of government agency fund investors. Since then, the government share decreased from its high at 38% in 2012 to 29% in 2014. It remains to be seen if the increase reported for 2015 will be confirmed in later issues of the Invest Europe statistics, i.e. when the relatively high share (34%) of yet unclassified fund investors will be more properly identified.

²⁷ The results for 2015 are based on 40 final VC fund closings (22 funds with an early-stage focus, 5 funds with a later stage focus and 13 funds with a balanced stage focus).

In order to put EIF’s activity in context, some calculations can be taken into account that were performed for a recent EIF Working Paper by Kraemer-Eis, Signore and Prencipe (2016), which sheds more light on the impact of EIF on the VC ecosystem. The authors estimate, inter alia, that the VC investment activity backed by EIF represented 41% of total VC investments in Europe in 2014 (29% in 2007). The share directly attributable to EIF amounts to 10% (5% in 2007), which hints to the significant leverage that characterises EIF-backed investments. With regard to fundraising, the authors estimate that volumes backed by EIF in 2014 amount to 45% of the overall volumes collected by European VC investors (36% in 2007), against a share directly attributable to EIF totalling 12% (5% in 2007). More information can be found in Box 7 and in Kraemer-Eis, Signore and Prencipe (2016).

Moreover, EIF is supporting an increasing number of first-time teams, and many VC funds in which EIF invested successfully managed to close with their full target size. It is also important to see that many of the commercial VC funds being the pillars of Europe’s VC market today would not be there without having been kick-started by EIF. This clearly indicates EIF’s catalytic role for European VC, rather than a crowding-out effect. This view was confirmed in an Unquote Intelligence (2014) survey among General Partners (GPs) and Limited Partners (LPs), which found that “the overriding benefit of [public funding bodies’] (PFB) money is the crucial role it plays in attracting other investors”. Moreover, “[h]aving PFB money in a fund does not deter other LPs from committing”.

Figure 28: Investor base: Share of government agencies in VC fundraising²⁸



Source: Authors, based on data from Invest Europe

²⁸ Based on incremental amounts raised during year (in contrast to final closings only).

Box 7: The European venture capital landscape: an EIF perspective²⁹

In the past 20 years, the European Investment Fund (EIF, the Fund) has been the leading public provider of risk capital, and in particular of venture capital (VC), to young and innovative European start-ups. EIF's involvement in the European venture capital market rose substantially in the post-crisis period: an estimated 10% of European VC investments in 2014 are directly attributable to EIF (up from 5% in 2007). Because of its indirect approach to invest in VC funds and not start-ups, EIF activity has supported an estimated 41% of European VC investment volumes in 2014 (29% in 2007).

EIF's increased engagement towards the European VC landscape also confers additional responsibilities with respect to the VC market and the broader public. In particular, being among the main goals of EIF the pursuit of a sustainable European venture capital ecosystem, a challenging task becomes the monitoring and assessment on whether such objectives are effectively attained. To address these important arguments, Kraemer-Eis *et al.* (2016) introduces to a series of working papers titled "The European venture capital landscape: an EIF perspective". The goal of the series is twofold: first, to assess the magnitude of the economic effects to which EIF-backed investments contributed by means of numerous descriptive analyses. Second, to assess whether EIF's intervention in the market significantly affects the performance of the start-ups it supports, as well as the broader European VC ecosystem.

The first issue of the series tackles the question on whether EIF activity has effectively crowded-in VC financing, contributing to a sustainable European VC ecosystem. That is, whether other market players have intensified their activity in the aftermath of EIF's increased investments. The authors test this hypothesis by using data on VC investment amounts in the 2007-2014 period for 223 European NUTS-2 level regions, combining EIF internal data and statistics provided by Invest Europe.

The study finds a positive, strong and statistically significant average effect of the EIF funding on VC amounts invested the year thereafter. On average, a 1% increase in EIF-provided VC capital in a region led to a 1.41% increase in other investors' activity in the same region, one year later. Moreover, the analysis finds the EIF crowding-in power to particularly affect regions with lower levels of educational achievement, hinting that the catalytic effect of the Fund has been stronger in less developed venture capital markets.

Moreover, the paper analyses some general features of the 2,934 EIF-backed start-ups in the seed and start-up stage, invested over the 1996-2014 period. By focusing on their geographical distribution, the study provides a novel perspective on the key European hubs attracting VC investments over the last 20 years, highlighting the crucial role played by, *inter alia*, cross-border investments. Future instalments of this series will explore the firm-level dynamics (e.g. growth performance, innovation, exits) of EIF-backed VC start-ups.

²⁹ This text box was contributed by Simone Signore.

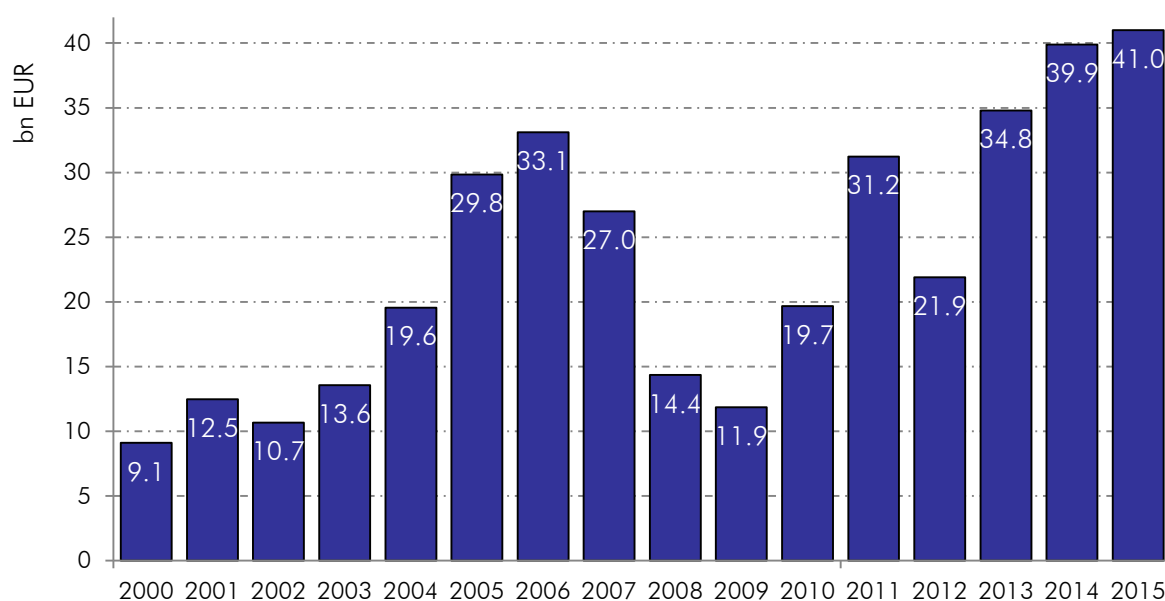
4.3 Divestment activity

The exit markets have remained remarkably strong. In the previous two years, Invest Europe statistics had already recorded the highest PE divestment amounts ever. In 2015, total divestments by PE firms located in Europe recorded another increase, i.e. by 3% to EUR 41.0bn (see Figure 29).³⁰

Total divestments of portfolio companies based in Europe increased by 5%. That rise was mainly due to higher activity in the growth (increase by EUR 0.9bn, meaning +39%, to EUR 3.2bn) and buyout (+EUR 0.8bn, +2%, to EUR 34.3bn) capital segments of the market, but also divestments in the venture segment increased (+EUR 0.2bn, +10%, to EUR 2.1bn).³¹

A closer look at the details of the Invest Europe divestment statistics shows the remarkable strength of the exit markets in the recent past. As regards overall PE, the relative importance of write-offs has continuously decreased since 2010, except for a slight increase in 2013 (see Figure 30). Trade sales and sales to another PE house together account for more than half of the total divestments amounts. Moreover, the share of public offerings has considerably increased to more than a quarter of all divestments in 2015, due to significantly stronger sales of quoted equity. In the VC market, the relative importance of write-offs has only slightly decreased, while trade sales and sales to a financial institution increased.

Figure 29: Divestments (by amount at cost divested) by private equity firms located in Europe



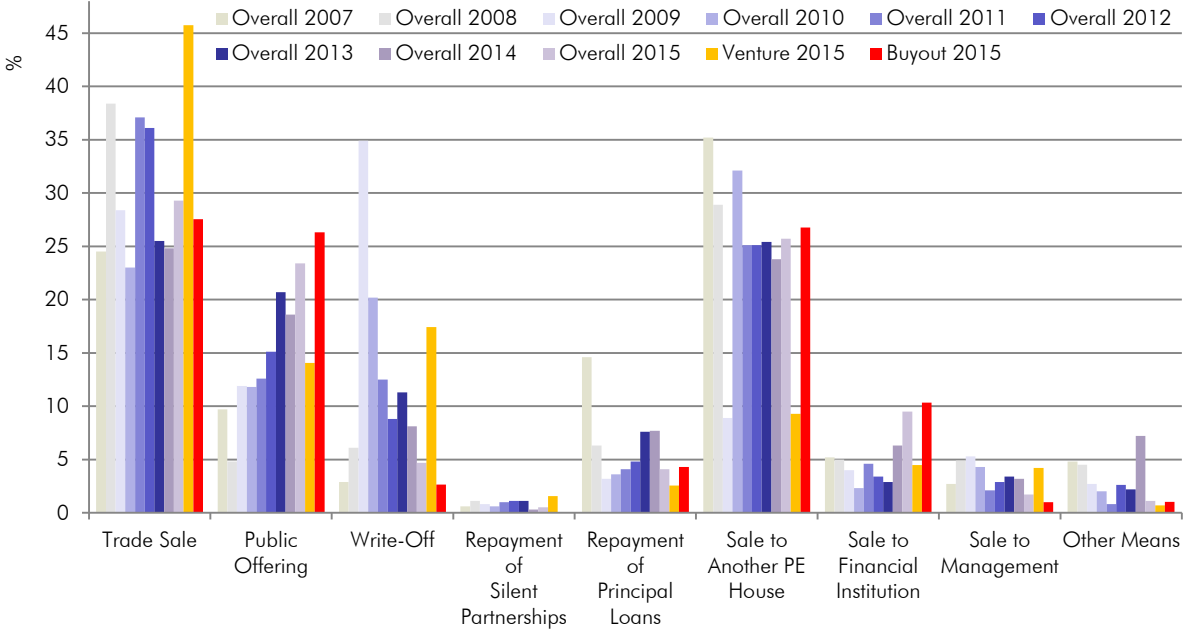
Invest Europe changed the data provider with effect from 2007 on. Since then, Invest Europe PE activity statistics are based on data from PEREP Analytics.

Source: Authors, based on data from Invest Europe

³⁰ Invest Europe statistics show divestment amounts at cost, i.e. the total amount divested is shown as the total amount that had been previously invested, hence not including any profit on the investment.

³¹ The numbers for VC, buyout and growth divestments do not sum up to total PE divestments, as total PE divestments additionally include the rescue/turnaround and replacement capital market segments.

Figure 30: Divestment routes (shares)³²



Source: Authors, based on data from Invest Europe

4.4 Lower mid-market and hybrid debt/equity finance: An important market segment

Following EIF’s definition (see EIF, 2016), the lower mid-market (LMM) covers fund strategies targeting equity and mezzanine investments at growth and buyout stages with a particular focus on SMEs and mid-caps. EIF provides its core LMM products (equity, hybrid debt-equity and private debt for SMEs and mid-caps) as alternative sources of long-term finance to established businesses and later stage technology companies. In the current market context, a full range of equity products combined or not with a debt component proved highly successful, particularly for shareholding reorganisation, organic and external growth, restructuring or expansion.

Hybrid debt/equity finance is a diverse asset class in between traditional senior debt and equity instruments. According to the OECD (2014b), “this form of finance has not received as much public attention as venture capital or specialised exchanges for SMEs, but it holds potential to respond to [...] critical problems in SME finance.”

According to EIF market insight, the lower-mid and mezzanine markets have shown a stable upward trend in business climate; higher levels of available liquidity, a growing deal flow and heightened exit activity signalled a clear recovery in these segments in 2015. For the first time since the start of the financial crises, funds have been reaching, and some even exceeding, their fundraising targets (EIF, 2016). However, as mentioned in Chapter 4.4, the PE market in general

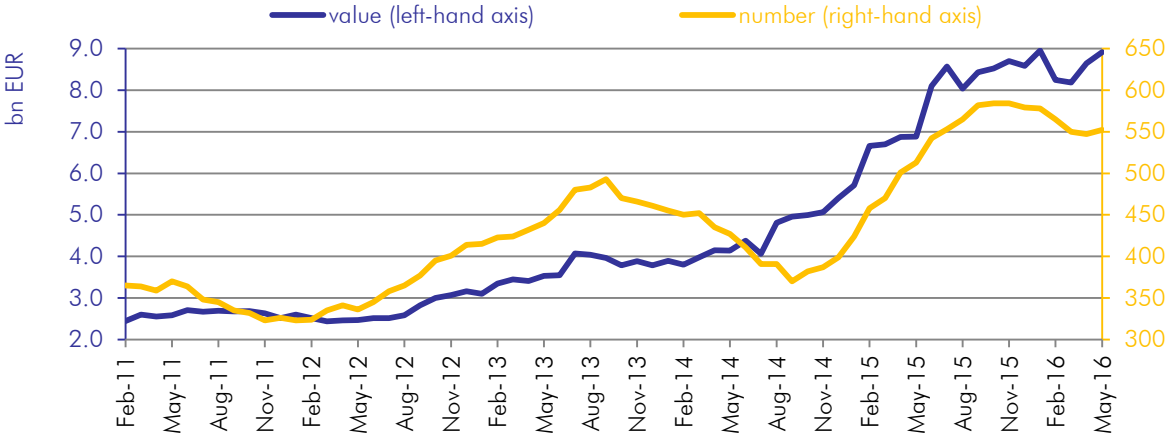
³² Based on amounts at cost divested; industry/office approach (i.e. divestments by funds located in Europe). “Overall” figures are not the weighted average of the “buyout” and “venture” figures, as “overall” figures additionally include the growth, rescue/turnaround and replacement capital market segments. In the Invest Europe data, the category “Public Offerings” includes divestment on flotation (IPOs) and sale of quoted equity.

and the mid market in particular is prone to the risk of high valuations and potential overheating, which is caused by the ample liquidity in the markets. Once central banks will start withdrawing from their expansionary monetary policy stance, these risks could quickly materialise. The recent decline in the Argos Mid Market Index³³ (-14% in value terms in the 1st quarter 2016 compared to the previous quarter) could already be a related sign. According to Epsilon Research (2016), investors were concerned, inter alia, about the global economic growth perspectives and the potential strengthening of the monetary policy by the Fed. However, experienced managers are still able to invest in less visible mid market companies and to provide added value in order to have them becoming more attractive and sustainable.

4.5 PE prospects³⁴

The recent positive developments in European PE and VC activity figures were also confirmed by other sources. For example, Go4Venture Advisers’ early indicator, the European Tech Headline Transactions Index³⁵, has recorded, on average, strong increases in terms of investment values since summer 2012. In contrast, the number of deals had declined for a year since autumn 2013, before it started to pick up again (see Figure 31, which shows the index development on a 12-month rolling-horizon basis). From autumn last year until April, the number of deals declined once more.

Figure 31: European tech headline investment transactions (12-month rolling horizon)³⁶



Source: Authors’ calculations, based on Go4Venture Advisers data.

³³ The Argos Mid Market Index measures the evolution of euro zone private mid market company valuations. See Epsilon Research (2016) for more information.

³⁴ We are grateful to several colleagues for very helpful comments and discussions. In particular, we would like to thank Uli Grabenwarter for an extensive written contribution to this subchapter.

³⁵ Go4Venture’s European Tech Headline Transactions Index “is a derivative index” which is “compiled [...] based on the deals reported in major trade publications and news feeds [...] as an early indicator of evolutions in the private investments market for European TMT companies. [...] TMT is defined to include Technology, including IT and Life Sciences (except drug discovery); Media, including Internet & Digital Media; Telecom Services (alternative operators only)”. For this and more information on definition and methodology see www.go4venture.com/

³⁶ In the two lines in the diagram, each data point shows the sum of the total value of deals (blue line) and the sum of the total number of deals (yellow line) observed in the month to which the respective data point is related and over the 11 months prior to that data point. For example, in July 2013, the total value of deals observed during the period from August 2012 to July 2013 amounted to EUR 4.1bn, and a total number of 480 deals were observed during the same period.

Looking forward, the favourable developments in the PE/VC market might become more strongly contested by risks related to the current economic and monetary environment. According to a recent Preqin survey (Preqin, 2016b), pricing/valuations were by far perceived as the biggest challenge investors were facing. While 70% of fund investors across the globe raised this concern, performance and deal flow were stated by 40% and 34%, respectively. This is quite a remarkable turn from the situation two years ago, when regulation, performance and the economic environment had been Limited Partners' key concerns (Preqin, 2014). Warning voices of possible overheating have been uttered since some time (e.g. Go4Venture Advisers, 2015), because of the strongly expansive monetary policy stance that has led to ample global liquidity and low interest rates. In line with this, fundraising, liquidity and availability/pricing of debt financing are to be found only towards the lower end of the investors' biggest challenges ranking (Preqin, 2016b). Another key issue is the possibly longer period of uncertainty about the timing and nature of the UK's departure from the EU, following the Brexit vote on June 23, which might have negative implications for the PE industry, investors and (potential) investee companies.

Regulation is still among investors' concerns, albeit at a lower rank than before. Invest Europe (2016b) provides a comprehensive overview of the regulatory initiatives and changes and their potential impact on PE/VC in Europe. We cannot go into a detailed assessment of all the different rule sets here (just to mention a few names and "popular" abbreviations, e.g., AIFMD, EuVECA, ELTIF, CRD IV, Solvency II, IORP, MiFID II/MiFIR, UCITS V, the review of the state aid guidelines, various taxation rules, and last not least the "Capital Markets Union" policy initiative). Besides regulatory initiatives, structural market weaknesses such as the difficult access of smaller companies to IPO markets (see, for example, EU IPO Task Force, 2015), limit the upside potential of the European VC market.

Moreover, the economic developments over the last years have resulted in significant structural changes in the global and European economic landscape. The digitalisation of the economy has led to a differentiation of market segments. On the one hand, companies in research-intensive sectors continue to follow more traditional growth models with capital-intensive development stages at the beginning of their life. On the other, companies in the digital space are able to start their activities with very limited resources but are exposed to unprecedented needs for funding in the internationalisation and globalisation of their business models. As a result, and depending of the sector and the business models of the companies, time-spans from start-up to global leader have shortened considerably and require companies to scale quickly to sustain the risk of seeing their business model being out-dated before they capture a significant market share.

On a global level, the VC market has adapted to this new diversity of its target sectors. This has led to a bifurcation of the market between sometimes relatively small funds with the aim of scouting emerging business models whilst a new class of giant VC funds expands globally from the US, providing large scale capital to businesses in their global market expansion. In the large scale technology growth capital space Europe has no established players, which explains why virtually every European funding round especially in digital technology growth capital has been led by US VC growth capital funds. However, a number of growth stage VC funds have successfully completed their fundraising recently and hence, going forward aim to play the lead role in funding

rounds of, for example, digital economy companies in Europe on their pathway to global category leaders.

In the shadow of companies driving or directly affected by the “digital revolution”, SMEs and mid-caps in traditional industries are reshaping their strategies for competing in a rapidly changing economic environment and are in need of flexible funding instruments with growth equity, mezzanine debt and hybrid debt to classical debt features. Moreover, recent EIF market insight showed that growth-stage companies are experiencing a serious lack of growth (follow-on) funding in order to accelerate their international expansion and to strengthen their position against global competitors.

In order to strengthen investment capacities, co-investment can be a promising feature of the PE market. According to Coller Capital surveys, “most LPs expect co-investments to remain a fixed feature of the PE landscape” (Coller Capital, 2015). Moreover, 63% of LPs reported “that their co-investments have outperformed their overall PE portfolios in recent years” (Coller Capital, 2016)³⁷. In an EIF survey among VC fund managers in Germany, 66% of the participants saw a benefit from the availability of stable providers of co-investment capacity when addressing potential investment opportunities. 52% would have closed more investments if they could have relied on stable providers of co-investment capacity in the past (the share was notably high for managers of ICT funds at 71%). 57% of respondents listed too small fund size as one of the main reasons why they decided not to invest. 66% of participants saw a high or very high market need for such a co-investment product (source: EIF). This is even more relevant, as currently the large majority of LPs seems to believe “that the LP community lacks the necessary investment skills, experience and processes to make successful co-investments” (Coller Capital, 2015). Time constraints, a limited understanding of co-investment performance drivers, and the inability to recruit staff with the requisite skills were cited as “the main challenges preventing LPs from making successful co-investments”.

Geographically, Europe is a far less homogenous VC market than the US. Whilst the core markets in Europe (UK, France, Scandinavia and to some extent and in some sectors Germany) have seen some recovery since 2008, other geographies continue to struggle with the size of their domestic VC market which is in no relation to their share in the aggregate GDP of the EU (notably Italy and Spain). Sizable differences in the development of the VC markets prevail, especially in the peripheral parts of the EU where markets not only suffer from subcritical size but equally from EU’s very fragmented institutional investor base. On the one hand, for most market segments especially in the early stage VC segment proximity between the VC fund managers and their target portfolio companies is essential. On the other hand, Europe lacks to a large extent the market segment of international pan-European VC growth capital funds that are able to effectively support companies in their global market penetration effort. However, when it comes to the question of policy support instruments, it has to be noted that the value of capital injected for funding Europe’s economic growth is not primarily driven by volume but by impact. This means that large-scale growth capital

³⁷ Coller Capital’s Global Private Equity Barometer is published twice-yearly and intends to give an overview of the plans and opinions of institutional PE investors (LPs) based in North America, Europe and Asia-Pacific (incl. the Middle East). The 24th edition (summer 2016) of the Global PE Barometer captured the views of 110 PE investors from round the world, surveyed in March-April 2016.

funds will make no difference to achieving the policy objectives for the EU's competitiveness if they are not associated with the knowledge of how to grow businesses to global scale.

All these challenges continue to create access to funding problems in the European VC market. The difficulties for young innovative companies to access seed and early stage finance increased during the crisis, as VCs became more risk-averse and focussed more on later stage investments (Wilson, 2015b). A Coller Capital (2013) study found that more than half of the global LPs believe that there are insufficient sources, other than VC, available to finance innovation and growth in Europe. This supports a view that public backing is needed in order to strengthen the market. We had outlined recent OECD findings on policy measures taken by governments to support seed and early-stage financing in previous issues of the ESBFO. Indeed, an Unquote Intelligence (2014) survey found that "public money remains absolutely critical to the European venture industry and is likely to remain so for the next five years", and this has been particularly true for new funds, as most public funding bodies support first-time funds, while this is true for only approximately half of private investors. Besides the additional funding volumes, public investors' participation in a PE/VC fund can also have a positive signalling effect on private investors, e.g. due to perceived strong due diligence requirements and an assumed relatively high stability of public LPs' commitment to a fund. These advantages seem to outweigh the potential disadvantages (e.g. a possibly negative impact on speed and responsiveness or imposed restrictions in the investment strategy of the fund) of public investors' participation.

In this context, the relationship between private VC activities and governmental support was analysed in several empirical studies: According to Colombo, Cumming and Vismara (2014), the design of a public VC investment scheme is important for their impact. In particular, governmental VC schemes seem to have been more successful when they acted alongside private investors, which would favour a governmental fund-of-funds set-up over direct public investments. Indeed, the focus of support instruments "has shifted from government equity funds investing directly to more indirect models such as co-investments funds and fund-of-funds" in OECD countries (Wilson, 2015b). Moreover, Brander, Du and Hellmann (2014), in a continuation of their 2010-study, find that enterprises funded by both governmental VC and private VC obtain more investment than enterprises funded purely by private VCs, and much more than those funded purely by governmental support. There is also a positive association between mixed governmental/private funding and successful exits, as measured by initial public offerings and acquisitions, attributable largely to the additional investment. These findings are in line with Bertoni and Tykvová (2012), who concluded "that syndicates between private and governmental venture capital investors, in which the private investor takes the lead, are the most efficient form in terms of innovation production that outperforms all other forms." However, as said earlier, public policy in the area of venture capital should go beyond an exclusive support of VC funds (see Hellmann, Schure and Vo, 2015), but rather aim to attract equity financing to Europe also from other sources, such as angel investors and crowdfunding (see Wilson, 2015a; see also Aubrey et al., 2015, for related policy recommendations to support growth firms).

The private equity and venture capital markets have shown remarkable positive developments in the recent past. However, several risks have also been observed. Even if a recent survey found that

the large majority of global PE fund investors does not intend to change their commitment pace despite the current market volatility (Coller Capital, 2016), it remains to be seen if a sustainable longer-term positive trend can become prevalent. While in some cases an improvement in performance is indeed driven by fundamental economic value, part of the upside performance may also be driven by higher demand due to dry powder looking for investments. Moreover, current EIF insight suggests that the number of “fast” exits on the VC side (less than 2 years holding period) have tended to increase over recent years. This could be explained by fund managers tending to privilege a quick divestment due to current valuations, driven by a positive short term market sentiment, instead of longer term buy and build strategy. All this is to be looked at with caution. It is then, however, important to support those companies in their continued growth that have well-developing economic fundamentals, and to also help, through the support of financial intermediaries, additional and complementary businesses to maintain and strengthen the backbone of the European VC market, i.e. a strong and continued supply of new innovative companies. In addition, the VC ecosystem is developing, including the emergence of more and more successful incubators and accelerators. Should these trends continue, the potential returns of early-stage companies would have significantly positive impacts on the performance of VC investing.

In all, Europe therefore needs an integrated portfolio of funding instruments in support of the various segments of its start-up³⁸, SME and mid-cap landscape to foster the recovery from the 2008 financial crisis and to unleash the full potential of EU companies’ competitiveness and their contribution to Europe’s economic growth and innovation. Instruments should be complementary to existing initiatives in terms of sector, stage or geographic focus. However, the dynamics of recent economic developments e.g. in the area of the digital economy, has made the segmentation between early stage and late stage VC somewhat redundant. Policy instruments that create artificial boundaries of development stages of businesses could be prohibitive to an efficient VC market. Moreover, EU’s VC markets show different development stages and so require different policy instruments. In less developed markets instruments may need to work strongly together with the actors in the informal VC markets (BAs, Incubators, TT Centres) and be complemented by flexible co-investment products to grow the domestic VC market. However, companies with global ambitions compete globally. Instruments investing in future industry leaders compete for investors who seek exposure to the best companies on a global scale, not with respect to a given geography. Therefore, giving flexibility in the geographic boundaries of policy instruments is not only key in retaining EU-based businesses in Europe but may attract non-EU based businesses to relocate to Europe. Based on these considerations, it appears vital to offer a flexibility of instruments adapted to diverse market conditions in the various geographies of the EU. Such should be implementable in a time and cost efficient manner. Moreover, in times of economic slowdown and scarcity of private capital the temptation grows to construct policy instruments that substitute the private sector. However, there is in fact a need to use public sector resources with the primary objectives of mobilising private sector capital, as clearly demonstrated, for example, by the leverage factor built in the Investment Plan for Europe (see Chapter 7 for more details) and other instruments implemented by the EIF. As a reference catalytic investor in European venture and

³⁸ In order to shed some more light on the relationship between VC and start-ups, Brinckmann (2015) recently analysed, in cooperation with EIF RMA, the effect of entrepreneurs’ profiles on the performance of VC-backed start-ups. We presented key parts of this work in the previous ESBFO issue (see Kraemer-Eis, Lang, Torfs and Gvetadze, 2015).

growth capital funds, EIF is actively working in the direction outlined above: EIF has increased its counter-cyclical role by providing financing solutions to boost entrepreneurship and innovation. In the coming years, EIF will continue to act as a cornerstone investor across the spectrum from technology transfer to venture capital to the lower mid-market and mezzanine financing. EIF's activity in the equity sphere also includes the launch and extension of new and pilot initiatives. Please see for more information the EIF website, www.eif.org.

5 SME guarantees and SME Securitisation in Europe

5.1 SME guarantees

5.1.1 Market failure and policy response

Information asymmetries in the credit market: the rationale for public sector involvement

Public CGSs are used in many developed and developing economies to alleviate the constraints facing SMEs in accessing finance. Indeed, financial institutions are usually reluctant to extend uncollateralised credit to SMEs, even at high interest rates, in part because of the high costs of obtaining adequate information on the true credit quality of small, typically young companies. Many of these firms do not have the necessary amount and type of assets that could serve as collateral for the loan. As a result, many SMEs with economically viable projects cannot obtain the necessary financing from the regular system of financial intermediation. This phenomenon is often referred to as the SME financing gap, i.e. an insufficient supply of credit (an analogue argumentation is valid for equity financing) to SMEs (OECD, 2006), the existence of which is driven by a market failure typical for the credit market: information asymmetries.³⁹ Information asymmetries can lead to credit rationing through either *moral hazard* problems or an *adverse selection* of low quality borrowers (Akerlof, 1970). Adverse selection occurs when banks cannot differentiate between good and bad projects. Higher interest rates will discourage businesses with the least risky projects to take out loans. This then implies that, for any given interest rate, inherently riskier projects will be overrepresented in the loan application pool (Jaffee and Russel, 1976; Stiglitz and Weiss, 1981). Moral hazard problems occur when limited liability in the event of default provides borrowers with an incentive to take up excessive risk.⁴⁰ This means that in the presence of asymmetric information, banks are reluctant to use higher interest rates, because it reduces their equilibrium profits. As a consequence, the rational response of the banks is to keep the supply of credit below the demand, rather than to increase the interest rate charged on loans.

Information asymmetry induced credit rationing is particularly prevalent in the market for lending to SMEs, for two reasons. The first reason relates to their lack of collateral: the availability of collateral provides a way for borrowers to directly eliminate the asymmetric information problem. Pledging collateral in a loan-agreement allows firms to bindingly signal their true credit worthiness. However, firms do not always possess the required collateral. This holds especially true for small and medium sized enterprises (SMEs). The credit rationing result is therefore particularly relevant for this segment of firms, where failure to meet lenders' collateral requirement aggravates access to finance problems. In addition, the use of collateral comes with a number of drawbacks. For one, the collateral may be worth more to the borrower than to the financial institution providing the loan. In addition, the use of collateral usually increases the cost of borrowing, as it generally involves legal and other administrative procedures. The second reason SMEs are more affected by credit rationing than larger companies relates to the fact that credit market information asymmetries are more pronounced for small firms and the cost of monitoring them is higher. Large

³⁹ See OECD (2014b) for an overview of market failures in SME lending and mitigation techniques.

⁴⁰ Both the adverse selection as well as the moral hazard argument crucially hinge on the insight that higher interest rates reduce the borrower's stake in the project underlying the loan (Tirole, 2010), which is an illustration of the typical principal-agent problem (Arrow, 1985).

companies are required to adhere to corporate norms, legal standards, formal reporting requirements etc., whereas business decision making processes, transparency rules, dividing lines between company and personal assets are less defined for SMEs. SMEs are often young organisations, so that credit history and operational track records are by construction shorter compared to their larger counterparts. Market failures in the bank lending market therefore imply that many SMEs with economically viable projects will not be able to obtain the necessary financing from the regular system of financial intermediation.

Recently, two factors have contributed to a worsening of the SME financing gap. First, a number of studies have put forward the conclusion that credit constraint issues are further deepened by increasing market concentration in the banking sector. Ryan et al. (2014) for example, show how bank market power is associated with an increase in financing constraints, and thus leads to lower levels of SME investment levels. This conclusion is confirmed by Chong et al. (2013) who show that lowering market concentration in the banking sector indeed alleviates financing constraints. Given the pace of consolidation in the European banking sector has been accelerating over the past decade (Uhde and Heimeshoff, 2009), these observations are particularly relevant for SMEs in Europe. Second, the sharp drop in real estate prices negatively impacted the credit availability to SMEs, who often use property assets as collateral (OECD, 2012).

Information asymmetries exist to a lesser degree if a strong relationship between lender and borrower has been established. Hence, unsurprisingly, most SMEs have a close relationship with one (sometimes two) "house bank(s)" (EBF, 2015). A close relationship with a lender makes the borrower well aware of what information needs to be provided, including the extent of collaterals required (support in this regard is also given by third parties like, for instance, chambers and guarantee societies with specific knowledge of the local SME market). In addition, it enables the lender to know well not only the hard but also the soft facts of the borrower. Thus, through due diligence/lenders' examination (screening) and by a firm's ability to signal its credit worthiness (incl. an institutional assessment or rating by an independent agency and the provision of collateral, also in form of a guarantee), information asymmetries can be reduced. However, this means that new or young firms with a lack of collateral and, by definition, without a track record, are the ones with the greatest degree of difficulty in accessing debt capital. These financing obstacles can also negatively affect productivity in the economy.

Given the strategic importance of SMEs as drivers of economic growth and innovation, it is of crucial importance to address the consequences or credit market failures in order to exploit the externalities from entrepreneurial dynamism (Honohan, 2009).

Using CGSs to alleviate the supply shortage

Guarantee mechanisms, "whereby should the borrower default the guarantor compensates a pre-defined share of the outstanding loan" (OECD, 2014b, 2015d), are a commonly used response to address the consequences of these kinds of market failures, as guarantees reduce the risk of lenders and favour the provision of financing to viable businesses that are constrained in their access to finance. Credit guarantee schemes (CGSs) "are used widely across economies as

important tools to ease financial constraints for SMEs and start-ups” (OECD, 2013), in order to alleviate market failures in SME financing.

Moreover, loan guarantee programs expanded substantially in the years 2007-2011, as governments responded to the financial crisis. Carefully designed guarantee schemes have positive macroeconomic effects, meaning that the costs for the tax payers due to default payments are outweighed by the positive stimulating effects (such as on employment and tax revenue) of guarantees for the economy. In addition, “new elements were added to some of these programmes, such as reduced red tape and more rapid provision (i.e. ‘express guarantees’ [in Belgium]), and new instruments were created outside traditional guarantee programmes” (OECD, 2014b). Therefore, credit guarantee programs continue to be “the most widely used instrument at governments’ disposal to ease SME access to finance” (OECD, 2015c; see also OECD, 2015e, 2016). Moreover, guarantees are “increasingly targeting young and innovative firms in an effort to boost employment and value added” (OECD, 2016). While CGSs do not alleviate information asymmetries directly, and hence do not address the root of the market failure,⁴¹ they can increase the incentives of lenders to supply credit to SMEs by providing a substitute for collateral, and if designed correctly, increase overall welfare. Some studies have investigated the welfare effects of CGS policies and documented the superiority of CGSs compared to other instruments to alleviate welfare losses associated with credit market failures.

Arping et al. (2010) examine the conditions under which CGSs are socially preferred over government co-funding, using a moral hazard model in the spirit of Holmstrom and Tirole (1997). They conclude that provided entrepreneurs are not substituting public for private collateral, a welfare-maximising strategy prefers CGSs over government co-funding of investment projects. Government involvement in the establishment and funding of CGSs can also be motivated by resolving coordination failure between private-sector entities, which prevents them from pooling their resources. Anginer et al. (2014) argue that when lenders are risk averse, efficient provision of guarantees may not occur on a private sector basis due to collective action problems, i.e. although the stakeholders are all aware of the problem, the lack of action comes from the misalignment of the private interests with those of the society. They also stress that the incentives for collective action are even weaker in economies with less developed financial systems. The state, on the contrary, is able to resolve the collective action frictions that get in the way of risk spreading. However, to achieve this objective, the state has to maintain the incentives for lenders to monitor projects efficiently, and to deter the borrower from excessive risk taking. This can be done by pricing guarantees in a way that ensures the expected losses being covered by the fees charged, and promotes the risk being shared with the private sector.

In addition, CGSs hold other advantages. First, the final lending decision stays with a market-based, private-sector entity – the bank –, which has the expertise and the necessary technology to evaluate credit applications and projects. This is likely to ensure a more efficient selection among borrowers than if the task is done by a public agency, since – given that the guarantee is partial -

⁴¹ This would only be the case to the extent that CGS has a comparative advantage in screening activities, vis-à-vis traditional credit institutions. The way in which CGSs function in reality indicates this is likely not the case: in practice the credit appraisal of the final borrower is still executed by the lender and CGSs often guarantee full portfolios of loans and therefore do not maintain a personal relationship with the borrower.

it leaves part of the risk with the privately operating lender. Second, compared to direct lending programmes, CGSs have much lower initial cash flow needs, and as such, have a leverage component. As a consequence, they can also be used when fiscal constraints are tight. However, the small initial cash outlay of credit guarantee schemes also has disadvantages. Honohan (2010) notes that, as a large number of borrowers can be reached with only relatively small initial costs in the short run, political incentives exist for the public sector to supply guarantees generously, while concealing the true long-term fiscal costs of a programme behind the uncertainty around the expected long-term losses on the guarantee portfolio. This can result in unexpected fiscal costs further down the road. Third, supranational CGSs can contribute to an efficient geographic distribution of credit. Results from a recent EIB survey on European CGSs (forthcoming) highlight that all existing CGSs choose to operate within the national borders of the country they are headquartered in. This can be explained by the existence of cross-border information frictions related to national legal frameworks that govern the functioning of CGSs. Supranational CGSs can therefore contribute to an efficient cross-border allocation of credit.

The importance of credit guarantee schemes has been confirmed, *inter alia*, in a recent joint Working Paper of the EIF and the European Commission (Asdrubali and Signore, 2015; see also VIWGCGS, 2014). Based on an analysis of the Multi-Annual Programme for enterprises and entrepreneurship (MAP) EU SME Guarantee Facility and focussing on Central, Eastern and South Eastern Europe (CESEE) countries, Asdrubali and Signore (2015) find significant positive effects of this EU guarantee programme on the beneficiary firms. By breaking down the sample by country, signature year, size and age classes, the authors find that micro and young SMEs have benefited the most from MAP-guaranteed loans in terms of economic additionality. See for more details Asdrubali and Signore (2015); a summary can also be found in a previous ESBFO issue (Kraemer-Eis, Lang and Gvetadze, 2015a).

In order to alleviate problems experienced by SMEs in accessing finance, the EIF is playing an important role. Through a wide range of financial intermediaries, such as banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks, and other financial intermediaries, EIF can effectively provide both financing to SMEs and guarantees for SME financing. Apart from EIF guarantees for securitised SME financing instruments (see Chapter 5.2), EIF offers guarantees/counter-guarantees for portfolios of microcredits, SME loans or leases. See for more information the EIF website www.eif.org.

5.1.2 Market size and activity in 2015

Market information concerning CGS in Europe is gathered by AECM, the European Association of Guarantee Institutions.⁴² In the following we provide information about the countries with at least one AECM member to show the state and development of this important market segment.

⁴² We thank our colleagues from AECM for their support. AECM has currently 40 members in 21 EU Member States plus Bosnia and Herzegovina, Russia, Serbia and Turkey. In the AECM member countries, the AECM members cover all or almost all SME guarantee activity. Some AECM members are national associations or networks and thus have their own member organisations. AECM has purely private, mutual, public, and public-private mixed members. Source: AECM.

Key figures, based on *outstanding guarantees* on SME loan portfolios as at 31.12.2015, are presented in Table 3. In terms of total amounts of guarantee activities, the core countries are Italy (EUR 33.6bn), France (EUR 16.7bn), Turkey (EUR 5.9bn), Germany (EUR 5.6bn) and Spain (EUR 4.1bn). Italy also has the highest total *number* of outstanding guarantees (1,058,747), followed by Turkey (759,848) and France (705,448). The total number of SME beneficiaries in the portfolios of the AECM members amounted to more than 2.7m.

Table 3: Guarantee activity of AECM members in 2015 by country

Country	new business	outstanding			
	Volume [k EUR]	Volume [k EUR]	Number	Average guarantee size [k EUR]	Number of SME beneficiaries
Austria	216,937	897,572	5,507	163.0	4,446
Belgium ^a	266,944	759,839	9,716	78.2	7,735
Bosnia-Herzegovina	1,839	7,622	62	122.9	57
Bulgaria	65,098	88,320	1,582	55.8	1,458
Croatia	41,819	172,328	1,595	108.0	1,480
Czech Rep.	258,941	737,317	8,314	88.7	6,159
Estonia	64,176	116,287	1,218	95.5	989
France ^c	6,816,170	16,747,025	705,448	23.7	594,006
Germany	1,093,500	5,598,333	46,893	119.4	45,955
Greece	17,169	231,018	9,170	25.2	9,170
Hungary ^a	1,314,309	1,549,398	44,771	34.6	37,581
Italy ^{a,d}	9,553,492	33,566,242	1,058,747	31.7	1,348,767
Latvia	34,614	115,039	755	152.4	574
Lithuania	95,913	196,459	3,356	58.5	2,991
Luxembourg	318	931	50	18.6	50
Netherlands	420,216	1,756,226	17,677	99.4	15,979
Poland ^{c,d}	2,480,744	2,045,401	91,355	22.4	91,355
Portugal	1,336,248	3,152,998	89,524	35.2	49,393
Romania ^b	398,709	1,220,960	12,423	68.3	11,638
Russia	49,243	93,313	1,331	70.1	975
Serbia	1,182	9,908	612	16.2	612
Spain	974,407	4,073,568	69,799	58.4	118,879
Slovenia ^b	89,589	233,015	1,652	136.4	1,652
Turkey ^c	3,420,162	5,942,499	759,848	7.8	375,910
UK	159,710	995,791	11,915	83.6	11,915
Total	29,171,449	80,307,409	2,953,320	27.2	2,739,726

^aFor data availability reasons, AECM statistics for 2015 include the 2014 business figures of all Italian AECM members, of one Belgian and one Hungarian AECM member.

^bIn the case of Romania and Slovenia, one AECM member did not report the number of guarantees outstanding; hence, the average guarantee size can only be calculated based on the number of the remaining AECM members.

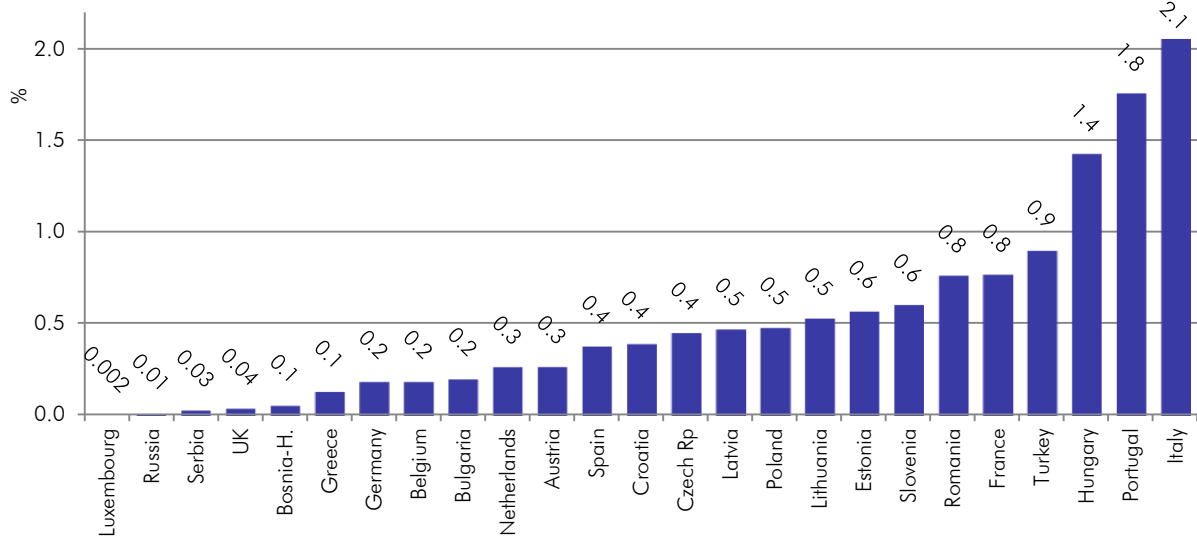
^cIn the cases of France, Poland and Turkey, the number of SME beneficiaries partly contains estimated data. In the case of France, this is also true for outstanding guarantees.

^dFor Italy and Spain, the number of SME beneficiaries is reported to be higher than the number of guarantees. For Poland, the new business volume is reported to be higher than the outstanding volume. In all cases, this is due to different reporting approaches (e.g. some SMEs are members of guarantee networks but do currently not use any guarantee; current years are not added to outstanding volumes).

Source: AECM (provisional figures)

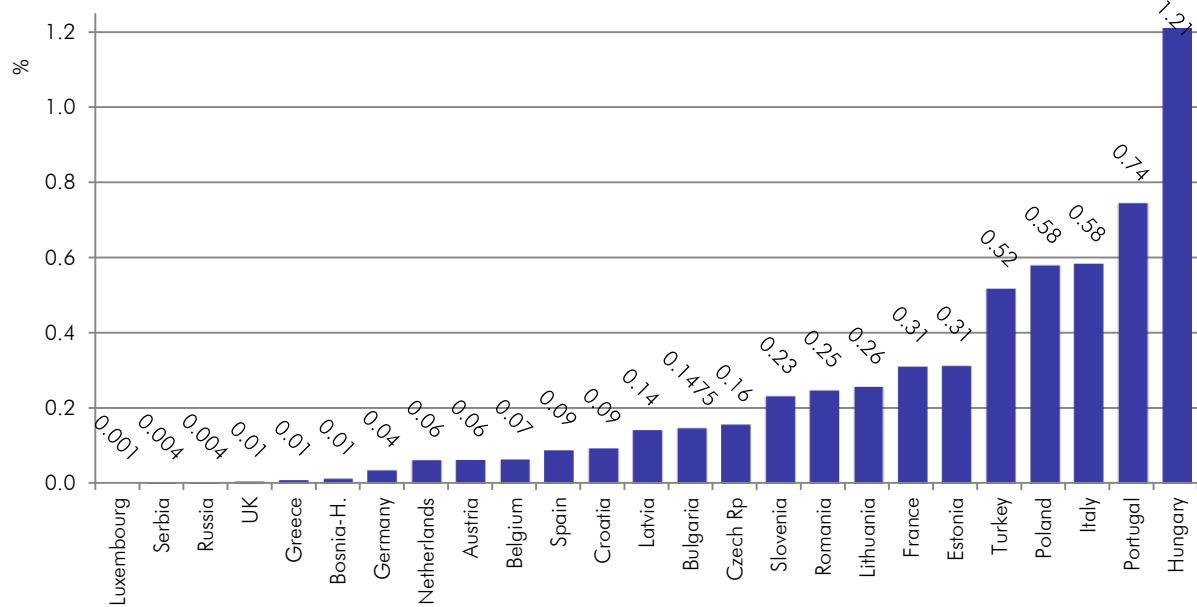
Compared to the value of economic activity, guarantees are relatively important (measured by the volume of outstanding guarantees in portfolio as a percentage of GDP) in Italy (2.1%), Portugal (1.8%) and Hungary (1.4%), as shown in Figure 32. According to the OECD (2013), guarantees are particularly relevant “in those countries where a network of local or sectoral guarantee institutions is well established”. The new guarantee activity in 2015 was strongest, related to GDP, in Hungary, Portugal, Italy, Poland and Turkey (see Figure 33).

Figure 32: Volumes of outstanding guarantees in portfolio scaled by GDP, 2015 data



Sources: AECM (provisional figures), IMF, own calculations.

Figure 33: Volumes of guarantees granted in 2015 scaled by GDP



Source: AECM (provisional figures), IMF, own calculations.

In 2015, the guarantee activity of AECM members has, on average, considerably increased, compared to the year before. The total outstanding guarantee volume of AECM members grew by 2.2% to EUR 80.3bn. However, this was also caused by the effect of adding the British Business Bank to the AECM statistics in 2015, which brought an additional guarantee volume of EUR 1.0bn. Those AECM members that were already part of the statistics in 2014, increased their outstanding guarantee volume by 0.9%. The highest growth rates were recorded in Hungary (+17.6%), Latvia (+17.4%), Turkey (+15.5%) and the Czech Republic (+14.2%). In contrast, the outstanding guarantee value decreased the most in Russia (-29.8%), Greece (-25.0%), Romania (-22.5%) and Bulgaria (-17.7%).

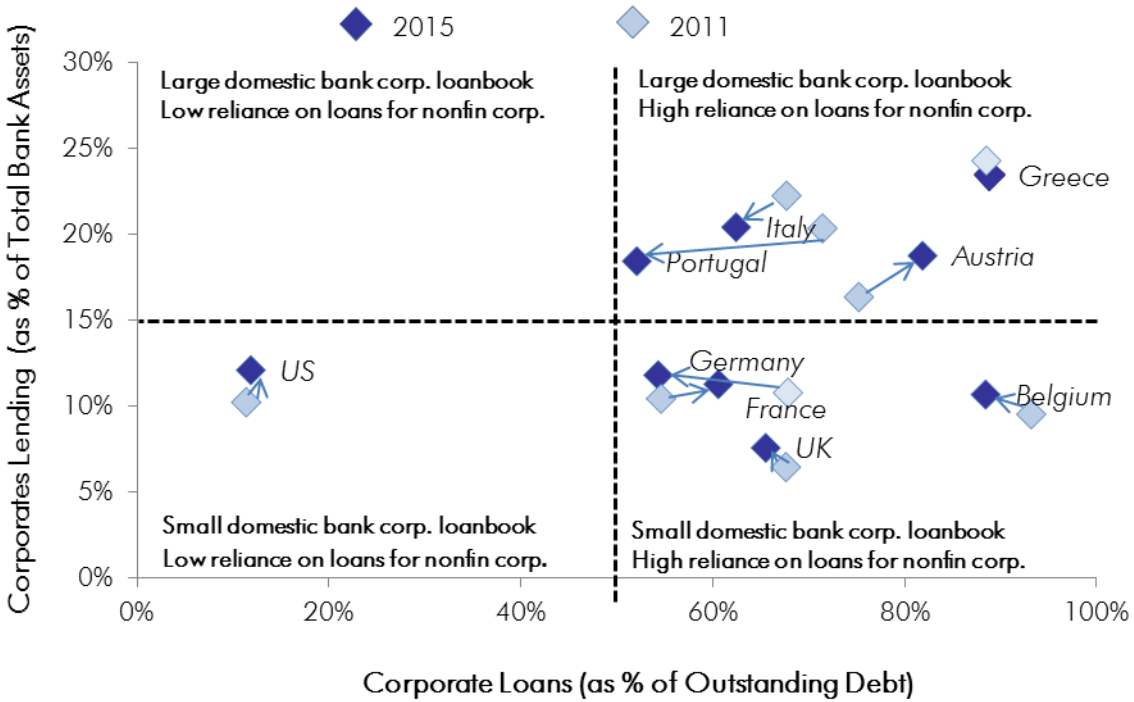
The volume of new guarantees granted in 2015 grew by 8.4%. When taking out the British and the Serbian members, who provided their business figures to AECM for the first time in 2015, the increase was still at 7.8%. The new guarantee business almost doubled in Austria, while significant increase were also recorded in the Czech Republic (+70%) and Portugal (+33%). The new guarantee business decreased the most in Greece (-68%), Bosnia-Herzegovina (-59%), Romania (-47%) and Russia (-26%).

5.2 SME Securitisation⁴³

European SMEs rely heavily on bank lending; Figure 34 provides an indication based on IMF data. As outlined in more detail in Kraemer-Eis (2014), this ratio is moving towards more capital market action: Cour-Thimann and Winkler (2013) state that external financing of the non-financial corporate sector (financing other than retained earnings) is dominated by bank financing (in the euro area). However, as the authors point out, this split refers to the stock - in terms of flows the figures fluctuate significantly: in particular as the corporate sector can to some extent substitute bank lending with other sources of finance. For SMEs, this possibility exists only to a very limited extent. During the crisis part of the declining bank lending was offset by an increase in capital market funding (see Figure 35): debt securities issued by corporations (but also quoted shares issued) increased. But, "such substitution is primarily possible for large corporations; it is less so for small and medium-sized firms, which constitute the bulk of employment and activity in the euro area" (Cour-Thimann and Winkler, 2013).

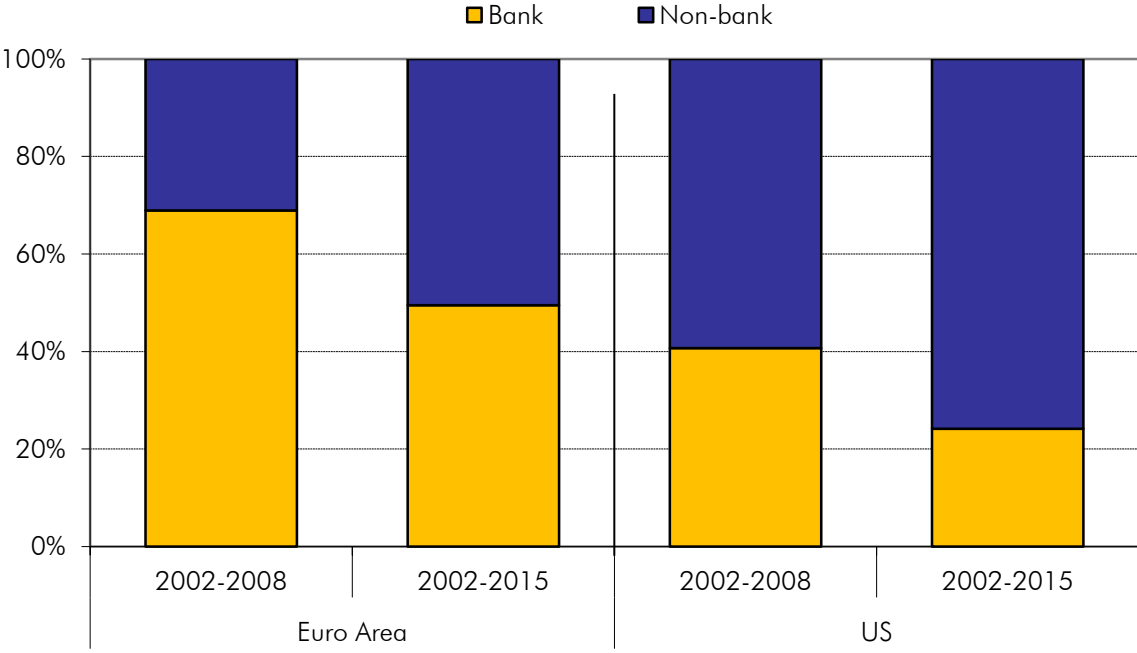
⁴³ The term SME Securitisation (SMESec) comprises transactions backed by SME loans, leases, etc. It is important not only to look at banks/lending when analysing SMESec, but equally at leasing companies, which form part of the securitisation market. Given that bank financing is and will be less available for leasing companies post-crisis, it can be expected that SMESec will be particularly relevant in the leasing area. For more information on the importance of leasing for SMEs finance, see Kraemer-Eis and Lang (2012 and 2014).

Figure 34: Reliance on bank financing by non-financial corporations (in %)



Source: Authors, based on IMF (2012) and updated information.

Figure 35: Funding of non-financial corporations in the euro area and the United States (shares in accumulated debt transactions)



Source: Authors, based on Cour-Thimann and Winkler (2013), with updated data.

As we stated already in our previous publications: securitisation per se is not good or bad - it is a toolbox, an instrument, a technique. As such it is value-free; but its aggressive, opaque, and overly complex use by some market participants has negative consequences for ultimately both issuers as well as investors. Negative repercussions are however also created by an overly simplified discussion where everything related to structured finance is lumped together and sometimes dismissed or branded as “toxic”. The instrument is neither “toxic” nor is the underlying asset (in the case of SMESec loans to SMEs) “toxic waste”.

On the contrary - loans to SMEs are a key driver for the functioning of the economy and, properly applied, the securitisation technique is a replicable tool that can enhance access to finance for SMEs. Using this instrument in developed capital markets, public sector support for SMEs (e.g. guaranteeing mezzanine tranches) can create multiplier effects - and hence it is an efficient use of public resources, which is especially important against the background of a high public debt burden in many key countries. “Taken together, strengthening SME securitisation may be one of the most effective ways to facilitate the flow of funds to the real economy, while not creating too much distortion” (Kaya, 2014).

The reputation of the SME securitisation market segment is continuously improving; a de-stigmatisation is happening, and the general perception is shifting from one of “toxic waste” to a means that could help overcome the negative effects of the crisis. However, as we will see later, SMESec placed with investors currently represents only a very small portion of the total issuance and there is for the time being only a very limited primary market.

5.2.1 SMESec market activity⁴⁴

The European securitisation market had grown steadily from the beginning of the previous decade until the outbreak of the crisis. However, the European market is much smaller than its US peer (see Figure 36). During the crisis, issuance remained initially at high levels (compared to pre-crisis values) in Europe, but these volumes were almost exclusively driven by the eligibility of ABS as collateral for ECB liquidity operations;⁴⁵ then the overall market activity decreased to the 2003/2004 levels, in particular due to regulatory uncertainties⁴⁶ and tighter euro system collateral rules.

Securitisation is a technique that needs significant know-how and sophisticated actors on the supply and demand side. However, in line with the shrinking activity volumes, the number of active market participants is also declining: there are a reduced number of active securitisation professionals, i.e. at investors, issuers, agents, etc.

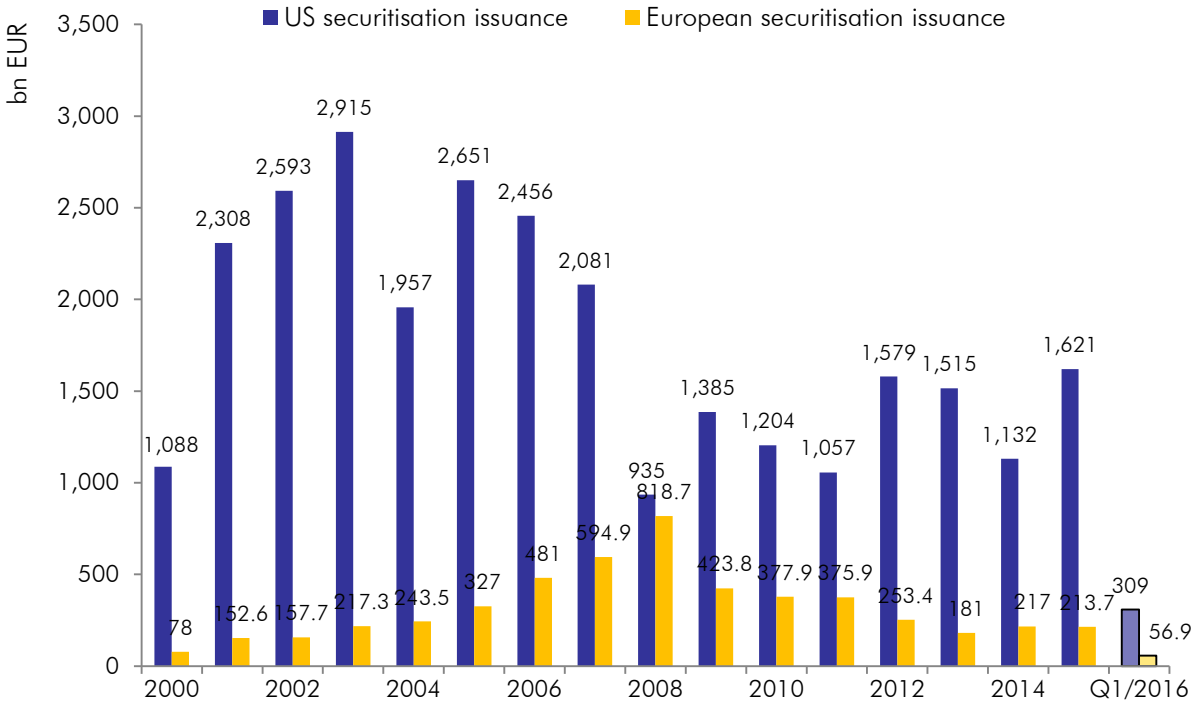
To date, public issuance is still hindered in particular by the regulatory framework (and related uncertainties) that makes transactions less attractive for originators and investors – as well as by ECB eligibility rules under the repo-collateral framework that favour alternative instruments, such as sovereign bonds or secured or unsecured bank debt.

⁴⁴ If not flagged otherwise, the data source is AFME, the Association for Financial Markets in Europe (i.e. AFME, 2016).

⁴⁵ The ECB’s asset repurchase or “repo” facility allows (among other assets) Asset Backed Securities to be used as collateral for funding.

⁴⁶ See for details concerning the regulatory developments e.g. AFME (2016).

Figure 36: Securitisation issuance Europe versus US (annual issuance 2000 - 2015, bn EUR)



Source: Authors, based on data from AFME/SIFMA

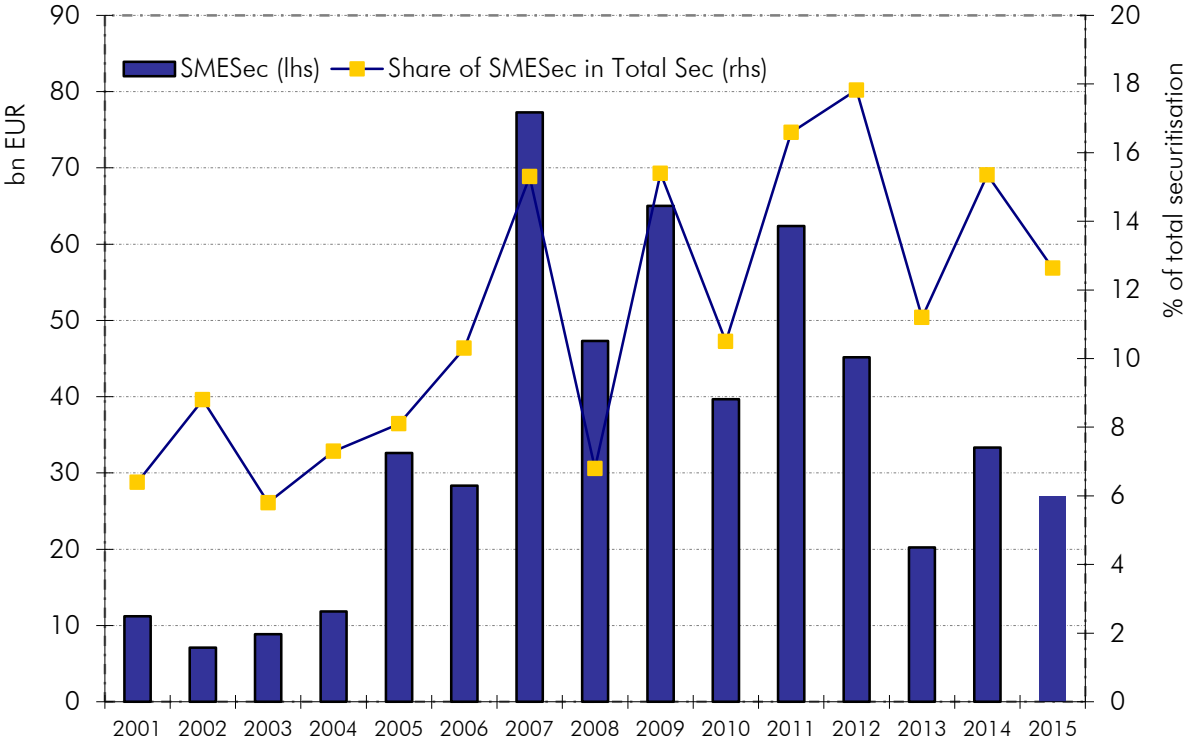
Issuance

The most active markets in 2015 in terms of overall securitisation issuance were UK (market share: 21%), Germany (21%), Italy (15%), Spain (12%), the Netherlands (10%) and France (8%). The overall market activity in 2015 (EUR 214bn) was similar to 2014 (EUR 217bn). In 2016, so far (Q1), a volume of almost EUR 57bn has been issued, an increase of 61% compared to Q1/2015.

SMESec issuance is still suffering from the crisis. The overall issued volume of SME deals in 2015 (EUR 27bn) was well below the 2014 values (EUR 33bn, see Figure 37). This year, Q1 SME issuance was higher than the one in Q1/2015 (EUR 4.6bn compared to EUR 4.1bn). The market share of SMESec in overall securitisation issuance rose (with some volatility) from 6% in 2001 to 18% (of total yearly issuance) in 2012, the highest value ever registered in Europe. This, however, came about due to the base effect, as the overall activity went down (while SMESec activity decreased slightly less). In 2015, the share of SMESec was 13%, slightly lower than the year before (15%); in Q1/2016 the share was only 8%.

During the crisis, also the large volumes of synthetic SMESec transactions, that were evidenced pre-2007 on SME portfolios dominated primarily by German SMEs on the back of KfW’s PROMISE program, virtually disappeared. Rating downgrades, based on revised rating agency criteria (i.e. counterparty and country ceiling criteria, without grandfathering), on downgrades of counterparties involved in the transactions, and on negative credit trends, contributed to the overall negative market sentiment.

Figure 37: SMESec issuance in Europe (volume and share of total securitisation, bn EUR and %)



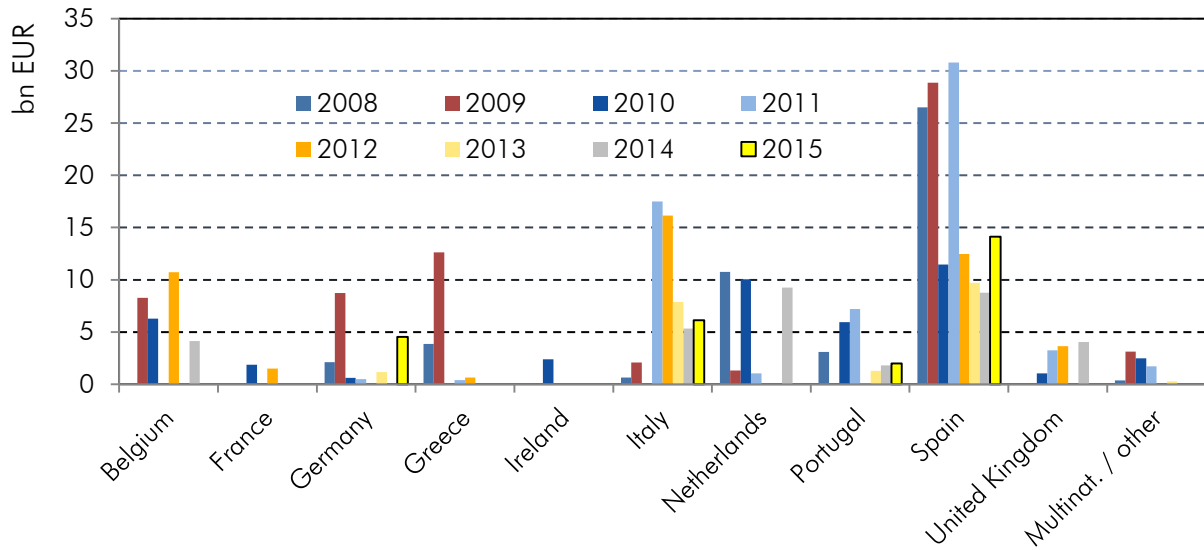
Source: Authors, based on data from AFME and own calculation

In terms of countries, the market activity is concentrated: The SME related issuance in 2015 occurred only in Spain (EUR 14.1bn, 53% of SME issuance), Italy (EUR 6.1bn, 23%), Germany (EUR 4.5bn, 17%), and Portugal (EUR 2bn, 7%) – see as well Figure 38 for an overview of the SMESec issuance by country during the crisis. However, it is important to note that the AFME data used above and in many of the following figures classifies only *lending*-based transaction in the SME basket. Most leasing-based transactions, classified in AFME’s data under ABS Leases in the overall ABS basket, are de-facto SME transactions. Moreover, in the securitisation market, there are often (synthetic) transactions on a bilateral or club basis that are not visible in the official statistics. Hence, the numbers, shown here, are an underestimation of the total SMESec market size.

Typical originators are large banks or banking groups – some of them are active as originators in several countries (e.g. UniCredit, Raiffeisen, ING Group), but as well mid-sized banks. Moreover, in particular in the field of leasing, non-bank asset finance providers are active as originators; for instance, Alba Leasing in Italy and the small and medium size asset-finance providers in the UK which are the primary target recipients of the British Business Bank’s ENABLE program.⁴⁷

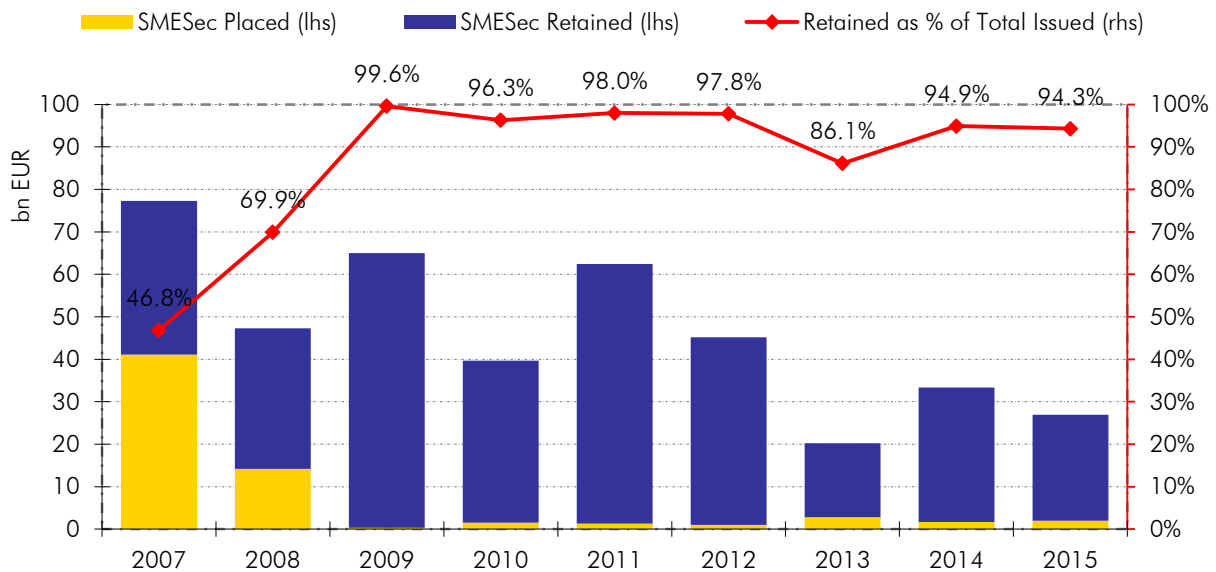
⁴⁷ See for more information e.g. <http://british-business-bank.co.uk/become-a-partner/wholesale-solutions/>

Figure 38: European SMESec issuance in Europe during the crisis (by country, in bn EUR)



Source: Authors, based on data from AFME

Figure 39: European SMESec by retention (bn EUR and %)



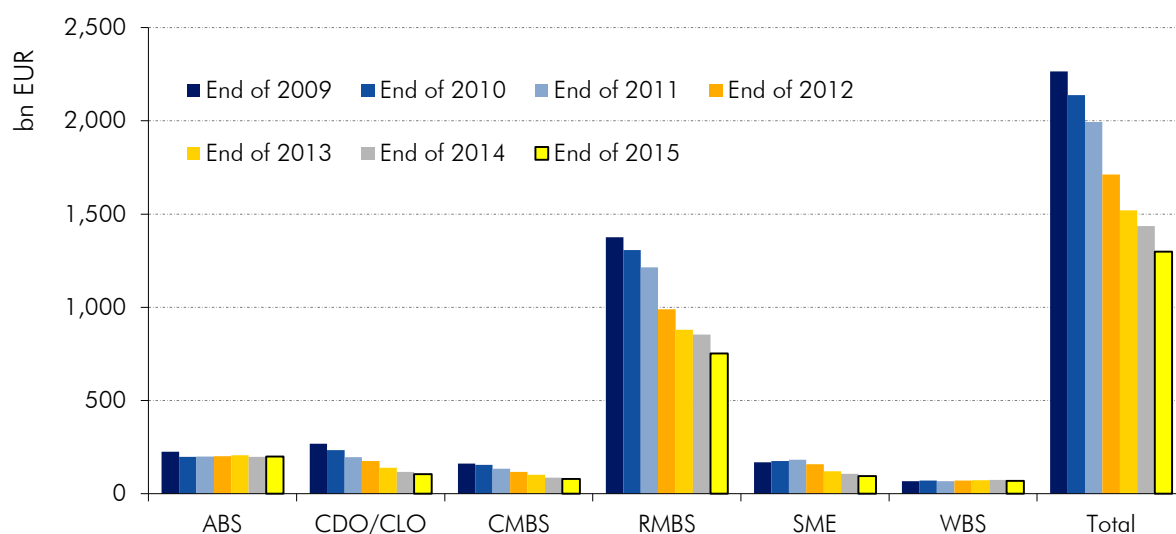
Source: Authors, based on data from AFME

As already mentioned, it is important to note that only a very small fraction of the issuance has been placed with investors (see Figure 39): the nature of the SMESec market changed from a developing market (pre-crisis, with most transactions placed in the primary market) to a purely retained/ECB repo-driven market during the crisis (with almost no placement on the primary market). This shift led to liquidity drying up and originators accepting higher all-in costs as, in addition to the credit enhancement, the repos envisage considerable haircuts to the face value of the notes.

Outstanding

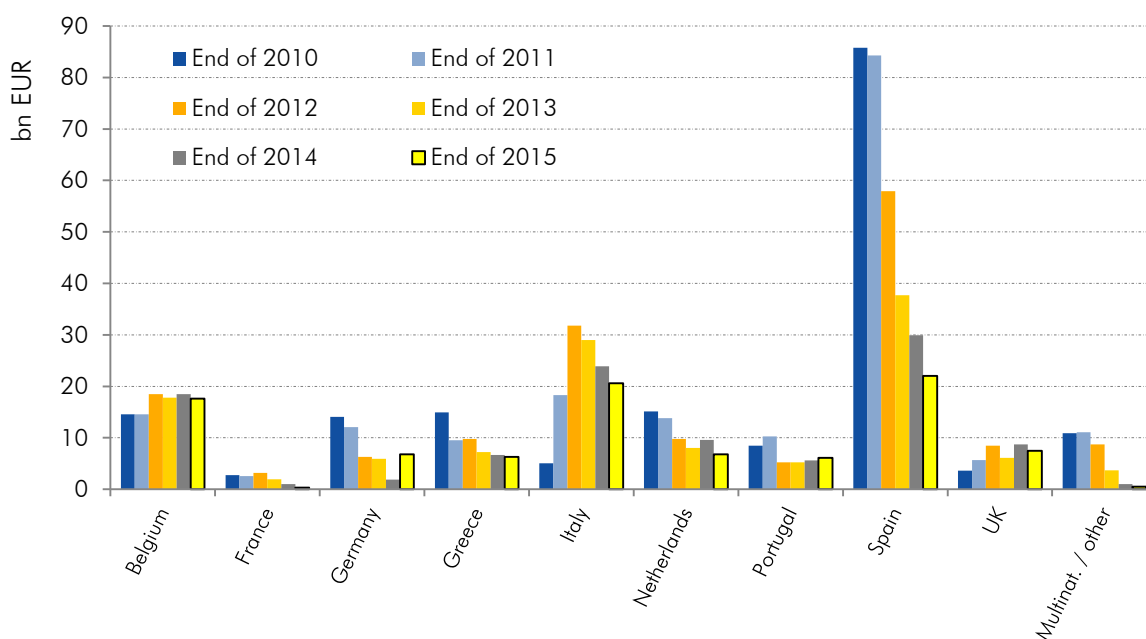
Due to low new activity levels, the volume of *total outstanding securitisation transactions* (see Figure 40) is on a downward trend (negative net supply). Compared to the end of 2014, until end of 2015, the total outstanding decreased by almost 10%. Since the end of 2009, the volume of total outstanding securitisation transactions decreased by 55%. During the same period, the volume of outstanding SMESec transactions decreased by 43%, from EUR 168bn to EUR 94.5bn (end of 2015; end of Q1/2016 outstanding SMESec transactions in Europe amounted to EUR 88bn).

Figure 40: European outstanding securitisation transactions by collateral (bn EUR)



Source: Authors, based on data from AFME

Figure 41: European SMESec outstanding volume by country (bn EUR)



Source: Authors, based on data from AFME

If SMESec volumes per end of 2015 are broken down by country (see Figure 41), the Spanish (23.3%), Italian (21.8%), and Belgian (18.6%) markets together are dominant and count for almost 64% of the overall SMESec outstanding, followed by the UK (7.9%), the Netherlands (7.2%), and Germany (7.2%).

SMESec performance trends

Despite the financial and sovereign crisis and the prolonged negative economic cycle, the European securitisation market in general has performed relatively well with comparatively low default rates.⁴⁸ The low losses are not only based on the typically high granularity, diversification and seasoning of these transactions, but also on the structural features (such as large credit enhancement) that helped counterbalance the negative effects of the deteriorating European economy (i.e. increased SME default rates).

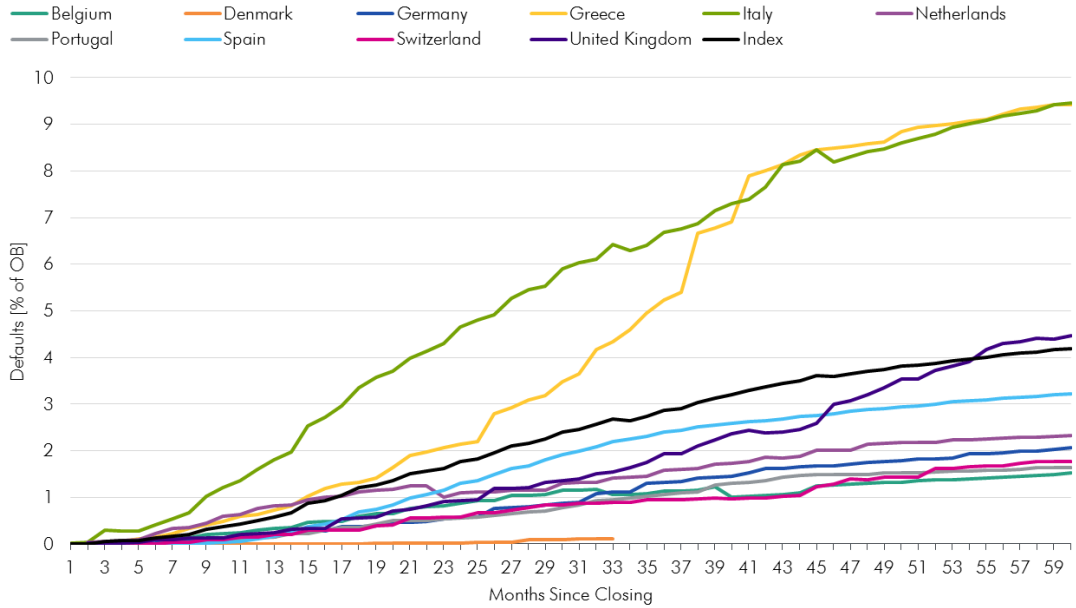
The track record of SMESec in Europe is relatively limited: the market started only towards the end of the 1990s – at the time, this segment was relatively unknown to investors and rating agencies (based on the novelty of the applied tools, but as well based on the heterogeneity of SMEs/SME loans), and the securitisation technique was also new to most of the originators – and many banks were not in a position to securitise SME loans (a typical hurdle is represented by the IT infrastructure that has to be able to adequately support the securitisation transactions).

On the one hand, before the crisis started, SMESec volumes were small compared to the overall securitisation market – and the market had not had much time to develop. On the other hand, the limited track record was one of the reasons for the relatively conservative SMESec structures which could explain the relatively good SMESec performance in Europe compared to other segments of the European securitisation market and to the US.⁴⁹ Figure 42 and Figure 43 show the cumulative credit events or defaults on original balance by country and by vintage (of the SME transactions in the EMEA region rated by Moody's).

⁴⁸ With some exceptions, i.e. the non-granular hybrid transactions (German Mezzanine CDOs). For more details see Kraemer-Eis, Passaris, and Tappi (2013).

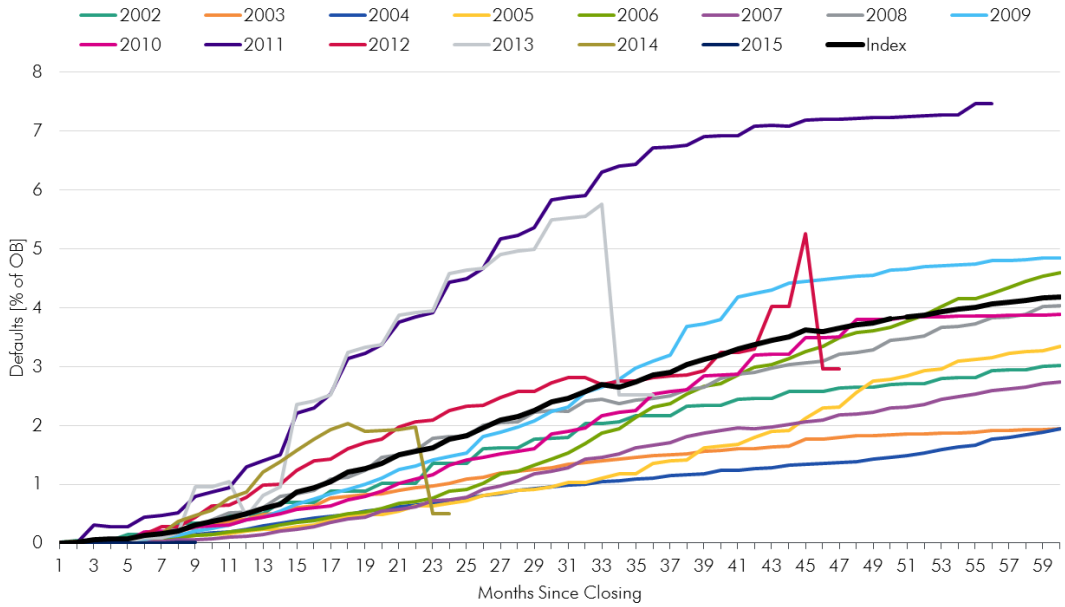
⁴⁹ According to Standard & Poor's (2014), only 1.58% of European Structured Finance notes (rated by Standard & Poor's) outstanding in mid-2007 had defaulted by mid-2014. The cumulative default rate for SMESec transactions was at 0.55% – for comparison: the cumulative default rate for US Structured Finance notes was at 19.3%, the one for CDO of ABS was at 41.08%. Similar statements can be made for transactions rated by Fitch or Moody's. See also EBA (2014) for an analysis of historical credit performance of the securitisation market. It is sometimes stated that securitisation might lead to higher risk taking by banks (or lower lending standards). This is neither confirmed by performance data, nor by research. In a recent study, Kara, Marques-Ibanez, and Ongena (2015), analysing data from the euro-denominated syndicated loan market, found out, that in the run up to the financial crisis, banks, relying on securitisation, did not lower their lending standards more than other institutions.

Figure 42: EMEA ABS SME loan and lease cumulative credit events or defaults on original balance (seasoning by country)⁵⁰



Source: Moody's (2016)

Figure 43: EMEA ABS SME loan and lease cumulative credit events or defaults on original balance (seasoning by vintage)



Source: Moody's (2016)

⁵⁰ Terminated transactions are included in the index calculation, hence here “cumulative” curves can show as well a drop. Moody’s believes that this information must be included for an accurate representation of trends over time. Additionally, Moody’s notes show that vintage seasoning charts might move unexpectedly for the last few data points, because transactions start at different points in time within a vintage and, hence, some transactions may be more seasoned than others. The index includes only the transactions rated by Moody’s.

As explained in more detail in our previous working papers, the SMESec market has also been hit by a wave of downgrades due to weaker (crisis-driven) performance effects in the underlying portfolios, as well as the rating methodology changes. Typically, AAA tranches show strong rating stability, but during the crisis also AAA and AA tranches migrated downward. This was mostly driven by downgrades of the respective country/sovereign ratings, and the limitation by the country ceilings, or they may be driven by downgrades of (not replaced) counterparties (whose rating is in turn affected by the respective sovereign ratings).

The rating transition data shows that the downgrade pressure for SME transactions persists across all tranche levels. The example below (Table 6) shows the rating migration of SME Collateralised Loan Obligation (CLO) transactions (rated by Fitch, migration since transaction closing). For example, of all the tranches initially rated AAA, 62% (by number⁵¹) have paid in full (pif), 14% are still AAA, 2% moved down to AA etc.

Table 4: Fitch European SMEs Rating Transition Matrix (May 2016)⁵²

% of tranches		Current rating									
		PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf
Initial Ratings	AAAsf	62%	14%	2%	16%	5%	0%	2%	0%	0%	0%
	AAsf	32%	3%	42%	6%	3%	3%	10%	0%	0%	0%
	Asf	14%	0%	25%	36%	6%	11%	8%	0%	0%	0%
	BBBsf	7%	0%	4%	7%	14%	11%	18%	4%	32%	4%
	BBsf	0%	0%	0%	0%	0%	43%	14%	7%	29%	7%
	Bsf	0%	0%	0%	25%	0%	50%	25%	0%	0%	0%
	CCCsf	0%	0%	0%	0%	0%	25%	0%	0%	25%	50%
	CCsf	0%	0%	0%	0%	0%	0%	0%	0%	0%	100%
	Csf	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

Source: Fitch (2016)

5.2.2 SMESec prospects

In general, a well-functioning securitisation market can be essential in helping financial intermediaries broaden their funding base, achieve capital relief and ultimately, increase their SME financing. Strengthening the SME securitisation market can be an effective way to facilitate the flow of funds to the real economy, while not creating too much distortion. In this respect, public initiatives that support SMESec may be helpful though of course, in doing this, the introduction of new risks should be avoided (for instance, securitisation transactions have to be transparent and have standardised structures; in addition, originators have to have sufficient *skin in the game* to avoid moral hazard (Kaya, 2014). Moreover, these initiatives can be an efficient way of using public resources as they lead to a multiplier effect.

Integrated EU capital markets (and their need for transparency and standardisation) and the relative complexity of securitisation techniques require considerable know-how and show the

⁵¹ Relative to the number of tranches in a given initial rating category.
⁵² The addition of sf indicates a rating for structured finance transactions.

necessity for specialised institutions. As an established and respected player in the European market, EIF can play a role via market presence, reputation building, and signalling. Its securitisation activities, as well as initiatives and latest developments are explained in detail in Kraemer-Eis, Passaris, Tappi and Inglisa (2015).

Over the last year, EIF has been involved in a number of diverse and innovative transactions. Market appetite has been especially strong in respect to (i) synthetic securitisation and (ii) warehousing facilities. With respect to the former, EIF has provided guarantees to Italian, Austrian, German and French financial intermediaries, allowing them to partially release regulatory capital absorbed by the securitised portfolios. On the funding front, warehousing transactions have dominated the scene, with EIF partnering with the British Business Bank in the UK as guarantor of the ENABLE Programme⁵³. We expect synthetics and warehouses to represent an important portion of our pipeline throughout 2016.

One example of a new type of transaction that can be seen as a milestone in the area of marketplace lending securitisation is described in Box 8.

Box 8: SBOLT 2016-1 – the first European P2P securitisation

With the transaction Small Business Origination Loan Trust 2016-1 DAC (SBOLT 2016-1), EIF and KfW, the government-backed German Promotional Bank, are supporting small businesses in the UK through their investment in the securitisation of loans originated across the Funding Circle marketplace.

In technical terms it is a static cash securitisation of unsecured loans some of which benefit from personal guarantees, and which are extended to SMEs and individual entrepreneurs in the UK and originated via an online marketplace platform operated by Funding Circle Limited. EIF guarantees part of the senior notes while the remaining part of the capital structure was placed with market investors. The overall transaction has a volume of just below GBP 130m. Rated by two Rating Agencies, this public transaction is the first of its kind across Europe, opening up such type of small business lending as an asset class to an even wider range of investors. It supports lending to small businesses in the real economy and reduces their dependency on bank lending, as recommended by the Bank of England and the European Central Bank.

Since launching, Funding Circle has worked with both local and national governments, and a wide range of institutional investors. SBOLT is a natural evolution of this, and demonstrates the EIF and KfW's commitment to small businesses in Europe. The transaction contributes twofold to the European Commission's Capital Markets Union (CMU) initiative as it supports on the one hand the development of the emerging marketplace lending (and as such the diversification of financing sources of SMEs), on the other hand, as a milestone for European P2P securitisation (see Hale, 2016), it contributes to the revival of the SMESec market.

⁵³ The most recent transaction in the framework of the ENABLE Programme has been closed with Henry Howard Finance, an asset-finance provider, further details are available at: http://www.eif.org/what_we_do/guarantees/news/2016/eif_british_business_bank_enable.htm

Box 8 continued:

George Passaris, Head of Securitisation at the EIF said: "Small businesses across the UK will benefit from the European Investment Fund's significant new support for Funding Circle, one of the UK's largest peer-to-peer platforms. The EIF is pleased to work alongside KfW on the first securitisation transaction in Europe to support alternative financing of SME's that will help Funding Circle provide more loans to small and medium-sized businesses. This new engagement demonstrates the European Investment Fund's firm commitment to help companies across Europe and across the UK to expand, create jobs and explore new opportunities."

Rita Geyermann, Head of Asset Management at KfW said: "Investing in securitisation transactions backed by SME exposures in Europe has become one of our promotional objectives in order to support the availability of finance to SMEs. By investing in this innovative transaction in cooperation with the EIF, we are convinced we can stimulate SME lending via capital markets in the UK."

Sachin Patel, Global Co-Head of Capital Markets at Funding Circle said: "This landmark transaction is the first of its kind. The investment by KfW, with the support of the EIF, marks the next step in our journey to open up a traditional fixed income asset class to new types of investors for the first time. We're committed to building the infrastructure where any investor, big or small, can lend to small businesses across the world."

Overall, the SMESec market in Europe is still underdeveloped (AFME and BCG, 2015). There are many advantages of SMESec – for banks, for investors, and – most importantly - for the SMEs (see for a detailed discussion Kraemer-Eis, Schaber, and Tappi, 2010, Wehinger and Nassr, 2015, Bank of America/Merrill Lynch, 2015a, or Aiyar, Al-Eyd, Barkbu, and Jobst, 2015). The benefits, arising from originators tapping the securitisation market, can channel through to a positive effect on SME's access to finance and hence to the SMEs themselves, especially as a result of a targeted intervention aimed specifically at this goal. A recovery and development of the primary securitisation markets could play a role in unlocking credit supply and economic recovery. However, this will only be to the benefit of SMEs if the freed-up capital / fresh liquidity is going to be used to finance the real economy (i.e. for new SME lending).

In November 2014, the ECB started its Asset Backed Purchase Programme (ABSPP). The overall objective is to enhance the transmission of the monetary policy, support the provision of credit to the Euro Area economy and, as a result, to provide further monetary policy accommodation. The ECB's support of the ABS market in general, and the SMESec market in particular, is a positive step. However, the programme has so far not achieved significant volumes, moreover, as it is based on publicly placed transactions, there is almost no direct impact on the SME segment on the market. As per end of April 2016, EUR 19.043bn have been bought by the ECB (mainly in the secondary market), compared to around EUR 172.253bn under the Covered Bond Purchase Programme (source: ECB⁵⁴).

⁵⁴ <https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html>. On 10.09.2015, the ECB clarified its intention to buy mezzanine tranches of European ABS with an eligible third party guarantee. However, the ECB's requirement of a *guarantee on demand* ("The guarantee shall be payable on first demand independently of the guaranteed marketable asset or credit claim") leads for guarantors to a gap between their payment obligation to ECB (on demand) and the receipt of payment from the mezzanine ABS tranches. This feature limits the number of potential

As described above, even 7 years after the start of the financial crisis, the European SMESec has still not recovered. Unbalanced regulation is still to be seen as the main impediment. We provide an overview over latest developments in Kraemer-Eis, Passaris, Tappi and Inglisa (2015) and do not go into details here. Most individual proposed regulations make sense on a stand-alone basis, but negative spill-overs from a non-holistic approach lead to unintended consequences that hinder a market development. For instance, the newly proposed Capital Requirements Regulation's (CRR) article 270 provides certain regulatory capital advantages to the originators in the context of synthetic transactions executed with a multi-lateral development bank; however, such advantage is not achievable if a private investor also enters into the transaction, which is a non-desirable outcome, we believe.

Originators and investors need to have certainty and clarity. Short and medium term perspective, reasonably defined criteria for high quality securitisations HQS (incl. SMESec) - which should comprise of structures that are simple, transparent and efficient and which should receive preferential regulatory treatment - could be a way out of this dilemma.⁵⁵ However, it also has to be borne in mind that the proposed risk weights for HQS will still result in increased capital requirements for IRB banks compared to today. Moreover, another perspective regarding HQS - mentioned by some market participants - is, that it can even circumvent a proper securitisation market recovery if "everything but HQS" is still seen as being toxic. New securitisation regulation can only be expected towards the end of 2017 at the earliest and first 'quality-labelled' transactions will not happen before 2018.

The EIB Group, leveraging on the structured finance capabilities of EIF, has engaged in providing responses to several consultations aiming at testing market's sensibility in respect of high quality securitisation. The response to "Criteria for identifying simple, transparent and comparable securitisations" published by BCBS-IOSCO provides an exhaustive summary of our view on this topic⁵⁶. The fog around the future regulation design is lifting – which is good in order to reduce the respective uncertainty. We note that the approach likely to be steering the forthcoming regulation suggests a "light" set of high quality criteria, which in turn translates in a marginal (rather than substantial) reduction in the risk-weights.⁵⁷ Concerning the forthcoming Capital Requirements Regulation, in our opinion, more could be achieved with a view to both increasing the breadth of the market for synthetic transactions (see Box 9 below), and to reduce the overall reliance on rating agencies, especially with a view to establishing level playing field among different asset classes and funding instruments.⁵⁸

guarantors significantly since a wrap of this sort would not be a market standard. To our knowledge there were so far no transactions of this kind.

⁵⁵ We use here HQS as term – in the current discussion, also other terminologies are used in the same context, e.g. STS (simple, transparent, and standardised) securitisation, used e.g. by the ECB, or STC (simple, transparent and comparable) securitisation, used by BCBS-IOSCO, or SST (simple, standard and transparent) securitisation, used by the European Banking Authority. September's proposed regulation published by the European Commission suggests that the STS acronym will prevail in European regulation.

⁵⁶ EIB Group's response is available at the consultation's web page:

<http://www.bis.org/bcbs/publ/comments/d304/overview.htm>

⁵⁷ See also in this context the Working Document by Rapporteur Tang for the European Parliament, Committee on Economic and Monetary Affairs (European Parliament, 2016).

⁵⁸ See Council of the EU (2015).

Box 9: Different synthetic faces

As described in earlier EIF working papers (see e.g. Kraemer-Eis, Schaber, and Tappi, 2010), in *synthetic transactions* traditional securitisation techniques are combined with Financial Guarantees or Credit Default Swaps (CDSs) in order to provide credit protection on a pool of loans. An originator buys protection on (part of) a portfolio of loans or leases. The credit risk is transferred to the protection seller without transferring the assets themselves (hence the term “synthetic”, compared to a “true sale”).

There is a variety of different synthetic structures used with different objectives, e.g. based on granular portfolios/concentrated portfolios, funded / not funded, CDS against whole pool/individual tranches, based on managed/static pools, and also “squared” transactions (e.g. CDS on different ABS tranches), etc. These approaches vary significantly in terms of complexity, transparency, and standardisation – a synthetic securitisation can be rather simple and standardised, but as well highly complex and non-transparent (see for an overview e.g. EBA, 2015). Hence, it is not correct to speak of synthetics as ONE single market segment – it is rather, like securitisation itself, a technique. Synthetic securitisations have often lower administrative costs than their cash peers, as well as less legal and operational complexity (Moody’s, 2014). Although different concerning several characteristics, in terms of risk, synthetic transactions often also do not differ significantly from their cash deals, as they are “usually designed to replicate the exposure of cash deals” (Moody’s, 2014).

Synthetic transactions were used in the past - mainly until the crisis - in a number of European countries and based on different asset classes. According to Bank of America/Merrill Lynch (2015), most of the synthetic issuance in Europe came from the CDOs and RMBS sectors, in particular driven by the transactions under KfW’s Promise (SME transactions) and Provide (RMBS) platforms. These transactions were highly standardised bank balance sheet CDOs.

The same source confirms that there is “no conclusive general evidence that synthetic securitisations have performed credit-wise worse than comparable traditional securitisations, yet performance has varied significantly across asset classes and structures.” The authors find similar performances in synthetic SME ABS transactions compared to their cash peers, in particular as the performance of the underlying exposures are the key performance driver – then mitigated or magnified by structural features (Bank of America/Merrill Lynch, 2015).

As a consequence, different types of *synthetics* should be distinguished – also in terms of regulation. Typically, synthetic transactions in the form of arbitrage CLOs/CLNs or managed CDS are complex, often non-transparent, and custom-tailored. On the other hand, synthetic transactions in the form of tranching guarantees (balance sheet transactions) can be simple, transparent, and standardised. Properly designed and adequately treated from a regulatory perspective they can be an efficient tool to enhance access to finance for SMEs and to be used in the context of EU related SME financing programmes.

The synthetic market would be encouraged by removing the uncertainty that currently surrounds the process for obtaining regulatory approval of capital relief transactions. Clarifying the regulator’s role is key, and its remit should be verifying the compliance of the proposed transactions with the relevant CRR’s article (244). EIF is currently involved in discussions with both, market participants and EU bodies, advocating for the smoothest approval process.

Box 9 continued:

At the Ecofin Council meeting of the 08th December 2015, Ministers confirmed an agreement reached by the Coreper⁵⁹ on proposals aimed at facilitating the development of a securitisation market in Europe. A framework for securitisation is seen by the Council as the first major building block of the EU's plan, launched during 2015, to develop a fully functioning capital markets union by the end of 2019.⁶⁰ "The speed of proceedings in the Council has been unprecedentedly fast and the attention has now moved to the European Parliament." (AFME, 2016).

The Council's statements confirm the recognised important role of securitisation and in particular SMESec. Moreover, in our opinion, it confirms as well EIF's efforts to revive the SMESec market. Overall, the EIF - and the EIB Group as a whole – has been supporting SMESec already since many years and continues to do so. Details regarding the interventions can be found in Kraemer-Eis, Passaris, Tappi, and Inglisa (2015). EIF continues its institutional dialogue on a number of topics relevant to decisions in connection to the regulatory framework and the Capital Markets Union, this includes exchanges with EBA, EU Institutions, market participants, and national regulators to share market experience and to provide suggestions on securitisation issues.

Underpinning the various discussions on the treatment of synthetic securitisation transactions is the current legislative proposals by the Commission laying down the rules for STS securitisation and for amendments to the Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms. Under the former, the Commission's proposal and the subsequent suggestions by both the Council and the European Parliament, do not allow synthetic securitisations to qualify for an STS treatment. The draft document though, introduces an exception, under Article 270, singling out senior tranches of SMEsec transactions that meet certain STS criteria. More encouragingly it provides the possibility of a subsequent inclusion of synthetic securitisation transactions to qualify as STS, following a suitable feasibility analysis by the EBA and a potential positive recommendation to the Council and the European Parliament.

During the on-going discussion of the two legislative proposals, EIF has been engaging with all relevant bodies to offer advice on these matters, based on its long standing presence and expertise in the SMESec market. More specifically and in light of the current discussion of the inclusion of SMESec transactions for a beneficial STS treatment, EIF has recently put forward (inter alia) a number of suggestions that it believes will benefit such structures and will ultimately allow the better functioning of the SMESec market, which will have a direct and positive impact on SME financing in the EU.

⁵⁹ Permanent Representatives Committee: <http://www.consilium.europa.eu/en/press/press-releases/2015/12/02-capital-markets-union-securitisation/>

⁶⁰ See: http://www.consilium.europa.eu/en/meetings/ecofin/2015/12/st15068_en15_pdf/

6 Microfinance market

6.1 Microfinance and social inclusion

6.1.1 What is Microfinance?

“Microcredit is generally recognised [...] as an effective financing channel for job creation and social inclusion, which can attenuate the adverse effects of the current financial crisis while contributing to entrepreneurship and economic growth in the EU” (European Commission, 2012b). In Europe, microfinance consists mainly of small loans (less than EUR 25,000) that are tailored to microenterprises (see Box 10 for an elaboration on some definitions) and people who aspire self-employed but face difficulties in accessing the traditional banking system. Throughout the EU, 99% of all start-ups are micro or small enterprises, one third of which were launched by unemployed people.

Box 10: What is “micro”?

A **microenterprise** is any enterprise with fewer than 10 employees and a turnover below EUR 2m (as defined in the Commission Recommendation 2003/361/EC of 6 May 2003, as amended).

A **microfinance institution (MFI)** is an organisation/financial intermediary that provides microfinance services. There is a wide spectrum of different MFI business models in Europe.

Microcredit in general is defined by the European Commission as a loan or lease under EUR 25,000 to support the development of self-employment and microenterprises. It has a double impact: (1) an economic impact, as it allows the creation of income generating activities, and (2) a social impact, as it contributes to the financial inclusion and, thus, to the social inclusion of individuals.

Microfinance, as a general term, is traditionally defined as the provision of basic financial services to poor (low-income) people who traditionally lack access to banking and related services (CGAP Definition, Consultative Group to Assist the Poor). However, more and more often, the definition is used in a wider sense, also to include financial services to existing microenterprises. This wider concept is used in the present text and in order to achieve a pragmatic approach, we follow a segmentation, following a differentiation introduced by EMN (2012):

Microenterprise lending = micro-lending to existing enterprises. Organisations that implement the lending model of microenterprise lending tend to focus on the upper end market of microfinance, providing loans to bankable or nearly bankable microenterprises that have difficulties accessing loans up to 25,000 EUR from commercial banks due to risk aversion or lacking liabilities. The average volume of the provided loans is markedly higher than in the model of social inclusion lending, meant to support the start or stabilisation of microenterprises with a growth perspective. The maximum loan sizes go up to 25,000 EUR (or even higher in some cases).

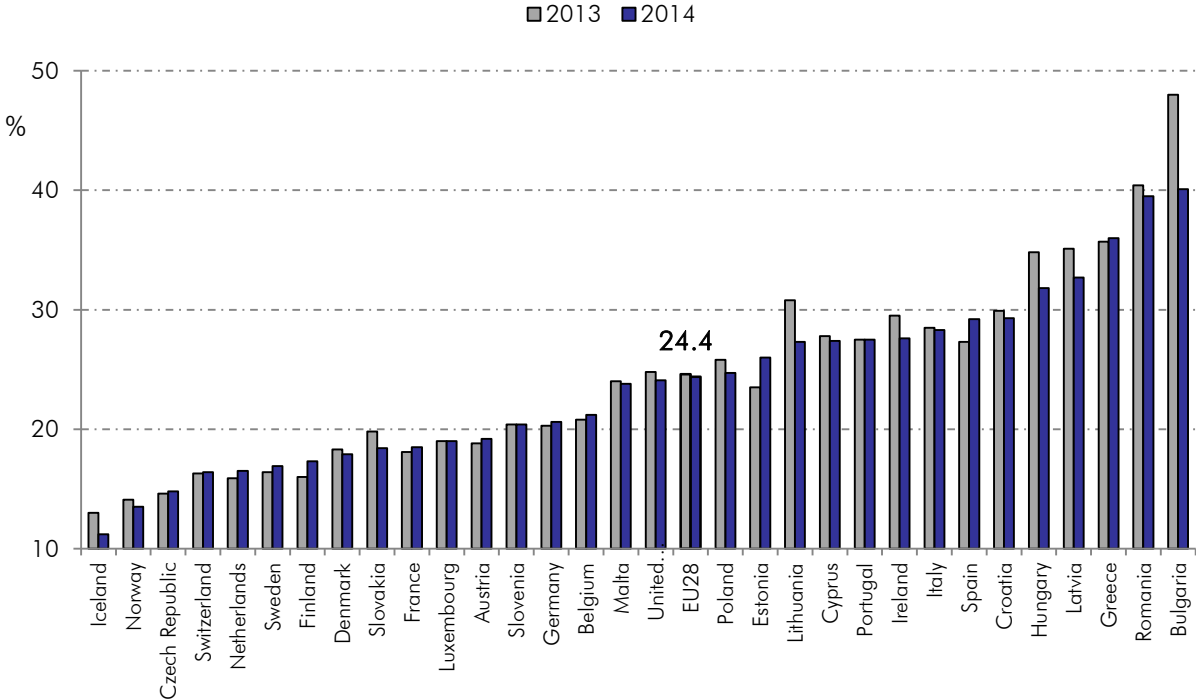
Social inclusion lending = lending to self-employed individuals that are excluded from banking services, due to their socioeconomic status of being socially excluded or (long term) unemployed and/or belonging to financially excluded population groups like ethnic minorities or young people. The average loan sizes are relatively low, meant to support basic income creating activities.

EIF has conducted extensive research on the European microfinance market (see for example, Kraemer-Eis and Conforti (2009) and Bruhn-Leon, Eriksson and Kraemer-Eis (2012)), in which they conclude that there is no common microfinance business model in Europe. Instead, it was found that the market is highly fragmented and diverse, characterised by a wide spectra of final beneficiaries and financial intermediaries. Part of this fragmentation has geographical roots, as the role of microfinance is seen very differently across Europe. In Western Europe, microfinance is considered to be a social policy tool, as it serves businesses that are not commercially attractive for the mainstream financing providers, but nevertheless are able to create social value. In Eastern Europe on the other hand, microfinance is seen as a business activity, which targets viable microenterprises that are financially excluded because the traditional credit market remains underdeveloped (for a discussion on the principles driving credit rationing, see 5.1.1).

6.1.2 A support tool for necessity-driven business creation

Microfinance is an essential tool to facilitate necessity-driven business creation, which arises when entrepreneurship is driven by push-factors that originate from adverse conditions in the labour market. That is, when a combination of poor labour market prospects and poverty drives people to start new businesses. This is not to say that every unemployed individual would be eligible to become a successful entrepreneur, but it does imply that countries faced with adverse labour market conditions provide a fertile ground for necessity-driven entrepreneurial activity. Therefore, this section discusses some important indicators related to unemployment, poverty and social exclusion.

Figure 44: People at risk of poverty or social exclusion (percentage of total population)

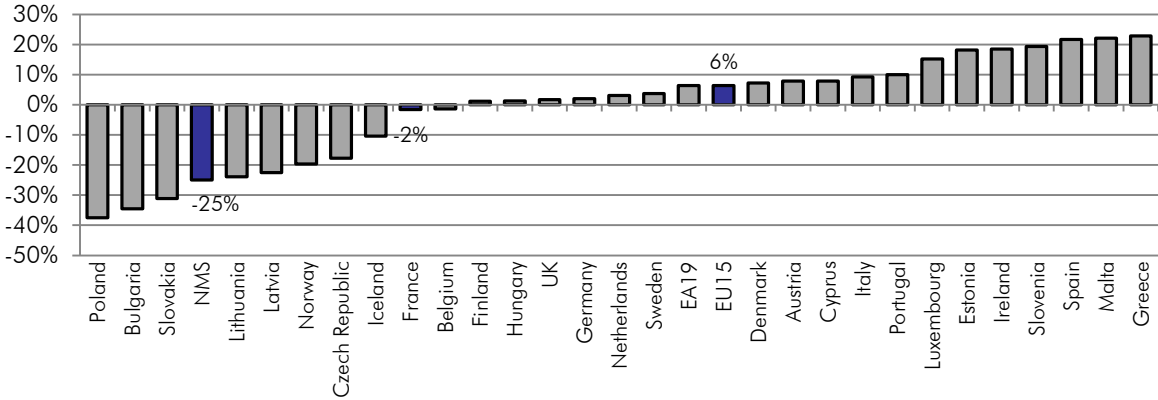


Source: Authors, based on data from Eurostat

In the context of the Europe 2020 social inclusion targets, Eurostat has constructed the “people at risk of poverty or social exclusion” indicator⁶¹, depicted in Figure 44. The indicator corresponds to the sum of individuals who are at risk of poverty, after social transfers, are severely materially deprived, or are living in households with very low work intensity.⁶² Per 2014, nearly one fourth of EU-28 citizens were at risk of poverty and social inclusion. The highest rates of risk of poverty or social inclusion were recorded in some Eastern European countries (Bulgaria, Romania). The geographical subdivide in poverty risk becomes clear when considering the mostly Nordic and Western European countries on the other side of the spectrum (Iceland, Norway, Netherlands, Sweden). While some countries have made significant progress compared to 2013 (Bulgaria, Lithuania), in others the situation worsened significantly: Estonia, but also Spain experienced a marked increase in its poverty rate, a likely consequence of the double crisis the country suffered.

That the global financial and sovereign debt crisis has had a detrimental impact on the progress towards achieving the Europe 2020 goals becomes clear from Figure 45, which illustrates the relative change (in percentage terms) since 2006. Interestingly, while poverty risk in absolute terms was highest in the East of Europe, in the post-crisis period it were some Western European countries who clearly fared worse. In the New Member States (NMS) taken together, the number of people at risk of poverty or social inclusion decreased by 25%. This contrasts with the EU15 members, which show a marked increase of 6%. In fact, apart from France and Belgium in none of the Western European Euro countries, the number of people at risk of poverty or social inclusion decreased since 2006.

Figure 45: Number of people at risk of poverty or social exclusion, relative change since the crisis (2006-2014)

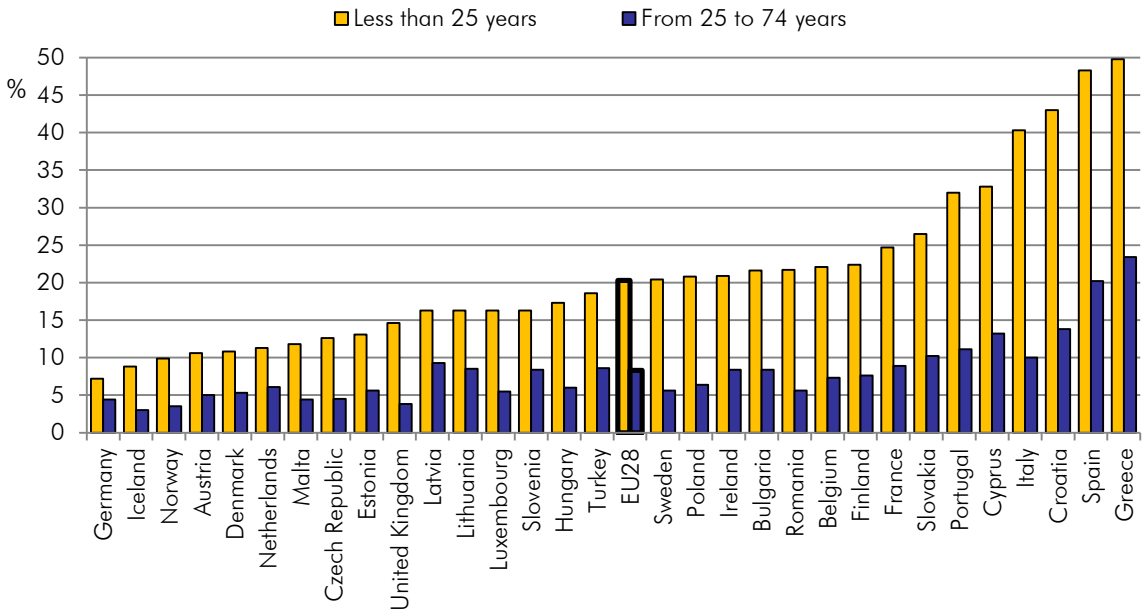


Source: Authors, based on data from Eurostat

⁶¹ See the Eurostat internet site on the Europe 2020 indicators at: http://epp.eurostat.ec.europa.eu/portal/page/portal/europe_2020_indicators/headline_indicators
⁶² Individuals are only counted once, even if they are present in several sub-indicators. At risk-of-poverty are persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers). Material deprivation covers indicators relating to economic strain and durables. Severely materially-deprived persons have living conditions severely constrained by a lack of resources. People living in households with very low work intensity are those aged 0-59, living in households where the adults (aged 18-59) worked less than 20% of their total work potential during the past year. For more information please see: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=t2020_50

The statistics depicted in Figure 44 and Figure 45 are important because people at risk of poverty are a potentially important group of business creators, since a decision to start a business often arises out of necessity. According to the Eurobarometer Survey on Entrepreneurship (European Commission, 2012a), the majority of self-employed people indicated that dissatisfaction with their previous work was an important decision to start a business. In line with this, the OECD (2014a) reports that the majority of entrepreneurs start businesses to improve their economic situation (OECD, 2014a).⁶³

Figure 46: Unemployment rate by age groups, 2015



Source: Authors, based on data from Eurostat

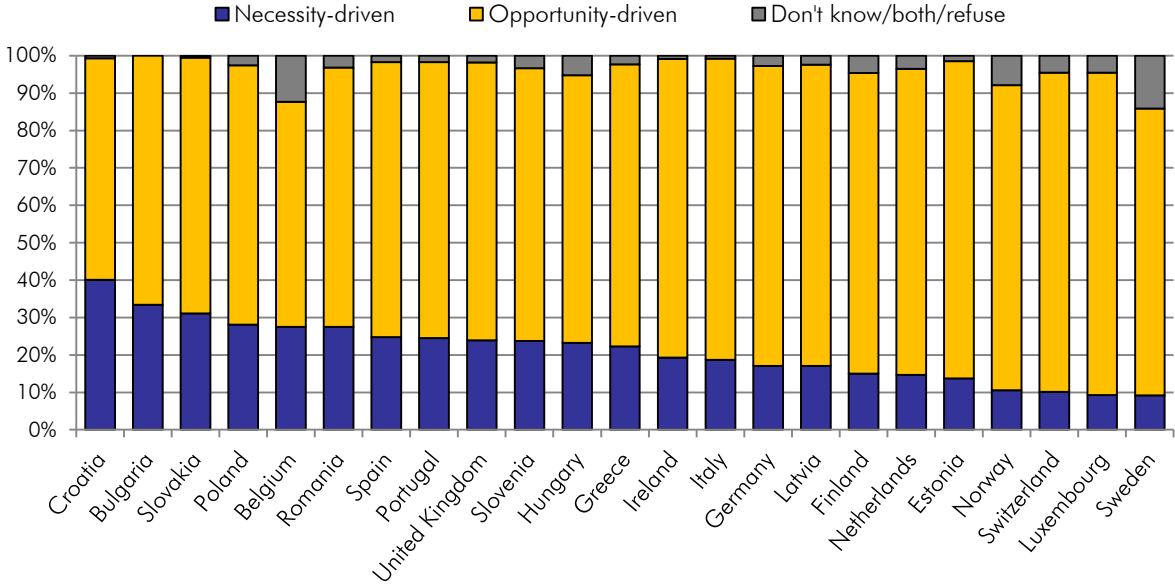
Since adverse labour market conditions are the most important driver for necessity-driven entrepreneurship, Figure 46 plots the unemployment rate for a number of European countries. In the aftermath of the 2007-financial crisis, unemployment remains one of Europe’s main challenges, in particular for the age cohort of workers under 25. Long term unemployment spells can lead to a loss of skills, or labour market discouragement in general, which is particularly problematic among young workers, as it can result in a lost generation of workers (Choudhry et al, 2012). Supporting measures to facilitate the transition of these worker groups from unemployment to self-employment are therefore of crucial importance (OECD, 2014a; European Commission, 2014). This has become even more important in the context of the current refugee crisis (see Box 11).

The incidence of necessity-driven entrepreneurial decisions is illustrated by country in Figure 47. The highest rates are recorded in Croatia, Bulgaria and Slovenia, where around a third of entrepreneurs started their business because they had no better options in the labour market. The odd-duck in the top of the ranking is Belgium, which records a necessity-driven entrepreneurial rate

⁶³ According to the Eurobarometer Survey on Entrepreneurship (European Commission, 2012a), in most countries of the EU, the majority of self-employed people found dissatisfaction with their previous work very important in their decision to start a business.

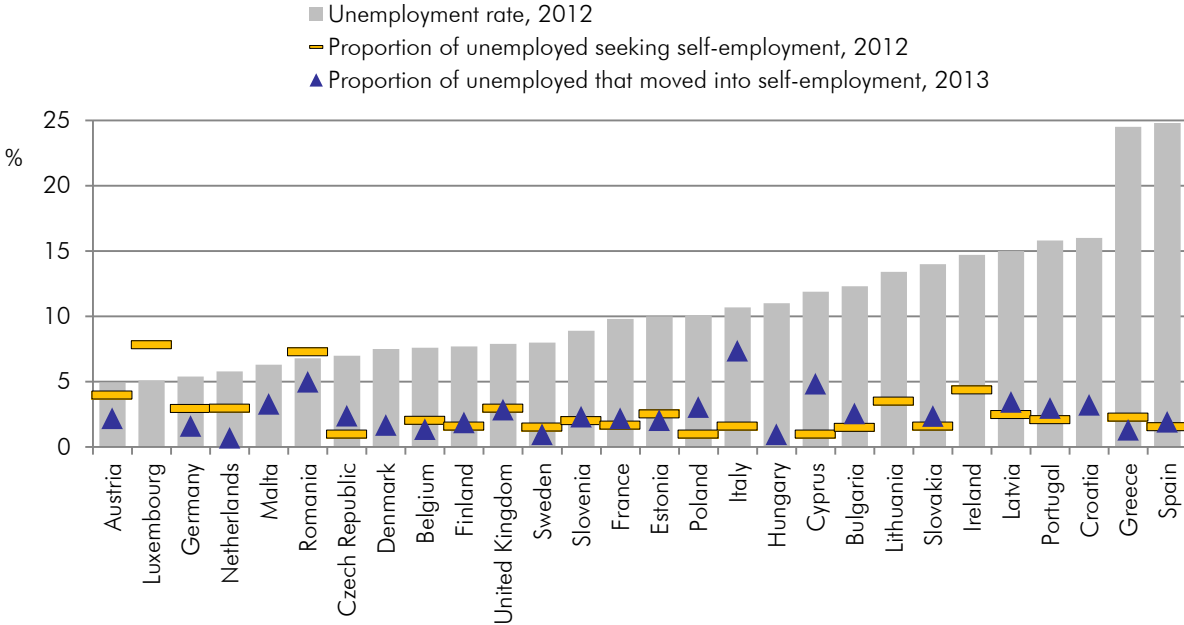
of 27.5%, a rate that exceeds rates recorded in Greece. The relatively low rate in countries like Greece and Latvia could of course point to existing barriers to entrepreneurship there, such as limited access to external finance, which stops aspiring entrepreneurs to effectively start a business.

Figure 47: Necessity-driven entrepreneurial rates (2015)



Source: GEM 2015/16 Global Report

Figure 48: Self-employment by the unemployed, 2013



Note: Data for Ireland, Lithuania, Luxembourg, Hungary, Denmark, Croatia and Malta is partially missing.

Source: OECD (2015c), Eurostat

This conclusion is consistent with the contradictory image that emerges from Figure 48, which illustrates the transition rate of unemployed workers into self-employment: while unemployment in Greece reaches record-levels, this goes combined with a relatively low number of necessity-driven entrepreneurship rate, and a very low transition rate from unemployment to self-employment. Similar observations can be made in the case of Latvia, and to a lesser extent for Spain. Per 2013, more than 685,000 (2.7%) unemployed EU workers successfully entered self-employment.

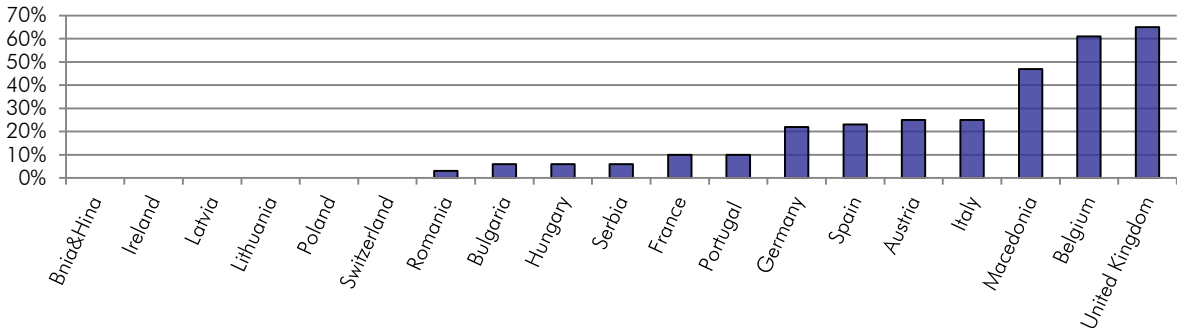
Box 11: The importance of microfinance for the refugee crisis

Recent events in the Middle-East have triggered one of the largest movements of refugees in recent history, as an unprecedented number of people are fleeing the conflict in Syria and Iraq. While in normal times immigration flows are unlikely to have severe negative effects on natives’ employment prospects (Angrist & Kugler 2003; Carrasco et al., 2008), the European labour market is currently still recovering from the recent financial crisis. Unemployment in many European countries is still at elevated levels (see Figure 46) and governments are struggling to balance budgets. This implies labour markets might not be able to efficiently absorb the added supply of labour. Therefore, many observers believe that the availability of new, cheaper labour will crowd out native workers from the labour market. These fears might be unjustified, however, as it is well-documented that first-generation immigrants are characterised by a distinct entrepreneurial drive (Borjas, 1986; Neville et al, 2014).

A number of studies have provided evidence that this is the case despite the fact they face significant barriers to entrepreneurship, vis-à-vis natives. One of those barriers to entrepreneurship is rooted in a deficient access to finance. A number of studies have described the prevalence of financial exclusion among immigrant populations (Anderloni & Vandone, 2008; Bohn & Pearlman, 2013). Their difficulties in accessing finance can be driven by cultural factors (Osili and Paulson, 2008; Albareto & Mistrelli, 2010), linguistic barriers or a lack of financial education in general (Aiyar et al., 2016). These driving factors are particularly relevant in the context of the current refugee crisis. In the current economic climate, it is therefore essential to create an environment of financial inclusion in order to facilitate refugee’s integration process and to limit the potentially adverse consequences for local labour markets.

According to an IMF study, microfinance provides an optimal policy tool to address financial exclusion of refugees, a conclusion shared by de Lima et al. (2016). By definition, microfinance is a product that can be easily tailored to fit the specific needs of refugee entrepreneurs, taking into account the socio-cultural aspect of their origin societies (EMN, 2013). This is reflected in a relatively high share of microloans being disbursed to migrants: an EMN survey in 21 European countries revealed that in 2013 18 percent of the total value of newly originated microloans benefited migrants, although this average concealed large country disparities (see Figure B.6 below).

Figure B.6: share of total value of microloans disbursed to migrants and ethnic minorities in 2013



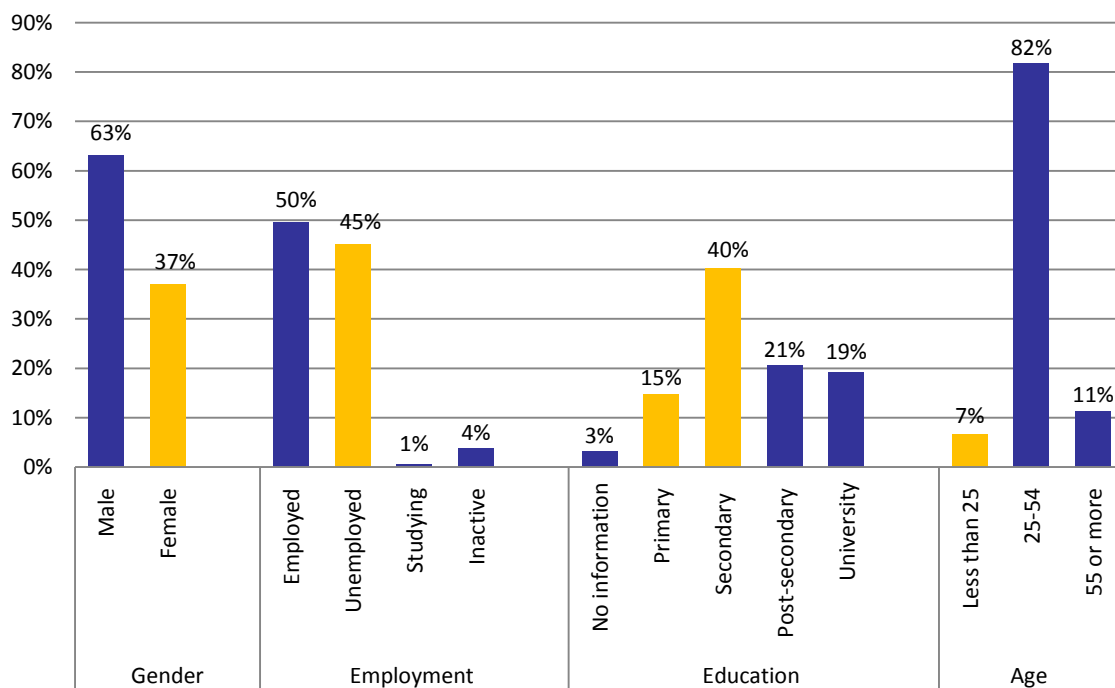
Source: EMN (2014)

Box 11 continued:

Given its pioneering and supporting role in the microfinance industry, the EIF can play a prominent role in dealing with Europe's current refugee crisis. Migrants already make up an important target group under a number of EIF programs. EPMF and EaSI for example, support self-entrepreneurship and employment in work-integration social enterprises that hire vulnerable worker groups, including refugees and migrants, as does EIF's Social Impact Accelerator (SIA), a fund-of-funds structure investing in Social Venture Funds. In fact, some of EIF's non-bank cooperation partners focus primarily on clients with a migrant background, for example, MicroStart in Belgium and PerMicro in Italy.

With regard to social background of individual microenterprises, the table below provides a summary of non-financial information at final beneficiary level of Progress microfinance (for more information on the programme, see Chapter 6.5). The information is based on data reported by a total of more than 14,000 self-employed individuals. The results show a significant outreach to unemployed people and to other typical groups with difficulties in accessing the traditional banking system.

Figure 49: Social background of self-employed



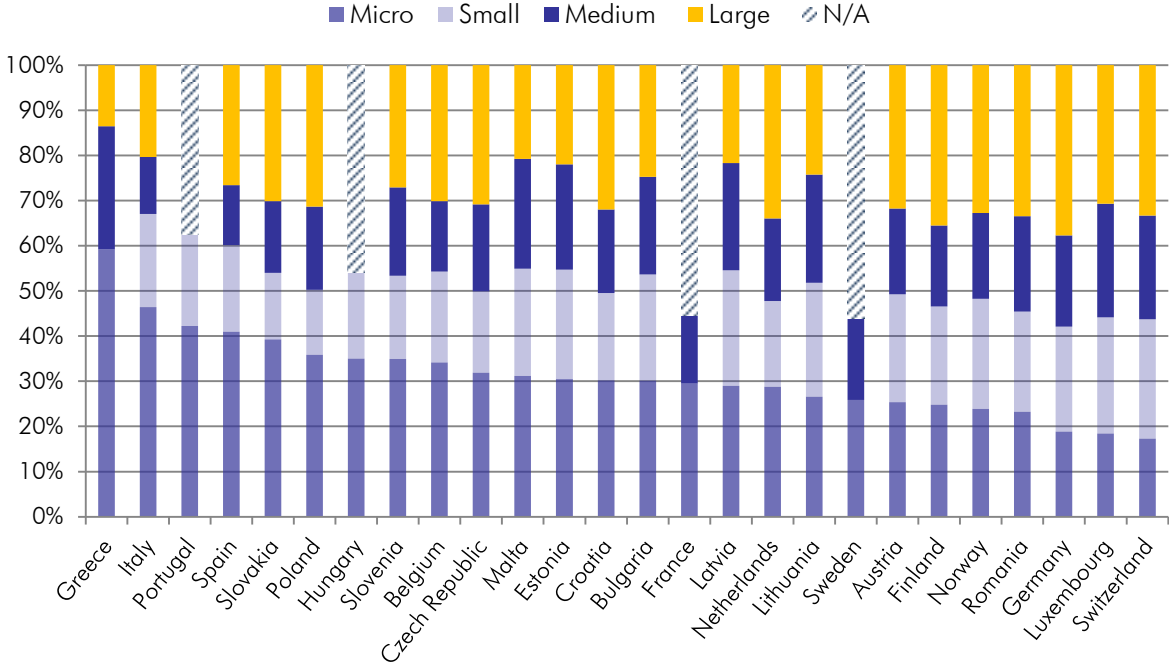
Source: EIF

In light of the adverse labour market impact of the financial and sovereign debt crisis, it remains of utmost importance to provide those labour market segments that suffered most with the necessary opportunities to improve upon their fortunes. Microfinance, characterised by a high degree of flexibility in its implementation, is a product that can be tailored to support the needs of aspiring entrepreneurs from disadvantaged labour market segments. Given the sector of microenterprises is prone to finance market failures in the external financing market, it should be considered a crucial policy tool in alleviating the negative impact of the crisis on European labour markets.

6.2 The demand for microfinance: microenterprises and their finance decisions

Microenterprises, making up 93% of all European businesses, are important contributors to employment. Micro-business seem to be relatively more important in countries with elevated unemployment levels: in Spain, Portugal and Italy employment by microenterprises accounts for more than 40% of total employment and in Greece this amounts almost to 60% (Figure 50).

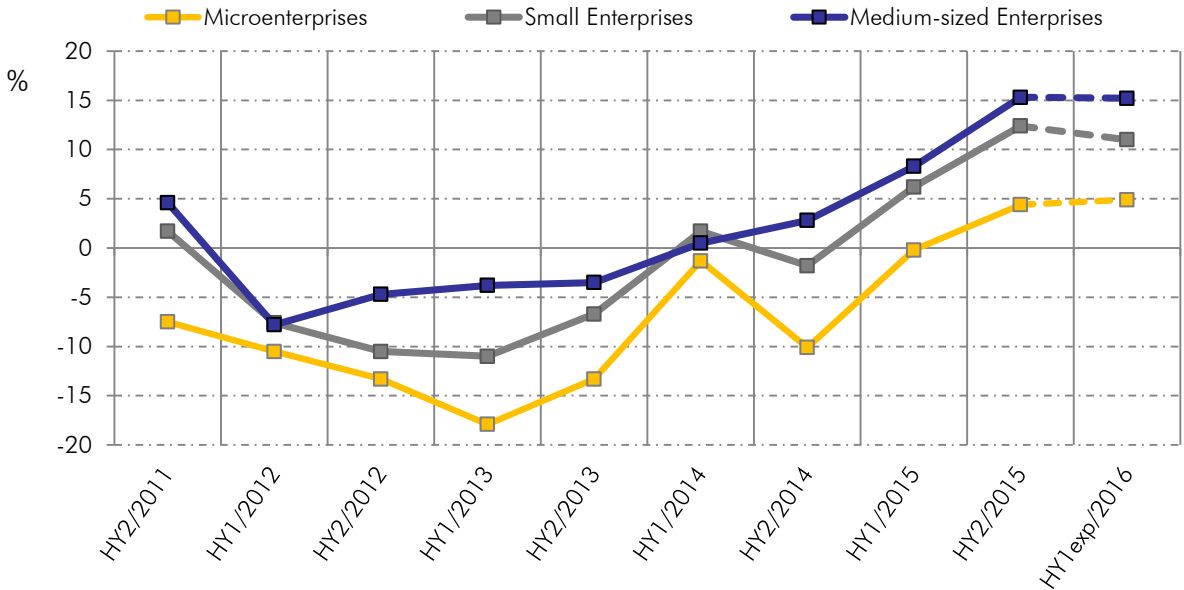
Figure 50: Relative employment share by microenterprises compared to other enterprise size classes, 2013



Source: Eurostat

While microenterprises are an important element of the European economic fabric, they generally face more challenging conditions compared to their larger counterparts. This is evidenced by Figure 51, which illustrates microenterprises’ perception about the current economic climate and compares it to larger firms’ perception. For the first half of 2016, microenterprises are on balance expecting a positive change (4.9%) in their overall situation, thereby being significantly less optimistic than their larger counterparts. The UEAPME survey furthermore reveals that they expect their investment climate to worsen (UEAPME, 2016). Given the importance of microenterprises in sustaining employment levels of vulnerable labour market groups, policy makers ought to be cautious for a situation of underinvestment.

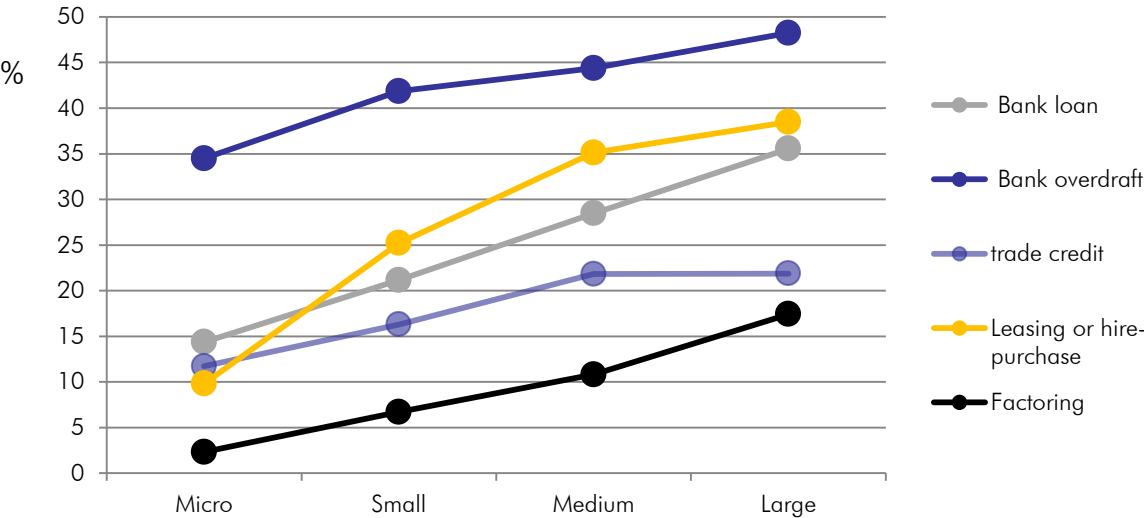
Figure 51: Overall situation of European microenterprises compared to other size classes



Source: UEAPME Study Unit (2016)

Microenterprises, on balance, reported slightly decreased needs for bank loans. Moreover, they use bank loans and other external financing sources considerably less than other SME size classes, presumably due to difficult access to finance. Figure 52 shows that the usage of different financing sources on average typically increases with the size of the SME (ECB, 2016a). Among the reasons why bank loans are less relevant for microenterprises, they reported insufficient collateral or guarantee, as well as high interest rates or price.

Figure 52: Different financing sources used by enterprises (by enterprise size class), 2016



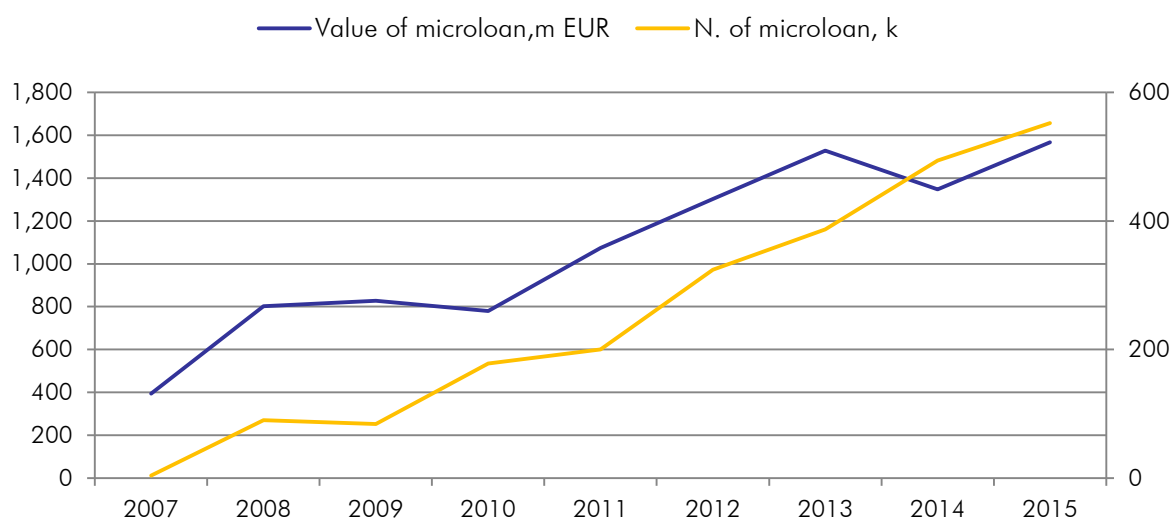
Source: Authors, based on ECB SAFE (2016a) data

6.3 The supply of microfinance: a sector characterised by significant diversity

European microfinance providers are very diverse across Europe. In addition to commercial banks that target microenterprises as part of their general SME lending activity, the spectrum of European microcredit developers includes many profit-oriented and non-profit associations: microfinance associations, credit unions, cooperatives, Community Development Financial Institutions (CDFIs), non-bank financial institutions (NBFIs), government bodies, religious institutions and Non-Governmental Organisations (NGOs). The focus of MFIs' activities changes from Western to Eastern Europe. Most of the MFIs in Eastern Europe are mainly focused on micro-lending. In contrast, Western European MFIs provide a more diversified set of financial products, not only to microenterprises but to bigger corporations as well. The duality indicates that the development stage of the microfinance sector is highly dependent on the geographic market under consideration.

The recent survey by EMN-MFC⁶⁴ shows a high diversity with regard to social target groups and societal policy goals. Almost two thirds of all surveyed MFIs reported that their main mission was financial inclusion (71%), followed by job creation (70%), and social inclusion and poverty reduction (60%). Estimates reveal that for 2015, a minimum of 393,115 microenterprises and start-ups received support by the surveyed organisations (see Figure 53 below).

Figure 53: Evolution of Microfinance in Europe



Source: Authors, based on data from EMN-MFC (2016)

Also according to the EMN-MFC survey, microcredit provision in Europe is following a positive trend, as the total value lending value and the number of microloans has been steadily increasing. The surveyed European microfinance institutions (MFIs) disbursed a total of 552,834 microloans in 2015, compared to 387,812 microloans in 2013, an increase of 43%. Over that same period, total lending volume increased slightly, from EUR 1,528m in 2013 to EUR 1,567m in 2015. These

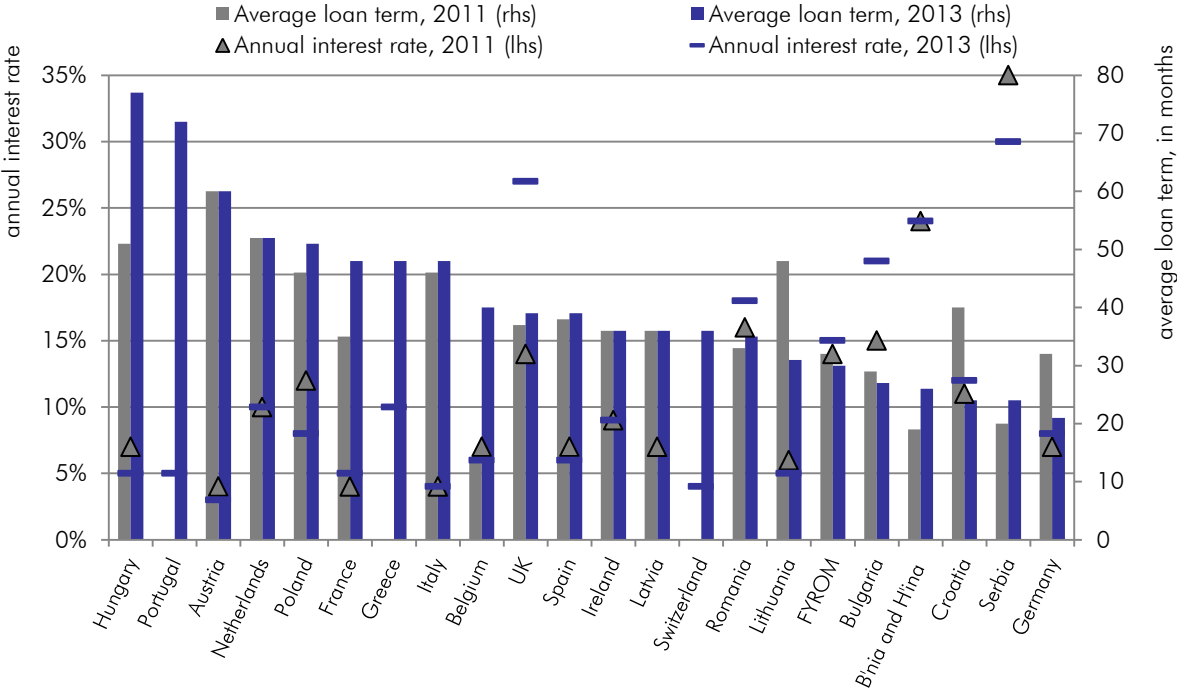
⁶⁴ The European Microfinance Network (EMN) and Microfinance Center (MFC)'s *Overview of the microcredit sector in Europe for the period 2014-2015* is based on a survey among 149 MFIs in 22 countries. The results presented are preliminary and are subject to changes.

numbers imply that the average loan size decreased (from EUR 8,606 in 2013 to EUR 7,271 in 2015), providing evidence for an increased micro-focus.

The characteristics of microloans are quite different for business and personal consumption. The average interest rate charged by the surveyed MFIs for business consumption purpose is 10,9% with an average loan term of 40 months, while the average interest rate charged for personal consumption purpose is 19,3% with an average loan term of 30 months (EMN-MFC, 2016).

Moreover, characteristics of microloans for business purposes are diverse across countries (Figure 54). According to the previous EMN survey for the period 2012-2013, the average interest rate among the surveyed microfinance providers amounted to 10% in 2013 (11% in 2011), but ranged from 5% in France, Italy, Austria and Switzerland, to as high as 27% in the UK, and even higher in non-EU Balkan states. Similarly, average loan durations display a significant amount of country-level heterogeneity. The longest terms are found in Hungary (77 months), Portugal (72) and Austria (60 months). Typically, shorter loan terms are observed in countries with high average interest rates and low average loan volumes, such as the Balkan states and Germany (EMN, 2014).

Figure 54: Microcredit conditions in Europe



Source: Authors, based on data from EMN (2014)

The differences in average interest rates are typically related to differences in the legal framework, MFI business models, pricing policies, refinancing cost, cost structure and the subsidy levels. Without usury laws or interest rate ceilings in place, the interest rate generally decreases in the loan size (EMN, 2012, 2014). Micro-loans are usually offered with a special focus on social inclusion. Higher interest rates (“high” compared to “standard” lending business) for micro-loans typically

reflect the non-subsidised, cost-covering business models (often MFIs in the central-eastern part of the EU), while the lower interest rates are reflecting higher prevalence of social microfinance, corporate social responsibility initiatives, and MFIs with subsidised, partly grant-dependent business models (often in the western part of the EU). Typically, for-profit institutions charge higher interest rates (cost coverage) and grant larger loans (economies of scale). However, it is important to note that profit orientation is consistent with a socially-oriented investment strategy. In fact, the micro-loan business model, if operated on sustainable terms in the long run, inherently requires relatively high interest rates (Bruhn-Leon, Eriksson and Kraemer-Eis, 2012).

6.4 The microenterprise financing gap

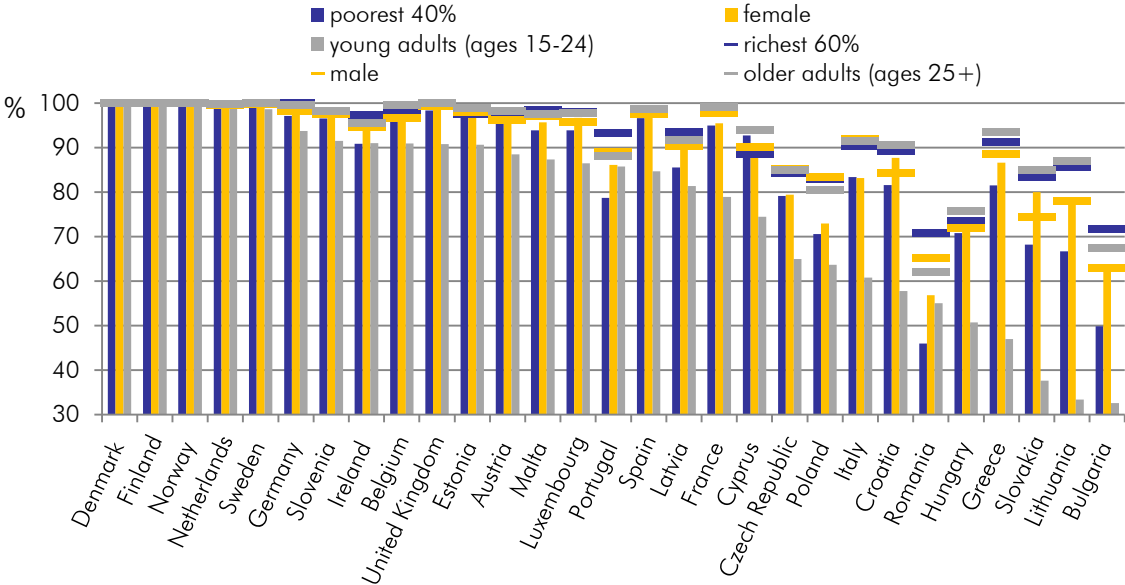
The challenges for microenterprises to access external financing are even greater than for other (bigger) types of SMEs. Almost by construction, these are young firms without prior track record or formal reporting obligations. In addition, necessity-driven entrepreneurs, again by definition, are highly unlikely to meet the required collateral requirements often demanded by traditional finance market players (OECD/ European Commission, 2014). This implies that credit rationing becomes particularly relevant for this sub segment of the market.⁶⁵ This section discusses some indicators that illustrate how access to finance often is restricted for vulnerable labour market segments and microenterprises.

Financial inclusion, at its most basic level, starts by having access to a simple bank account. The Global Findex, the financial inclusion survey⁶⁶ illustrates how financial inclusiveness varies strongly between countries and social groups (see Figure 55). In countries like Denmark, Finland, and Norway, 100% of the respondents reported having accounts in financial institutions, regardless of the social group they belong to. This contrasts strongly with countries like Romania, Bulgaria and Hungary, which on average do not only have lower levels of financial inclusion, but also stronger within country social disparities. The highest gap in account penetration between rich and poor was observed in Romania (25%) and in Bulgaria (22%). On average, women reported lower account-holding rates than men. Significant gender gaps are observed in Romania and Poland, but surprisingly also in France. Account ownership also difference between age groups (ages 15–24 vs age 25 and above). The age gap is particularly pronounced in Lithuania (54%), followed by Slovakia (47%) and Greece (46%).

⁶⁵ For a full discussion on the mechanisms underlying finance market failures and credit rationing, see 5.1.1

⁶⁶ The Global Financial Inclusion (Global Findex) database, launched by the World Bank in 2011, provides comparable indicators showing how people around the world save, borrow, make payments, and manage risk. The indicators in the 2014 Global Financial Inclusion (Global Findex) database are drawn from survey data covering almost 150,000 people in 143 economies - representing more than 97 percent of the world's population.

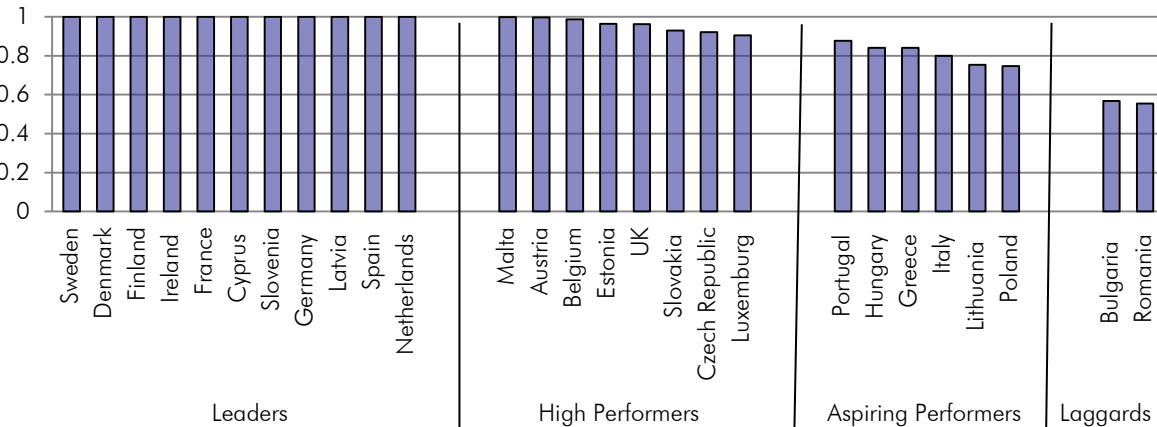
Figure 55: The percentage of respondents who report having an account at a bank or another type of financial institution



Source: Global Findex Database

Financial inclusion is a multi-dimensional concept, of which having a bank account is just one aspect. MFC (Microfinance Center) proposes a composite indicator that measures the inclusiveness of the financial system, conditional on its available inputs. Accordingly, it classifies countries into four distinct categories: leaders, high performers, aspiring performers and laggards. Figure 56 shows the resulting ranking. Out of 27 EU countries, 11 countries received a score of 1, indicating an efficient and inclusive financial system.⁶⁷

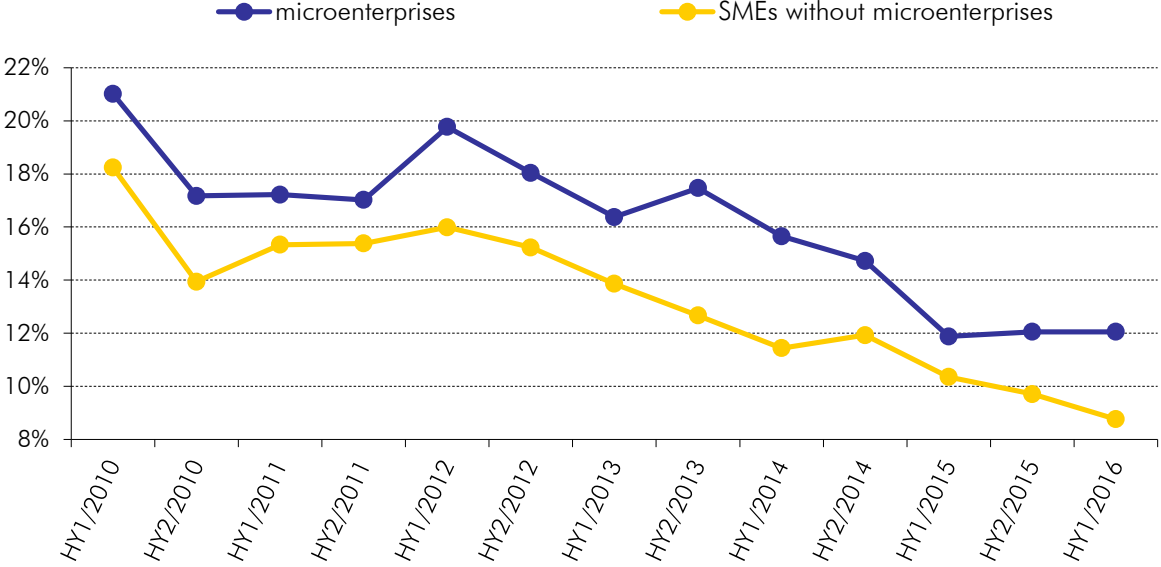
Figure 56: Financial inclusion score and rankings for 27 EU countries



Source: Korynski and Pytkowska (2016)

⁶⁷ The score measures how efficiently inputs (financial Infrastructure, demand conditions pro-inclusion policies) are transformed into outputs (bank accounts, credit, savings, insurance).

Figure 57: Share of enterprises reporting access to finance as their most important problem

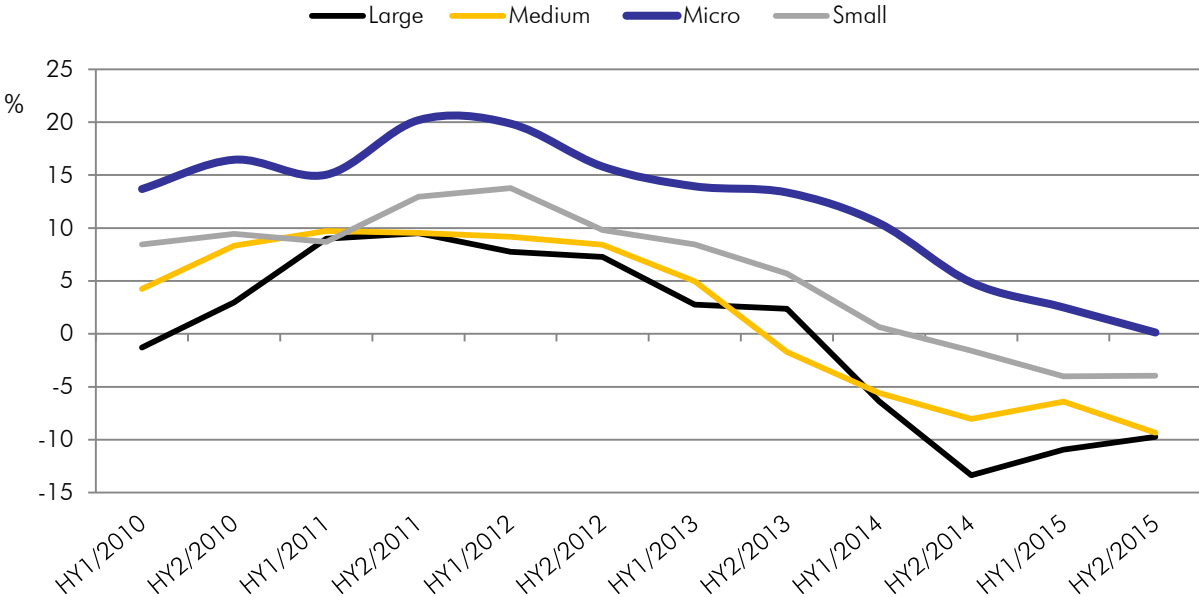


Source: Authors, based on data from ECB (2016), Statistical Data Warehouse

The ECB survey on the access to finance of enterprises (SAFE) in the Euro Area (ECB, 2016) provides additional insights regarding the financing situation of European microenterprises. According to the latest SAFE survey, the share of enterprises which see “access to finance” as their most important problem remained relatively stable (Figure 57). Importantly, the share of microenterprises reporting access to finance to be their most important problem consistently exceeds the share of bigger SMEs, a discrepancy that grew larger over the last three semesters. This is in line the report of the ECB (2016a) that states that bank loan rejection rate is still the highest for microenterprises (12%), compared to 6% for small firms and 4% for medium-sized firms. Consequently, the share of microenterprises that did not apply for a loan due to fear of rejection (discouraged borrowers) remains high at 9 percent.

Figure 58 shows how microenterprises report on changes in their perceived financing gap and compares this to other company size classes. Also here it becomes apparent that microenterprises believe they operate in a more challenging environment than larger firms: not only are they consistently less positive about their financing situation, it is also the only size class that is still perceiving their financing gap to be growing during the first semester of 2016 (although marginally so). The situation continues to improve, however, line with the other size classes the percentage of micro-firms reporting an increasing financing gap has steadily decreased over the past years.

Figure 58: Perceived change in the external financing gap (by firm size)



Source: Authors, based on ECB SAFE (2016a), Statistical Data Warehouse

6.5 Microfinance prospects

Microenterprises in general, and workers from vulnerable labour market segments that cherish entrepreneurial ambitions specifically, still face significant difficulties in accessing financial resources from traditional credit channels. Microenterprises still face a tight credit supply by mainstream banks with a high risk aversion and increasing need to de-leverage their balance sheets. Disadvantaged groups, such as long term unemployed, or workers with a migrant background, lack the necessary collateral to secure loans from traditional loan providers. In this environment of credit allocation, lending might be allocated away from small, young and opaque firms as they are perceived to be more risky than their larger peers and have smaller financing needs which are difficult to cover in a cost-efficient manner by mainstream funding providers.

Financial inclusion of potential business creators is especially important in countries with high unemployment numbers. In addition to the financial support, unemployed people are often in need of acquiring the necessary skills for success through coaching and mentoring. Therefore, aside from these financial products and services, many European MFIs provide non-financial services as well. Microfinance can be an important tool to overcome the effects of the crisis for some specific groups and in particular to support inclusive growth.

If microfinance providers do not have access to stable funding, the perspectives of the sector with regard to growth and self-sufficiency are limited. The stability of MFI’s funding channels is currently threatened, as budget deficits and fiscal conservatism pressurise funding flows from national governments. In response, the MFIs are developing more efficient and lean operational processes, thereby reducing lending costs. In addition, they are on a continuing search for additional funding sources (EMN, 2014).

Against the background of the current difficult conditions, support on a European level has become of central importance – via funding, guarantees and technical assistance to a broad range of financial intermediaries, from small non-bank financial institutions to well-established microfinance banks – in order to make microfinance a fully-fledged segment of the European financial sector. Bruhn-Leon, Eriksson and Kraemer-Eis (2012) discuss the rationale for public support in the microfinance area and explain how European policy – through the EIF - currently supports the microfinance sector under the Progress Microfinance mandate. The intervention logic is based on the market structure of the microfinance sector and its characterising diversity. It seeks to maximise outreach through a flexible investment approach in terms of eligible types of investments and types of financial intermediaries. The key target group are non-bank MFIs, but the range of financial intermediaries is extended also to banks with good outreach to microfinance clients, such as cooperative banks or micro-banks.

Results show so far that non-bank MFIs have been the most active lenders over the first five years of Progress Microfinance, as their main focus is micro-lending, unlike banks. Moreover, many non-bank MFIs have made use of the flexibility under Progress Microfinance to provide funding and risk coverage denominated in local currency. Progress Microfinance so far has covered 23 countries. It is estimated that Progress Microfinance has as of June 2016 mobilised EUR 420m (84% of target) of new financing across some 46,500 (101% of target) eligible micro-borrowers. The target of providing EUR 500m of new microcredits to minimum 46,000 micro-borrowers is still within reach.

In mid-2015 the Progress Microfinance successor program, the program for Employment and Social Innovation (EaSI) was launched and the related mandate agreement between the European Commission and the EIF was signed on 24 June 2015. The EaSI investment period will run until 2023. EaSI contributes to the Europe 2020 strategy by supporting the EU's objective of high level employment, adequate social protection, fighting against social exclusion and poverty and improving working conditions. EIF will manage and implement EaSI, enhancing access to microfinance for vulnerable groups and microenterprises and social enterprises, while building-up the institutional capacities of microcredit and social finance providers. In an initial phase the EC will make available EUR 96m through a new guarantee instrument, to offer credit risk protection for lending products provided to micro and social enterprises. In a second phase, likely to start in the second semester of 2016, additional funds will be made available by the EC also for funded instruments to intermediaries such as senior loans, subordinated loans and direct equity investments. The initial demand for the EaSI guarantee instrument has been very high and as of June 2016 it is estimated that the signed guarantee agreements, covering 14 countries (including Albania as the first outside of EU-28), over time will mobilise almost EUR 560m of new financing to some 46,000 eligible micro-borrowers.

7 Concluding remarks

The financing outlook of European SMEs has remained relatively stable since the publication of the last ESBFO in December 2015. Even though the situation improved noticeably over the past two years, a significant proportion of European SMEs still experience barriers in access to finance. Furthermore, this proportion varies strongly from country to country. In addition, worries about the general economic outlook weighed on firms' investment decisions. The already high level of uncertainty regarding the economic outlook is now magnified by the expressed will of the British people to leave the European Union. It can be expected that the decision will have negative consequences for the economic recovery process.

In this report we mentioned the emerging group of *Fintech companies* only briefly. There is on the one hand certainly a lot of hype around this market segment now – and such boom typically causes not only positive experiences, but also bad examples and shake-outs. On the other hand, there is as well a lot of substance as Fintechs are becoming an integral part of the SME financing landscape. They are drivers for new business models, new financing channels, and not least they are often successful start-ups and SMEs themselves. For established market players Fintechs can play various roles – e.g. as competitors, integration targets, or in a symbiosis as business partners. New coalitions are emerging, in particular in the fields of crowdfunding (both, lending and equity) – examples are combinations of microfinance and crowdlending, Business Angel/Venture Capital financing and crowdinvesting, or banks using marketplace lenders as distribution channels. Given their increasing role in the financing landscape, also for EIF, these market players are increasingly relevant, as financial intermediaries to enhance access to finance for SMEs, as counterparts in SMESec transactions (see Box 6 above), and as well as final beneficiaries/investee companies. These market developments and EIF's related involvement and support are perfectly in line with the spirit of the European Commission's plan to establish a Capital Markets Union (see below) and to diversify the financing possibilities for SMEs.

It is a key priority for the EIF to help establish a well-functioning, liquid *equity market* that attracts a wide range of private sector investors. In doing so, EIF aims at leveraging its market assistance and seizing market opportunities in all areas of the equity eco-system which are relevant to the sustainable development of the industry. EIF has increased – as the key catalytic investor in European venture and growth capital funds – its counter-cyclical role in providing financing solutions to boost entrepreneurship and innovation. In the coming years, EIF will continue to act as a cornerstone investor across the spectrum of Technology Transfer through Venture Capital to the Lower Mid-Market and mezzanine financing. This also includes the launch and extension of new/pilot initiatives, such as the support of Debt Funds or initiatives in the field of social entrepreneurship.

In the areas of *credit guarantees* and *securitisations*, EIF cooperates with a wide range of financial intermediaries. They include: banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks, and other financial institutions that provide financing or financing guarantees to SMEs. Given that SMEs have no direct access to the capital markets, banks are typically the most important source of external SME finance. Hence, funding limitations of banks

have direct impact on SME lending capacity. For loans to SMEs, a standardised, highly transparent and quality-controlled securitisation market could transform these illiquid loans into an asset class with adequate market liquidity.

Finally, *microfinance* is an important contribution to overcoming the effects of the crisis, and in particular to supporting inclusive growth. EIF provides funding, guarantees and technical assistance to a broad range of financial intermediaries, from small non-bank financial institutions to well-established microfinance banks to make microfinance a fully-fledged segment of the European financial sector. Moreover, EIF intends to sustain its support of microcredit, social investments, and participation in the increasing number of social finance institutions that are being established in the EU Member States.

We concluded our previous ESBFO with the introduction of the *Investment Plan for Europe (IPE)*⁶⁸. Given the importance of this project, we do the same again this time and provide an update. The IPE is based on three pillars, mobilising finance for investment, making finance reach the real economy, and improved investment environment, see Figure 59. Pillar three entails inter alia the Capital Markets Union (CMU) as important element; background information regarding the CMU can be found in Box 12.

Figure 59: Pillars of the IPE



Source: European Commission

As part of this investment plan’s pillar one, the European Fund for Strategic Investments (EFSI) aims to unlock investment by addressing market gaps and mobilising private resources. By taking on some of the risk, the EIB Group can help increase the appetite to invest. The EIB Group provides loans and other financial products that are partly covered by an EU budget. As there is abundant liquidity in the market, sound projects and risk-absorbing financial products will be able to attract more funding, especially from private investors.

⁶⁸ See <http://www.eib.org/efsi/index.htm> and http://www.eif.org/what_we_do/efsi/index.htm.

Box 12: Capital Markets Union (CMU)

The CMU Initiative, to be completed in 2019, aims at developing and integrating the EU financial markets to address financial market fragmentation across Member States. The purpose is to diversify the availability and access to funding sources by complementing bank financing and ensuring a more efficient and less-costly allocation of capital across borders. The thrust of the CMU is to provide a comprehensive structure of financial channels efficiently linking available liquidity and productive investment projects (see European Commission, 2015b).⁶⁹

The EU Commission adopted the CMU Action Plan on the 30th September 2015 and a set of legislative and non-legislative measures launching the implementation of the CMU (see European Commission, 2015c). In order to build a single market for capital, barriers between investors' money and investment opportunities need to be identified and removed, and the investment chain needs to be as efficient as possible, both nationally and cross-border. For the implementation of the CMU, the EC is pursuing a dual strategy of "quick wins" that aims to have short-term impact on capital markets, coupled with long term structural changes paving the way to greater integration and harmonisation of the European capital markets.

For the short-term, the Commission has prioritised the following set of actions:

- lowering barriers to accessing capital markets by targeting a review of the prospectus regime to avoid excessive administrative burden for companies, widening the investor base for SMEs and fostering their integration in capital markets by improving the availability, accessibility and comparability of credit information on SMEs,
- building a more sustainable securitisation market,
- boosting long term investment via the implementation of EFSI and by supporting the take-up of European Long-term Investment Funds (ELTIFs) regime,
- developing a European private placement market.

In the medium to long term, in order to achieve the CMU, the Green paper identifies challenges to be overcome in three key areas:

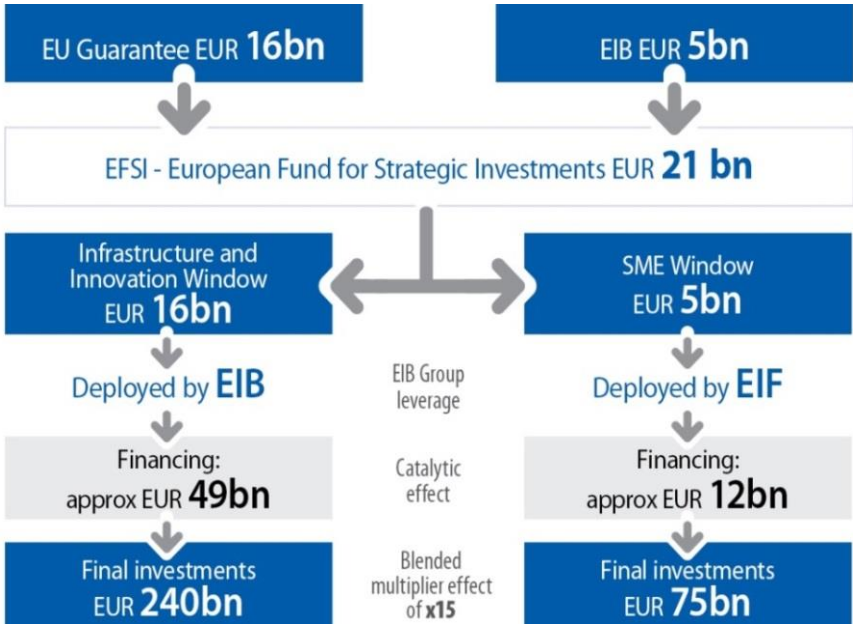
- access to finance has to be improved, notably for SMEs and investment projects such as infrastructure,
- funding sources need to be boosted and diversified, and
- the effectiveness of markets needs to be improved, notably by the development of a single rule book on company law and insolvency law.

In April 2016 the EC published a detailed status report (European Commission, 2016a), summarizing the steps taken since adoption of the CMU action plan, the key initiatives planned by the end of 2016, as well as the plan for action for the years 2017 and 2018.

EFSI is a strategic partnership between the EC and the EIB Group. The EIB Group contributes EUR 5bn to the initiative alongside a EUR 16bn guarantee from the EU budget (see Figure 59). The EFSI SME Window (SMEW) is being implemented by the EIF through guarantee and equity agreements between the EIF and financial intermediaries signed in 2015-2018.

⁶⁹ The EIB Group responded to the related public consultation. For more information please see: <https://ec.europa.eu/eusurvey/publication/capital-markets-union-2015>

Figure 60: EFSI structure



Source: EIB Group

The resources under EFSI enable EIF to deploy its existing support for SMEs at a higher and faster rate than initially planned to satisfy strong demand of support to SME access to finance. During the first phase, initial EFSI resources under the SME Window are being used to accelerate and enhance the deployment of existing EU flagship programmes which EIF manages – i.e. COSME, InnovFin – and to significantly increase the Risk Capital Resources (RCR) mandate for equity investments, which EIB has entrusted to EIF. Thanks to EFSI, also the RCR equity mandate which EIF manages on behalf of EIB has been increased by EUR 2.5bn.

In the second phase of EFSI SMEW deployment (commencing 2016), new products will be rolled out, starting with a new equity product, available (but not exclusively) to National Promotional Institutions (NPIs) through an equity investment platform – the date of signature is expected at the end of July 2016. This new product is expected to be deployed from Q3/2016 onwards and will provide a further significant boost to the investments supported under the SME Window. The focus will be on the financing of early-stage companies, as well as growth-stage and RDI-intensive SMEs/small mid-caps, including social enterprises. Privately managed pan-European VC funds or funds shall also be supported by this new product. The equity investment platform represents a flexible, non-binding governance framework which offers the possibility for NPIs to match the total budget of investments under the EFSI SME Window on a 1:1 basis. More generally, it is an opportunity for EIF and NPIs to establish a closer, more coordinated operational interaction.

In addition, further EFSI SMEW products are planned to be designed and rolled out in the period 2016-2017, including notably an SME securitisation product (as well in cooperation with NPIs), products for social impact and microfinance, and guarantee products for innovative companies.

The implementation of the SME window is well on track. As at 31 May 2016, only one year after the start, EUR 48bn of the EUR 75bn SME Window investment target (representing 64%) has already been mobilised in terms of approved transactions. Regarding signed transactions, EUR

44.4bn (representing 59% of final target) have been achieved as per end of May. These signed transactions are with financial intermediaries from 22 countries, support 130k companies (estimated number) and support the creation of 188k jobs (estimated number).

The demand from intermediaries to finance SMEs remains very high and the ultimate investment objective of EUR 75bn is expected to be reached by mid-2017. An increase of the SME window capacity by EUR 500m is in preparation and expected to be approved in July 2016. Following such increase, the overall level of mobilised investments could well exceed EUR 82.5bn (depending on the type of additional products still to be approved and rolled out).

ANNEX

Annex 1: Private Equity Glossary

(selection, from EVCA/Invest Europe)

- **Buyout:** A buyout is a transaction financed by a mix of debt and equity, in which a business, a business unit or a company is acquired with the help of a financial investor from the current shareholders (the vendor).
- **Buyout fund:** Funds whose strategy is to acquire other businesses; this may also include mezzanine debt funds which provide (generally subordinated) debt to facilitate financing buyouts, frequently alongside a right to some of the equity upside.
- **Capital weighted average IRR:** The average IRR weighted by fund size.
- **Carried interest:** A share of the profit accruing to an investment fund management company or individual members of the fund management team, as a compensation for the own capital invested and their risk taken. Carried interest (typically up to 20% of the profits of the fund) becomes payable once the limited partners have achieved repayment of their original investment in the fund plus a defined hurdle rate.
- **Closing:** A closing is reached when a certain amount of money has been committed to a private equity fund. Several intermediary closings can occur before the final closing of a fund is reached.
- **Commitment:** A limited partner's obligation to provide a certain amount of capital to a private equity fund when the general partner asks for capital.
- **Deal flow:** The number of investment opportunities available to a private equity house.
- **Disbursement:** The flow of investment funds from private equity funds into portfolio companies.
- **Distribution:** The amount disbursed to the limited partners in a private equity fund.
- **Divestment:** See exit.
- **Drawdown:** When investors commit themselves to back a private equity fund, all the funding may not be needed at once. Some is used as drawn down later. The amount that is drawn down is defined as contributed capital.
- **Early stage:** Seed and start-up stages of a business.
- **Early stage fund:** Venture capital funds focused on investing in companies in the early part of their lives.
- **Exit:** Liquidation of holdings by a private equity fund. Among the various methods of exiting an investment are: trade sale; sale by public offering (including IPO); write-offs; repayment of preference shares/loans; sale to another venture capitalist; sale to a financial institution.
- **Expansion capital:** Also called development capital. Financing provided for the growth and expansion of a company, which may or may not break even or trade profitably. Capital may be used to: finance increased production capacity; market or product development; provide additional working capital.
- **Follow-on investment:** An additional investment in a portfolio company which has already received funding from a private equity firm.
- **Fund:** A private equity investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies (investee companies). These are generally private companies whose shares are not quoted on any stock exchange. The fund can take the form either of a company or of an unincorporated arrangement such as a limited partnership. See limited partnership.

- **Fund of Funds:** A fund that takes equity positions in other funds. A fund of fund that primarily invests in new funds is a Primary or Primaries fund of funds. One that focuses on investing in existing funds is referred to as a Secondary fund of funds.
- **Fund size:** the total amount of capital committed by the limited and general partners of a fund.
- **Fundraising:** The process in which venture capitalists themselves raise money to create an investment fund. These funds are raised from private, corporate or institutional investors, who make commitments to the fund which will be invested by the general partner.
- **General Partner:** A partner in a private equity management company who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.
- **General Partner's commitment:** Fund managers typically invest their personal capital right alongside their investors capital, which often works to instil a higher level of confidence in the fund. The limited partners look for a meaningful general partner investment of 1% to 3% of the fund.
- **Generalist fund:** Funds with either a stated focus of investing in all stages of private equity investment, or funds with a broad area of investment activity.
- **Holding period:** The length of time an investment remains in a portfolio. Can also mean the length of time an investment must be held in order to qualify for Capital Gains Tax benefits.
- **Horizon IRR:** The Horizon IRR allows for an indication of performance trends in the industry. It uses the fund's net asset value at the beginning of the period as an initial cash outflow and the Residual Value at the end of the period as the terminal cash flow. The IRR is calculated using those values plus any cash actually received into or paid by the fund from or to investors in the defined time period (i.e. horizon).
- **Hurdle rate:** A return ceiling that a private equity fund management company needs to return to the fund's investors in addition to the repayment of their initial commitment, before fund managers become entitled to carried interest payments from the fund.
- **Inception:** The starting point at which IRR calculations for a fund are calculated; the vintage year or date of first capital drawdown.
- **Institutional investor:** An organisation such as a bank, investment company, mutual fund, insurance company, pension fund or endowment fund, which professionally invest, substantial assets in international capital markets.
- **Internal rate of return (IRR):** The IRR is the interim net return earned by investors (Limited Partners), from the fund from inception to a stated date. The IRR is calculated as an annualised effective compounded rate of return using monthly cash flows to and from investors, together with the Residual Value as a terminal cash flow to investors. The IRR is therefore net, i.e. after deduction of all fees and carried interest. In cases of captive or semi-captive investment vehicles without fees or carried interest, the IRR is adjusted to create a synthetic net return using assumed fees and carried interest. For the avoidance of doubts: IRR means the financial IRR and not the economic IRR, i.e. it does not account for any externalities.
- **IPO (Initial public offering):** The sale or distribution of a company's shares to the public for the first time. An IPO of the investee company's shares is one the ways in which a private equity fund can exit from an investment.
- **Later stage:** Expansion, replacement capital and buyout stages of investment.
- **Leverage buyout (LBO):** A buyout in which the New Company's capital structure incorporates a particularly high level of debt, much of which is normally secured against the company's assets.
- **Limited Partnership:** The legal structure used by most venture and private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the

management firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). The general partner receives a management fee and a percentage of the profits. The limited partners receive income, capital gains, and tax benefits. The general partner (management firm) manages the partnership using policy laid down in a Partnership Agreement. The agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.

- **Management fees:** Fee received by a private equity fund management company from its limited partners, to cover the fund's overhead costs, allowing for the proper management of the company. This annual management charge is equal to a certain percentage of the investors' commitments to the fund.
- **Mezzanine finance:** Loan finance that is halfway between equity and secured debt, either unsecured or with junior access to security. Typically, some of the return on the instrument is deferred in the form of rolled-up payment-in-kind (PIK) interest and/or an equity kicker. A mezzanine fund is a fund focusing on mezzanine financing.
- **Multiples or relative valuation:** This estimates the value of an asset by looking at the pricing of "comparable" assets relative to a variable such as earnings, cash flows, book value or sales.
- **Pooled IRR:** The IRR obtained by taking cash flows from inception together with the Residual Value for each fund and aggregating them into a pool as if they were a single fund. This is superior to either the average, which can be skewed by large returns on relatively small investments, or the capital weighted IRR which weights each IRR by capital committed. This latter measure would be accurate only if all investments were made at once at the beginning of the funds life.
- **Portfolio company:** The company or entity into which a private equity fund invests directly.
- **Pre seed stage:** The investment stage before a company is at the seed level. Pre-seed investments are mainly linked to universities and to the financing of research projects, with the aim of building a commercial company around it later on.
- **Private Equity:** Private equity provides equity capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies (also called venture capital), to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. It can also resolve ownership and management issues. A succession in family-owned companies, or the buyout and buying of a business by experienced managers may be achieved by using private equity funding.
- **Private Equity Fund:** A private equity investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies. These are generally private companies whose shares are not quoted on a stock exchange. The fund can take the form of either a company or an unincorporated arrangement such as a Limited Partnership.
- **Quartile:** The IRR which lies a quarter from the bottom (lower quartile point) or top (upper quartile point) of the table ranking the individual fund IRRs.
- **Rounds:** Stages of financing of a company. A first round of financing is the initial raising of outside capital. Successive rounds may attract different types of investors as companies mature.
- **Secondary investment:** An investment where a fund buys either, a portfolio of direct investments of an existing private equity fund or limited partner's positions in these funds.
- **Seed stage:** Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.
- **Start-up:** Companies that are in the process of being set up or may have been in business for a short time, but have not sold their product commercially.

- **Target company:** The company that the offeror is considering investing in. In the context of a public-to-private deal this company will be the listed company that an offeror is considering investing in with the objective of bringing the company back into private ownership.
- **Top Quarter:** Comprises funds with an IRR equal to or above the upper quartile point.
- **Track record:** A private equity management house's experience, history and past performance.
- **Venture Capital:** Professional equity co-invested with the entrepreneur to fund an early-stage (seed and start-up) or expansion venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment. Venture capital is a subset of private equity.
- **Venture Capitalist:** The manager of private equity fund who has responsibility for the management of the fund's investment in a particular portfolio company. In the hands-on approach (the general model for private equity investment), the venture capitalist brings in not only moneys as equity capital (i.e. without security/charge on assets), but also extremely valuable domain knowledge, business contacts, brand-equity, strategic advice, etc.
- **Vintage year:** The year of fund formation and first drawdown of capital.
- **Volatility:** The volatility of a stock describes the extent of its variance over time.
- **Write-off:** The write-down of a portfolio company's value to zero. The value of the investment is eliminated and the return to investors is zero or negative.

Annex 2: Securitisation Glossary

- **Attachment Point:** The attachment point is the level of subordination that a particular tranche has beneath it. The attachment point is a proxy of percentage of the transaction that will absorb losses before the senior tranche is adversely affected.
- **Credit Default Swap:** An agreement used in synthetic securitisations where the originator (protection buyer) sells the credit risk of an underlying portfolio to a counterparty (protection seller) without transferring the ownership of the assets.
- **Credit Enhancement:** Refers to one or more measures taken in a securitisation structure to enhance the security, the credit quality or the rating of the securitised instrument, e.g. by providing a third party guarantee (such as the EIF guarantee). The credit enhancement could be provided in the form of:
 - (i) Structural credit enhancement (tranching of the transaction in senior, mezzanine and junior tranches);
 - (ii) Originator credit enhancement (cash collateral, profit retention, interest sub-participation);
 - (iii) Third party credit enhancement (e.g. EIF or monoline insurers).
- **Credit Linked Notes (CLN):** A security issued by an SPV (or directly from the balance-sheet of the originator) credit-linked to the default risk of an underlying portfolio of assets. Usually used in synthetic securitisations for the mezzanine tranches of a transaction.
- **Collateralised loan obligations (CLOs)** are a form of securitisation where payments from multiple middle sized and large business loans are pooled together and passed on to different classes of owners in various tranches.
- **First Loss Piece (FLP):** Part of a securitisation transaction which is usually kept by the originator (as an "equity piece") and which covers the risk of first loss in the portfolio. Its size is a function of the historical losses, so as to protect the investors against the economic risk (estimated loss) of the transaction. **Issuer:** Refers to the SPV which issues the securities to the investors.

- **Kirb:** means the sum of the expected loss and regulatory capital that a financial intermediary assigns to an exposure (a portfolio) by using an Internal Rating Based (IRB) approach.
- **Mezzanine Risk:** Risk or tranche which is subordinated to senior risk, but ranks senior to the FLP.
- **Originator:** The entity assigning receivables in a securitisation transaction (funded transaction) or seeking credit risk protection on the assets (unfunded transaction).
- **Primary market:** The market in which securities are issued.
- **Secondary market:** The market where issued securities are traded.
- **Senior:** The class of securities with the highest claim against the underlying assets in a securitisation transaction. Often they are secured or collateralised, or have a prior claim against the assets. In true sale structures they rank senior in the cash flow allocation of the issuer's available funds.
- **Servicer:** Refers to the entity that continues to collect the receivables, enforcement of receivables, etc. Generally, the originator is also the servicer.
- **Special Purpose Vehicle (SPV):** Issuing entity holding the legal rights over the assets transferred by the originator. An SPV has generally a limited purpose and/or life.
- **Subordinated:** The classes of securities with lower priority or claim against the underlying assets in a securitisation transaction. Typically, these are unsecured obligations. They are also called Junior (or Mezzanine) notes and bonds.
- **Synthetic securitisation:** A transaction where the assets are not sold to an SPV but remain on balance sheet; and where only the credit risk of the assets is transferred to the market through credit default swaps or credit linked notes.
- **Tranche:** A piece, a portion or slice within a structured transaction.
- **Portfolio Tranching Cover:** The technique by which an Originator can buy protection on a portfolio. Such protection is only activated when the losses exceed a given threshold (Attachment Point).
- **True sale:** It refers to the separation of the portfolio risk from the risk of the originator, i.e. there is a non-recourse assignment of assets from the originator to the issuer (special purpose vehicle). To be contrasted with synthetic securitisations where only the underlying credit risk is transferred.
- **Whole Business Securitisation (WBS):** Securitisation of the general operating cash flow arising from a certain line or area of the business of the originator over the long term.

Annex 3: List of acronyms

- ABCP: Asset Backed Commercial Paper
- ABSPP: Asset Backed Securities Purchase Programme
- AECM: European Association of Mutual Guarantee Societies
- AFME: Association for Financial Markets in Europe
- AIFMD: Alternative Investment Fund Managers Directive
- AIMA - Alternative Investment Management Association
- BA: Business Angel
- BAN: Business Angels Network
- BCBS-IOSCO: Basel Committee on Banking Supervision-Board of the International Organisation of Securities Commissions
- BCG: Boston Consulting Group
- BIS: Bank for International Settlements
- BLS: Bank Lending Survey
- bn: billion

- BoE: Bank of England
- bp: basis point(s)
- CDFIs: Community Development Financial Institutions
- CDO: Collateralised Debt Obligation
- CDP: Cassa Depositi e Prestiti, Italy
- CDS: Credit Default Swap
- CESEE (countries): (countries in) Central, Eastern and South-Eastern Europe
- CGAP: Consultative Group to Assist the Poor
- CGS: Credit Guarantee Scheme
- CIP: Competitiveness and Innovation Framework Programme
- CLN: Credit Linked Note
- CLO: Collateralised Loan Obligation
- CMU: Capital Markets Union
- COM: European Commission (also: EC)
- COSME: Programme for the Competitiveness of enterprises and SMEs (COSME) 2014-2020
- CRD: Capital Requirements Directive
- CRR: Capital Requirements Regulation
- CVC: Corporate Venture Capital
- EAF: European Angels Fund
- EBA: European Banking Authority
- EBAN: European Business Angels Network
- EBF: European Banking Federation
- EC: European Commission (also: COM)
- ECB: European Central Bank
- EFG: Equity Facility for Growth
- EFSI: European Fund for Strategic Investments
- EFTA: European Free Trade Association
- EIB: European Investment Bank
- EIF: European Investment Fund
- EIOPA: European Insurance and Occupational Pension Authority
- EL: expected loss
- EMEA: Europe, Middle East, and Africa
- EMN: European Microfinance Network
- ERB: External Ratings Based
- EREM: EIB Group Risk Enhancement Mandate
- ERP: European Recovery Program
- ESBFO: European Small Business Finance Outlook
- ESIF: European Structural and Investment Fund
- EU-28: the 28 EU Member States
- EUR: Euro
- EuVECA: European Venture Capital Fund Regulation
- EVCA: European Private Equity & Venture Capital Association
- FLP: First Loss Piece
- FLPG: First Loss Portfolio Guarantee
- FRSP: Funded Risk Sharing Product
- FTPYME: Fondos de Titulización de activos para Pequeñas Y Medianas Empresas (Asset Securitisation Funds for SMEs)
- FYROM: Former Yugoslav Republic of Macedonia
- GDP: Gross Domestic Product
- GEM: Global Entrepreneurship monitor
- GP: General Partner
- HICP: Harmonised index of consumer prices
- HQS: High Quality Securitisation
- HY: Half Year
- ICT: Information and communications technologies

- IMF: International Monetary Fund
- InnovFin: EU Finance for Innovators
- IPO: Initial Public Offering
- IRB: Internal Ratings Based
- IRF: Initial Rate Fixation
- IRR: Internal Rate of Return
- IT: Information Technology
- JEREMIE: Joint European Resources for Micro to Medium Enterprises
- k: thousand
- KfW: Kreditanstalt für Wiederaufbau, Germany
- Kirb: IRB capital requirements for the underlying pool of securitised assets
- LBO: Leveraged buy out
- LGD: loss given default
- LGF: Loan Guarantee Facility
- LP: Limited Partner
- m: million
- MAP: Multi Annual Programme for Enterprise and Entrepreneurship
- MCIF: Mezzanine Co-Investment Facility
- MFC (Microfinance Center)
- MFI (in the context of ECB): Monetary Financial Institutions
- MFI (in the context of microfinance): Microfinance Institution
- NBFIs: Non-bank Financial Institutions
- NFC: Non-financial corporation
- NGO: Non-Governmental Organisation
- NPB: National Promotional Bank
- NPI: National Promotional Institution
- NPL: Non-performing loan
- OECD: Organisation for Economic Co-Operation and Development
- PCS: Prime Collateralised Securities
- PD: probability of default
- PE: Private Equity
- PFB: Public Funding Body
- pif: paid in full
- PRSL: Portfolio Risk Sharing Loan
- PVCI: Portugal Venture Capital Initiative
- Q: Quarter
- QE: Quantitative Easing
- RCR: Risk Capital Resources
- RMA: Research and Market Analysis
- RMBS: Residential mortgage backed securities
- RSI: Risk-Sharing Instrument for Innovative and Research oriented SMEs and small mid-caps
- SA: Standardised Approach
- SAFE: Survey on the Access to Finance of Enterprises
- sf: Structured Finance
- SFA: Supervisory Formula Approach
- SIA: Social Impact Accelerator
- SME: Small and medium sized enterprise
- SMEG: SME Guarantee Facility
- SMESec: SME Securitisation (comprising transactions based on SME loans, leases etc.)
- SPGM: Sociedade Portuguesa Garantia Mutua, Portugal
- SPV: Special Purpose Vehicle
- SSM: Single Supervisory Mechanism
- SST: simple, standard and transparent
- STC: simple, transparent and comparable
- STS: simple, transparent and standardised
- TMT: Technology, Media, Telecom

- TT: Technology transfer
- UEAPME: European Association of Craft, Small and Medium-sized Enterprises
- UK: United Kingdom
- US: United States
- VC: Venture Capital
- WAL: weighted average life
- WBS: Whole Business Securitisation

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