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SME credit guarantees issued by the European Investment Fund (EIF)¹

Credit guarantee mechanisms are a commonly used response to market failures and market weaknesses in the area of SMEs' access to finance. Guarantees reduce the risk of lenders and favour the provision of financing to viable businesses that are constrained in their access to finance. The European Investment Fund (EIF) is focused on enhancing access to finance for SMEs and small mid-caps and is a key multinational provider of credit guarantees. With a special focus on the Investment Plan for Europe (IPE) – also often called the “Juncker Plan” – this paper explains EIF's approach and current product offering².



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Why SME guarantees?³

In the area of access to finance for SMEs, a market imperfection/failure is not only present during a deep recession or a financial crisis, but also on an on-going basis as a fundamental structural issue (see OECD (2014), for an overview of market failures in SME lending and mitigation techniques). There are several reasons for this – one of them is the disproportionality between the extent, and hence the cost, to assess a relatively small company's application for finance and the potential revenue. Whereas the credit assessment contains a certain fixed cost element (i.e. independent of the size of the finance requested), the revenue is, inter alia, dependent on the amount – however, small firms typically need smaller loan amounts than larger companies, and banks have an incentive to achieve economies of scale. The aforementioned issue is reinforced by the asymmetric information (in the case of debt: information gap between lender and borrower – and the availability (and quality) of information about smaller – and in particular younger – enterprises is typically even worse than for the bigger and more mature companies), combined

with uncertainty, which causes agency problems that affect debt providers behaviour (see Akerlof, 1970, Jaffee and Russell, 1976, Stiglitz and Weiss, 1981, and Arrow, 1985)⁴. This results in an insufficient supply of credit, which can be particular true in the case of SME financing (OECD, 2006)⁵.

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

1. For more information about the European Investment Fund, please visit http://www.eif.org/news_centre/research/index.htm.
2. This paper reflects the views of the authors; it also benefits from the contribution of Stefano BRAGOLI (Senior Structured Finance Manager at EIF) and Frank LANG (Senior Manager, EIF's Research and Market Analysis) for which we are very grateful. All errors are of the authors.
3. This section is based on EIF's *European Small Business Finance Outlook*, Dec-2015 (KRAEMER-EIS, LANG, TORFS and GVETADZE) where interested readers can find further information about SME financing.
4. Agency theory/the principal-agent approach is often applied in economic literature for analysing relationships between lenders and borrowers (e.g. contract design, selection process, credit constraints, etc.).
5. STIGLITZ and WEISS (1981) argued that under certain circumstances credit rationing can be rational for banks.

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.

Guarantee mechanisms, “whereby should the borrower default the guarantor compensates a pre-defined share of the outstanding loan” (OECD, 2014), are a commonly used response to 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 widely used across economies as important tools to ease financial constraints for SMEs and start-ups” (OECD, 2013), i.e. in order to alleviate market failures in SME financing. Guarantee institutions exist in private or public form and have in a number of countries a long history, like the mutual guarantee schemes in Italy, which are based on a close relationship with their members. Moreover, loan guarantee programmes expanded substantially in the years 2007-2011, as a government policy response to the financial crisis. Public guarantee schemes are often viewed as having 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 revenues) 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, 2014). Therefore, loan guarantee programmes continue to be “the most widely used instrument at governments’ disposal to ease SME access to finance” (OECD, 2015). Further, guarantees are “increasingly targeting young and innovative firms in an effort to boost employment and value added” (OECD, 2016).

Increasing needs for guarantees during downturns

During a downturn banks’ capital and liquidity positions are generally weakened, leading to reduced availability of credit across the economy. At the same time, heightened uncertainty increases the adverse selection and moral hazard problems embedded in SME lending. Borrowers’

default probabilities increase and in parallel, collateral values decrease. All these factors contribute to increasing the financing gap for SMEs, resulting in the potential for economic welfare enhancements through public sector intervention in the form of guarantees. To fulfil their policy objectives, CGSs must be adequately priced and structured, and ideally the risk reduction they provide should be adequately reflected in regulatory capital relief – and in an integrated banking market such regulatory treatment should be homogeneous. Low cost guarantees give rise to moral hazard, undermining lenders’ incentives to monitor and select projects efficiently. **A well designed credit guarantee scheme should ensure that risk is shared with the private sector.** The use of credit guarantees has been increased during the crisis in many countries (Revoltella and Kraemer-Eis, 2015).

The EIF as key multinational provider of credit guarantees

What is the EIF?

The EIF is the specialist provider of the **European Investment Bank (EIB) Group**⁶ with respect to 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)⁷. The EIF is focused on enhancing access to finance for SMEs and small mid-caps and is a key multinational provider of credit guarantees.

The guarantee activity encompasses “mandate” transactions which are the bulk of EIF activity whereby the EIF manages and distributes the allocated resources by the European Commission (EC) or the EIB; and “own risk” transactions where the EIF deploys its own capital. In order to alleviate problems experienced by SMEs in accessing finance, EIF is playing an important role via a wide range of financial intermediaries, such as banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks, and other financial intermediaries. **EIF offers guarantees/counter-guarantees for portfolios of microcredits, SME loans or leases, as well as guarantees for securitised SME financing instruments.** In the following sections, first the portfolio guarantee activities in the context of the implementation of the Invest-

6. The EIB Group consists of the EIB and the EIF with the former being the main shareholder of the EIF (61.2%); the remaining equity is held by the the European Union (represented by the European Commission, 26.5%), as well as 30 public and private financial institutions from European Union Member States and Turkey (12.3%).

7. This section is based on KRAEMER-EIS, LANG, TORFS and GVETADZE, 2015.



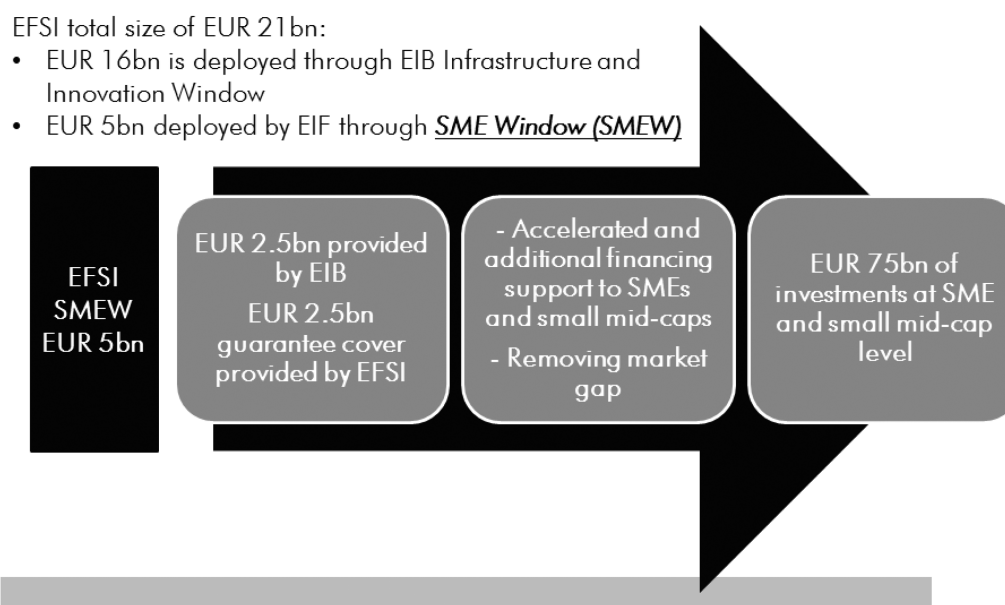
ment Plan for Europe are presented, followed by a short summary of EIF's guarantee activities related to SME securitisation (SMESec)⁸.

EIF's guarantees and the Investment Plan for Europe

EIF manages several mandates on behalf of the EIB, the EC and national and regional Managing Authorities. Among the EC mandates, the EIF manages the Loan Guarantee Facility (LGF) under the Programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME) and the InnovFin SME Guarantee Facility (InnovFin) under Horizon 2020. Both facilities are windows of the Single EU Debt Financial Instrument, which is financially supported by COSME and Horizon 2020 to support growth, research and innovation of European enterprises.

EIF's guarantee activities are as well an important pillar of the *Investment Plan for Europe* – also called the *Juncker Plan*⁹. The global economic and financial crisis has hampered investment in infrastructure, innovation and the private sector. As part of the *Juncker Plan*, the European Fund for Strategic Investments (EFSI) aims to unlock investment by addressing market gaps and mobilising private resources (see *Table 1. – EFSI Initial Contribution*). By taking on some of the risk, the EIB Group can help increase the appetite to invest providing loans and other financial products that will be partly covered by the 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.

Table 1. EFSI Initial Contribution



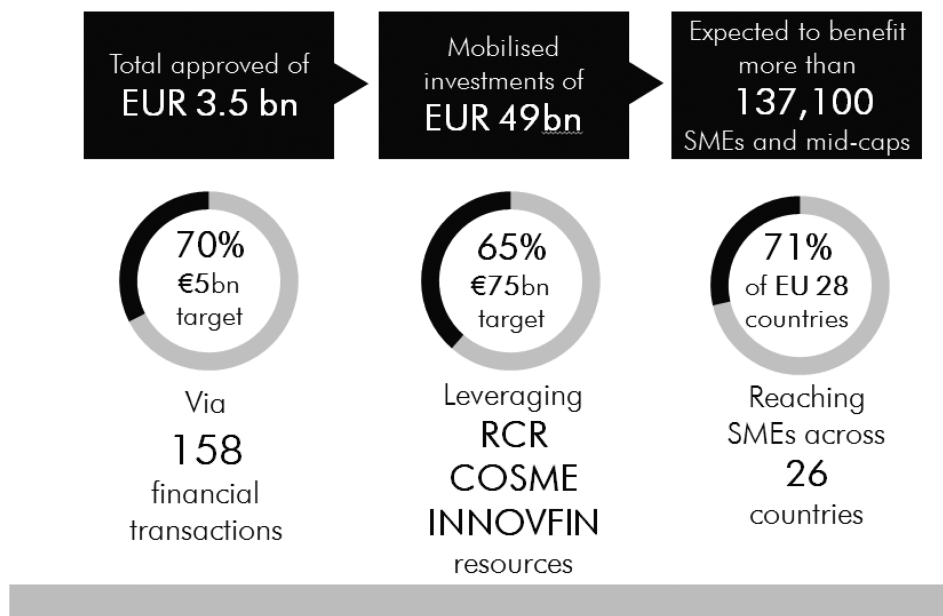
EFSI is a strategic partnership between the EC and the EIB Group with the latter contributing EUR 5bn to the new initiative alongside a EUR 16bn guarantee from the EU budget. The EFSI *SME Window* (SMEW, EUR 5bn volume) is being implemented by the EIF through guarantee and equity agreements between the EIF and financial intermediaries to be signed in 2015-2018. The objective of the SMEW is to mobilise final investments of EUR 75bn and the financial support must be additional to what would have been delivered under the existing and already foreseen programmes in the period 2015-2018.

The implementation of the SME Window is well on track. As per mid-March 2016, EIF has approved 158 transactions for EUR 3.5bn, i.e. 70% of SMEW total volume. It is expected that these transactions trigger investments of around EUR 49bn and that more than 137,100 SMEs and small mid-caps benefit (see *Table 2. – SME Window Implementation as of mid-March 2016*). Further signatures should follow soon, as reflected by EIF's substantial deal pipeline.

8. More information about the EIF can be found at: www.eif.org.

9. See for more information: <http://www.eib.org/about/invest-eu/index.htm>.

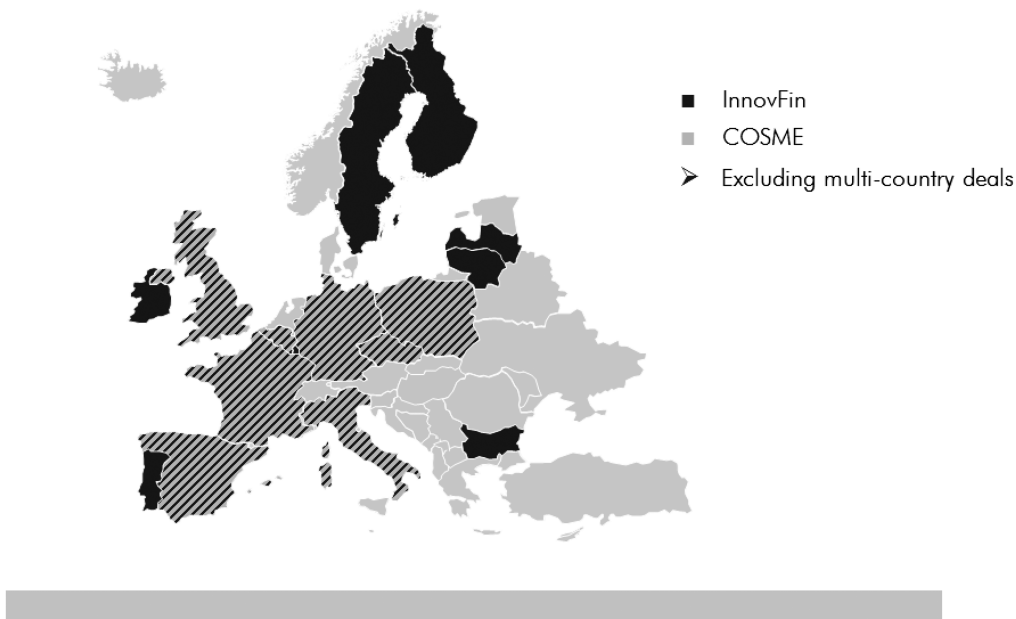
Table 2. SME Window Implementation as of mid-March 2016



As far as guarantees programmes are concerned, initial EFSI resources under the SMEW are used to accelerate and enhance the deployment of existing EU flagship

programmes managed by the EIF, i.e. COSME and InnovFin (see Table 3. – Country Coverage under EFSI as of mid-April 2016).

Table 3. Country Coverage under EFSI as of mid-April 2016



A front loading of the InnovFin and COSME programmes was approved in April 2015 by the EIF Board, including a EUR 0.5bn warehousing capacity by EIF.

As a result, the first guarantee agreement under EFSI was signed on 12th of May 2015 with the French public invest-

ment bank Bpifrance (a subsidiary of Caisse des Dépôts) even before the European Fund for Strategic Investments was formally established which, in turn, reflects the EIB Group’s commitment to respond swiftly to calls from Member States, the EC and the European Parliament for a rapid launch of concrete initiatives under EFSI¹⁰. The

10. For more information see: http://www.eif.org/what_we_do/efsi/index.htm.



resources under EFSI enable EIF to deploy its existing support for SMEs at a higher and faster rate than initially planned.

Through COSME LGF, EIF offers guarantees and counter-guarantees, including securitisation of SME debt finance portfolios, to selected financial intermediaries (e.g. guarantee institutions, banks, leasing companies, loan/debt funds¹¹, etc.) to help them provide more loans and leases to SMEs.

By sharing the risk, COSME guarantees allow the financial intermediaries to expand the range of SMEs they can finance, facilitating access to debt finance for many SMEs which might be having difficulties in accessing the traditional banking system.

As at mid-April 2016, 39 agreements have been signed in 17 different countries enabling SME financing up to EUR 11bn (see *Table 4. – COSME LGF Country Coverage*).

Table 4. COSME LGF Country Coverage



COSME LGF is a successor to the SME Guarantee Facility (SMEG), successfully implemented by EIF, on behalf of the EC, under the Competitiveness and Innovation Framework Programme (CIP) in the period 2007-2013.¹² Until June 2015, more than 373,000 SMEs were supported under CIP SMEG, and 72 agreements with 55 intermediaries were signed in 24 countries. The loan amount that CIP SMEG has so far generated for SMEs was EUR 19.9bn.

The **InnovFin SME Guarantee Facility** is part of “InnovFin – EU Finance for Innovators”, an initiative launched by the EC and the EIB Group in the framework

of Horizon 2020.

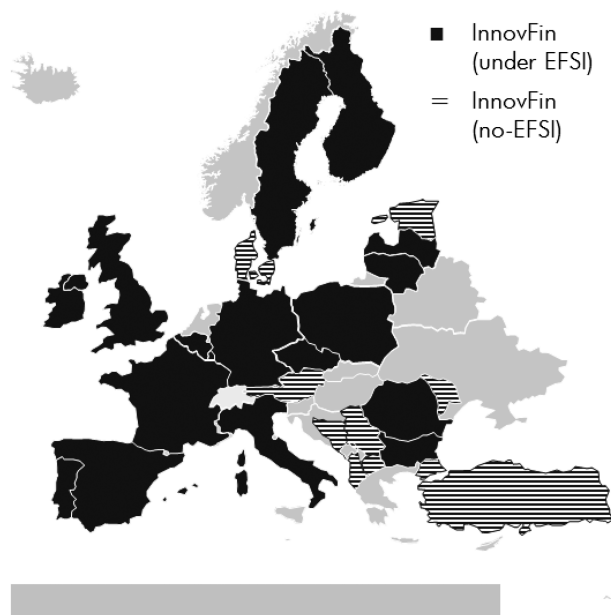
EIF, acting as the implementing body, covers a portion of the losses incurred by the financial intermediaries on loans, leases, bonds and guarantees. In this way, the EU and EIF allow the provision of more debt financing to research-based and innovative SMEs and small mid-caps (up to 499 employees).

As at mid-April 2016, 49 agreements have been signed in 27 different countries enabling SME financing up to approximately EUR 6.9bn (see *Table 5. – InnovFin Country Coverage*).

11. See KRAEMER-EIS *et al.* (2014) for more information on institutional non-bank lending and the role of Debt Funds.

12. Source: EIF. For more information on the COSME LGF see http://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/index.htm. For more information on the CIP SMEG see http://www.eif.org/what_we_do/guarantees/cip_portfolio_guarantees/index.htm.

Table 5. InnovFin Country Coverage



The InnovFin SME Guarantee Facility builds on the success of the Risk Sharing Instrument (RSI), developed under FP7 (i.e. the 7th EU Framework Programme for Research and Technological Development 2007-2013), managed and implemented by EIF. The RSI Facility for Innovative and Research oriented SMEs and small mid-caps was an EIF/EIB/EC joint pilot guarantee scheme that aimed at improving access to debt finance for innovative SMEs and small mid-caps. RSI had been launched in 2012 and was speedily introduced to financial intermediaries with absorption and deployment to SMEs following swiftly. As of December 2015, 40 operations (including 4 increases) with 36 different intermediaries in 18 countries had been signed, totalling approximately EUR 1.6bn, which enables SME financing of up to EUR 3.2bn. 4,237 innovative SMEs and small mid-caps have been financed.

Over time additional instruments are foreseen to be implemented under EFSI, including uncapped guarantees and SMESec. In this respect, the EIB Group and various National Promotional Institutions (NPIs) are working on a concept to design a joint securitisation platform. The working group aims at defining a platform that will allow national and multilateral promotional institutions as well as potentially other public sources (as for example resources from the European Structural and Investment Funds, ESIF) to offer interested originators (in particular, banks and leasing companies) a common framework of parameters to support their securitisation transactions.

Further EIF portfolio guarantee activities

EIF has been entrusted with the **EIB Group Risk Enhancement Mandate (EREM)**; a more detailed overview was provided in Kraemer-Eis, Lang, and Gvetadze, (2014), which encourages further SME lending in the EU. EREM is a facility of up to EUR 6bn (EUR 4bn from EIB supplemented by EUR 2bn from EIF) that will back, inter alia, additional guarantees to be issued by EIF over the next seven years. Although aimed at increasing the coherence and consistency among different instruments, EREM is more to be seen as a special measure to fight effects of the crisis, whereby the EU instruments are mainly meant to mitigate the structural weaknesses in SME lending.

Another instrument to alleviate the impact of the crisis is the **EU SME Initiative** with its objective to achieve an increase in the volume of SME lending. Its overall aim is to combine the resources available from the EU (COSME and Horizon 2020), the EIB Group, third parties and the Member States (European Structural and Investment Funds, ESIF) to achieve rapid and significant impact. Spain has been the first country to implement this new EU initiative with an amount of EUR 800m out of its ESIF available funds. This amount is currently being leveraged with financial institutions through a risk sharing mechanism, so that more SMEs will benefit from European resources on advantageous terms. It is expected that at least EUR 3.2bn of new SME financing will be supported under this programme in Spain (see EIF, 2015)¹³. In addi-

13. More information on the SME Initiative in Spain can be found here http://www.eif.org/what_we_do/guarantees/sme_initiative/smei_spain/index.htm.



tion to Spain, the SME Initiative is in implementation phase in Malta and Bulgaria and in the future it might be extended to other EU Member States.¹⁴

Moreover, the *Cultural and Creative Sectors guarantee facility* (under the Creative Europe Programme) is under development to be available during the second quarter of 2016. With an initial budget of EUR 122m, this facility will focus on enhancing access to finance for SMEs in the cultural and creative sector through the provision of guarantees to financial intermediaries, together with expert advice, to increase their understanding of the cultural and creative sectors.

Many of EIF's guarantee products are also available for leasing providers – see for more details Kraemer-Eis and Lang, 2012 and 2014. Leaseurope and EIF recently compiled an overview of EIF's guarantee instruments in a new 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).

The impact of credit guarantee schemes has been analysed, inter alia, in a joint Working Paper of the EIF and the European Commission (Asdrubali and Signore, 2015). 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, the authors found significant positive effects of this EU guarantee programme on the beneficiary firms. By breaking down the sample by country, year of signature, size and age classes, it has been found that micro and young SMEs have benefited the most from MAP-guaranteed loans in terms of economic additionality.

EIF's SMESec guarantees (credit enhancement)¹⁵

EIF started its securitisation business already in the late 1990s. At that time, the business was fully based on own resources ("own risk") and became a core business activity of EIF. As a result, an additional important activity of the EIF became guarantees in the context of SME securitisation (SMESec). In addition, as SMESec has the potential to improve financing conditions for SMEs, also its public support is justified (for details see Kraemer-Eis, Passaris, and Tappi, 2013).

Around fifteen years ago, public support in the form of national programmes (e.g. FTPYME in Spain (by the

Kingdom of Spain) and PROMISE (by KfW in Germany) and EIF-support on supranational level already contributed significantly to the emergence of a European SMESec market. EIF was instrumental to develop this market segment in Europe and initiated transactions in many countries, including Belgium, Bulgaria, Czech Republic, Denmark, France, Germany, Greece, Italy, the Netherlands, Portugal, Poland, Serbia, Spain, and UK.

From 1997 to September 2015, EIF participated as a guarantor in 134 SMESec transactions, with a total commitment of approx. EUR 9.4bn covering 19 countries.

However in recent years, due to the financial crisis, activity volumes in SME securitisation remain substantially below the levels observed pre-crisis. **For the re-emergence of a primary European SME securitisation market, official sector support is as well required** (Aiyar, Al-Eyd, Barkbu, and Jobst, 2015) – and it could form an important element in the efforts to enhance access to finance for SMEs in Europe. In this context, **not only does the supplied volume matter, but the positive signalling effect, triggered by the public involvement and support, could be equally important.** However, despite increasing "mental support", currently no European country with the exception of Spain's FTPYME has launched significant support programmes to revive the SMESec market. In this context, joint forces of key public market players might help – in terms of financial resources and know how – to provide scalable solutions.

At pan-European level, the EIB Group as a whole has supported the SMESec market already since many years, based on "own risk"; more recently third party "mandates" have also been designed to provide support to SMESec. The objective was (and still is) not only to support the transactions, but to contribute to the market development, including through spreading of know-how and best market practices (including support in terms of transaction structuring, discussions with regulators and national authorities etc.).

With the combination of long-term liquidity provided by the EIB and EIF's longstanding market experience in providing guarantees for SME portfolios, the EIB Group is well placed to contribute to reviving the securitisation market. EIB can purchase ABS backed by SME loans/leases or other asset classes (as well as covered bonds, diversified payment rights securities and similar) as loan substitutes for Loans for SMEs and/or mid-caps. In the

14. Further information can be found here: http://www.eif.org/what_we_do/guarantees/sme_initiative/index.htm.

15. This section is based on a recent EIF Working Paper, specifically dedicated to SMESec, see KRAEMER-EIS, PASSARIS, TAPPI, INGLISA, 2015.

current highly liquid and price-competitive market context, originators seek clear advantages of EIB purchases e.g. as an alternative to the ECB's ABS purchase programme. They are also looking at regulatory capital relief opportunities utilising SMESec.

The EIB Group as a whole has maintained its presence and support of the SMESec market during the whole period of the recent economic turmoil through the launch of several initiatives in the securitisation domain, namely (i) the EIB Group ABS Initiative for SMEs, and (ii) credit enhancement of mezzanine tranches under the "EREM" (EIB Group Risk Enhancement Mandate) ABS Credit Enhancement window.

As mentioned above, there are joint initiatives of the EIB Group and the European Commission (and Member States), namely (i) the Joint SME Initiative with the European Commission, as well as (ii) the securitisation platform to be launched under the Investment Plan for Europe (an initiative with National Promotional Institutions (NPIs)). In addition, there is the possibility to support SMESec transactions under the COSME programme. Details regarding these initiatives can be found in Kraemer-Eis, Passaris, Tappi, Inglisa (2015).

Overall ...

... in the areas of *portfolio guarantees* and *securitisations*, EIF is a key player and 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 guarantees to SMEs. Via its guarantees, EIF provides significant support on a pan-European level to enhance access to finance for European SMEs and small mid-caps.¹⁶

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Tables (EIF internal data source)

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- Table 2. – SME Window Implementation as of mid-March 2016
- Table 3. – Country Coverage under EFSI as of mid-April 2016
- Table 4. – COSME LGF Country Coverage
- Table 5. – InnovFin Country Coverage

16. More information regarding EIF can be found at www.eif.org; more information regarding SME finance can be found at http://www.eif.org/news_centre/research/index.htm.