

Vierteljahrshefte zur Wirtschaftsforschung 1.2017

EU Capital Markets Union:
an alluring opportunity or a
blind alley?
Concept and micro-
perspectives of CMU

Hans-Helmut Kotz and Dorothea Schäfer
EU Capital Markets Union: an alluring opportunity or a blind alley? Concept and micro-perspectives of CMU | 5

Michael Thiel
A methodological perspective on the Capital Markets Union: using economics to derive effective policy measures | 9

Grégory Leveigue and Jean-Paul Pollin
Ambitions and limits of financial disintermediation in the Euro Area | 29

Andreas Bley and Jan Philip Weber
Capital Markets Union: deepening the Single Market makes sense, but don't expect too much | 43

Markus Demary
Challenges for the European Capital Markets Union: reviving financial integration and safeguarding financial stability | 55

Karl-Peter Schackmann-Fallis and Sonja Scheffler
Aligning financial systems to meet the needs of citizens and enterprises | 69

Horst Gischer and Christian Ilchmann
CMU—a threat to the German banking sector? | 81

Helmut Kraemer-Eis and Frank Lang
Access to funds: how could CMU support SME financing? | 95

Peter Cornelius
The structure and integration of the European buyout industry | 111

Dorothea Schäfer and Andreas Stephan
Innovation and Investment Funding in the post-crisis period: have financing patterns and financial constraints of German firms changed? | 129

Authors | 143

Access to funds: how could CMU support SME financing?*

HELMUT KRAEMER-EIS AND FRANK LANG

Helmut Kraemer-Eis, European Investment Fund (EIF), e-mail: h.kraemer-eis@eif.org

Frank Lang, European Investment Fund (EIF), e-mail: f.lang@eif.org

Summary: Many policy actions of the CMU have the objective to enhance access to finance for the so-called backbone of the European economy—the SMEs. The CMU aims at improving the framework conditions for SME financing, at strengthening bank lending—as the most important external financing source for SMEs—and to diversify the range of potential financing sources for SMEs—for various financial instruments from debt to equity. This article explains the SME financing-related objectives of the CMU by looking at the initiatives to enhance the lending capacity of banks, before it turns to the discussion of alternative financing. Due to the multitude of links to SMEs, not all CMU elements can be tackled in the same detail, but we focus on some key areas like securitisation and venture capital—including latest regulatory developments.

Zusammenfassung: Das Ziel vieler politischer Handlungsfelder der „Kapitalmarktunion“ ist es, den Finanzierungszugang für kleine und mittlere Unternehmen (KMU), des sogenannten Rückgrats der europäischen Wirtschaft, zu erleichtern und zu erweitern. Die Kapitalmarktunion bezweckt die Verbesserung der Rahmenbedingungen für die KMU-Finanzierung, die Stärkung der Kreditvergabe durch Banken – der wichtigsten externen Finanzierungsquelle für KMU – und die Diversifizierung der Bandbreite möglicher Finanzierungsquellen für KMU für verschiedene Instrumente von Fremd- bis Eigenkapital. Der vorliegende Artikel erläutert die auf die KMU-Finanzierung bezogenen Ziele der Kapitalmarktunion, indem zunächst die Initiativen zur Verbesserung der Kreditvergabemöglichkeiten von Banken erörtert werden, der sich dann die Diskussion alternativer Finanzierungsformen anschließt. Aufgrund der Vielzahl von Verbindungen zu KMU-Themen können nicht alle Elemente der Kapitalmarktunion im gleichen Ausmaß abgedeckt werden. Vielmehr setzen wir den Fokus auf einige zentrale Felder wie Verbriefung und Risikokapital (Venture Capital), einschließlich jüngster regulatorischer Entwicklungen.

→ JEL Classification: G00, M13, O16

→ Keywords: European Union, Capital Markets Union, SMEs, corporate finance, alternative finance, startups

* Any views expressed herein, including interpretation(s) of regulations, reflect the current views of the author(s), which do not necessarily correspond to the views of EIF or of the EIB Group. Views expressed herein may differ from views set out in other documents, including similar research papers, published by EIF or by the EIB Group. Contents of this Article, including views expressed, are current at the date of drafting, and may change without notice. The article was prepared in June 2017 and reflects the situation at that time.

I The link between CMU and SMEs

The *Investment Plan for Europe*, also known as the “Juncker Plan”, as it has been announced by European Commission (EC) president Jean Claude Juncker in November 2014, aims at unlocking public and private investments in the EU. The plan is based on three pillars:

1. Mobilising finance for investment (including the European Fund for Strategic Investment, EFSI¹),
2. Making finance reach the real economy (e.g. European Investment Advisory Hub), and
3. Improving the investment environment.

The *Capital Markets Union (CMU)* is an important part of the third pillar—but of course all three pillars are strongly interlinked. The CMU Initiative 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 improving access to bank financing and complementing it, as well as 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). Many of the CMU’s policy actions have the objective to enhance access to finance for the so-called backbone of the European economy, the SMEs.

For the implementation of the CMU, the EC is pursuing a dual strategy of “quick wins” that aims at having 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. This article covers the main links between CMU and SMEs; for many aspects—i.e. related to the situation of SME financing in Europe, we cannot go into greater detail here but refer the reader to Kraemer-Eis et al (2017).

2 CMU as a tool to address SMEs’ access to finance constraints

In general, due to various reasons (i.e. lack of track record, information, collateral, etc.) access to finance is usually more difficult for SMEs than for larger companies and we explain the reasons for such rationing in more detail in Kraemer-Eis et al. (2017). However, THE SME does not exist. Rather, there is large heterogeneity within this population, e.g. by size, industry, age, activity and ownership, as well as many cross-border differences. The financing of these companies is similarly diverse. For example, recent studies on the combined use of financing instruments

1 As part of this investment plan’s pillar one, the European Fund for Strategic Investments (EFSI) aims at unlocking additional investments of at least 315 billion euro over a three year period by addressing market gaps and mobilising private resources. EFSI is a strategic partnership between the EC and the EIB Group and consists of two windows, the Infrastructure/Innovation Window, deployed through the European Investment Bank (EIB), and the SME Window, implemented through the European Investment Fund (EIF, part of the EIB Group). The financial instruments used for the purposes of the EFSI SME Window are mainly guarantees and equity investments. As such, EFSI is of high importance for SME financing in Europe. For more information about EFSI in general and the SME Window specifically see www.eif.org/what_we_do/efsij/index.htm

by SMEs identified several distinct SME financing types, which can be profiled according to the companies' firm-, product-, industry- and country-specific characteristics (see Masiak et al. 2017; Moritz et al. 2016; and Moritz et al. 2015). Even though banks remain the most important external financing source of SMEs, it is crucial to note that they also take alternative paths in their search for funding.

The CMU can contribute to the mitigation of SMEs' access to funding constraints. In doing so, it aims at improving the access to financing not only from banks but also from alternative sources. A basis for this approach is that European SMEs receive five times less funding from capital markets than their US peers (European Commission 2015c). The EC's idea is that stronger capital markets could complement Europe's tradition of bank financing. This is expected to mobilise capital and channel it, inter alia, to SMEs. Therefore, among other actions,² the EC plans to diversify the funding choices for Europe's businesses and SMEs and to enhance the capacity of banks to lend (European Commission 2015c). In order to broaden the range of available funding sources, the EC intends to implement a range of measures, which will be complemented by initiatives to enhance the lending capacity of banks.

In the following, we start by looking at the initiatives to enhance the banks' lending capacity, before we turn to the discussion of alternative financing sources. In general, we cannot discuss all CMU elements of relevance for SME financing in detail but have to set thematic priorities.

3 **Fostering bank lending to SMEs through securitisation**

European companies rely heavily on bank lending, in particular compared to the US (see Kraemer-Eis et al. 2017 for a more detailed discussion). In order to improve SMEs' access to bank lending, the EC envisages three key actions within the CMU framework for "leveraging banking capacity to support the wider economy". First, in order to strengthen local financing networks, the EC is exploring the possibility for all EU Member States to authorise credit unions outside the EU's capital requirements rules for banks. Secondly, the EC is looking into the development of a pan-European framework for covered bonds, building on national regimes that work well, and similar structures to support SME loans. Thirdly, the EC is working on a framework for simple, transparent and standardised (STS) securitisations and revision of the capital calibrations for banks, in order to contribute to the revival of the EU securitisation markets. In the following, we focus on the initiatives in the field of securitisation, while we briefly cover the first two thematic areas in chapter 5.

As a part of the CMU, the EC intends to revive securitisation, with the objective "to ensure that it can act as an effective funding channel to the wider economy and mechanism to diversify risk" (European Commission 2015c). In addition to the financial support provided under the Investment Plan for Europe, the EC aims at improving the legal and regulatory framework in order to

2 Other actions include measures that aim at (a) ensuring an appropriate regulatory environment for long term and sustainable investment and financing of Europe's infrastructure, (b) increasing investment and choices for retail and institutional investors and (c) bringing down cross-border barriers and developing capital markets for all 28 Member States. In the CMU mid-term review communication, the EC published priority actions that also address some additional capital market dimensions (see European Commission 2017e for details).

facilitate banks' and insurers' investment in high-quality securitisation, in particular in "simple, transparent and standardised" products.

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 financing to the real economy, including to SMEs (Kraemer-Eis et al. 2016b). 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 (e.g. SME loans/leases) "toxic waste".

The SME securitisation (SMESec) market is still underdeveloped in Europe.³ The visible issued SME deal volumes in Europe were only at 19.8 billion euro in 2016, representing 8.3 percent of the overall securitisation issuance.⁴ We observe that total European ABS issuance volumes have roughly been stable during the last three years, while the specific weights of the different asset classes have been shifting. SMESec has been decreasing year to year due to a lower origination activity and to shrinking SME stocks in the financial intermediaries' loan books (Kraemer-Eis et al. 2017).

The EC submitted a proposal on STS securitisations (including SME transactions) and a revision of prudential capital calibrations for banks. Equivalent calibrations for insurers are envisaged as well. On 30 May 2017, the presidency of the Council of the EU reached an agreement with European Parliament (EP) representatives on the "securitisation package", comprising STS and a revised capital charges framework for credit institutions and investment firms originating, sponsoring or investing in securitisation products (amendments to the Capital Requirements Regulation, CRR). Following the agreement, the related regulations are expected to be formally endorsed by the Council and the EP soon (Council of the EU 2017b, European Commission 2017b, European Commission, 2015c). According to EC estimates, "the swift implementation of the securitisation package could unlock up to 150 billion euro of additional funding to the real economy" (European Commission 2017b).

The agreement covers two (draft) regulations: The first one brings together rules that apply to all securitisations, including STS, which are currently scattered amongst different legal acts. It aims at ensuring "consistency and convergence across sectors (such as banking, asset management and insurance), and streamlines and simplifies existing rules" (Council of the EU 2017b). In

3 For detailed information about SMESec and its relevance please refer to Kraemer-Eis et al. (2010), Kraemer-Eis, Passaris and Tappi (2013) and Kraemer-Eis et al. (2015), and for market activity data and developments Kraemer-Eis et al. (2017).

4 On a European level, harmonised data on the volume of SME lending (i.e. lending by the size class of the borrowing enterprise) does not exist. Darvas (2013) estimated that the total stock of SME loans in the EU amounted to 1,695 billion euro in 2010. At the same time, the stock of outstanding SMESec transactions was at 175 billion euro in Europe (Kraemer-Eis et al. 2017); please note that the geographic coverages of the two numbers do not completely overlap. Other estimates are based on statistics by loan sizes classes. The underlying assumption is that smaller loans are typically taken by smaller companies (see Huerga et al. 2012 and Kraemer-Eis et al. 2014). Following a similar approach used by the European Banking Authority (2016), which uses ECB statistics and assumes that SME loans are loans up to and including 1 million euro, we calculated that the amount of newly issued SME loans was at 717 billion euro in 2016 (business loans other than revolving loans and overdrafts, convenience and extended credit card debt), of which 156 billion euro were of original maturity or interest rate fixation of more than one year.

addition, it establishes a general and cross-sector regime to define and set rules related to STS securitisation. It is important to highlight that the STS concept does not refer to the quality of the underlying assets involved, but to the process by which the securitisation is structured (Council of the EU 2017b).

The other part of the agreement amends regulation 575/2013 on bank capital requirements. It sets out capital requirements for positions in securitisation, which aims at providing for “a more risk-sensitive regulatory treatment for STS securitisations” (Council of the EU 2017b). One of the main political issues resolved relates to the risk retention requirement. This refers to the interest in the securitisation that originators, sponsors or original lenders of securitisations need to retain themselves. The requirement will ensure that securitised products are not created solely for the purpose of distribution to investors. The agreed text sets the risk retention requirement at 5 percent, in accordance with existing international standards (Council of the EU 2017b).

Other elements of the agreement include the creation of a data repository system for securitisation transactions, which will increase market transparency, and a light-touch authorisation process for third parties that assist in verifying compliance with STS securitisation requirements. The aim of the latter is to prevent conflicts of interest. The text makes clear that, even when a third party is involved in the STS certification process, liability for compliance with the rules remains completely with originators, sponsors, original lenders and securitisation special purpose entities (Council of the EU 2017b).

All in all, the agreement brings out important features of the future STS securitisation market segment. However, at the time of writing this article (early June 2017), several relevant details of the agreed regulatory texts were not yet disclosed to the public (e.g., certification of STS securitisation by third parties; penalties in case of noncompliance with the criteria; capital requirements). It will be necessary to know these specifications in order to assess the potential of the new rules to create a successful STS segment, which can contribute to the revival of the European securitisation market (Moeglich 2017, Kraemer-Eis et al. 2017).

Over the past years, public issuance was indeed hindered by the regulatory uncertainties that make transactions less attractive for originators and investors, by the availability of cheap funding for banks driven by the ultra-loose monetary policy, 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. Furthermore, spread levels required by investors are often unattractive for originators—both compared to funding alternatives as well as for capital release purposes (Kraemer-Eis et al. 2016b, Kraemer-Eis et al. 2015). Therefore, the approach of the CMU Action Plan to change the rules of the game to a certain extent can help mitigating some of the current obstacles to securitisation. However, it will most likely not be sufficient in order to produce a strong effect on market activity as long as the current monetary policy environment remains unchanged. Once the monetary framework conditions will move away from their current crisis-mode towards normalisation, the CMU can contribute to a recovery of the securitisation market.⁵

5 This constellation shows the double edged effects of ECB policy on securitisation: on the one hand the ECB is trying to support the (SME) securitisation market (see e.g. the many positive statements in favor of developing a European securitisation market (reputation building), or the implementation of the ABSPP), on the other hand, e.g., the ultra-loose monetary policy results in disincentives for originators to securitise.

4 Alternative financing sources

In order to improve the financing for innovation, start-ups and non-listed companies, the CMU includes support measures for non-bank debt financing and equity instruments for the start-up and early expansion phase. The former initiatives are dedicated to instruments such as crowd-funding, loan-originating funds and private placements, while the latter mainly cover venture capital funds and business angel financing.

4.1 Crowdfunding

Crowdfunding refers to an open call to the public to raise funds for a specific project, typically via the internet (see, also for more details, European Commission 2016b, Kraemer-Eis et al. 2017). It is usually divided into four main types: reward-based, donation-based, lending-based, and investment-based (equity) crowdfunding, but hybrid forms exist as well (see, also for more details, Block et al. 2017 and European Commission 2015a). Lending-based crowdfunding is by far the most important type in terms of total amounts raised, but also equity crowdfunding makes for an important part of business financing through crowdfunding; however, the activity is concentrated in a small number of countries, in particular in the UK (Block et al. 2017, European Commission 2016b).

The share of crowdfunding in total European business financing is still relatively small.⁶ Nevertheless, given its rapid development and high growth rates, it has the potential to strongly increase in importance for SME financing in the future, in particular for companies in the early-stages of their development (European Commission 2016b).

However, the crowdfunding boom of the recent past did not only create positive experiences, but also negative examples and shake-outs (Kraemer-Eis et al. 2016a). As all investment forms, crowdfunding entails a number of risks (e. g. project liquidity risk, platform failure, cyber-attacks) and concerns (e. g. investors' inexperience, reliability of the investment, lack of regulation or heterogeneous regulatory regimes), in particular for retail investors and small businesses (European Commission 2016b). Therefore, a discussion about the regulatory coverage of this sector has started and rules for this sector have been implemented on the national level (see European Commission 2016b for an overview). On the European level, the EC has not yet intended to introduce laws for crowdfunding. Rather, under the CMU Action Plan, the EC focusses on monitoring developments and promoting best practice, appropriate investor protection and consistency of national regimes in order to support the development of this sector and to increase the potential for cross-border transactions (European Commission 2015c, European Commission 2016a).

With the appropriate regulatory environment, crowdfunding, but also other financing models that are driven by "Fintechs", have the potential to become 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. Moreover, new coalitions are emerging. Examples are the combinations of microfinance and

⁶ There is no official statistics as regards the overall business volume for crowdfunding. Wardrop et al. (2016) estimate an overall transaction volume of 5,431 million euro for 2015 (covering all types, i. e. including debt-based (consumer and business), equity-based, reward-based, etc.). See for a summary Kraemer-Eis et al. (2017) and for details Wardrop et al. (2016).

crowdfunding, business angel/venture capital financing and crowdinvesting, or banks using marketplace lenders as distribution channels. Given their increasing role in the financing landscape, these market players are increasingly relevant as financial players to enhance access to finance for SMEs (see Kraemer-Eis et al. 2016a, also for details). Therefore, based on a public consultation on Fintechs, the EC intends to look into new issues that may need to be integrated into the CMU policy framework, following the CMU mid-term review. The EC will, inter alia, assess the case for an EU licensing and passporting framework for Fintech activities (European Commission 2017e).

4.2 Loan-originating funds

The CMU Action Plan also highlights the importance of “loan-originating funds” or “direct lending funds” as a “potentially important future source of non-bank credit”. According to the EC description, “[l]arge institutional investors or investment funds may invest in or directly originate loans (sometimes in partnership with banks) to mid-sized firms” (European Commission 2015c)⁷. In the CMU Action Plan, the EC announced to work together with Member States and the European Supervisory Authorities (ESAs) to assess the need for a coordinated approach and the case for a future EU framework for loan-originating funds, whilst ensuring that they are “regulated appropriately from an investor protection and financial stability perspective” (European Commission 2015c).

In times of deleveraging by banks, debt funds have indeed started to be important alternative—direct or indirect—providers of credit financing for SMEs. While such non-bank lending institutions are quite common in more market-based economies such as the US, relatively little is known about these alternative debt providers in traditionally largely bank-based European countries (Kraemer-Eis et al. 2016a). Due to its fragmentation and opacity it is even ambitious to speak about A or ONE market segment and THE debt fund does not exist; there are no generally accepted definitions and the range of structures, that could potentially be called debt funds, is wide.

Based on the information available, the dynamic in this market segment shows that its importance is growing, and increasing volumes in non-bank lending appear to be a trend (see, e. g., Creditreform 2015/2016, Kraemer-Eis 2014, Kraemer-Eis et al. 2016a, Moeglich and Raebel 2014, Prequin 2014). Creditreform (2015) found a strong surge in the number and cumulated loan volumes of direct lending funds (which represent approximately half of all private debt funds in Europe); this financing form had been hardly used in Europe until 2011. Moreover, recent AIMA findings show that an increasing number of funds that work in cooperation with a bank are fundraising (Will 2016). 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 (Kraemer-Eis et al. 2016a, Will 2016). However, it is yet too early 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 (Kraemer-Eis et al. 2016a, Will 2016). Moreover, as initiatives take place so far only in a limited number of countries and most of the players are first time teams/funds, the private debt market is still in an early stage in Europe.

⁷ See for an overview of different types of debt funds Kraemer-Eis et al. (2014).

Nevertheless, 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. According to a Preqin survey, the majority of institutional investors consider Europe as the region with the best opportunities for alternative debt investments, because of the relative underdevelopment of the private debt market in Europe (in comparison to the US) and significant deal opportunities (Kraemer-Eis et al. 2016a, Will, 2016).

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 (Kraemer-Eis et al. 2016a, Will 2016). Current fundraising numbers and the objected growth of this new market segment support this view. However, so far only the minority of debt funds focus on SMEs. Driven by risk/return considerations, most of them are targeting the bigger category of companies (bigger mid-caps to large caps) and/or mezzanine instruments (Kraemer-Eis 2014). Against this background as well as the need to strengthen alternative financing channels for SMEs and mid-caps to fill the bank financing gap, initiatives to support such an emerging market for the segment of smaller companies appear to be straightforward.

The launch of the CMU 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.⁸

4.3 Venture and Growth Capital Funds and Business Angel Financing

An important objective of the CMU is to improve the access to equity financing for the start-up and early expansion phase, provided by venture capital (VC) funds and business angels. The related initiatives include a proposal for pan-European VC funds-of-funds (FoF) and multi-country funds, supported by the EU budget to mobilise private capital, regulatory reforms, and the promotion of best practices on tax incentives. The pan-European VC FoF programme was launched by the EC and the EIF in late 2016 (see Kraemer-Eis et al. 2016b for more details). In addition, as a part of the CMU actions, the EC will also provide technical assistance to those Member States that wish to develop market-based finance, including venture capital (European Commission 2017a).

The first proposal aims at increasing the size of VC funds in Europe, increasing private investment in VC and overcoming fragmentation (European Commission 2017c). The other measures are driven by similar objectives: The revision of the Regulation on European Venture Capital Funds (EuVECA) and the Regulation on European Social Entrepreneurship Fund (EUSEF) is intended to attract more investors and to expedite cross-border marketing and investment, while tax incentives could support equity financing in particular for innovative companies and start-ups.

⁸ The approach of the EREM Loan Funds instrument, which is implemented by the European Investment Fund (EIF) and provides financial support at a European level and, at the same time, helps 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 (see Kraemer-Eis 2014 and Kraemer-Eis et al. 2016a for more information).

In addition, in the framework of the CMU action plan, the EC aims at strengthening the access to public capital markets, based on, inter alia, a review of regulatory barriers to SME admission on public markets and SME Growth Markets and a review of EU corporate bond markets (European Commission 2015c). Public offers of debt or equity instruments are the main funding route for mid-sized and large companies, which are seeking to raise financing in excess of 50 million euro, but, more importantly in this context, they provide an exit opportunity for, inter alia, providers of private equity (European Commission 2015c). Public markets are therefore important for the transition of high-growth mid-sized companies to more established global players. However, at present, many SMEs consider the initial (and the on-going) listing cost to outweigh the benefits of going public (European Commission 2015c). The antipathy against going public is even higher and more wide-spread amongst SMEs than for larger firms, mainly driven by the fear of losing control, but as well by significantly higher disclosure requirements and the cost of going public (European Commission 2017e, European Commission 2015d, IPO Task Force 2015).

A diagnosis of the current situation of the European market for equity financing of the start-up and early expansion phase shows indeed several problems that motivate policy action. The availability of risk capital is of utmost importance to finance the start and growth of young and innovative companies. It is by nature not a financing instrument for all types of companies, but in particular for a group of enterprises with very high growth potential. However, “Europe has a shortage of risk capital for small, early-stage growing businesses”, which is holding back the development of high-growth sectors that are essential for economic competitiveness (AFME 2017). Limited financing opportunities are not only prevalent at the seed and start-up stage of a company’s life-cycle, but also when innovative companies seek finance to realise their growth ambitions.

It is undeniable that there have been positive developments in recent years. This is visible, inter alia, in the existence of several European tech “hubs”, which seem to act as the beating heart of a complex network of national and international investments (Kraemer-Eis et al. 2016b, based on Kraemer-Eis, Signore and Prencipe 2016). Nevertheless, Europe’s risk capital markets have remained highly fragmented; the European VC market is geographically far less homogenous than its US counterpart. 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 countries 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. 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 (Kraemer-Eis et al. 2016b).

Moreover, the European VC market has remained underdeveloped compared to the US and, increasingly, Asia. The gap between the VC markets in the US and in Europe is visible in all development stages, but it is particularly high at the later stage and also very significant at the seed stage (AFME 2017). Moreover, in the growth capital segment, the amounts invested in the US still exceed those in Europe by 3 times. Between 2009 and 2014, an additional 90 billion euro would have been available for financing European companies, if VC markets had been as developed as in the US, according to EC estimates (Council of the EU 2017a).⁹

9 Additional means for VC and growth financing could, inter alia, help reducing the scale-up financing gap, which we describe in the following. See also Kraemer-Eis et al. (2017) for a more detailed description. Bongini et al. (2017) provide further insight into the untapped potential for European SMEs to take up additional capital market (including equity) financing.

These differences are also reflected by substantial distinctions in fund and deal sizes: While at the start-up stage there is relatively little difference in terms of fund size (US vs Europe), US companies are funded by significantly larger funds at the scale-up stage. Moreover, in the period 2007–2015, the average VC-backed US company received five times higher amounts than its EU counterpart, i. e. 6.3 million euro compared to 1.3 million euro (AFME 2017).

Larger investment rounds can be achieved by having more investors (syndicate size) and/or by having larger investment amounts per investor (ticket size). Both syndicate sizes and ticket sizes are bigger in the US than in Europe. For example, looking across all fund vintages 2005–2015, 28 percent of the US funds were larger than 250 million USD, in contrast to only 10 percent in Europe (Durufflé et al. 2017). In all, Europe’s most promising young companies are still relatively ill-equipped to stand up to global challenges. In this area, Europe is lagging behind and struggling to catch up.

This “growth stage trap” phenomenon means that Europe is not reaping the benefits of the most promising young companies it has nurtured, once they pass the seed, start-up, and early expansion stage and embark on an ambitious, global growth path for which they seek higher investment ticket sizes. In the process, Europe loses much-needed entrepreneurship, technological know-how, and jobs. Thus during the period 2003 to 2015, on average, 44 percent of the VC companies backed by EIF investee funds which were sold were acquired by non-European buyers, in particular from the US. These buyers mainly targeted start-ups in the same industry (vertical integration) (Prencipe 2017) and such acquisitions might change business strategies and the location of economic activity of the target companies.¹⁰

European VC funds allocate almost twice as much of their investments to companies at seed stage as the ones based in the US. However, only 44 percent of European VC investments were in support of later-stage companies, whereas US companies at this stage get almost two-thirds of all VC investments by volume (AFME 2017). Moreover, growth-stage companies are experiencing a serious lack of growth (follow-on) funding to accelerate their international expansion and to strengthen their position against global competitors. In line with these arguments, AFME (2017) sees a lack of VC fund capacity, especially for later-stage investments, a lack of follow-on financing rounds from venture capital funds, and a lack of commitments in venture capital funds by, e. g., pension funds and insurers in Europe. The relatively small average size of European venture capital funds and regulatory constraints discourage large institutional investors from investing in the asset class. Durufflé et al. (2017) identified the creation of larger venture funds and a venture debt market, reinvigorated tech IPOs, improved markets for secondary shares and not selling companies too early as main elements of a strategy that would help Europe catch up to the US in terms of scale-up funding.

Europe clearly lacks a seamless funding infrastructure for supporting the full corporate financing escalator. As a result, Europe is facing the growing reality that its successful public support for early-stage investment risks turning into an incubator for non-EU economies. The issue is not only about the availability of funding; it is about the type of funding: this second “growth stage

¹⁰ The most frequent corporate buyers of EIF-backed start-ups in the analysed sample were GlaxoSmithKline, Broadcom Corp., Alcatel, eBay, Microsoft and Apple (Prencipe 2017).

trap” is very different in nature from the first, “early stage gap” and requires new home-grown tools and means to address it.

However, public backing of the European VC market should aim at crowding-in private investors and catalysing private sector investments in order to support development of an integrated European VC market, which is originated by venture capitalists (and other key actors) as market-oriented professionals, such as business angels (BAs).

BAs represent an important class of PE investors, primarily consisting of high-net-worth individuals who usually have business or managerial experience. They tend to invest their own money, either individually or in formal or informal syndicates, into businesses which are not publicly traded (see, also for more information, Kraemer-Eis et al. 2016b, Kraemer-Eis and Schillo 2011, OECD 2011, OECD 2016, BAND 2016). BAs have become an increasingly important source of equity capital at the seed and early stage (European Commission 2015c, OECD 2017).

Therefore, it is appropriate that the CMU Action Plan also covers BAs. Apart from the promotion of tax incentives in the areas of VC and BA financing, mentioned at the beginning of this chapter, the EC intends to “continue to support cross-border networking and capacity building for business angels, with a particular focus on Central and Eastern Europe, to develop cross-border platforms, connecting business angels with innovative SMEs and facilitating match-funding” (European Commission 2015c). In doing so, the EC aims at contributing to a stronger network of BAs, capable of operating across EU borders.

Moreover, also the other CMU-related EC actions in the field of equity financing for the start-up and early expansion phase are a welcome step forward. The current EuVECA and EuSEF regulations, which both came into force in 2013, had established two new types of collective investment funds in order to make it easier and more attractive for investors to invest in unlisted SMEs. The EuVECA and EuSEF label allows fund managers to market these funds across the EU to professional and non-professional investors able to commit a minimum of 100k euro (European Commission 2017a). In order to progress on the way to the CMU, the EC antedated the start of the general review of the regulations by two years. Following a consultation to identify targeted changes to the rules that could boost the take-up of these investment funds, the EC proposed an overhaul of the regulations in 2016. On 30 May 2017, representatives of the Council of the EU and the European Parliament (EP) reached an agreement on the amendments. The agreed has been submitted to the ordinary legislative procedure (Council of the EU 2017a, European Commission 2017a).

The agreed changes to the EuVECA and EuSEF rules will make the funds covered by these rules available to fund managers of all sizes, expand the range of companies that the funds can invest in and make the cross-border marketing of such funds cheaper and easier (Council of the EU 2017a). More concretely, the agreement allows also larger fund managers with assets under management of more than 500 million euro to market and manage EuVECA and EuSEF funds. This will enable a broader range of funds, including in the growth capital segment, to acquire this “marketing passport”, which will ultimately help making more capital available for “scale-up” businesses that have moved beyond the start-up phase. Furthermore, the range of companies in which EuVECA funds can invest is expanded to include unlisted companies with up to 499 em-

ployees (small mid-caps) and SMEs listed on SME Growth Markets.¹¹ In addition, the agreement decreases the costs by explicitly prohibiting fees imposed by competent authorities of host Member States where no supervisory activity is performed (European Commission 2017a). The new rules will also simplify the registration processes and determine the minimum capital necessary to become a manager.

By extending the availability of these rules to larger fund managers, it can in principle be expected that additional financial means can be channelled to the European VC market and the investee companies. At the same time, the broader range of enterprises available for investments should improve the diversification options of EuVECA funds and, hence, make themselves more attractive for investors (European Commission 2017a). Moreover, according to the CMU mid-term review, additional actions are considered to facilitate cross-border EU investments and the cross-border distribution and supervision of investment funds (European Commission 2017e). The CMU actions also support the objectives of the recent EC “Start-up and Scale-up Initiative”, which was published in November 2016, aiming to give Europe’s innovative entrepreneurs better opportunities for growing to world leading companies (European Commission 2016c).

5 Other actions

Other actions include activities in a broad range of areas. The EC will, inter alia, propose a comprehensive EU strategy on EU-level steps to support local and regional capital market development across the EU (European Commission 2017e). Moreover, with regard to the pan-European capital market development, the EC is considering the following initiatives:

Due to the challenges that the SME ABS market has been facing since the crisis, financial institutions have been seeking alternative means of funding SME loans. *Covered bonds* can help to support SME financing via funding advantages for the originating banks, and it might well be that in many countries legislators are going to introduce covered bonds legal frameworks (Kraemer-Eis et al. 2013). However, the covered bond market is currently fragmented in Europe and plays only a very minor role in the context of SME financing. Disparities between the legal frameworks and supervisory practices of the Member States that have dedicated covered bond laws limit possibilities for market standardisation in underwriting and disclosure practices. This may result in obstacles to market depth, liquidity and investor access, in particular on a cross-border basis. An EU framework for a more integrated covered bond market could help reducing the cost of funding for banks issuing covered bonds, in particular in certain Member States (European Commission 2015c). Therefore, in the CMU mid-term review, which was presented in June 2017, the EC announced that it will put forward “a legislative proposal for an EU-framework on covered bonds” in early 2018, in order to help banks finance their lending activity (European Commission 2017d, European Commission 2017e). In parallel, the EC will explore the possibility of developing European Secured Notes as an instrument for SME and infrastructure loans (European Commission 2017e).

¹¹ Based on the 2014 MIFID II directive on markets in financial instruments, a SME Growth Market is a Multilateral Trading Facility, where at least 50 percent of the issuers whose financial instruments are traded on are SMEs. SMEs are defined as companies that have an average market capitalisation of less than 200 million euro (European Commission 2017e).

Private placements typically cover financing needs in excess of 20 million euro and are currently limited to a small number of countries in Europe (European Commission 2015c). They are usually a financing tool for medium to large unlisted companies, even though initiatives exist to make this instrument more easily available for mid-sized firms (Nassr and Wehinger 2015). With regard to private placements, according to the CMU Action Plan, the EC “will seek to draw on best practices and promote them across the EU” (European Commission 2015c). In order to do so, the EC will publish a “Recommendation on private placements”, which will be informed by the results of a study, to be published in late 2017 (European Commission 2017e).

Under the CMU Action Plan, the EC also explores the possibility for all Member States to benefit from *local credit unions* to operate outside the scope of the EU’s capital requirements rules for banks. In November 2016, the EC proposed an amendment to the EU’s capital requirement rules for banks, empowering it to exempt the entire credit union sector of a Member State (European Commission 2017e). Credit unions, in which for example SMEs can finance each other on a not-for-profit basis, operate in some Member States. They can also facilitate the exchange of know-how among members. However, the application of complex banking regulation may constitute a disproportionate obstacle to credit unions and other not-for-profit cooperatives serving SMEs. This may particularly be the case when they are small and focused principally on taking funds from and redistributing them among members, so that the risks for the wider financial system remain limited (European Commission 2015c).

Capital markets can also help banks to overcome the challenges of *non-performing loans* (NPLs) which are weighing heavily on some national banking systems in Europe. NPLs have a significant adverse impact on banks’ profitability and their ability to lend, including to SMEs. As part of its efforts to address the NPL issue, the EC will present measures to support secondary markets for NPLs. The EC will also launch an impact assessment with a view to considering a possible legislative initiative to strengthen the ability of secured creditors to recover value from secured loans to corporates and entrepreneurs, while remaining consistent with and complementary to the EC proposal of 2016 on the effective functioning of the pre-insolvency/restructuring systems and doing its utmost to support the co-legislators in finding an agreement on that proposal as a priority (European Commission 2017e).

Moreover, the EC intends to support SMEs seeking finance, in order to bridge the *information gap* between SMEs and investors, in particular in the area of non-bank financing (for a recent overview of theoretical considerations on information asymmetries in SME lending see Chatzouz et al. 2017 and Kraemer-Eis et al. 2017). More concretely, the EC aims at strengthening the feedback given by banks declining SME credit applications, map out existing local or national support and advisory capacities across the EU in order to promote best practices on assisting SMEs that could benefit from alternative funding options, and investigate how to develop or support pan-European information systems that link up national systems to bring together finance-seeking SMEs and finance providers (European Commission 2015c).

6 Concluding remarks

European SMEs depend very much on banks as provider of external financing. This will also remain in the future. However, in general, companies in different stages of their lifecycles need

different financing tools (equity, debt, mezzanine). Moreover, evidence from the crisis shows that the diversification of the sources of funding of companies improves the resilience of companies during cyclical downturns.

Therefore, the European Commission's ambitious plan to establish a CMU until the end of 2019—with all its different features—can improve the framework conditions for SMEs in Europe. Due to the heterogeneity of the SME population also the effects of the proposed policy actions may be heterogeneous across various types of SMEs and across countries (Demary et al. 2016). This article focusses on the financing for SMEs. However, to close, it has to be borne in mind that financing is only a part of the success story for enterprises—it is equally important to provide the right environment for SMEs to work, to be able and to be willing to grow. As such, the CMU and the aspect of financing have to be seen in the context of the overarching concept of the Investment Plan for Europe.

References

- AFME (2017): The Shortage of Risk Capital for Europe's High Growth Businesses. March 2017.
- BAND (2016): BANDquarter: How to explore the landscape of Angel Investing in Europe. Issue 1/2016.
- Block, J. H., M. Colombo, D. J. Cumming, and S. Vismara (2017): New players in entrepreneurial finance and why they are there. *Small Bus Econ* (2017). doi:10.1007/s11187-016-9826-6. First published online: 17.1.2017.
- Bongini, P., A. Ferrando, E. Rossi, and M. Rossolini (2017): Suitable or non-suitable? An investigation of Eurozone SMEs access to market-based finance. *CEPR Discussion Papers*, No. 12006.
- Chatzouz, M., A. Gereben, F. Lang, and W. Torfs (2017): Credit Guarantee Schemes for SME lending in Western Europe. *EIF Working Paper 2017/42*. June 2017.
- Council of the EU (2017a): Capital markets union: Agreement on venture capital rules. Press release 313/17. 30.05.2017.
- Council of the EU (2017b): Capital markets union: agreement reached on securitisation. Press release 314/17. 30.05.2017.
- Creditreform (2015): Kreditfonds in Europa—Direct Lending im Aufwind. *Creditreform Rating Agentur. Financial Research*. August 2015.
- Creditreform (2016): The European Debt Fund Industry: Gaining Traction. *Financial Research*. September 2016.
- Darvas, Z. (2013): Banking system soundness is the key to more SME financing. *Bruegel Policy Contribution*. Issue 2013/10. July 2013.
- Demary, M., J. Hornik, and G. Watfe (2016): SME financing in the EU: moving beyond one-size-fits-all. *IW Report 11/2016*.
- Duruflé, G., T. Hellmann, and K. Wilson (2017): From Start-up to Scale-up: Examining Public Policies for the Financing of High-Growth Ventures. *Saïd Business School Research Papers*, 2017-05.
- EU IPO Task Force (2015): EU IPO Report. *Rebuilding IPOs in Europe : Creating jobs and growth in European capital markets*. European Issuers, EVCA, FESE. March 2015.
- European Banking Authority (2016): EBA report on SMEs and SME supporting factor. *EBA/OP/2016/04*. 23 March 2016.

- European Commission (2015a): Crowdfunding: Mapping EU markets and events study.
- European Commission (2015b): Green Paper. Building a Capital Markets Union. COM(2015) 63 final. 18.2.2015.
- European Commission (2015c): Action Plan on Building a Capital Markets Union. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. COM(2015) 468 final. 30.9.2015.
- European Commission (2015d): Economic Analysis Accompanying the document Action Plan on Building a Capital Markets Union. SWD(2015) 183 final. 30.9.2015.
- European Commission (2016a): Capital Markets Union: Commission supports crowdfunding as alternative source of finance for Europe's start-ups. Press release. IP/16/1647. 3.5.2016.
- European Commission (2016b): Crowdfunding in the EU Capital Markets Union. Commission Staff Working Document. SWD(2016) 154 final. 3.5.2016.
- European Commission (2016c): Commission gives boost to start-ups in Europe. Press release. IP/16/3882. 22.11.2016.
- European Commission (2017a): Capital Markets Union: EU agrees to more support for venture capital and social enterprises. Press release. IP/17/1477. 30.5.2017.
- European Commission (2017b): Capital Markets Union: EU reaches agreement on reviving securitisation market. Press release. IP/17/1480. 30.5.2017.
- European Commission (2017c): Commission and EIF start selecting Pan-European Venture Capital Fund-of-Funds promoters. News Alert. 7.2.2017.
- European Commission (2017d): Completing the Capital Markets Union: Building on the first round of achievements. Press release. IP/17/1529. 8.6.2017.
- European Commission (2017e): On the Mid-Term Review of the Capital Markets Union Action Plan. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. COM(2017) 292 final. 8.6.2017.
- Hueriga, J., J. Puigvert, and C. Rodriguez (2012): Enhancements on ECB MFI Interest Rate Statistics. In: OECD—The Statistics Newsletter. Issue No. 55. March 2012.
- Kraemer-Eis, H. (2014): Institutional non-bank lending and the role of Debt Funds. With contributions from F. Battazzi, R. Charrier, M. Natoli, M. Squilloni. EIF Working Paper 2014/25. October 2014.
- Kraemer-Eis, H., F. Lang, and S. Gvetadze (2013): European Small Business Finance Outlook—June 2013. EIF Working Paper 2013/18.
- Kraemer-Eis, H., F. Lang, and S. Gvetadze (2014): European Small Business Finance Outlook—December 2014. EIF Working Paper 2014/26.
- Kraemer-Eis, H., F. Lang, W. Torfs, and S. Gvetadze (2016a): European Small Business Finance Outlook—June 2016. EIF Working Paper 2016/35.
- Kraemer-Eis, H., F. Lang, W. Torfs, and S. Gvetadze (2016b): European Small Business Finance Outlook—December 2016. EIF Working Paper 2016/37.
- Kraemer-Eis, H., F. Lang, W. Torfs, and S. Gvetadze (2017): European Small Business Finance Outlook—June 2017. EIF Working Paper 2017/43.
- Kraemer-Eis, H., G. Passaris, and A. Tappi (2013): SME loan securitisation 2.0—Market assessment and policy options. EIF Working Paper 2013/19. EIF Research & Market Analysis. October 2013.
- Kraemer-Eis, H., G. Passaris, A. Tappi, and G. Inglis (2015): SME Securitisation—at a crossroads? EIF Working Paper 2015/31. EIF Research & Market Analysis. December 2015.

- Kraemer-Eis, H., M. Schaber, and A. Tappi (2010): SME loan securitisation. An important tool to support European SME lending. EIF Working Paper 2010/7. EIF Research & Market Analysis. October 2010.
- Kraemer-Eis, H., and M. Schillo (2011): Business Angels in Germany—EIF's initiative to support the non-institutional financing market. EIF Working Paper 2011/11. November 2011.
- Kraemer-Eis, H., S. Signore, and D. Prencipe (2016): The European venture capital landscape: an EIF perspective. Volume I: The impact of EIF on the VC ecosystem. EIF Working Paper 2016/34. EIF Research & Market Analysis. June 2016.
- Masiak, C., A. Moritz, and F. Lang (2017): Financing patterns of European SMEs revisited: an updated empirical taxonomy and determinants of SME financing clusters. EIF Working Paper 2017/40.
- Moeglich, A.-K. (2017): Der EU-Rat und das Parlament erzielen Übereinkunft bei STS. ABS & Structured Credits. DZ Bank AG Publikation. 31.5.2017.
- Moeglich, A.-K., and R. Raebel (2014): Kreditfonds—ein Marktüberblick. ABS & Structured Credits. DZ Bank AG Publikation. 27.2.2014.
- Moritz, A., J. Block, and A. Heinz (2015): Financing patterns of European SMEs: an empirical taxonomy. EIF Working Paper 2017/30.
- Moritz, A., J. Block, and A. Heinz (2016): Financing Patterns of European SMEs—an Empirical Taxonomy. *Venture Capital* 18 (2): 115–148.
- Nassr, I. K., and G. Wehinger (2015): Unlocking SME finance through market-based debt: Securitisation, private placements and bonds. *OECD Journal: Financial Market Trends*, 2014/2. 22.4.2015.
- OECD (2011): Financing high-growth firms. The role of angel investors. December 2011.
- OECD (2016): Financing SMEs and Entrepreneurs 2016. An OECD Scoreboard. April 2016.
- OECD (2017): Financing SMEs and Entrepreneurs 2017. An OECD Scoreboard. April 2017.
- Prencipe (2017): Liquidity events and returns of EIF-backed VC investments. Vol III of The European venture capital landscape: an EIF perspective. EIF Working Paper 2017/41. April 2017.
- Preqin (2014): Private debt: the new alternative? Preqin Special Report. July 2014.
- Wardrop, B. Z. R., T. Z. A. Lui, J. Burton, and A. James (2016): Sustaining momentum. The 2nd European alternative finance industry report, Cambridge Centre for Alternative finance, 9, 2016.
- Will, L. (2016): The Functioning of Debt Funds and their Role in SME Financing in Europe. Master thesis. University of Trier. 6.5.2016. Mimeo.