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Executive summary[1]

This European Small Business Finance Outlook (ESBFO) provides an overview of the main markets relevant to EIF (equity[2], guarantees/securitisation, microfinance). It is an update of the ESBFO December 2013.

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

Market Environment:

- Europe continues with an uneven and gradual recovery. The labour market is still expected to register a double-digit unemployment rate.
- Most of the business indicators have started improving in recent months and confidence has increased. Bankruptcies are expected to decrease in Europe.
- The ECB Bank Lending Survey shows that, on balance, the reporting euro-area banks have further tightened their credit standards for non-financial corporations. However, the survey reports a slight decrease in the additional net tightening.
- According to the European Commission's and the ECB's latest ''Survey on the Access to Finance'' of SMEs (SAFE), access to finance moved down from being the second to being the third most pressing problem for euro area SMEs compared to the previous survey round.
- Great disparities in access to finance by country persist. In distressed countries, such as Greece, Ireland, Italy, Spain and Portugal, "Access to finance" is a very pressing problem for SMEs, while in Germany, Austria or in Finland less than 10% of SMEs reported ''Access to finance'' as the most pressing problem.
- It is not exactly measurable to what extent current weaknesses in bank lending to SMEs are driven by demand- or by supply-side factors. However, there is a risk that even in countries where weak bank lending is driven by the demand side, it is uncertain whether banks are able and/or willing to provide the necessary lending once the demand picks up (driven by economic recovery, respectively the expectation of the latter).
- In an increasingly risk-averse environment, the tendency not to lend to small and young firms is further increasing as well - as these are by nature more risky than their larger peers.

[1] This paper benefited from comments and inputs by many EIF colleagues for which we are very grateful. 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.

Private equity:

- Following the big crash of European private equity (PE) investment in 2008/2009, PE had partially rebounded over 2010 and 2011. However, the recovery suffered a further setback in 2012, but stayed well above the 2009 crisis trough. In 2013, PE investment stabilised at EUR 37.7bn, according to EVCA figures. In terms of amounts invested, positive growth was mainly reported for the buyout and the later-stage venture market segments. However, growth capital and the replacement capital segments strongly decreased, and also venture investments with a start-up and seed stage focus continued to decline.
- Some of the gap left by the fall in venture capital (VC) investment since 2008 has been filled in by business angel activity in recent years; their proximity to the market has been beneficial during this difficult period.
- According to the EVCA figures, total PE fundraising amounts more than doubled in 2013, while VC fundraising recorded only a moderate improvement. PE divestment activity recorded the highest levels ever, and also VC divestments increased considerably in 2013.
- Continued investors' cautious sentiment for VC is shown by the shift in the investor base during the recent years. According to the EVCA figures, government agencies accounted for 38% of total VC fundraising in 2013, thereby continuing to support the market counter-cyclically in the current crisis, during which total VC fundraising levels and the number of VC funds have both approximately halved.
- According to the Thomson Reuters data, European VC performance has stabilised, albeit at a low level. Moreover, EIF is observing an increasing number of auspicious early-stage companies. They show a promising pattern of growth and good potential positively to impact the funds' future performance.

SME Guarantees / Securitisation:

- Credit guarantees continue to be the most widely used policy instrument to alleviate market failures in SME financing and to ease related financial constraints (OECD, 2014).
- According to AECM statistics, Italy and France exhibit the largest volume and number of outstanding SME guarantees. Related to GDP, Italy and Portugal have the largest markets.
- AECM preliminary data of outstanding guarantees reports a decrease in volumes and a parallel increase in the number of guarantees for 2012 and 2013. Hence, the guarantee size has on average declined, probably due to an increase of guarantees with smaller amounts, as well as of short-term guarantees (i.e. working capital loan and bridge financing guarantees), but also meaning a move back to pre-crisis levels.
- Lower guarantee amounts are, inter alia, caused by weak economic activity and by public budget cuts. Support from the European level could improve the situation at least on the supply side. In this respect, several new initiatives are being prepared.
- In the SME securitisation market, actual activity remains low. Despite the financial and sovereign crisis, the European securitisation market has in general performed relatively well so far; also the SME segment shows low default rates.

- The reputation of this market segment is continuously improving; a de-stigmatisation is happening and the image is being corrected from "toxic waste" to a tool that can help to overcome the negative effects of the crisis.
- With regard to future /potential regulatory treatments of SMESec, a holistic view should be taken and the impact of the "regulatory wave" duly analysed. The regulatory framework should reflect the actual risks of SMESec.
- Transparency is a prerequisite for any structured transaction; the introduction of a properly defined concept of "high quality securitisation" can add substantial information.
- The ECB's Governing Council recently announced that it would intensify preparatory work on outright purchases of (simple and transparent) securities backed by loans to non-financial companies. If the ECB is going to start such purchases, and how these could look like, is still uncertain.

Microfinance:

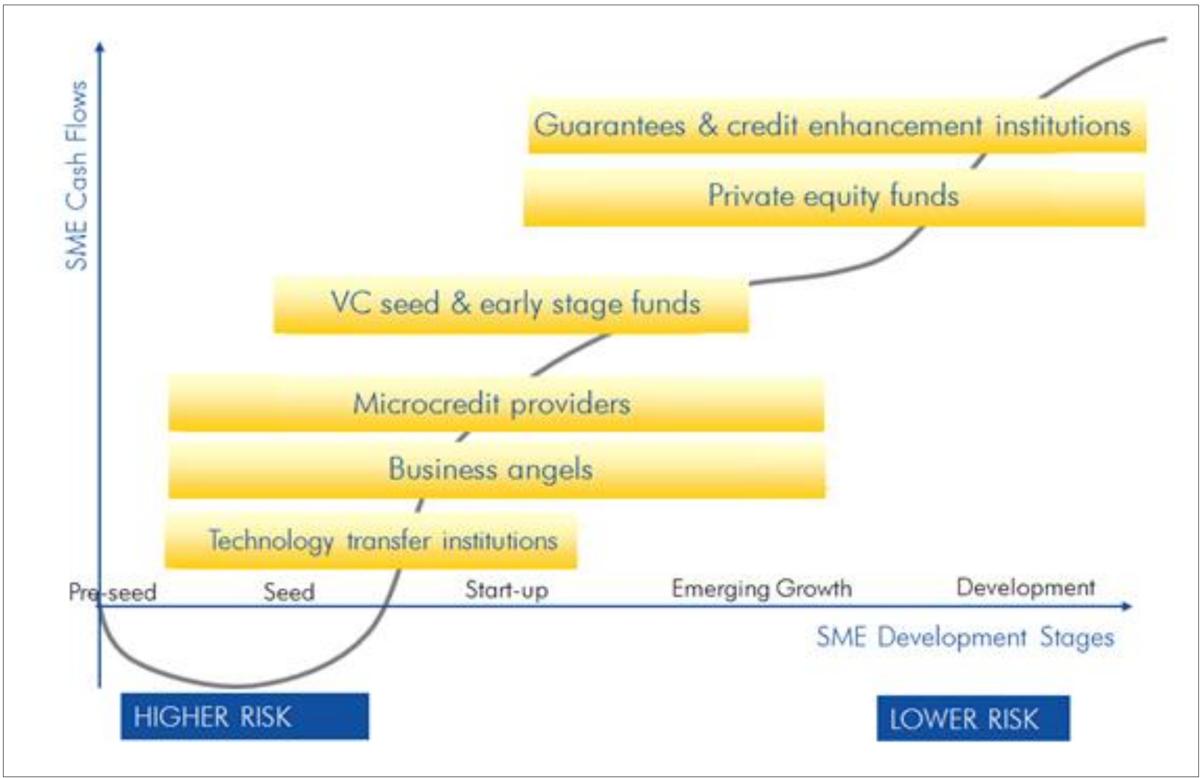
- Microfinance is generally associated with social and economic objectives, and it is an important financing channel for job creation. However, the European microfinance market is still young and heterogeneous, especially with regard to the diversity of lending approaches. In a still risk averse environment of credit allocation, lending is expected to be allocated away from small and young firms, as they are more risky than other SMEs.
- According to the data from the latest ECB survey on the access to finance of SMEs in the euro area, the share of enterprises which see access to finance as their most pressing problem is larger among microenterprises than among their larger peers.
- The recent EMN survey reports a remarkable growth both in the overall total value and the number of microloans provided by the surveyed MFIs. With regard to future trends, MFIs expect less public support in the coming years, due to public budget restrictions.

Table of contents

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). The following Figure 1 shows 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 (equity[3], guarantees/securitisation, microfinance). The present edition is an update of the ESBFO December 2013.

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 the important aspects of microfinance in Europe.

[3] Please see footnote 2 concerning the term "equity finance".

2 Economic environment and insolvencies

Since the publication of the previous ESBFO in December 2013, the global economic outlook has slightly weakened. The International Monetary Fund (IMF) has recently estimated a slowdown of global growth from 3.2% in 2012 to 3.0% in 2013. Global growth is expected to increase again to 3.6% in 2014. However, compared to IMF's previous projections (October 2013), the estimated growth for 2013 has been increased by 0.1 percentage point, while the forecast for 2014 has remained unchanged (IMF, 2014).

The European Commission has also updated its projections for the European Union (EU), expecting a very small positive (+0.1%) growth rate for 2013, followed by higher growth in 2014 (+1.6%) and in 2015 (+2.0%), see table 1. For2014 and 2015, the labour market is again expected to register a double-digit unemployment rate in the EU. However, private and public consumption are both expected moderately to expand. As over the past three years, net exports have remained the most powerful growth driver in 2013. For 2014, domestic demand is expected to take over as the main contributor to growth (European Commission, 2014a).

Table 1: Main features of the European Commission spring 2014 forecast for the EU

(Real annual percentage change, unless otherwise stated)				Spring 2014 estimates / forecasts		
	2010	2011	2012	2013	2014	2015
GDP	2.0	1.6	-0.4	0.1	1.6	2.0
Private consumption	1.1	0.3	-0.7	0.0	1.2	1.6
Public consumption	0.6	-0.2	-0.2	0.4	0.7	0.6
Total investment	-0.2	1.6	-2.9	-2.3	3.1	4.7
Employment	-0.8	0.2	-0.3	-0.4	0.6	0.7
Unemployment rate (a)	9.6	9.6	10.4	10.8	10.5	10.1
Inflation (b)	2.1	3.1	2.6	1.2	0.9	1.3
Government balance (% GDP)	-6.5	-4.4	-3.9	-3.3	-2.6	-2.5
Government debt (% GDP)	80.1	83.0	86.8	88.9	89.5	89.2
Adjusted current-account balance (% GDP)	-0.5	-0.3	0.6	1.2	1.5	1.5
Contribution to change in GDP						
Private and Public Consumption	0.7	0.2	-0.4	0.1	0.9	1.0
Investment and Inventories	0.8	0.6	-1.0	-0.5	0.5	0.8
Net exports	0.5	0.9	1.1	0.5	0.2	0.1

(a) Percentage of the labour force.

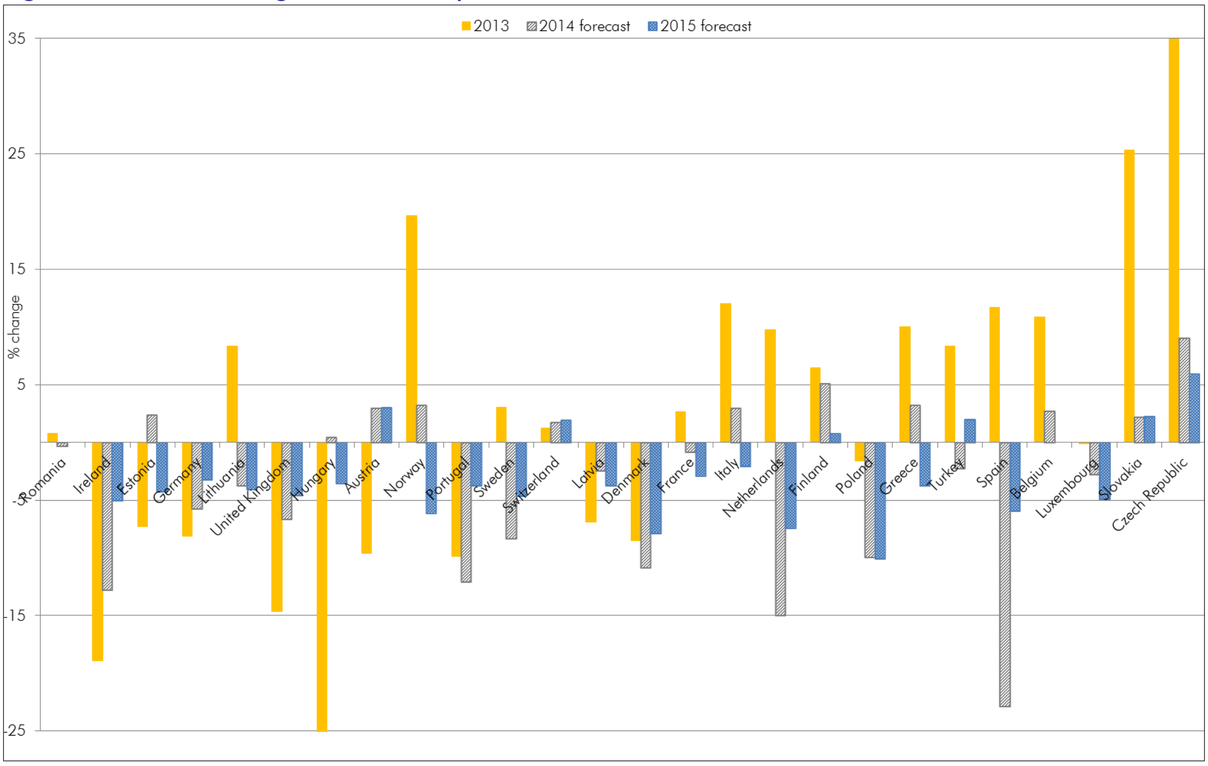
(b) Harmonised index of consumer prices (HICP), annual percentage change.

Source: European Commission (2014a)

The aforementioned economic developments have an impact on insolvencies. Recently, Euler Hermes (2014) has updated the predicted decrease in global business insolvencies in 2014 to a significantly more optimistic level. For 2014, the Euler Hermes Global Insolvency Index[4], which analyses changes in business insolvencies across the world, forecasts a decrease (-8%) for the third year in a row (-2.4% in 2013 and -1.5% in 2012).

Concerning the euro area, the Insolvency Index registered an increase in bankruptcies by +6% in 2013, while the projection for 2014 has been recently updated by Euler Hermes to a more optimistic level of -13% (compared to +1% projected in December 2013). At the same time, the regional disparities have remained prevalent, as indicated in Figure 2.

Figure 2: Rate of change in insolvency, 2013-2015



Source: Based on Euler Hermes (2014)

In 2013, the insolvency indexes increased at a record rate of +57% in the Czech Republic, while double-digit increases were also recorded in Slovakia (+25%), Norway (+20%), Italy (+12%) and Spain (+12%). On the other hand, the most significant falls in the European insolvency indexes were recorded in Hungary (-40%), Ireland (-19%) and the UK (-15%).

[4] For each country, an insolvency index is calculated with a basis of 2000=100. The Global Insolvency Index (GII) is the weighted sum of the national indices. Each country is weighted according to its share of the total GDP (at current exchange rates) of the countries included in the study, which account for more than 85% of world GDP at current exchange rates for 2011 (Euler Hermes, 2014).

3 Small business environment

3.1 Importance of SMEs

SMEs are defined by the European Commission as having fewer than 250 employees. They should also have an annual turnover of up to EUR 50m, or a balance sheet total of no more than EUR 43m (Commission Recommendation of 6 May 2003), see Table 2.

Table 2: EU definition of SMEs

Enterprise category	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 (2013a)

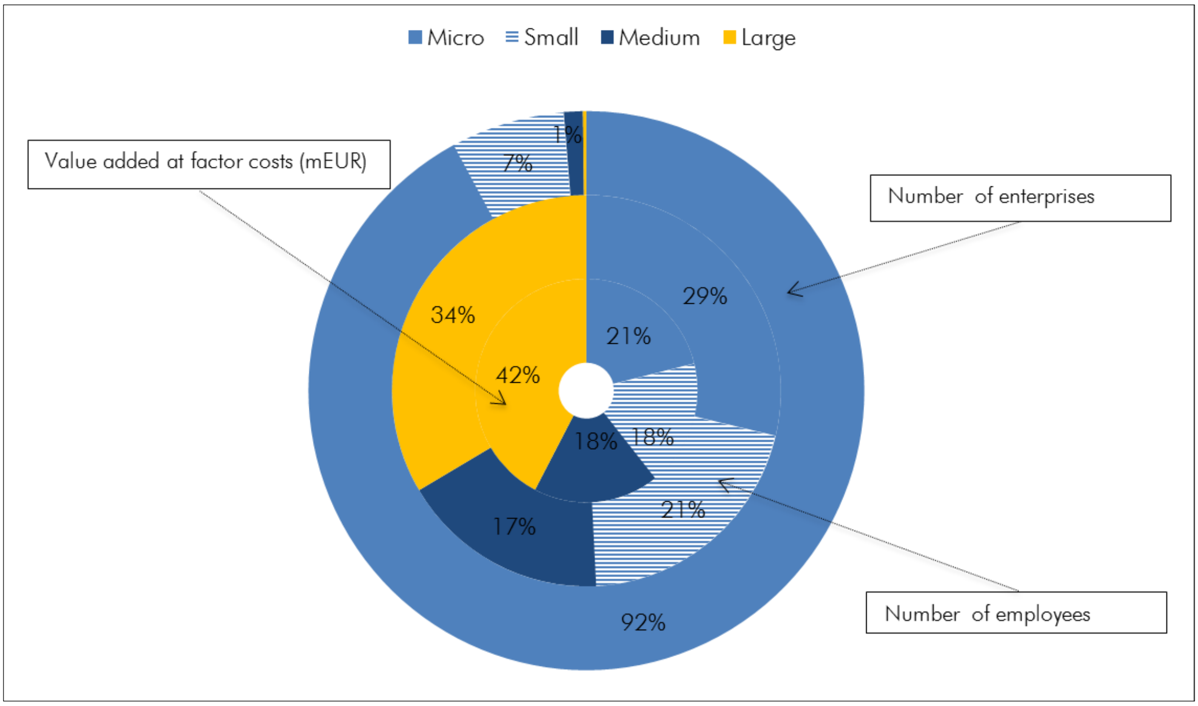
Small and medium-sized enterprises are known as the backbone of the European economy, contributing to job creation and economic growth. In 2012, more than 20m of SMEs in the European Union made for 99.8% of all non-financial enterprises, employed 86.8m people (66.5% of the total employment), and generated 57.7% of total added value (see Figure 3).[5] Especially young SMEs are a very important source of job creation; their contribution to the total job creation is twice as much as their representation in the total employment (Criscuolo, Gal and Menon, 2014[6]). Research shows that the impact of a credit supply shock was more severe in countries with a high share of SMEs than in countries with a low share (Klein, 2014); this implies that easing access to finance for SMEs plays a critical role during an economic recovery.

Forecasts concerning the number of SMEs in the EU, the number of persons employed by SMEs and their added value are moderately optimistic. The number of SMEs is expected to grow by 5.2% in 2014, compared to the 2008 level (see Figure 4). The number of micro-enterprises is expected to grow more than other size classes (5.4%). The number of people employed by SMEs has been lower than the 2008 level, however it is expected to recover in 2014. In contrast, the level of value-added produced by SMEs in 2008 will not be reached in 2014, but the expectation is more optimistic than in the previous years.

[5] Gross value added is the difference between output and intermediate consumption. As an aggregate measure of production, GDP is equal to the sum of the gross value added of all resident institutional units (i.e. industries) engaged in production, plus any taxes and minus any subsidies, on products not included in the value of their outputs.
http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Category:Glossary

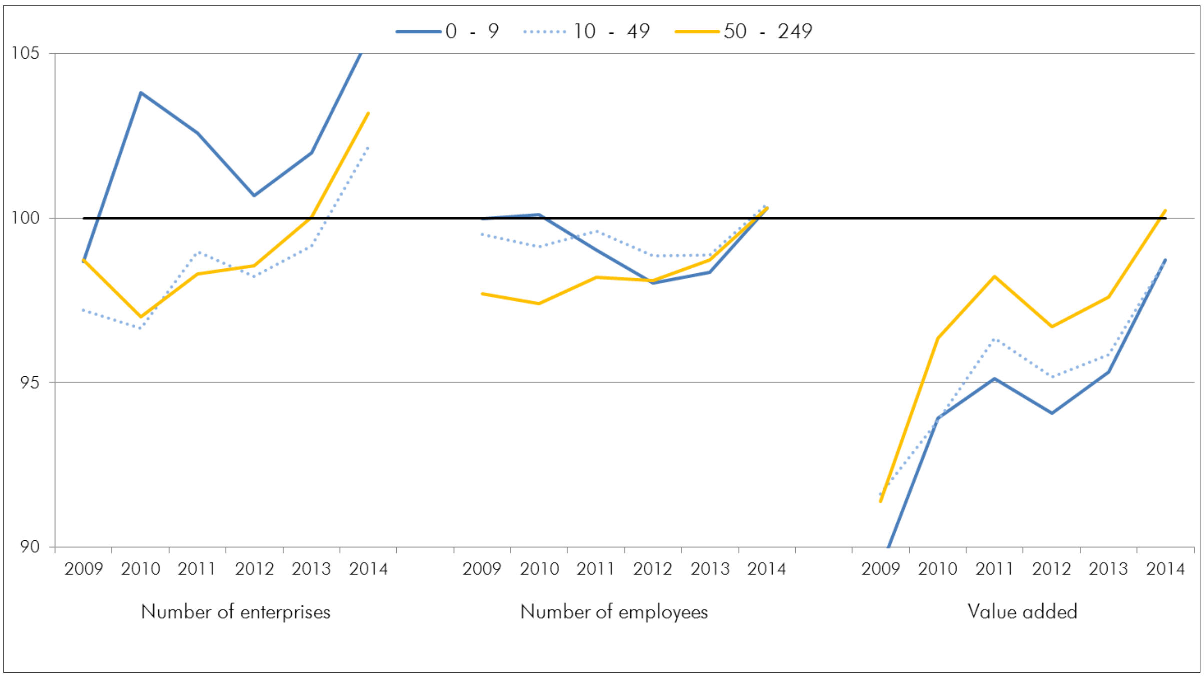
[6] The OECD work is based on firm-level data across 18 OECD countries, over 10 years.

Figure 3: SMEs, Employment and Value added, 2012



Source: European Commission (2013a)

Figure 4: Number of SMEs, Employement and Value added, 2011-2014, 2008=100



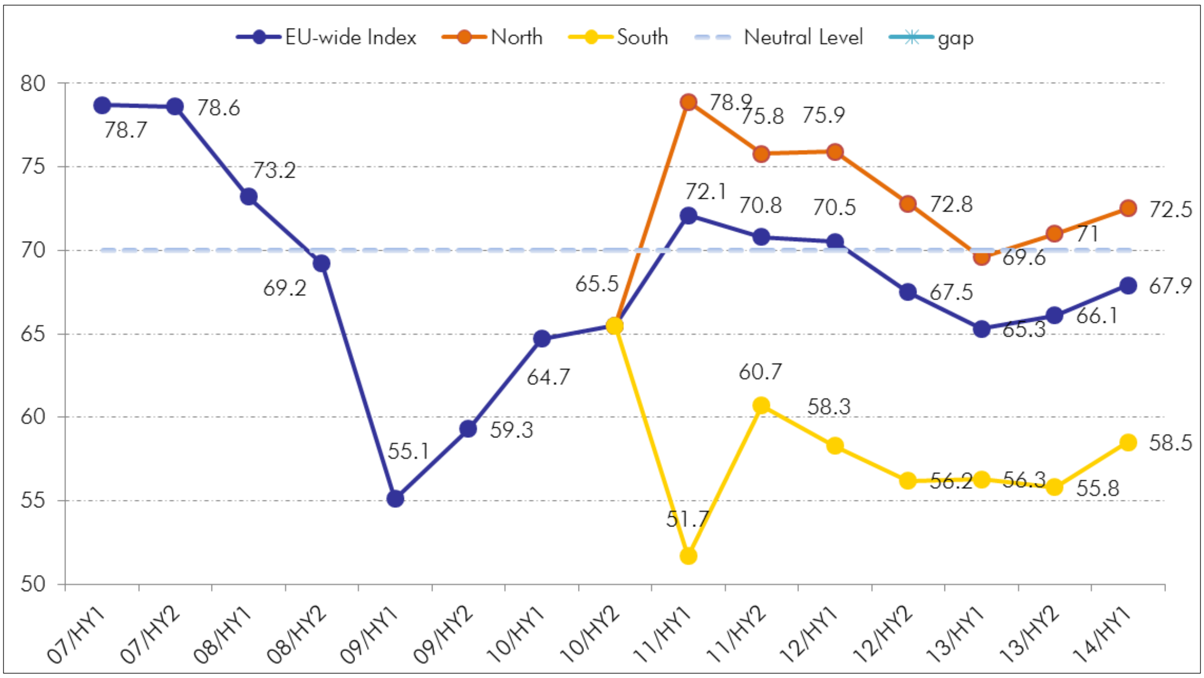
Source: European Commission (2013a)

3.2 SME business climate

The moderate optimism, described above, is also confirmed by UEAPME's SME Business Climate Index: it increased by almost two percentage points since last semester (see Figure 5). The index (67.9%) for the first half-year of 2014 is still standing below its neutral level of 70%, meaning that it is too early to speak of a recovery (see Figure 5). However, the trend for the EU is rising, which could indicate that there is a realistic hope to enter a real recovery phase later this year, if the right policy response is provided by Europe (UEAPME Study Unit, 2014).

A significant progress was observed in the countries of the south/the periphery.[7] The SME Business Climate Index for these countries increased by 2.7 percentage points (pp) in the first half-year of 2014, which is higher than the increase in the countries of the north and the centre[8] (1.5 percentage points). As a result, the imbalance between the two diverse country groups has diminished, with the current gap equal to 14 percentage points, compared to 15.2 pp in the second half-year of 2013 (UEAPME Study Unit, 2014).

Figure 5: SME Business Climate Index[9]



Source: EIF, based on data from UEAPME Study Unit (2014)

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7 Croatia, Cyprus, Greece, Ireland, Italy, Malta, Portugal, Slovenia and Spain.

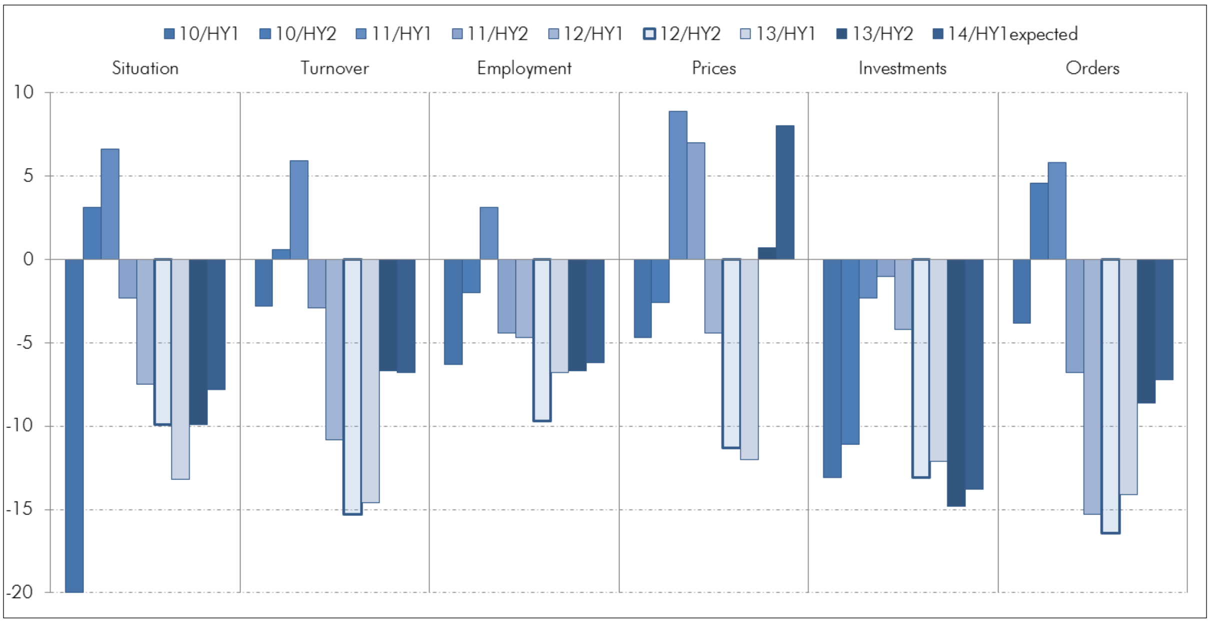
8 Austria, Belgium, Bulgaria, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Romania, Slovakia, Sweden and UK.

9 The UEAPME SME Business Climate Index is calculated as the average of the current situation and the expectations for the next period, resulting from the sum of positive and neutral (meaning: no change) answers pertaining to the overall situation for the business. For example, for "semester A" with 25% positive, neutral 55%, and 20% negative answers, the Index would be (25 + 55 =) 80, and for "semester B" with 40% positive, 30% neutral, and 30% negative answers, it would fall to (40 + 30 =) 70. However, the respective balances of positive minus negative answers would show an opposite result, growing from "semester A" (25 – 20 =) 5% to "semester B" (40 – 30 =) 10%. Therefore, these balances should also be examined, and are reported in UEAPME's EU Craft and SME Barometer.

These improvements in sentiments are confirmed by the recent results of the European Commission's economic sentiment indicator (ESI) for the EU and the euro area, as well as by the Business Climate Indicator (BCI) for the euro area. Improved sentiment of the euro area was mainly driven by higher consumer confidence (European Commission, 2014b and 2014c). The improvements in the ESI in the EU were similar to the improvements in the euro area, except for raised selling price expectations in services.

Figure 6 shows the balance of "positive minus negative" answers reported by European SMEs, according to UEAPME Study Unit (2014), with reference to situation, turnover, employment, prices, investments and orders on a semi-annual base, starting from the first half-year 2010, with the last column being expectations for the first half-year of 2014. Specifically, for the first half of 2014, the overall situation and orders are on balance expected to fall by 7.8% and 7.2%, respectively. Despite the fact that both numbers are still negative, they indicate slightly smaller decreases than the numbers in the previous semester (situation (-9.9%) and orders (-8.6%)). Expectations for investment, on balance, are still negative (-13.8%). The only positive figure is the expectation for prices (increase by 8%). The surprisingly high level of this indicator shows that European small companies are not expecting any deflation in the near future (UEAPME Study Unit, 2014).

Figure 6: Main Results of the EU Craft and SME Barometer HY1/2014[10]



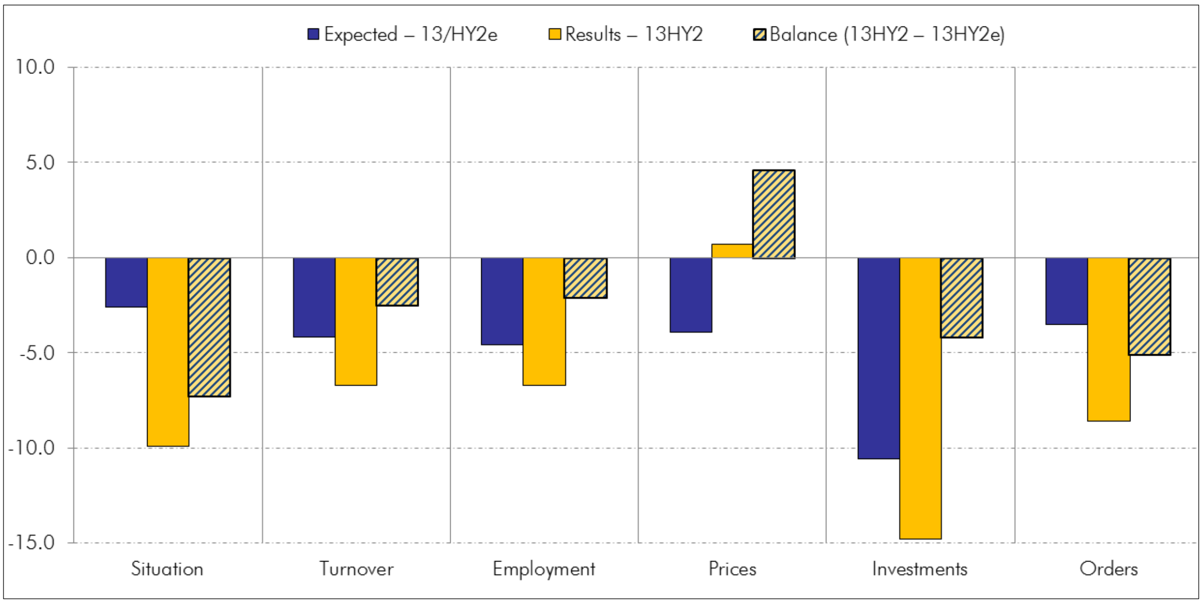
Source: EIF, based on data from UEAPME Study Unit (2014)

The balance between the expectations and the final results for the second half of 2013 is shown in Figure 7. The results for the indicators for the second half-year of 2013 were significantly worse

[10]The EU Craft and SME Barometer builds on surveys that are conducted by UEAPME member organisations. The 2013/H2 results are based on about 30,000 answers collected between May and September 2013. The balanced figures mentioned in the text show the difference between positive and negative answers, with national results weighted by employment figures. The surveyed categories include overall situation, turnover, employment, prices, investment, and orders. For details see UEAPME Study Unit (2013).

than expected with the exception of prices, which turned out better than expected. The most remarkable difference was observed for the overall situation for which the balance of expectations (-2.6%) contrasts significantly with the balance of the actual reported results (-9.9%). It seems that SMEs still lack confidence in the future development and are still waiting for a real recovery (UEAPME Study Unit, 2014).

Figure 7: Expectations of SMEs and real outcome for HY2/2013



Source: EIF, based on data from UEAPME Study Unit (2014)

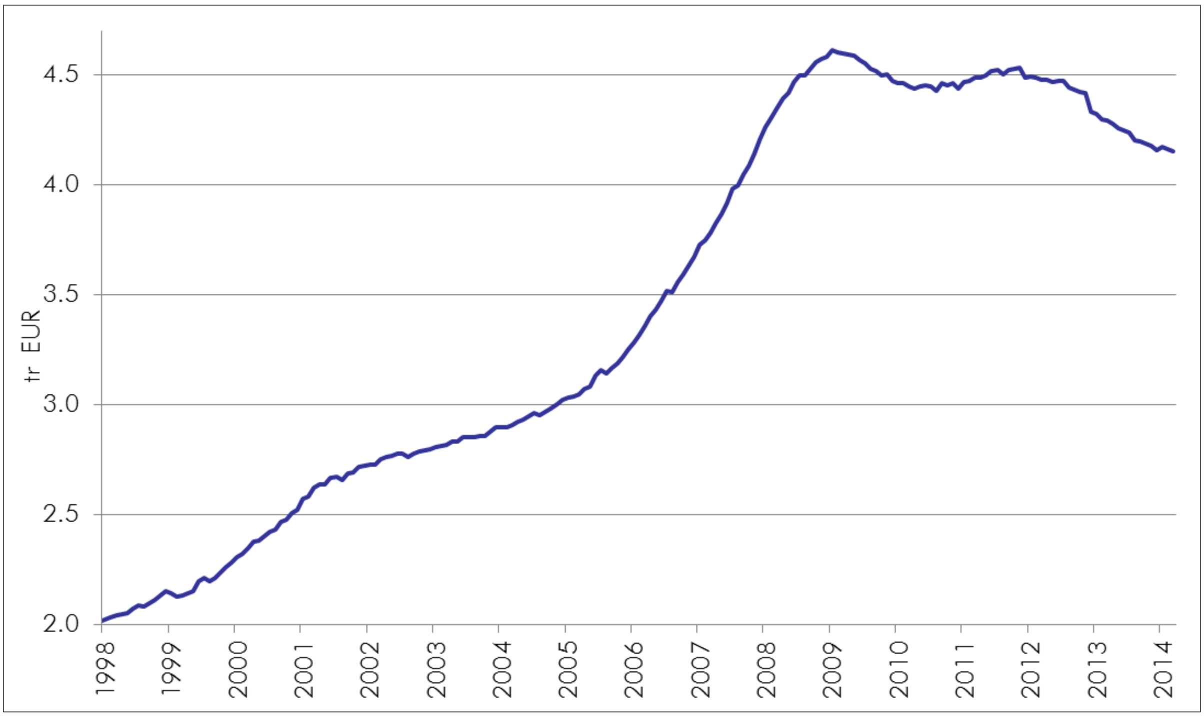
The results of the recent Eurochambres (2014) Economic Survey[11] point in a similar direction. According to this study, business confidence has increased in 2013, following two years of decline. Moreover, businesses were on balance expecting a further improvement for 2014 which is set to be the most optimistic year since the last peak increase in 2010. Furthermore, all indicators show an improvement in forecasts. The optimism shown by the businesses indicates that the structural reforms deployed in response to the crises are beginning to have an impact. Despite the general positive expectations for 2014, great disparities in business confidence by country persist. Lithuania remains the most optimistic of all followed by Romania and Finland. The highest increase in business confidence for 2014 was observed in Serbia. Improvements are also visible in Portugal, Spain and Greece as a result of their economic reforms. In Cyprus, which experienced the onset of the crisis later compared to others, businesses still showed the highest levels of pessimism.

[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, total turnover, domestic sales, export sales, employment & investment. The Eurochambres Economic Survey has been conducted since 1993. For details on the methodology see Eurochambres (2014).

3.3 Bank lending activity

According to ECB data, the trend in lending to non-financial corporations (NFCs) in Europe has been declining since 2009 and still has to bottom out (see Figure 8). Compared to the peak of EUR 4.6tr reached at the beginning of 2009, the volume of outstanding loans has decreased by more than 10% to EUR 4.14tr in the Euro area in March 2014.[12]

Figure 8: Outstanding Loans to Non-Financial Corporations in the Euro Area



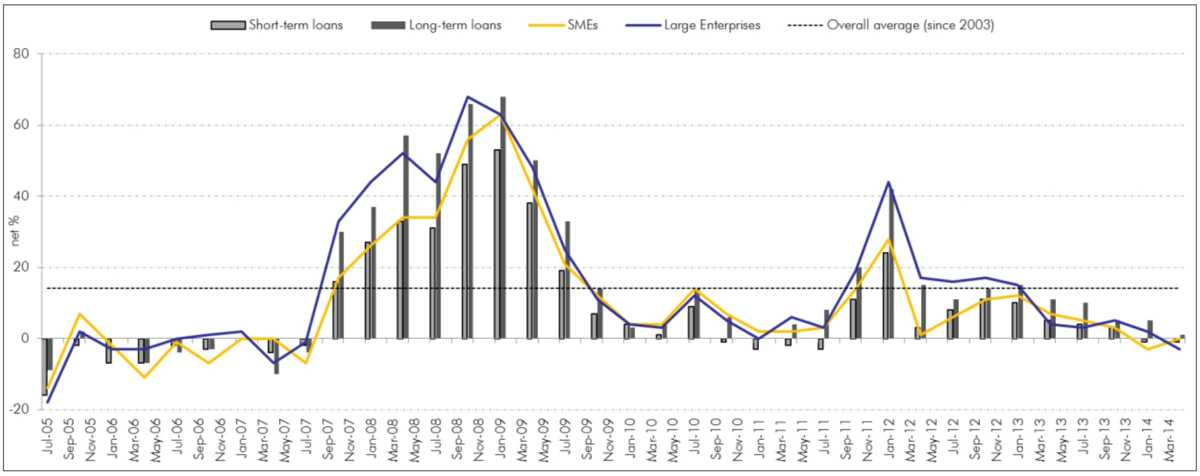
Source: EIF, based on data from ECB

[12]SME loan data do not exist on European level. Only recently did the European Commission initiate a project to improve the evaluation, collection and monitoring of SME lending data. With respect to financing cost for SMEs, Huerga et al. (2012) suggest that interest rates charged on small loans to NFCs (up to and including EUR 0.25m) could be used as a proxy. Even if new business volumes are also reported for small loans, the time series contains data going back only to June 2010. A longer history (back to 2003) exists for the size-class differentiation between loans to NFCs up to, and including, EUR 1m, and loans over EUR 1m. Looking at moving averages of the preceding 12 months, loans ≤ EUR 1m grew relatively steadily and reached their peak in April 2008 at EUR 86bn, which was 25% larger than by end-2003. Loans > EUR 1m grew for one year longer and peaked in April 2009 at EUR 276bn, which was 81% larger than by end-2003. Following their respective peaks, loans of both size-classes decreased continuously until June 2013, by 36% for loans ≤ EUR 1m and by 42% for loans > EUR 1m. While loans ≤ EUR 1m are today 20% below their 2003 levels, loans > EUR 1m are still 6% above the corresponding level. This particularly reflects the strong differences between the pre-crisis growths of both loan-size classes. However, it is questionable if the growth in loans to NFCs of ≤ EUR 1m can be taken as a proxy for the development of SME loans. For example, since 2011, loans to NFCs ≤ EUR 0.25m have decreased by 13%, while loans to NFCs ≤ EUR 1m (as well as loans to NFCs > EUR 1m) have (both) decreased by only 10%.

The current status of bank lending has also been analysed in the ECB's latest Bank Lending Survey (BLS, see ECB, 2014d)[13]: the net tightening of credit standards in the first quarter of 2014 still stands below its historical averages. On balance, the reporting euro area banks have further tightened their credit standards to non-financial corporations (NFCs). However, the survey reports a slight decrease in the *additional* net tightening[14]; a net 1% of banks reported a tightening in Q1/2014 (compared to 2% in the previous quarter).

As shown in Figure 9, the overall net tightening of credit standards was slightly less pronounced for SMEs compare to the previous period, while a slight net easing was reported for large firms for the first time since the second quarter of 2007. The net tightening of standards for SME loans decreased from 2% in Q4/2013 to 1% and the net tightening of standards for large enterprises decreased from 2% in Q4/2013 to (-5%), where the negative number indicates that the net percentages of banks contributed to easing standards. (ECB, 2014d).The BLS examines the net tightening of credit standards also with respect to the loan maturity and it declined for loans with longer maturities, while a slight net easing was reported for short-term loans.

Figure 9: Changes in credit standards applied to the approval of loans or credit lines to enterprises (SMEs versus large enterprises)



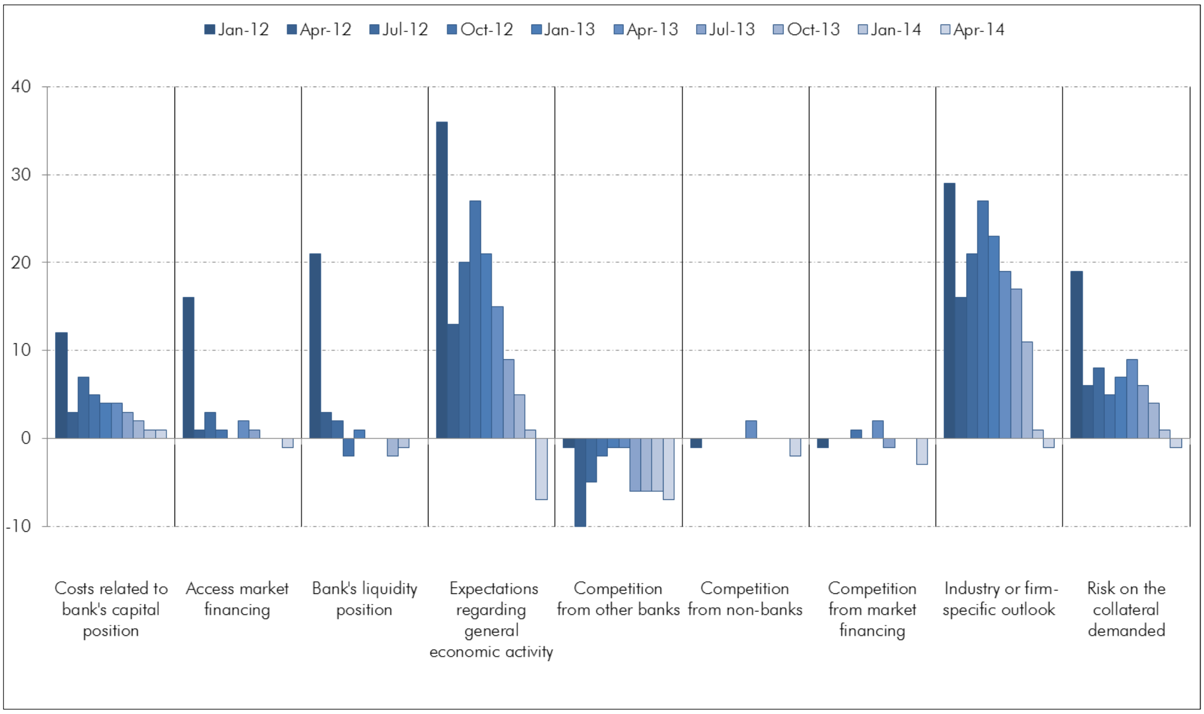
Source: EIF, based on data from ECB (2014d)

In Q1/2014, in net terms and as far as SMEs are concerned, the factor that mostly contributed to tighter credit standards was the costs related to bank's capital position. In contrast, the expectations concerning the industry (or firm) specific outlook, and the expectation regarding the general economic outlook, contributed to the easing of credit standards (ECB, 2014c), see Figure 10.

[13]This survey was conducted on 135 euro area banks and reports changes during the first quarter of 2014 (Q1/2014) and expectations of changes in the second quarter of 2014 (Q2/2014).

[14]Text and diagram refer to *net* percentages of banks contributing to tightening standards (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").

Figure 10: Factors contributing to tightening credit standards for SMEs[15]



Source: EIF, based on data from ECB (2014c)

According to the reporting banks, net *demand* for loans to NFCs turned positive in Q1/2014 (2% compared to -11% in Q4/2013) and reached above its historical average. This was mainly driven by a less pronounced negative impact of fixed investment and the positive impact of other financial needs, mainly inventories and working capital. Concerning the projections for Q2/2014, banks mainly expect a net easing of credit standards (for large firms and SMEs). Moreover, they expect an increase in demand (for all categories of loans).

The recent EIB bank lending survey for CESEE (Central, Eastern and Southeastern Europe) showed that supply conditions has tightened in the last six months. In contrast to the ECB survey for the euro area, the global market outlook contributed to deteriorated credit conditions in CESEE. Looking ahead, supply conditions are expected to be eased, driven by an expected increase in credit demand perceived by banks (EIB, 2014).

As additional reaction to the market conditions, beginning of June 2014, the ECB's Governing Council announced measures to enhance the functioning of the monetary policy transmission mechanism by supporting lending to the real economy, in particular to conduct a series of targeted longer-term refinancing operations (TLTROs) aimed at improving bank lending to the euro area non-financial private sector. Moreover, the Governing Council said it would intensify preparatory work on outright purchases of (simple and transparent) securities backed by loans to non-financial companies. It is still too early to say what the effects of these measures, respectively potential measures, is going to be.

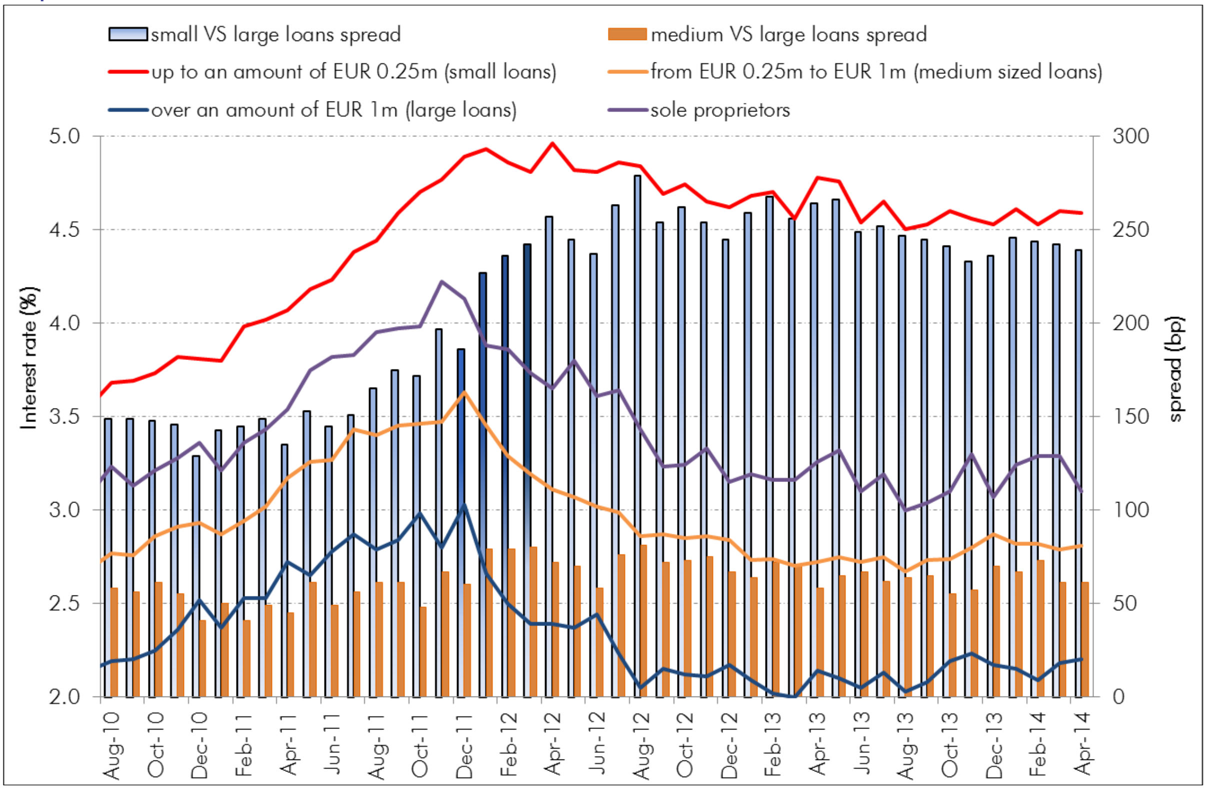
[15]The net percentages for responses to questions related to the factors are defined as the difference between the percentage of banks reporting that the given factor contributed to a tightening and the percentage reporting that it contributed to an easing.

3.4 ECB interest rate statistics

The interest rate statistics for monetary financial institutions, published by the ECB, provide information about the interest rates and volumes for different size classes of new euro-denominated loans. Since June 2011, the former category of loans (of up to EUR 1) to the euro area, extended to non-financial corporations, is divided into two sub-categories. One category includes loans up to and including EUR 0.25m, and the other loans over EUR 0.25m and up to EUR 1m.

Loans of amounts over EUR 0.25m up to EUR 1m (medium-size loans) had a rather stable spread over loans of more than EUR 1m (large loans), averaging 62 basis points (bp) for the period June 2010 to April 2014 (see Figure 11). In contrast, the interest rate spread between loans of up to EUR 0.25m (small loans) and large loans was higher, but relatively stable at an average level of 145bp from the start of the time series in June 2010 until July 2011. In the following months, this spread had showed an increasing trend until August 2012 when it reached a record high of 279bp. Since then, the spread has been rather stable, averaging 211bp.

Figure 11: Evolution of monetary financial institutions interest rates on new loans to non-financial corporations[16]



Sources: EIF, based on Huerga et al. (2012), ECB (2014b), ECB SDW, and own calculations

[16] New loans to non-financial corporations, with floating rate and up to three-month initial rate fixation by loan size, and new loans to sole proprietors (percentages per annum excluding charges; period averages). The series about new loans to "sole proprietors" have an initial rate fixation period of up to one year, and not up to three-months, as the rest of the series used in the graph, because data for lower rates of fixations are not collected.

Overall financing costs for euro area MFIs have continued to fall across most external financing sources. The aggregate improvement in financing conditions was confirmed by a declining spread between bank lending rates for very small loans and those for large loans to non-financial firms in most of the larger euro area economies. On the other hand, the difference between the loan pricing conditions for small and large firms remained high in more vulnerable countries, indicating the more adverse conditions faced by small firms because of their dependence on their domestic banking sectors (ECB, 2014e).

The gap in lending rates between periphery and core countries has slightly declined at the start of the year but has unfortunately increased in the past few months. The interest rate in Italy was almost 1.25 percentage points above the rate in Germany recently. In Spain, the premium was about 2 percentage points, in Greece and Portugal, about 3 percentage points (Commerzbank, 2014). However, often the pure access to debt-finance is often more important to SMEs than its costs (OECD, 2014).

3.5 SMEs' Access to finance

According to the European Commission's and the ECB's latest Survey on the Access to Finance of SMEs (SAFE), covering October 2013 to March 2014 (European Commission, 2013b and ECB, 2014c)[17], access to finance moved from the second to the third most pressing problem for euro area SMEs compare to the previous survey round. Compared to the previous survey wave, the percentage of companies that mention access to finance as their most pressing problem has moved to 14% down from 16%. 'Finding customers' stayed the most frequently mentioned concern. Unsurprisingly, the divergence across the countries was large. "On the high side, 42% of the SMEs in Greece, 23% in Ireland, 19% in Italy and 18% in Spain and Portugal mentioned 'Access to finance' as the most pressing problem, compared with around 6% of the SMEs in Germany and 9% in Austria and Finland on the low side" (ECB, 2014c).

Compared to the previous ECB survey (covering the period April to September 2013), there has been a slight increase in the percentage of SMEs which used the most popular sources of debt financing, i.e. bank loans and trade credits. Traditional bank financing (overdrafts, credit lines, bank loans), however, remained the most important external funding source (see Figure 12).

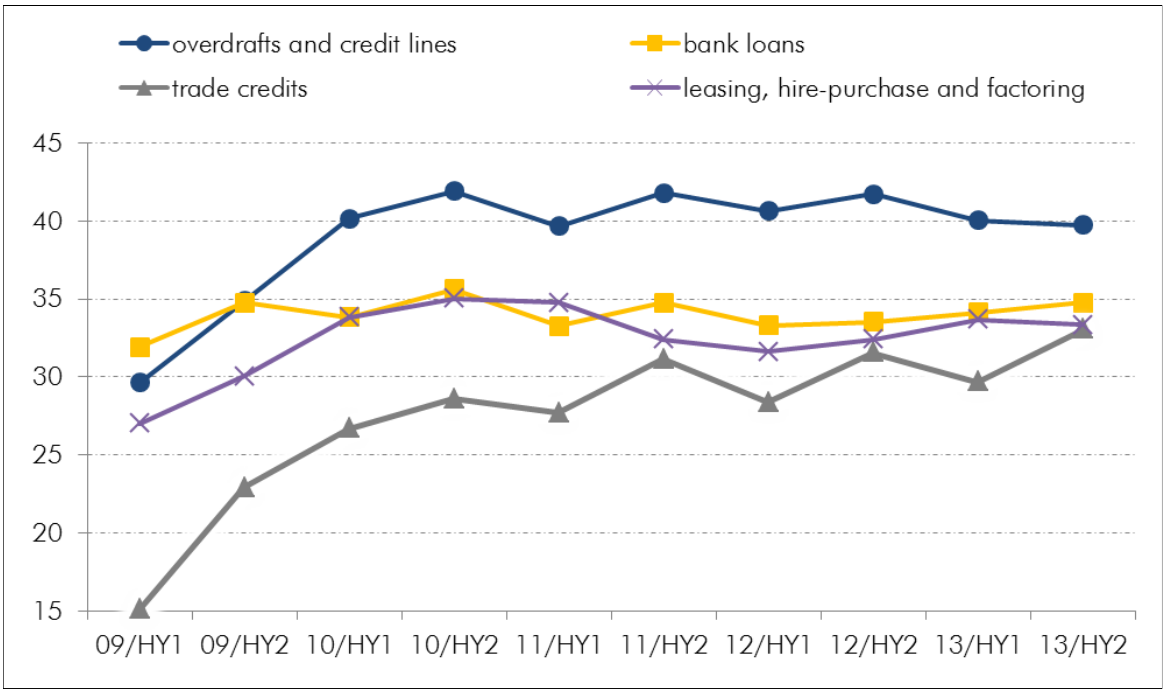
During the reference period, the net percentage[18] of SMEs reporting a higher *need* for bank loans has slightly decreased in comparison to the previous survey (4% down from 5%). At the same time, the net percentage of SMEs that perceived a deteriorated *availablity* of bank loans decreased significantly (see Figure 13). This improvement resulted mainly from the improvements in the

[17]The European Commission and the European Central Bank decided in 2008 to collaborate on a survey on the access to finance of SMEs in the European Union, and they established The Survey on the Access to Finance of Small and Medium-sized Enterprises (SAFE). SAFE ECB waves are run every 6 months, covering the Euro area countries. The SAFE Commission waves are published every 2 years, covering all EU countries and other countries participating in the Entrepreneurship and Innovation Programme of the CIP.

[18]"Net percentage" means the difference between the percentage of firms reporting an increase (or an improvement) for a given factor and that reporting a decrease (or deterioration).

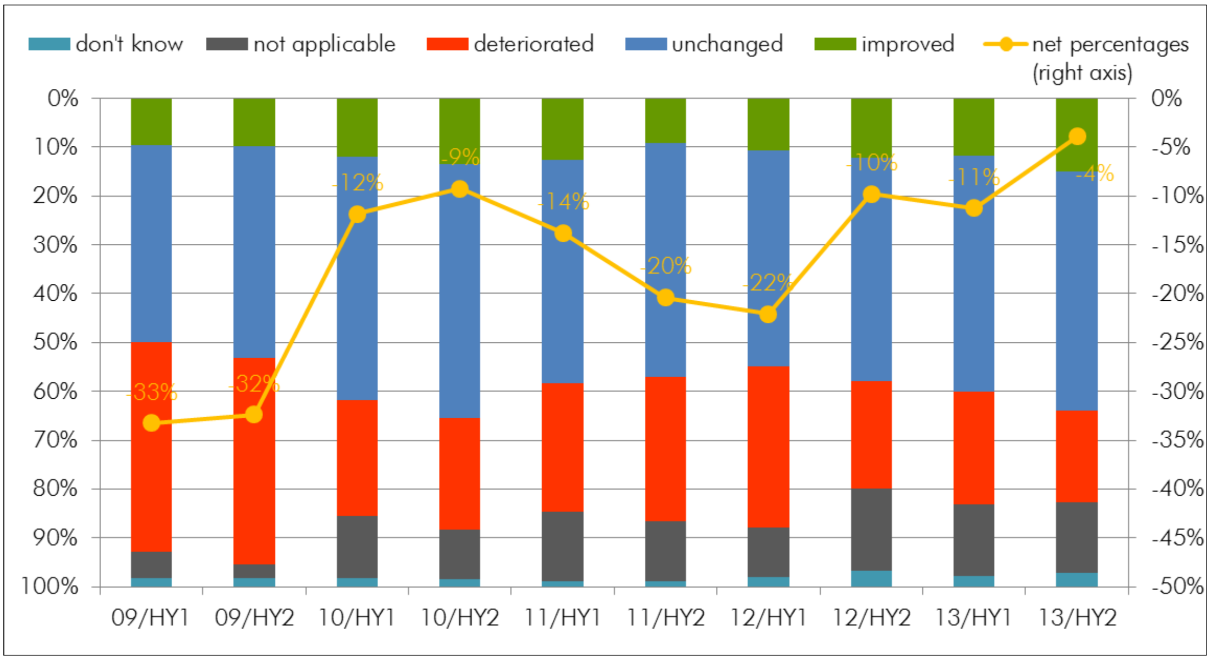
availability of bank loans in the largest euro area countries, predominantly in Germany and Spain (ECB, 2014c).

Figure 12: Sources of external financing of euro area SMEs
(over the preceding six months; percentage of respondent SMEs that used the different financing sources)



Source: EIF, based on ECB (2014b), Statistical Data Warehouse

Figure 13: Change in the availability of bank loans for euro area SMEs
(over the preceding 6 months; % of respondents)



Source: EIF, based on ECB (2014b), Statistical Data Warehouse

According to the responses of surveyed SMEs, the main factor which negatively impacted the availability of external financing remained the general economic outlook. However, on balance, a less negative impact was observed compared to the previous period (-12% compared with -24%).

The net percentage of SMEs reporting an increase in interest rates has now decreased to a level of 9% (from 19%). The net share of SMEs which observed increases in costs of financing other than interest rates (40% from 42%) and in collateral requirements (27% from 31%), has decreased, albeit at high levels. "Looking at individual euro area countries, the net percentage of SMEs reporting an increase in bank lending rates was highest in Finland (47%) and Italy (43%). In both countries the net percentage was significantly lower than the previous round. The most significant declines in the net percentage compared with the previous survey round were recorded in Greece (23% after 50%) and Spain (31% after 58%), followed by Ireland (35% after 50%), probably reflecting some improvement in the respective banking systems. By contrast, SMEs in Germany (-27%), Belgium (-7%) and France (-3%) reported on balance a decline in bank lending rates." (ECB, 2014c).

When looking at actual applications for external financing, the percentage of SMEs applied for a bank loan from October 2013 to March 2014 has remained broadly unchanged (+25%) compared to the previous survey. The main reason for SMEs not to apply for a bank loan still remains the availability of sufficient internal funds. The success rates of actual loan applications by SMEs remained broadly unchanged compared to the previous survey. 66% of the euro area SMEs reported that they had received the full requested amount. Nevertheless, SMEs continued to report a higher rejection rate than large firms (11% versus 2%).

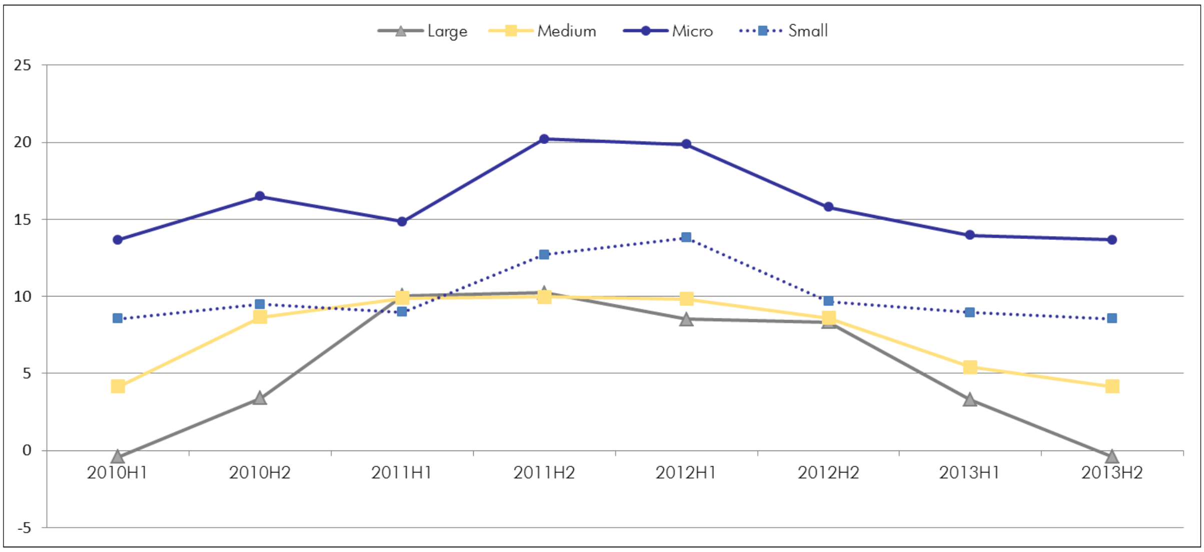
Looking ahead, and on balance, the euro area SMEs expect a slight improvement in access to bank loans and bank overdrafts during April and September 2014. In addition, SMEs expect a somewhat stronger increase in internal funds. These developments were mainly driven by Germany and Spain, where access to finance, including internal funds, has been improving since the last survey period. Despite some improvements in net expectations in other large euro area countries, SMEs in France showed a deterioration in the availability of bank loans during this period (-18%, after-11%).

There are also disparities in the perception of financing gaps across different enterprise size-classes. The results shown in Figure 14 below have been calculated on the SAFE data (demand-side data) and a new composite indicator on perceived changes in the needs and availability of external financing of firms[19]. The ECB's Bank Lending Survey (BLS) data allows comparison to the gap from the supply side, albeit only for bank loans. 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 credit standards. From July 2010

[19] 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.

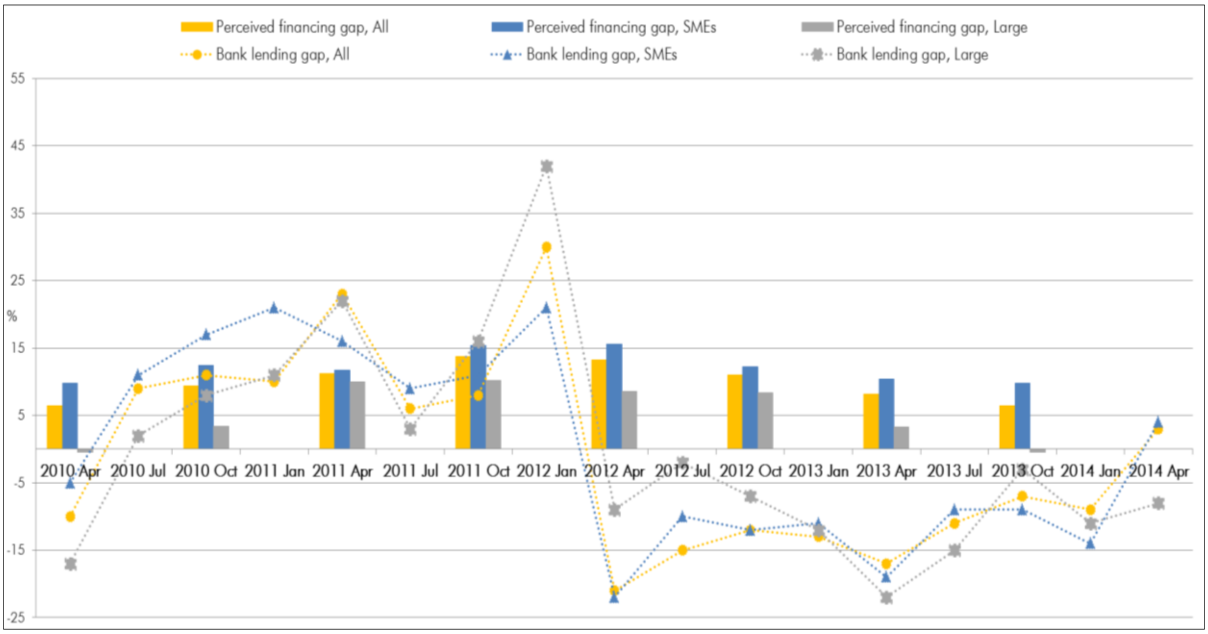
until January 2012, the perceived gaps in bank loans reported by the firms were in line with the gaps reported by the banks in the BLS (see Figure 15).

Figure 14: Perceived change in the external financing gap (by firm size)



Source: EIF, based on ECB (2014c), Statistical Data Warehouse

Figure 15: Perceived change in the external financing gap, reported by borrowers and lenders[20]



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: EIF, based on SAFE, BLS and own calculations

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

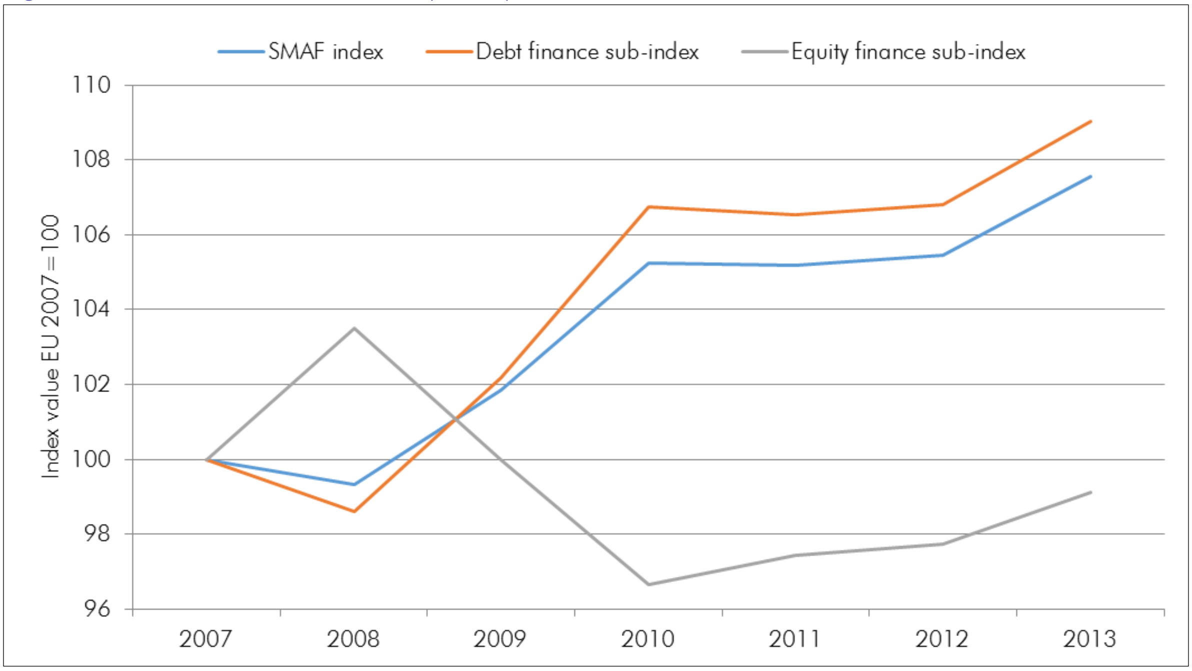
Since April 2012, a mismatch in perceptions has been observed: on balance, SMEs perceive a positive gap, while banks perceive no gap. In the second half of 2013, the net increase in financing gap perceived by SMEs was 9.7%, while the net increase in financing gap perceived by banks was (-9%). For large firms, the net increases in financing gaps were negative perceived by both sides, SMEs (-0.4%) and banks (-3%). These numbers indicate that SMEs experience a bigger mismatch in gap perceptions with banks than large firms.

Another useful instrument to track the conditions for SMEs' access to financial resources is the European Commission's SME Access to Finance (SMAF) index.[21] The SMAF index provides an indication of the change in the conditions of SMEs' access to finance over time for the EU and its Member States.

Based on preliminary figures for 2013, the aggregated SMAF index for the EU (see figure 16) has increased since 2008. The key factor for this improvement is the debt finance sub-index, which itself has increased due to the fall in interest rates for loans and overdrafts since 2009 for many EU countries. At the same time, the performance of the equity finance sub-index is still weighing on the overall SMAF index.

However, it has to be borne in mind that the aggregate view hides significant inter-country differences. France, Austria and Finland recorded the highest SMAF index values (above 120 for all three countries), whereas, Greece, Cyprus and Romania scored the lowest values (index values of 78, 82 and 85, respectively).

Figure 16: SME Access to Finance (SMAF) Index and its sub-indices for the EU



Source: European Commission (2014d). Based on preliminary data.

[21]The SMAF index is a weighted mean of two sub-indices: The access to debt finance index (85%) and the access to equity finance index (15%). High values in the overall Index and its sub-indices indicate better performance of the access to finance indicators relative to the EU level in 2007.

In general, as shown by the analyses above, the slowly recovering macro-economic situation in Europe, combined with the continuing balance sheet evolution of many banks, limits the volume of new lending (see as well Moody's, 2014b).[22] This leads to the even increasing need for guarantee and securitisation solutions to incentivise bank lending – as discussed in chapter 5. Moreover, alternative financing solutions to complement the lending and to diversify the sources of funding are playing an important role, in particular private equity – as described in chapter (4).

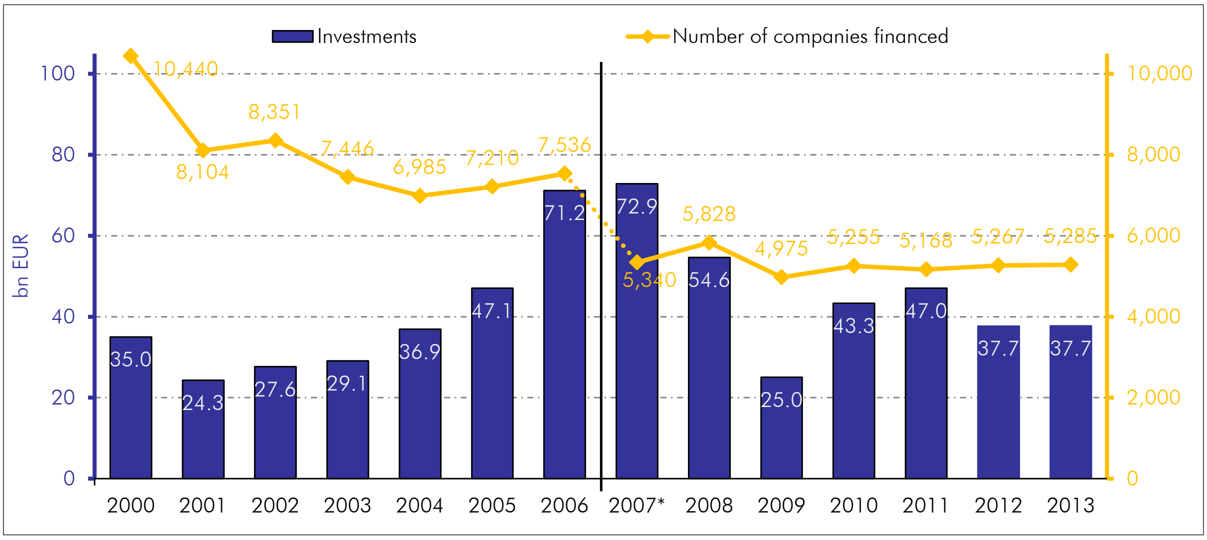
[22]It is worth mentioning that, for an economic recovery, the availability of sufficient external financing is very important, but it is only *one* element, as a significant portion of SME financing is based on internal sources (cash flow, reserves). However, according to Pelly and Kraemer-Eis (2011), "[t]he level and availability of internal funding [...] depends not only on the firm itself, but also on the business environment. Hence, policies aiming to boost growth must look beyond pure financial support to the entire business-enabling framework, including well-functioning labour, product and financial markets".

4 European private equity market

4.1 Investment activity

Following the big crash of European private equity (PE) investment in 2008/2009, PE had partially rebounded in the years 2010 and 2011. However, the recovery then suffered a setback in 2012, but stayed well above the 2009 crisis low (see Figure 17). In 2013, PE investment stabilised at EUR 37.72bn[23] (+0.1% compared to EUR 37.69bn in the year before), according to EVCA[24] figures. The number of companies which benefited from PE investment in 2013 also remained nearly unchanged (+0.3%) at a level of almost 5,300.

Figure 17: Investment activity by private equity firms located in Europe[25]



Source: EIF, based on data from EVCA
**Note: EVCA had changed the data provider with effect from 2007 on. Since then, EVCA PE activity statistics are based on data from PEREP Analytics.*

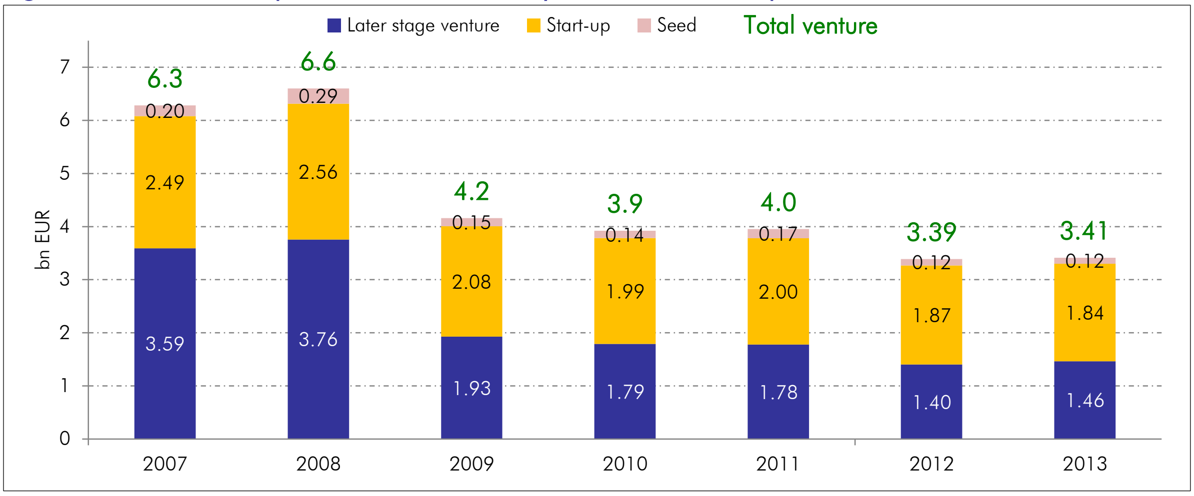
In terms of amounts invested, positive growth was mainly recorded in the buyout (+3.0%) and the venture (+0.8%) market segments, while the growth capital (–10.8%) and the replacement capital (–38.3%) segments strongly decreased. In the buyout sector, which forms by far the largest part of the market, investment activity amounted to EUR 29.6bn in 2013 (please note that the market segment Business Angels is not included in PE or VC statistics. As business angel financing is important for the financing of SMEs and innovation, we present more information in Box 1).

Within the venture capital market segment, only later stage investments picked up (+4.4% to EUR 1.5bn), while investments with a start-up (–1.7% to EUR 1.8bn) or seed (–3.6% to EUR 116m) stage focus continued to decrease.

[23]The EVCA figures mentioned in this chapter show investment activity by PE firms located in Europe ("industry approach" or "office approach").
[24]We would like to thank our colleagues from the EVCA research team for their support.
[25]All investment figures are equity value, i.e. excluding leverage.

These developments were at least partially driven by the general economic stabilisation, from which private equity – and in particular the buyout sector being the biggest segment of the market – has benefited.

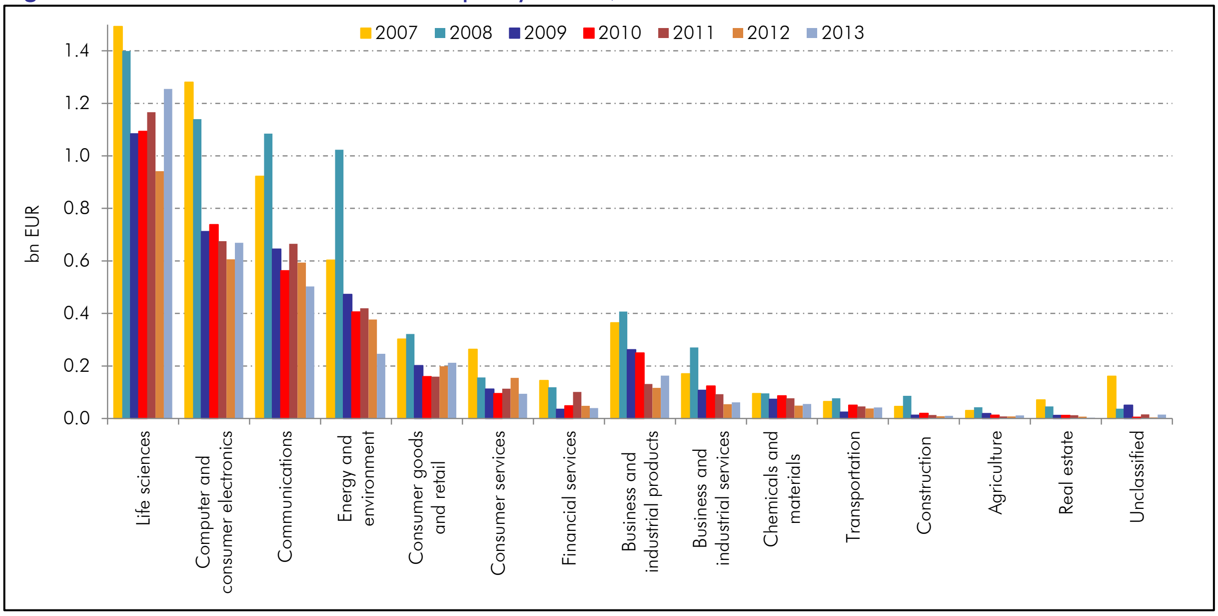
Figure 18: Venture Capital investment activity evolution in Europe



Source: EIF, based on data from EVCA

Recent developments in venture investment by sector are shown in Figure 19. The relative importance of sectors shows certain stability over time: life sciences, computer/consumer electronics, and communications remain the most relevant industries for venture investment. The *share* of life science in total VC investment activity has even increased from 25% in 2007 to 37% in 2013. This is broadly in line with the results of a recent Coller Capital (2014) survey among investors in PE and VC funds (the so-called Limited Partners or LPs), which was conducted in February and March 2014, according to which "LPs are currently looking most favourably on the IT sector – although European LPs show a significantly higher preference for biotech than other investors".

Figure 19: Venture investment in Europe by sector, 2007-2013[26]



Source: EIF, based on data from EVCA

Box 1: Business Angel activity

Business Angels represent an important class of private equity investors, primarily consisting of high-net-worth individuals. They tend to invest their own money, either individually or in formal or informal syndicates, in businesses which are not publicly traded.[27]

Business Angels 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, compared to the VC-backed ones. Moreover, the holding periods of Business Angel investments are typically shorter than the corresponding periods in Venture Capital funds (Kraemer-Eis and Schillo, 2011). The past three years have seen an increase in Business Angel investments in early-stage high-growth companies, as VC funds have migrated to less risky later-stage investments (Kraemer-Eis, Lang and Gvetadze, 2013a). Business Angels offer a number of advantages compared to VC funds:

- Lower transaction costs allow them to invest on a lower scale,
- Business Angels are geographically more dispersed, and often invest in local markets,
- They are very 'hands-on' investors.

There are difficulties in measuring the size of the business angel community, the main ones being identification and definition. Business Angels typically prefer to 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.

[26] This diagram and the related text are based on market approach (i.e. by country of portfolio company).
[27] For a general description of Business Angel financing we refer Kraemer-Eis and Schillo (2011) and to OECD (2011).

Box 1 continued:

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, 2014b). Such difficulties must be borne in mind when describing the market.

For the visible market segment, data is collected by angel associations from angel groups and networks. EBAN[28] (2014b), for example, reported an average increase in the number of Business Angel networks of 17% over the past 10 years to 468 in Europe in 2013, with estimated investments by the approximately 28k BAN members of EUR 554m. Most of the BA activity within the EU is concentrated on the UK, Spain, France, Germany, Finland and Sweden.

According to EBAN (2014b), the average amount invested per company decreased over the past three years to EUR 166k in 2013. This is well in line with the results of other studies on the size of funding (e.g. CSES (2012)), which estimated that Business Angels provided on average around EUR 100k to 200k per deal. Individual angel investments are varying significantly, and EBAN (2014b) reported a slight increase in the average investment per BA to EUR 20.4k in 2013.[29]

As explained, the invisible part of the market is dominant – therefore, data availability for general statements is limited. However, it can be assumed that during the crisis Business Angels behavior did not move in the same direction like bank lending or venture capital supply. Mason and Harrison (2013), e.g., show 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 on-going government support.

4.2 Fundraising activity

Total PE fundraising substantially improved in 2013. EVCA figures report a 118% increase (compared to the year before) in funds raised by private equity firms located in Europe to EUR 53.6bn (see Figure 20).[30] This is very positive news, in particular when taking into account the fall-back that PE fundraising had experienced in 2012.

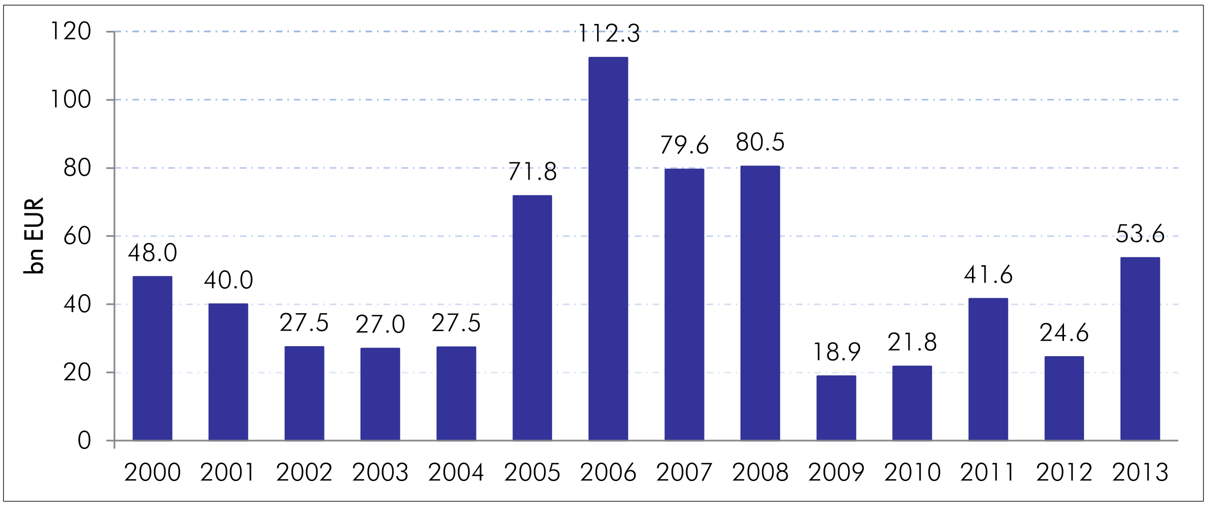
The recent improvements in PE fundraising were mainly driven by the buyout sector (+169% to EUR 44.9bn), which by far forms the largest part of the market. In addition, fundraising increased considerably in the growth capital (+124% to EUR 1.2bn) and generalist (+50% to EUR 2.0bn) segments of the market, while EVCA figures so far show another weak year for the mezzanine segment (–31% to EUR 1.5bn).

[28] The European Trade Association for Business Angels, Seed Funds, and other Early Stage Market Players.

[29] However, according to EBAN (2014b), the business figures "are not representative of the entire European market", because they cover only a certain part of the visible market. See also EBAN (2014a) for more information on EBAN statistics.

[30] Figures show fundraising activity (incremental amounts raised during the year) by private equity firms located in Europe ("industry approach" or "office approach").

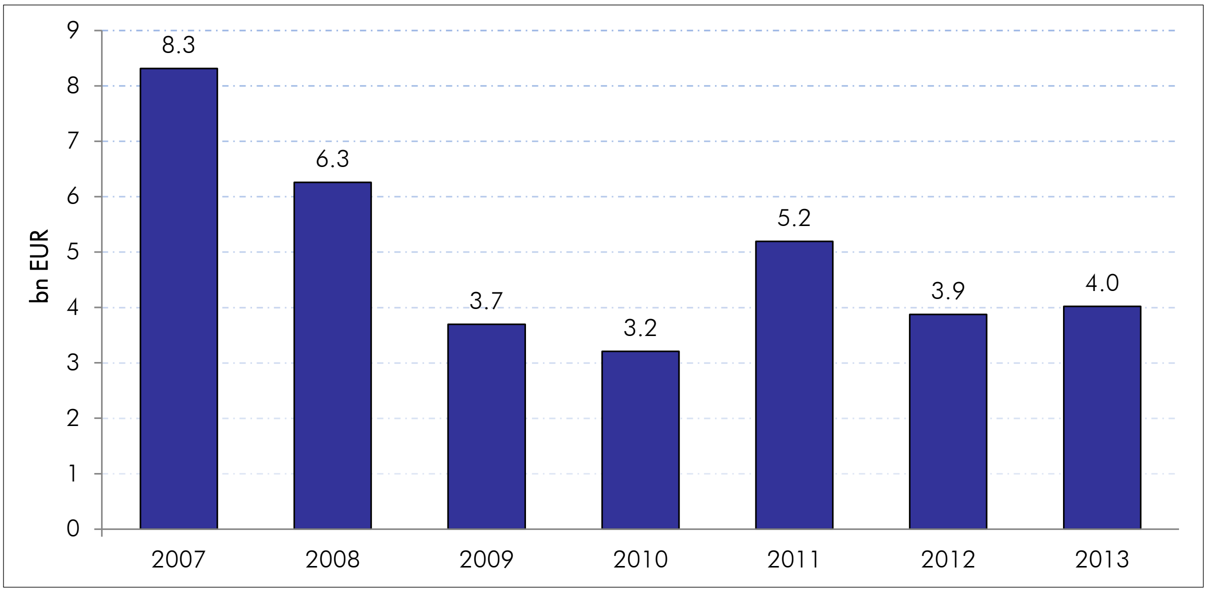
Figure 20: Funds raised by private equity firms located in Europe
(incremental amounts raised during year)



Source: Based on data from EVCA

For European VC fundraising, EVCA figures report an increase by 4% in 2013 (compared to the year before) to EUR 4.0bn (see Figure 21), with a particularly positive contribution coming from funds with a "balanced" stage focus (+41% to EUR 2.1bn). Funds with a later stage focus raised a total amount of EUR 237m (+7%), while the early stage segment recorded a drop by 21% to EUR 1.7bn. Total venture fundraising does, however, still not substantially exceed the levels of the crisis years 2009, 2010 and 2012. This confirms, one more time, that "Europe's venture capitalists face a funding shortage" (EVCA, 2013).

Figure 21: Funds raised by VC firms located in Europe
(incremental amounts raised during year)

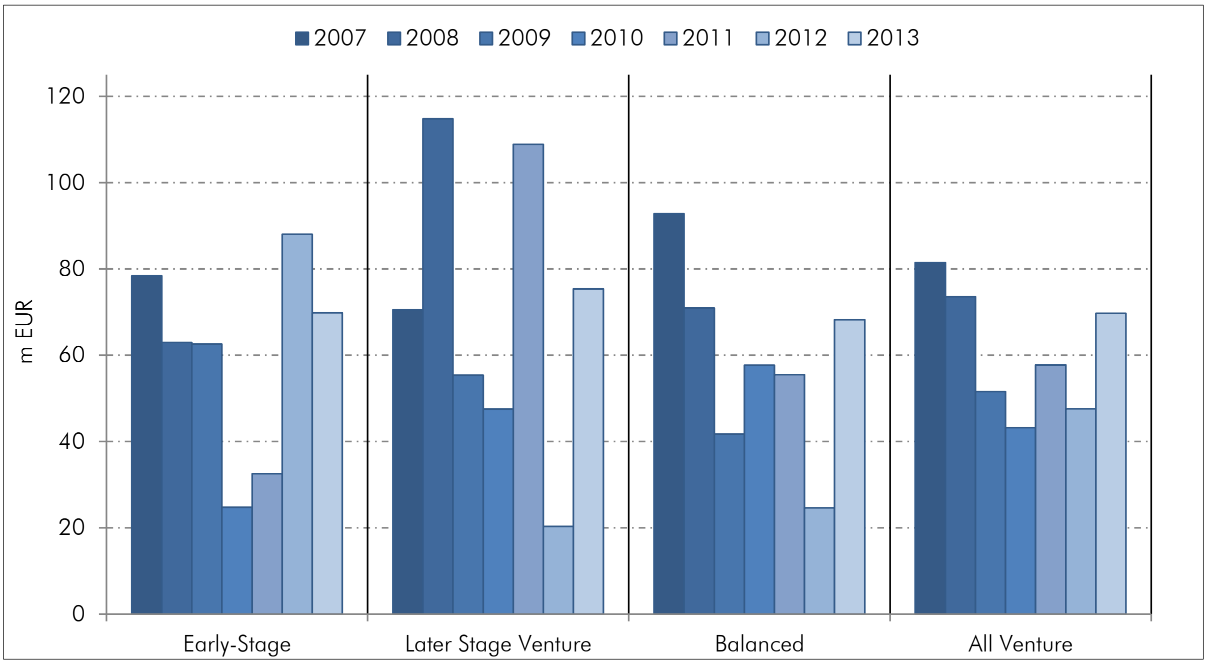


Source: Based on data from EVCA

Some positive signs come from the latest available developments in fund sizes. EVCA figures indicate that the average VC fund size has increased to EUR 70m (see Figure 22), based on 39 final fund closings reported in the EVCA statistics for 2013. 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 indicate positive news.

Figure 22: Average VC fund size

(based on final closings, cumulative amounts raised since inception)

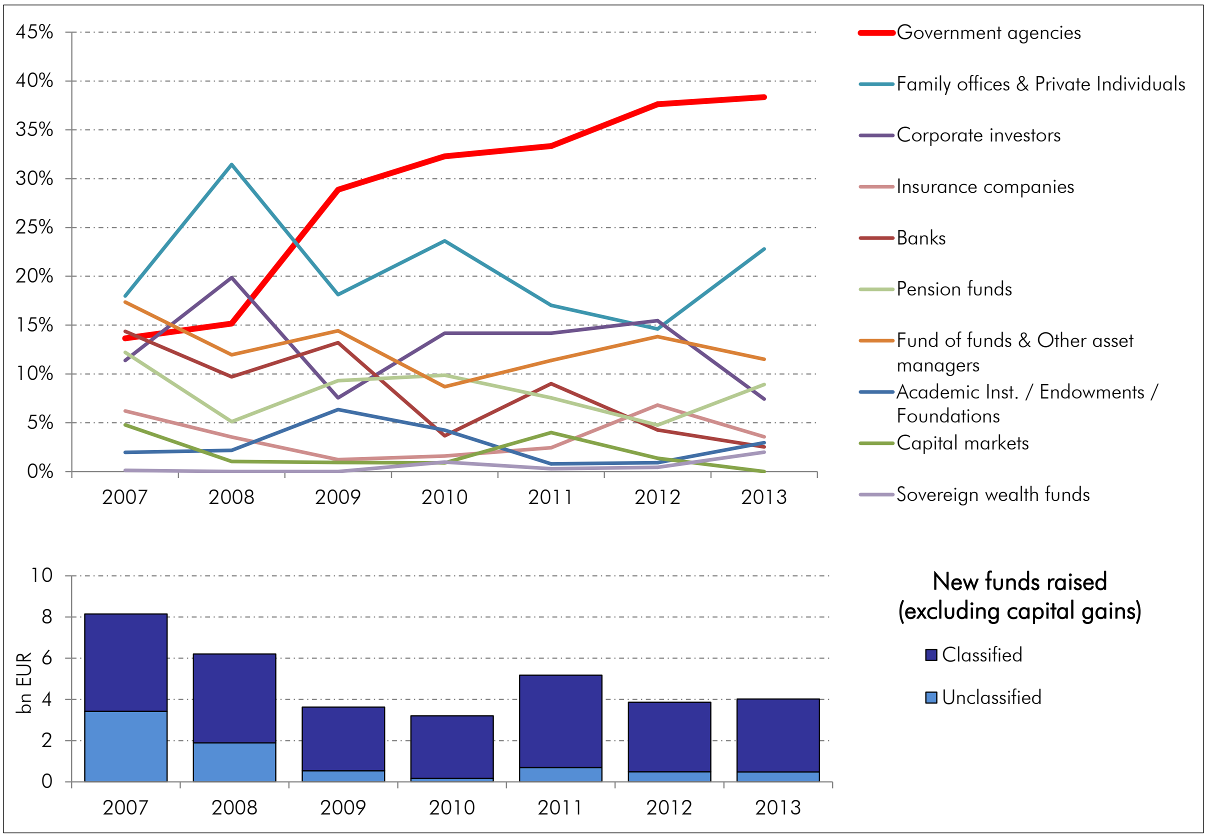


Source: Based on data from EVCA

However, EIF internal analysis and other findings suggest that large funds indeed perform better, but are managed by teams that previously had smaller funds that performed well. Thus, the size would be a consequence rather than a cause. The larger fund size would be a sign of more careful due diligence by LPs in current market conditions, backing only fund management teams with sufficient track record and structure, but not willing to back new relatively risky proposals. Indeed, as we had argued in our previous ESBFO (see Kraemer-Eis, Lang and Gvetadze, 2013b), fund managers' track records have become increasingly important, and according to Preqin (2013), "many LPs are choosing to invest in funds raised by more established managers". In addition, many VCs have at least partially turned to investments in companies with substantial revenues, i.e. to the growth equity market segment. These structural challenges in the European VC market and the risk-averse market sentiment create particular problems in access to funding for new fund management teams.

A sign of investors' still cautious sentiment for venture capital is the shift in the investor base, which has been going on during the past years (see Figure 23). According to EVCA figures, government agencies accounted for 38% of total investors into venture capital funds in 2013. However, even if the importance of government agencies is unsatisfyingly high for the long term, it is noteworthy that government agencies, rather than "killing the continent's start-ups with kindness" (The Economist, 2014), continue to play their role and support the market in a counter-cyclical way, in particular in the current times of an economic and financial crisis when total VC fundraising levels came down from EUR 8.3bn in 2007 to EUR 4bn in 2013. This led almost "naturally" to an increased share of government agency fund investors. Moreover, the number of VC funds "on the road" has approximately halved during the crisis.

Figure 23: Investor base: Share of government agencies in VC fundraising[31]



Source: Based on data from EVCA

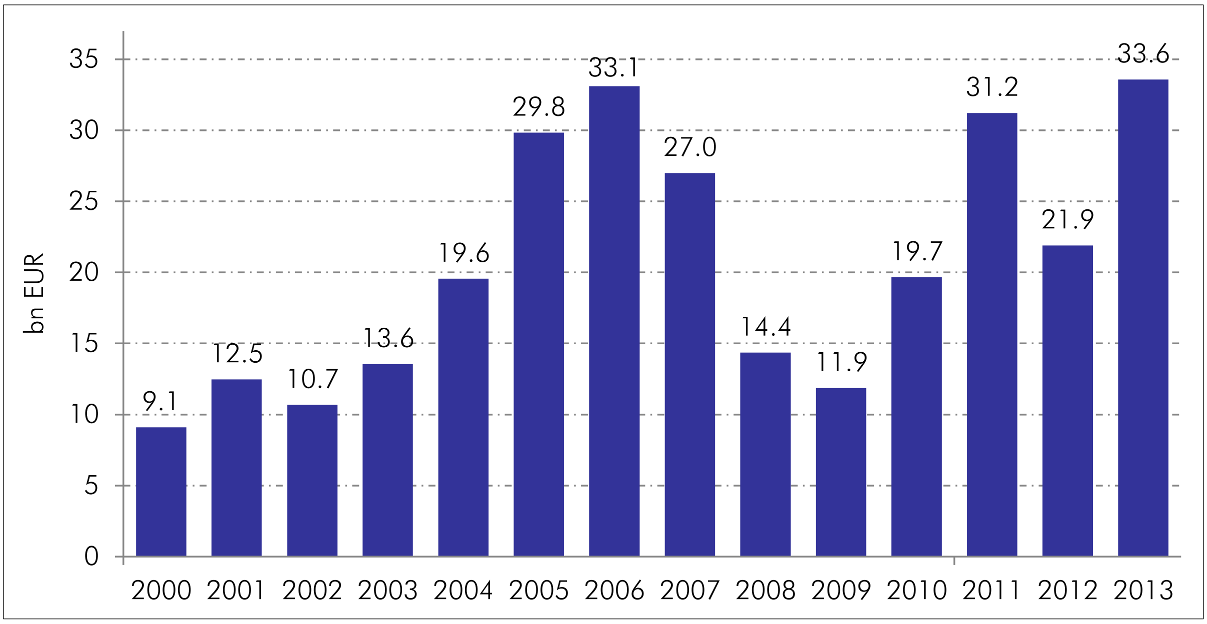
In order to put EIF's activity in context, one needs to take into account that EIF investment represented 15% of all VC fund investments in Europe last year. Assuming that the average stake in each fund ranges between 25 and 30% implies that EIF has invested in more than two-thirds of all VC funds launched in 2013. Not even 30% of VC funds in which EIF invested since 2011 managed to close with their full target size until today, and nearly 60% of the EIF-backed funds would not have had a first closing at a viable fund size without EIF's support. This clearly indicates EIF's catalytic role, rather than a crowding out effect, in times of an on-going severe crisis for European VC. However, even though EIF strives to stimulate market activity by its investments, it would not invest into funds which are not majority-financed by private investors.

4.3 Divestment activity

PE divestment activity improved substantially and recorded the highest levels ever, according to EVCA figures. Total divestments by PE firms located in Europe amounted to EUR 33.6bn in 2013, which was 53% above the value reached during the year before (see Figure 24). That rise was mainly due to increased activity in the buyout (+54% to EUR 28.2bn) segment of the market, but also divestments in the VC segment increased (+22% to EUR 2.4bn).

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

Figure 24: Divestments (by amount at cost divested) by private equity firms located in Europe

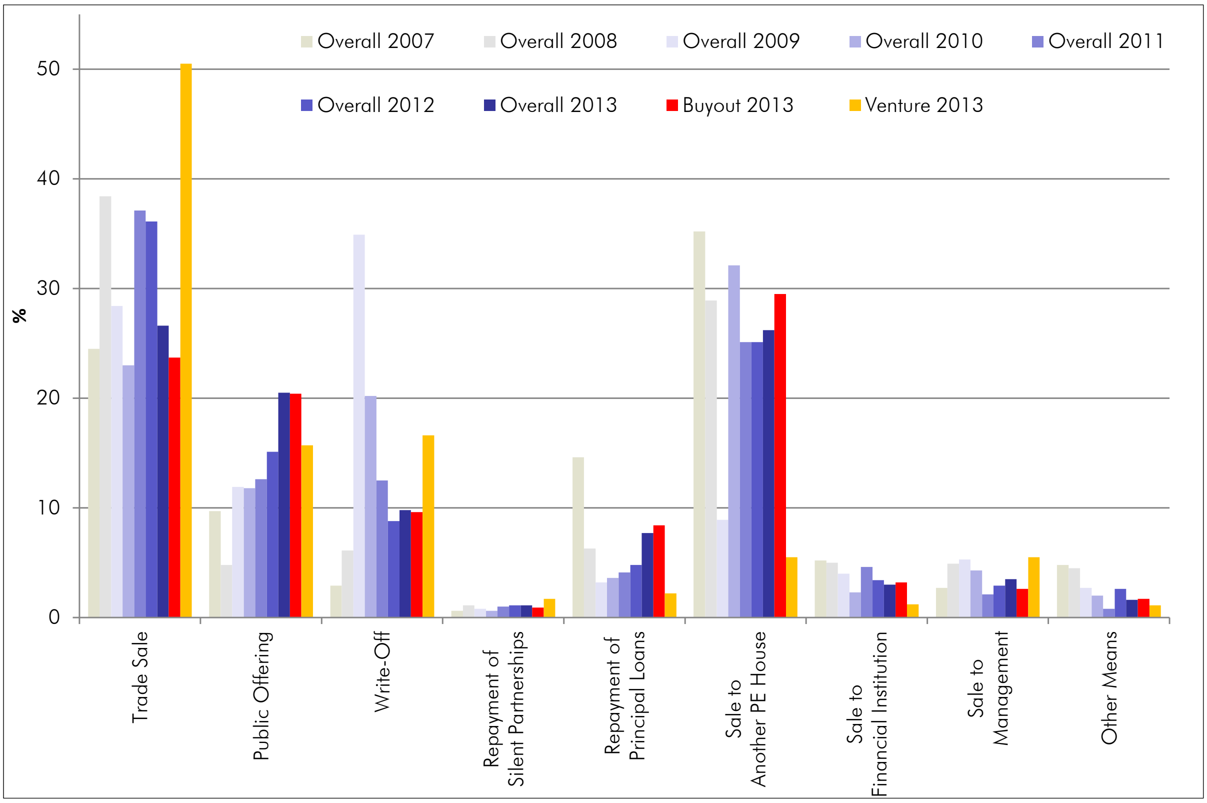


Source: Based on data from EVCA

Following a continuous decrease since 2010, the relative importance of write-offs as a form of divestment has slightly grown again in 2013 (see Figure 25). However, trade sales (although its share in total divestments has considerably decreased in 2013) and sales to another PE house are still the most popular form of divestment. Together, they account for more than 50% of the total exit value. The share of public offerings in total divestments increased to 20% in 2013. While write-offs made up only 10% of all buyout stage divestment amounts, they accounted for 17% in the venture part of the market. This means, however, already good news for venture capital, as last year's write-offs in the venture segment of the market had recorded their largest share (26%) in divestment amounts since the beginning of EVCA's VC records in 2007.

Another sign of a potentially slow movement towards "normalisation" in the VC exit market could be taken from the increase in the relative importance of public offerings (to a share of 16% in total divestments) in 2013. This followed the significant decrease of 2012, when public offerings had reached their lowest relative importance since the start of EVCA's VC records. The recent increase is mainly due to higher sales of quoted equity, but also the total value of initial public offerings (IPOs) has considerably grown.

Figure 25: Divestment routes (shares)[32]



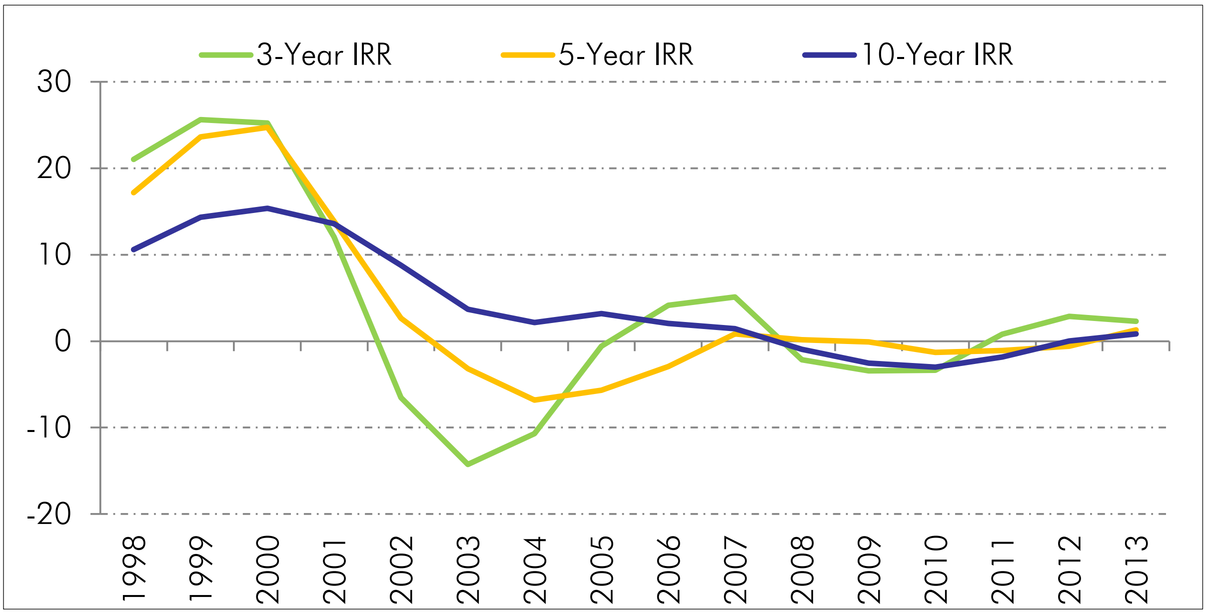
Source: Based on data from EVCA

4.4 Performance trends

According to the recent Thomson Reuters data, European venture capital performance has stabilised, albeit at a low level. Following three increases in a row, the 3-year rolling-horizon Internal Rate of Return (IRR) recorded only a small setback in 2013, and amounted to 2.3%. This is still good news, in particular when taking into account the long period of negative returns during the years 2008 to 2010. The longer term performance figures also convey a slightly optimistic message (see Figure 26). For the first time since 2008, the rolling-horizon IRRs for the 5-year (1.3%) and the 10-year (0.8%) periods are reported to be in the positive territory at the same time.

[32] Shares based on amounts at cost divested. "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.

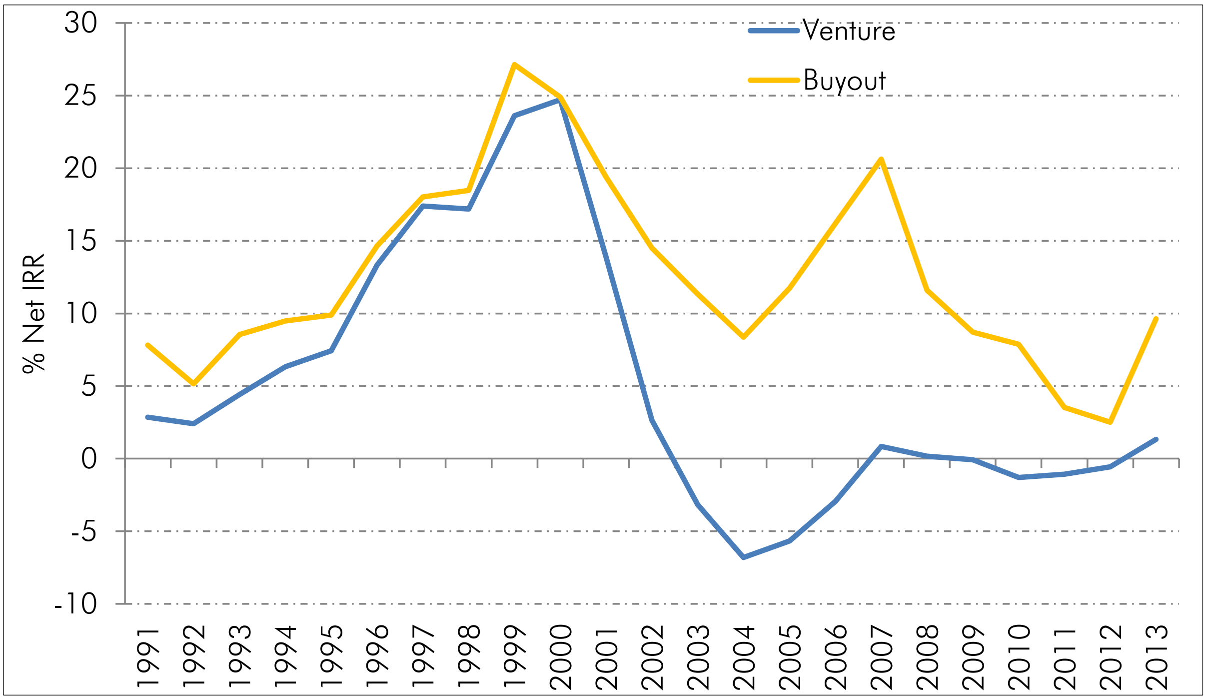
Figure 26: Rolling Horizon IRR European Venture Capital (in %)



Source: Based on Thomson Reuters data

VC performance in Europe, however, is still below the level of returns reported for the private equity industry as a whole, which also includes the buyout and the mezzanine segments of the market. For the 5-year rolling-horizon IRR, Figure 27 shows that the relatively good performance of the buyout sector compared to venture capital in Europe holds also true when looking at the past, in particular since 2001. However, the IRR figures for the buyout and the venture sectors had converged until 2012, before the performance picked up stronger in the buyout sector than for VC in 2013.

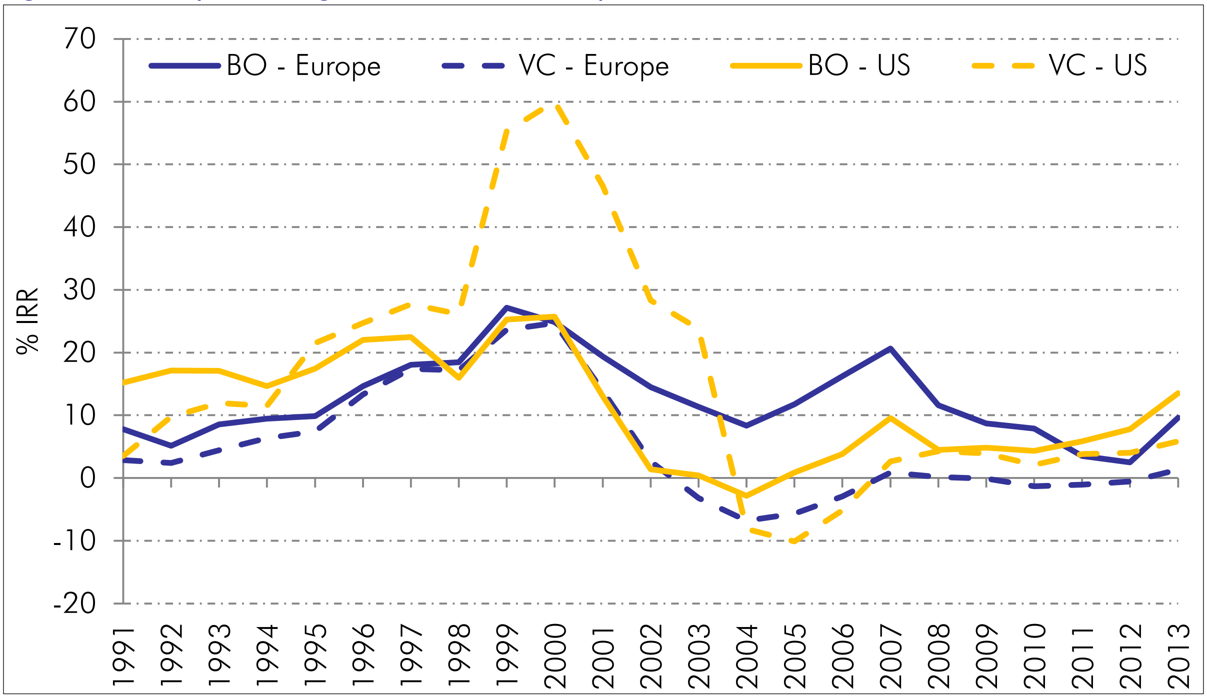
Figure 27: Five-year rolling-horizon net IRRs for European venture and buyout funds



Source: Based on Thomson Reuters data

From a geographical point of view, the European picture looks relatively brighter for the buyout sector than for venture capital. Figure 28 shows that buyout performance (measured as a rolling five-year-horizon IRR) in Europe was better than in the US between 1998 and 2010 (with the year 2000 being the only exception). However, the US buyout sector has been picking up over the last three years and, consequently, outperformed the European buyout market. The European *venture* sector performed worse than its American benchmark in almost all years. Only during 2004 and 2006, when US VC performance entered negative territory, did its European counterpart perform slightly better.

Figure 28: Five-year rolling-horizon IRRs for Europe and the US



Source: Based on Thomson Reuters data

4.5 Prospects

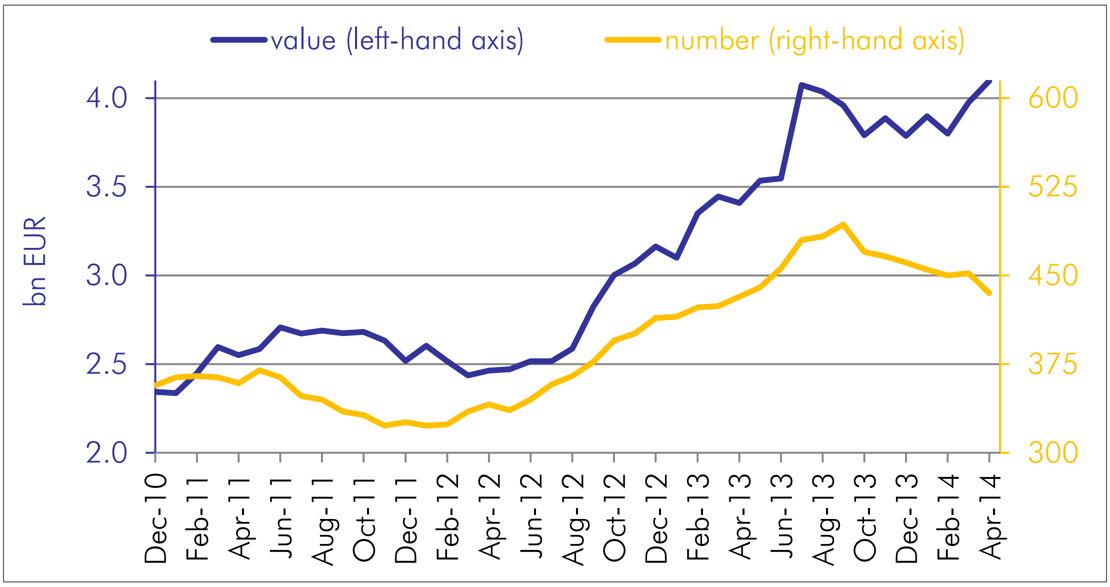
The positive developments in European PE and VC activity and performance figures for 2013 were recently confirmed by confident outlooks reported in surveys among fund investors. According to Preqin (2014b), the proportion of investors that find European investment opportunities attractive, has considerably increased in the last years. In particular, the share of North-America-based Limited Partners (LPs) that consider Europe as an attractive region for investment grew from 27% in December 2012 to 60% in December 2013. According to the same recent global survey among PE fund investors,[33] investors are returning from emerging markets (including Central and Eastern Europe) to more established markets in North America and Western Europe (Preqin,

[33]The "Preqin Investor Outlook: Alternative Assets, H1 2014 […] examines the investment plans and views of more than 430 investors in alternative assets, compiled from a series of interviews carried out by Preqin's analysts in December 2013. […] Interviews were conducted with investors based across the globe, with a range of investor types represented" (Preqin 2014a).

2014a). A recent Coller Capital (2014) survey[34] found that, while in particular "North American LPs […] are not yet convinced about Southern Europe", the majority of PE investors "see good opportunities in Northern Europe in the next three years". According to Go4Venture Advisers (2013a), the "renewed interest in European venture" has been "partly driven by the search for growth in the context of a moribund macro environment [and] low interest rates".

Hence, not surprisingly, Go4Venture Advisers' early indicator, the European Tech Headline Transactions Index[35], had recorded, on average, strong increases from summer 2012 to summer 2013. However, since that period, a general trend in the European Growth and VC markets shows a slowing rate of growth (Go4Venture Advisers, 2013d). This is reflected in the Tech Headline Investment Transactions Index, which has shown (on a 12-month rolling-horizon basis) a sideward movement in terms of value and a drop in terms of number of deals (see Figure 29).

Figure 29: European Tech Headline Investment Transactions (12-month rolling horizon)[36]



Source: EIF calculations based on Go4Venture Advisers data.

[34]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 summer edition of the Global PE Barometer captured the views of 115 PE investors from round the world, surveyed in February-March 2014. According to Coller Capital (2014), the "findings are globally representative of the LP population by: investor location, type of investing organisation, total assets under management, length of experience of PE investing".

[35]Go4Venture Advisers' 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 Go4Venture Advisers' (2013b), Go4Venture Advisers' (2013c) and Go4Venture Advisers' (2014b).

[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.

Indeed, the current economic situation and various regulatory changes continue to make the general market environment very challenging. According to the Preqin (2014a) survey, regulation, performance and the economic environment were still perceived as the biggest challenges that investors were currently facing. All these challenges continue to create access to funding problems, in particular for new funds, in the European VC market. Moreover, 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 especially needed for this market segment in order to strengthen, inter alia, the early-stage part of the market. We had outlined recent OECD findings on policy measures taken by governments to support seed and early-stage financing in the previous issues of the ESBFO (see Kraemer-Eis, Lang and Gvetadze, 2013a and 2013b).

The exit markets already seem to show signs of an overheating (Go4Venture Advisers, 2014a) and subsequent valuation corrections have taken place, "including recent IPOs" (Go4Venture Advisers, 2014b). According to Chassany et al. (2014) "Europe's strongest flotation market in seven years showed signs of fatigue", as "institutional investors have become more selective after a wave of disappointing listings [...] trading below their debut prices. [...] The shift in sentiment follows a similar turning point in the US, where investors are more discerning about companies planning to go public after a rout in share prices for biotechnology, social media and cloud computing companies. [...] Bankers said the window for listings was not shutting down completely, but investors were focusing on the largest and the fastest-growing of the IPO hopefuls and turning away from small to medium sized companies."

With regard to *performance*, the medium term perspective remains subdued. Despite the recent signs for a slight improvement in European economic growth, the risks related to the financial environment remain high and continue to weigh on the performance of private equity in all of its segments. However, the outcome of the crisis-related fund selection process in the market might not have been negative only (in terms of fewer investors), but might also have resulted in a more efficient investor base. Indeed, the lack of experience in the young European VC industry, relative to its US counterpart, has been a key source of its relatively weak performance envelope. Europe has developed its venture sector later than the US, and Europe has less repeat (or "serial") entrepreneurs. These differences have already become smaller, and this process can be expected to continue. Moreover, US investors have been an important part of some recent success stories in fundraising in Europe. According to Go4Venture Advisers (2013e), "it's rather ironic that US LPs seem to have more belief in European venture than European LPs themselves. In many ways this is a vote of confidence in a pan-European approach to venture investing."

Moreover, recent EIF market insight shows an increasing number of companies (names like Shazam, Skyscanner, Supercell, and Wonga amongst many others) in the early-stage segment that show ever increasing revenues with many now achieving profitability, positioning them well for sustained organic growth and ultimate strong returns for investors. It is, of course, important to support these companies in their continued growth, and 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 consequence, the medium-term perspective of the European VC market would be more positive than the backward-looking statistics reveal.[37]

To summarise, it remains to be seen if the green shoots observed last year could really develop into a longer-term positive trend. As a reference catalytic investor in European venture and growth capital funds, EIF is actively working to let the green shoots flourish: 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 (see Box 2 for more information concerning "mezzanine").

Box 2: Mezzanine finance

OECD (2014) writes about mezzanine finance that "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." However, mezzanine finance is a diverse asset class in between traditional senior debt and equity instruments. It can take any form from junior loan, without any equity component, to convertible debt, or debt with equity warrants. Most of the mezzanine volumes are used to finance acquisition by Private Equity funds of mid-to-large caps, in transactions denominated "sponsor-led" or "equity sponsored" by reference to the PE fund acting as equity sponsor. Similar instruments can also be used to finance organic growth (included add-ons and working capital) in transactions denominated "sponsor-less", for which neither the capital markets (too small amounts) nor the banks (not sufficiently capitalised companies or regulations) are able to provide a suitable solution. This type of hybrid debt equity instruments is also welcome for companies owned by shareholders not ready to accept the dilution of a private equity investment. However, despite its importance an injector of liquidity into the economy, this type of financing is often viewed as expensive debt, and so has been given limited attention and marketing.

The recent financial crisis revealed that "sponsor-less" mezzanine was not sufficiently developed in Europe. Consequently, in 2009, EIF began supporting this market under its Growth Capital initiative. EIF started investing in "sponsor-less" mezzanine funds through a new mandate, the Mezzanine Facility for Growth (MFG), which is a EUR 1bn fund-of-funds program from the EIB. With a view to playing a catalytic role in the creation of new market players, the MFG is supposed to meet the underlying market demand. It provides financing to support the growth plans of entrepreneurs who try to keep control of their companies, or of the shareholders of companies that need reorganisation of their capital structures. This hybrid mandate also includes a technology window under which venture debt can be provided to companies at the breakeven point, which, however, have still no access to standard bank funding. EIF is usually involved well ahead of most of the other potential investors in the set-up of funds, making significant participation before or at the first closing.

[37] For example, EIF currently sees a positive trend in VC/Growth stage performances, and the vintage years 2007 and beyond currently show encouraging interim results.

Box 2 continued:

In 2013, a total of EUR 110m was committed in mezzanine funds, catalysing EUR 300m of capital and EIF continued to play a catalytic role in this field, committing capital to new hybrid debt / equity and credit-oriented funds, enabling new market players to become established, increasing the visibility of the asset class to (new) investors and providing alternative sources of finance to SMEs and small mid-caps as well as to late stage technology companies. For the first time, EIF supported managers of hybrid and credit-oriented funds in Greece, Ireland and Portugal. During 2013, the mezzanine mandate granted by EIB has been doubled (EUR 2bn), converted into evergreen, and merged within the other EIB mandates. These additional resources expand EIF's capacity to support mezzanine funds in the EU.

Under the same umbrella, EIF established the "Mezzanine Dachfonds für Deutschland" (MDD) in 2012, a mezzanine fund-of funds program for Germany. MDD is a EUR 200m fund-of-funds funded by the BMWi (German Federal Ministry of Economics and Technology), LfA Förderbank (the development bank of Bavaria), and NRW.BANK (the development bank of North Rhine-Westphalia). For each MDD investment in a hybrid debt/equity fund active in Germany under MDD, EIF is co-investing an amount that is at least equivalent to MDD's.

On the back of the successful results, EIF's intention is to roll out the MDD model to other countries where private debt as an asset class for SMEs is set to develop.

This also includes the launch and extension of new and pilot initiatives. They include for example the European Angels Fund (EAF): EAF is a co-investment fund to provide equity to Business Angels. It was launched in March 2012 in Germany; after two years of operation, the EUR 70m fund has been largely committed and is about to be increased to EUR 135m. The EAF has been extended to Spain (EAF Spain – Fondo Isabel la Catolica) and Austria (EAF Austria – aws Business Angel Fonds) in 2013. Further roll-out to other countries is foreseen.[38] In the field of Business Angels and in addition to EAF, complementary approaches, also in cooperation with BA networks, are under discussion. Moreover, EIF is active in the field of Technology Transfer in order to support the commercialization of research know-how – see Box 3 for further information.

Box 3: Technology transfer activity[39]

Technology transfer (TT) encourages 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 result of the TT market evolution towards increased professionalisation, there was a strong underlying deal flow in the leading academic seed and licensing operators segment throughout the year 2013 and on-going TT investment funding is projected to continue to grow at a sustained rate. A new appetite for TT and acceleration funding in emerging markets also became apparent in 2013. In this context, EIF was very active in terms of investments achieving EUR 110.7m in nine transactions and backing top-tier teams

[38]More information on the EAF is available here: http://www.eif.org/what_we_do/equity/eaf/index.htm.

[39] Source: EIF Annual Report 2013.

Box 3 continued

Going forward, discussions are advancing with the European Commission (EC) to set up a Technology Transfer Finance Facility to be deployed alongside the Capacity-Building Technology Transfer scheme. Assuming EC funding can be invested on a subordinated basis, this facility, with its more aggressive risk profile, would open up a new market for EIF and address the needs of a larger number of European TT players particularly in their proof-of-concept phases. The overall amount of this pilot facility is under discussion. Looking ahead to 2014, EIF will continue with its policy of support for leading TT intermediaries while maintaining a risk profile commensurate with risk mitigation requirements. As a result of the EU's smart growth strategy, Member States are also expected to dedicate substantial resources to this area of activity.

Other examples are partnerships with corporate investors, structured as a Corporate Innovation Platform (CoriP)[40], to establish collaboration between fund managers, strategic investors and portfolio companies, as well as another pilot initiative – the Social Impact Accelerator (SIA)[41], the latter has been started to satisfy the growing need of equity finance for support to social enterprises (see as well Box 4). This segment of the business world is becoming increasingly instrumental in promoting social inclusion, providing alternative sources of employment to marginalised social groups, and contributing to growth.

Box 4: Social entrepreneurship and impact investing

There is no universally accepted definition of *social enterprises* or *social entrepreneurship*. Nevertheless, typically, social enterprises are meant to show the following common features: their primary goal is to serve a social interest (social, societal, environmental objectives) instead of profit maximisation, but alongside a financial return, they are often of an innovative nature (through the inputs and output), and they often employ society's most fragile and marginalised members who are typically excluded from the mainstream labour market - socially and financially excluded persons, disabled people, ex-prisoners, minorities.

The growing presence of social enterprises in Europe is a direct response by the private sector to provide certain public services, which are either not currently funded, or can no longer be funded from state or municipality budgets. The growth of the social entrepreneurship market segment also illustrates the current change of paradigm that marks a shift from a subsidy–based approach to sustainable economic models for the resolution of long-term social issues. The increasing gap in public services has triggered an increased number of ''change-makers'' to set up social enterprises that propose innovative ways to tackle current societal challenges. (Source: EIF.)

Investing activity related to social entrepreneurship is traditionally considered as *impact investing*. Impact investing is a profit-seeking investment activity that intentionally generates measurable benefits for society. Impact expectations and objectives are formulated prior to investing and the progress towards achieving these objectives are measured during the term of the investment.

[40]More information on the CoriP is available here: http://www.eif.org/what_we_do/equity/corip/index.htm.
[41]More information on the SIA is available here: http://www.eif.org/what_we_do/equity/sia/index.htm.

Box 4 continued:

True impact investors have no trade-off between financial returns and social impact, as these two elements are positively correlated. A recent survey of impact investors revealed that the majority (71%) of impact investors consider determining impact objectives essential and even more (80%) consider generating financial returns essential. Moreover, more than half targets ''competitive, market rate returns'' from their investment (J.P. Morgan, 2014).

With regard to the financial return prospect of Social Impact Funds, little evidence is publically available at this stage. This lack of information is largely due to the fact that most of the realised track record in Social Impact Investing is linked to the activity of family offices, which typically do not publicly disclose figures in relation to their investment performance. Nevertheless, dedicated research on the impact investing activities of family offices suggests that net returns to investors of 5% to 10% are achievable, depending on the investment's target sectors (Source: EIF).

EIF activities

The European Investment Fund (EIF), with the collaboration of private sector investors, has launched the Social Impact Accelerator (SIA), the first pan-European public-private partnership for social impact investing. SIA is a pilot initiative which addresses the growing need for availability of equity and hybrid finance to support social enterprises, a segment of the business world which is becoming increasingly instrumental in promoting social inclusion, providing alternative sources of employment for marginalised social groups and contributing to growth.

Beyond simple financial return targets, these social impact funds seek to trigger positive societal change as a result of their impact conscious investment activity. In addition to enhancing the availability of finance for social enterprises, SIA aims to build up the existing market infrastructure for social impact investing in such a way that this emerging asset class is placed on a path to long-term sustainability.

Under SIA, EIF has to date committed EUR 10m to Munich-based Social Venture Fund II (SVF II). SVF II is an investment fund operating along the lines of traditional private equity and venture capital funds but, next to the objective of achieving an adequate financial return for investors, targets tangible and measurable social and/or environmental impact objectives at the level of its portfolio investments. The commitment into SVF II is the first of many commitments EIF aims to make in this new area of activity. (Source: EIF.)

To pursue its equity activities, EIF invests its own funds as well as resources managed on behalf of mandators. These are deployed through various programmes including the EIB Risk Capital Resources (RCR) mandate and the EC CIP GIF programme. The EIB RCR mandate will be continued. The new EIB Group Risk Enhancement Mandate (EREM) will extend the offer of funding instruments to the actors in the social economy, notably social sector intermediaries such as social investment funds that are supporting social enterprises (see Box 5 for more information on EREM).

The EU level support for equity instruments for the programming period 2014 to 2020, given in the past through the CIP programme, is currently under negotiation to be continued and enhanced in the form of the COSME programme. Additional funds will be provided under

"Horizon 2020", which combines research and innovation funding provided by EU programmes. Moreover, private equity instruments can be supported under regional and local mandates (see EIF, 2014.)

5 SME guarantees and SME Securitisation in Europe

5.1 SME guarantees

Information asymmetries can be reduced via three ways: a strong relationship between lender and borrower, 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 or a guarantee). 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.

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 a recent overview of market failures in SME lending and mitigation techniques). The reasons for a market failure relate to insufficient supply of capital (debt or equity), and inadequacies on the demand side. This market failure is mainly based on asymmetric information (in the case of debt: information gap between lender and borrower), combined with uncertainty, which causes agency problems that affect debt providers´ behaviour (see Akerlof, 1970 and Arrow, 1985).[42]

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 "are used widely across economies as important tools to ease financial constraints for SMEs and start-ups" (OECD, 2013), and in order to alleviate market failures in SME financing. Moreover, loan guarantee programs expanded substantially in the years 2007-2011, as a government policy response to the financial crisis. 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". Therefore, loan guarantee programs continue to be "the most widely used policy instrument" (OECD, 2014).

However, data on the provision of guarantees to the benefit of SMEs in Europe is scarce. Some market information is gathered by AECM, the European Association of Mutual Guarantee Societies.[43] These data covers SME guarantees provided by AECM members. In the following we provide information about the countries with at least one AECM member in order to start to show the state and development of this important market segment.

[42] 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.)

[43] We would like to thank our colleagues from AECM for their support. AECM has currently 40 members in 20 EU Member States, Montenegro, Russia, and Turkey. EU countries without an AECM member are Cyprus, Denmark, Finland, Ireland, Malta, Slovakia, Sweden and the UK, even if guarantee activities exist. 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.

Market size

Key figures, based on *outstanding guarantees* on SME loan portfolios in 2013[44], are presented in Table 3. In terms of total amounts of guarantee and counter-guarantee activities, the core countries are Italy (EUR 32.9bn), France (EUR 16.5bn), Germany (EUR 5.8bn), and Spain (EUR 4.7bn). Italy also has the highest total *number* of outstanding guarantees (781,635), followed by: France (596,660), Turkey (283,231), Poland (150,314), Portugal (80,892) and Spain (73,200).

Table 3: Outstanding guarantees and counter-guarantees[45] on SME[46] loan portfolios[47] and resulting average guarantee size in 2013[44] by country

	guarantee and counter-guarantee activity			guarantee activity			counter-guarantee activity		
Country	Volume [k EUR]	Number	Average guarantee size [EUR]	Volume [k EUR]	Number	Average guarantee size [EUR]	Volume [k EUR]	Number	Average guarantee size [EUR]
Austria	373,336	5,759	64,827	373,336	5,759	64,827			
Belgium	737,780	9,643	76,509	712,409	8,002	89,029	25,371	1,641	15,461
Bulgaria	30,028	1,041	28,845	28,944	1,023	28,293	1,084	18	60,222
Czech Rep.	661,039	6,060	109,082	661,039	6,060	109,082			
Croatia	149,356	1,384	107,916	149,356	1,384	107,916			
Estonia	102,300	1,366	74,890	102,300	1,366	74,890			
France	16,548,860	596,660	27,736	15,748,860	587,960	26,786	800,000	8,700	91,954
Germany	5,794,999	48,431	119,655	5,794,999	48,431	119,655			
Greece	585,298	23,374	25,041	585,298	23,374	25,041			
Hungary	1,327,863	42,045	31,582	1,281,953	41,706	30,738	45,910	339	135,428
Italy	32,915,057	781,635	42,111	20,276,000	658,380	30,797	12,639,057	123,255	102,544
Latvia	86,104	386	223,067	86,104	386	223,067			
Lithuania	192,799	3,711	51,953	102,222	2,314	44,175	90,577	1,397	64,837
Luxembourg	1,563	61	25,623	1,563	61	25,623			
Netherlands	2,166,000	19,830	109,228	2,166,000	19,830	109,228			
Poland*	1,540,905	150,314	509	1,540,905	150,314	10,251			
Portugal	3,039,368	80,892	37,573	3,039,368	80,892	37,573			
Romania	1,623,948	36,737	44,205	1,369,233	29,955	45,710	254,715	6,782	37,558
Russia	265,706	1,812	146,637	265,706	1,812	146,637			
Spain	4,704,049	73,200	64,263	4,704,049	73,200	64,263			
Slovenia	194,195	1,841	105,483	193,705	1,781	108,762	490	60	8,167
Turkey	3,911,411	283,231	13,810	3,911,411	283,231	13,810			
Total	*76,951,964*	*2,169,413*	*35,471*	*63,094,760*	*2,027,221*	*31,124*	*13,857,204*	*142,192*	*97,454*

**For Poland, the number of guarantees and the average guarantee size are available for one AECM member only. Most recent figures for all Polish AECM members are from 2011, when the average guarantee size amounted to EUR 6,758.*

Source: AECM (provisional figures)

[44]For data availability reasons, AECM statistics include the business figures of the largest Italian AECM member with a time lag of one year. For the same reason, 2012 figures were used for AECM members from Greece, Luxembourg, and Poland and for one Slovenian member. No 2013 data was included for some smaller Belgian AECM members. These disclaimers apply as well for the diagrams and tables presented throughout this chapter.

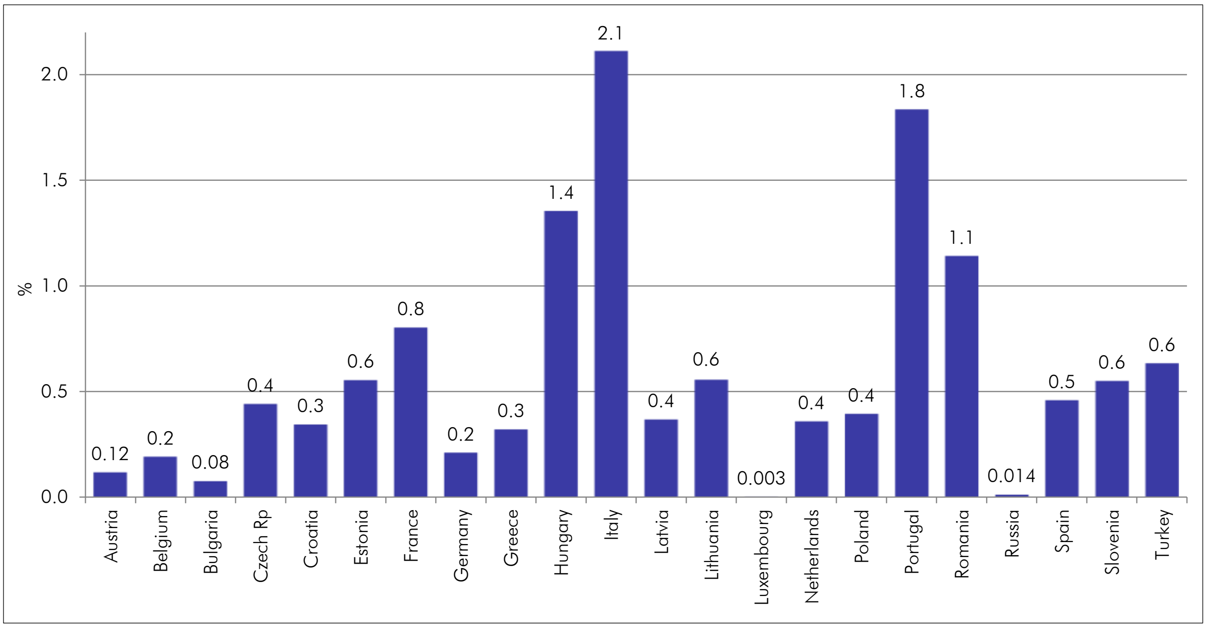
[45]In Romania and Slovenia, some AECM members provide counter-guarantees to other AECM members; in these cases, the summing-up of guarantee and counter-guarantee activities leads to a double-counting of the underlying guaranteed loans. However, for consistency of the data shown in the table, these were not cleaned accordingly.

[46]In the case of France, the counter-guarantee data include co-guarantees. These can also cover non-SME related areas such as regional infrastructure and municipality financing.

[47]In the case of some AECM members, guarantees or counter-guarantees cover *portfolios* of loans or guarantees; however, in most cases, they cover *single* loans/guarantees.

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%), Hungary (1.4%), and Romania (1.1%), as shown in Figure 30.[48] According to the OECD (2013), guarantees are particularly relevant "in those countries where a network of local or sectoral guarantee institutions is well established".

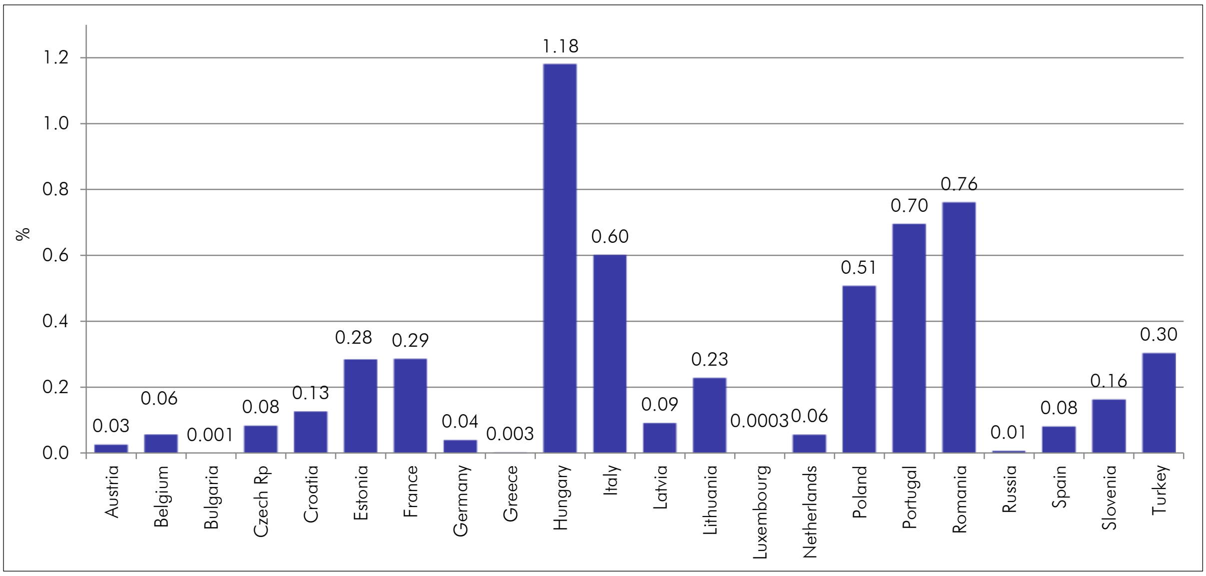
Figure 30: Volumes of outstanding guarantees in portfolio scaled by GDP, 2013 data



Source: AECM (provisional figures).

The guarantee activity in 2013 was strongest (related to GDP) in Hungary, Romania, Portugal, Italy and Poland (see Figure 31).

Figure 31: Volumes of guarantees granted in 2013 scaled by GDP



Source: AECM (provisional figures).

48 Here and in the following, all figures include guarantee, counter- and co-guarantee activities.

Recent activity

Guarantees outstanding

Changes in the volumes of guarantees outstanding

In 2013, according to the preliminary AECM data, the total *volume of outstanding guarantees in portfolio*, decreased by 2.1%, compared to the previous year.[49] Within the EU, the largest decreases were recorded in Bulgaria (–47.7%), the Czech Republic (–22.8%), Spain (–14.9%) and the Netherlands (–11.6%). Only five countries exhibited a positive growth rate, of which the strongest one was recorded for one Polish AECM member (+295.3%), following the launch of a new guarantee product. Other increases were reported for Lithuania (+11.2%), Turkey (+9.3%), France (+3.4%) and Portugal (+2.4%).

At the same time, the *number of outstanding guarantees* reported by AECM increased by 3.8%. Within the EU, by far the largest increase was recorded in France (+31.0%), followed by Portugal (+12.4%) and the Czech Republic (+11.2%). The most substantial decreases were reported for Romania (–38.7%) and Bulgaria (–36.7%). For the Czech Republic, the decrease in the guarantee volume (in EUR) with a parallel increase in the number of outstanding guarantees can to a large extent be explained by the devaluation of the Czech Koruna between end-2012 and end-2013.

The observed decrease in values, with a parallel increase in the number of guarantees, is reflected in the development of the *average guarantee sizes*, for which the AECM statistics show an increase from EUR 34.1k in 2008 to EUR 40.2k in 2011, while the value dropped backed again in 2012 (to EUR 37.4k), i.e. towards the average size reached in prior years. In 2013, the average guarantee size has further decreased to EUR 35.8k, based on the preliminary AECM statistics.

These developments can be explained by an increase of guarantees with smaller amounts, due to smaller underlying loan sizes because of lower investments, as well as of short-term guarantees (i.e. working capital loan guarantees and bridge-financing guarantees, which have in general smaller amounts). Short-term guarantees generally (for the AECM members) cover less than 12 months. Moreover, according to AECM, their members are currently faced with growing requests to increase the guarantee duration of already incurred guarantee commitments, because of SMEs' financing constraints, which lead to requests to reschedule loan repayments. These reschedulings of SME loan repayments and of the related guarantee commitments often imply lower guarantee values.

New guarantees provided

The volume of *new guarantees provided per year* was reported to be at the level of EUR 25.7bn in 2013 (EUR 23.3bn of guarantee activity plus EUR 2.4bn of counter-guarantee activity). For those

[49] Those AECM members, for which 2013 data is not yet available, were not included in the calculation of the growth rate.

AECM members that consistently reported data for 2012 and 2013, the volume of new guarantees (including counter-guarantees) increased by 2.0%.[50]

As for the developments in new guarantee business *by country* (for those countries for which 2012 and 2013 data is available), the strongest value increases of new guarantees granted per year were recorded for the Poland (+914.3%), the Czech Republic (+68.1%), Lithuania (+34.9%), Portugal (+33.0%), Slovenia (+13.9%) and Austria (+6.8%). Due to their relatively large business size, the increases in France (+2.7%) and Germany (+2.4%) also contributed strongly to the overall growth in the European guarantee business. The strongest decreases were observed in Bulgaria (–97.9%), the Netherlands (–29.2%), Turkey (–24.0%), Romania (–18.2%) and Spain (–13.4%). The large drop in activity that was recorded for Bulgaria is due to the termination of one major guarantee product (a newly developed product was started only this year). In addition, setbacks in demand and cuts in the budgets allocated to purely public guarantee schemes led to decreases in guarantee activity in some countries.

In terms of *number*, 681,347 new guarantees were issued in the course of 2013. For those AECM members that consistently reported data for 2012 and 2013, the number of new guarantees issued increased by 20.9% compared to the previous year. This seemed to reflect a bottoming out of the negative trend after strong falls in the number of new guarantees in 2010 and 2011.

The total number of *new SME[51] beneficiaries* in portfolio stood at 154.7k in 2013, for the subsample of the AECM members that provided this information.

Drivers of recent developments in guarantee business

The developments in SMEs guarantee transactions are, on the one hand, caused by special items in particular countries, while on the other, they seem to mirror the specific macro- and micro-economic situation in the different economies. Those countries that suffer relatively strongly from the current sovereign debt crisis and experience weak economic growth – or even a fall in economic activity – also show poor developments in guarantee transactions. This seems to be driven by both demand *and* supply side factors. In times of the weak economic output growth, SMEs business, investments, the related need for finance, and, hence, their implied demand for guarantees – are all low. At the same time, tightening restrictions on public budgets and high financial risk perceptions (ECB, 2013) are weighing quite heavily on guarantee supply. Consequently, public support from the European level could improve the situation, if only on the supply side. In some countries, e.g. Germany, the weak development of guarantees can also be explained by relatively favourable financing conditions, and so lesser need for them, following the strong increases in guarantee demand observed during the crisis years of 2009-10 (VDB, 2012). Hence, in some countries, the downturn in guarantee business mirrors a development towards the levels prevalent before the crisis.

[50] Those AECM members, for which 2013 data is not yet available, were not included in the calculation of the growth rate.

[51] Number of SMEs (in case of rural guarantees including farmers) related to the new amount of guarantees (including counter- and co-guarantees, and including guarantees for agricultural businesses) or new number of SME partners of mutual societies per year.

EIF's role and recent developments

In order to alleviate problems experienced by SMEs in accessing finance, EIF is playing an important counter-cyclical role. Through a wide range of financial intermediaries, such as banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks, and other financial institutions, 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 micro-credits, SME loans or leases.

As part of its mandate activity, EIF has managed the SME Guarantee (SMEG) Facility under the Competitiveness and Innovation Framework Programme (CIP) on behalf of the European Commission (EC) from 2007-2013. Under this facility, losses are covered using specifically allocated EC budgetary resources. Until end-2013, more than 310,000 SMEs were supported under CIP SMEG, and 66 agreements were signed in 22 countries. The loan amount that CIP SMEG has so far generated for SMEs was in the order of EUR 16bn. Moreover, EIF continues to deploy its financial products in order to catalyse EU structural funds. This is done with a view to enabling SME financing in countries less supported by "traditional" EIF products, namely risk-sharing loans and portfolio guarantee instruments under JEREMIE[52]. Under the JEREMIE First Loss Portfolio Guarantee (FLPG), EIF covers part of the credit risk relating to a new portfolio of loans and/or leases granted by a financial intermediary to SMEs. Moreover, EIF further implemented a risk sharing loan product, the Funded Risk Sharing Product (FRSP), whereby EIF provides funding to banks for the financing of new portfolios of SME loans (such loans to be co-financed by the financial institutions), and shares part of the credit risk related to the portfolios.

In addition, in 2011 EIF had launched the Risk-Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps (RSI) Facility. The RSI was an EIF/EIB/European Commission joint pilot guarantee scheme that aimed at improving access to debt finance for innovative SMEs and small mid-caps (enterprises with fewer than 500 employees) in support of research, development and innovation projects. RSI complemented the scope of the Risk Sharing Finance Facility (RSFF), which has been managed by the EIB and has mainly addressed large corporates and mid-caps. Under RSI, EIF issued guarantees and counter-guarantees to selected financial intermediaries in order to allow them to provide loans, financial leases and loan guarantees. The instrument proved that it could meet current market needs and was speedily introduced to financial intermediaries with absorption and deployment to SMEs following swiftly. As of April 2014, 34 operations with 29 different intermediaries in 15 countries had been signed, totalling EUR 1.44bn, which enables SME financing of up to EUR 2.9bn.

[52] JEREMIE stands for Joint European Resources for Micro to Medium Sized Enterprises. The initiative, developed in cooperation with the European Commission, offers EU Member States, through their national or regional Managing Authorities, the opportunity to use part of their EU Structural Funds to finance SMEs by means of equity, loans or guarantees, through a revolving Holding Fund acting as an umbrella fund. A JEREMIE Holding Fund can provide to selected financial intermediaries SME-focused financial instruments, including guarantees, co-guarantees and counter-guarantees, equity guarantees, (micro) loans, export-credit insurance, securitisation, venture capital, Business Angel Matching Funds and investments in Technology Transfer funds. For more information please see: http://www.eif.org/what_we_do/jeremie/index.htm

Looking forward, EIF has been entrusted with a dedicated EIB Group Risk Enhancement Mandate (EREM, see box 5), which will encourage further SME lending in the EU. EREM is a facility of up to EUR 6bn (EUR 4bn from EIB supplemented by EUR 2bn) that will back additional guarantees to be issued by EIF over the next seven years. With regard to the EU programmes, and looking towards the new programming period 2014-2020, the EU guarantee instruments are going to be continued and enhanced. Based on the experience gained with the previous programmes, EIF is actively negotiating the management of new EU resources that will provide easier access to lending for SMEs under the recently adopted Multiannual Financial Framework for 2014-2020 through initiatives including a Loan Guarantee Facility under the Competitiveness of Enterprises and SMEs (COSME) programme, the "InnovFin – EU Finance for Innovators" Facility (the RSI successor under the Horizon 2020 Programme), the Cultural and Creative Sectors Facility (under the Creative Europe Programme), and via continued support through the instruments available under European Structural and Investment Funds. It is the objective to increase coherence and consistency of the instruments. While EREM are more to be seen as a special measure to fight the crisis, the EU level instruments are mainly meant to mitigate the structural weaknesses in SME lending.

Another instrument to alleviate the impact of the crisis on SME lending is being discussed: the *EU SME Initiative*. Its objective is to achieve an increase in the volume of lending to SMEs. The concept of this initiative derives from the experiences of the existing programmes. Its overall aim is to combine the resources available from the EU (COSME and Horizon 2020), the EIB Group (EIB and EIF), third parties and the Member States to achieve rapid and significant impact.

For this and further information on EIF's activities, see EIF (2014).

5.2 SME Securitisation (SMESec)

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. That is why securitisation, or similar techniques, such as e.g. SME-covered bonds, are important to access the capital markets and allow mitigating the inherent illiquidity of SME portfolios.

SMEs' problems in accessing finance in many European countries have been described above. A well-functioning securitisation market could be a way to easing supply problems by helping banks diversify their funding and achieve capital relief. However, SME securitisation placed with investors currently represents only a very small portion of the total placed Asset Backed Securities (ABS) issuance. Goldman Sachs (Goldman Sachs, 2014) estimates that around 10% of total SME issuance was placed in the primary market in 2013. The bulk of SME ABS is further retained for ECB refinancing purposes.

The important role of securitisation in financing, and in particular SME Securitisation (SMESec)[53], has been publicly voiced more and more again for several months now. In a working paper on SMESec (Kraemer-Eis, Passaris, and Tappi, 2013), various statements in favour of SMESec by ECB, EC, IMF, AFME, UEAPME, the European Council, and others have been quoted. Yves Mersch, Member of the Executive Board of the ECB, has memorably said that "… connecting SME financing needs with the funds of bank and non-bank investors via securitisation of SME loans can assist banks' ability to fund and distribute risk. …We have seen that SME ABS can play a key role in bridging the gap between deleveraging banks and investors seeking to diversify their portfolio." (Mersch, 2014). Moreover, the ECB and the Bank of England have issued a joint letter, confirming that the two institutions are convinced about the need to revive the securitisation market in Europe (ECB and BoE, 2014a). In this context, on 29 May 2014, the ECB and the BoE (2014b) started a public consultation via a discussion paper to examine the potential benefits of securitisation, presenting possible policy options that the authorities could consider in response to various impediments that may currently be preventing the emergence of a robust securitisation market, and asking for feedback from interested parties.

5.2.1 Market activity[54]

The European securitisation market had grown steadily from the beginning of the previous decade until the outbreak of the crisis. During the crisis, issuance remained at high levels, but these high volumes were almost exclusively driven by the eligibility of ABS as collateral for ECB liquidity operations. After having peaked in three successive years over 2008-2010, the overall market activity decreased to the levels just before the crisis due to regulatory uncertainties and tighter euro system collateral rules.[55] 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 negative market sentiment. However, despite the crisis, the European securitisation market in general performed relatively well with comparably low default rates.

Nevertheless, SMESec is still suffering from the economic and financial crisis. The near-collapse of the European structured-finance market during the crisis has profoundly affected the status and outlook of SMESec. Unfortunately, the situation has only slightly improved over the recent past. It is still the case that originators mainly retained newly issued deals in order to create liquidity

[53]The term SME Securitisation (SMESec) comprises transactions based on 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 2014a).

[54]If not flagged otherwise, the data source is AFME, the Association for Financial Markets in Europe (i.e. AFME, 2014a, b).

[55]The ECB's asset repurchase or "repo" facility allows (among other assets) Asset Backed Securities to be used as collateral for funding.

buffers, and to use the assets as collateral with central banks for re-financing purposes. At this point in time, we can still not talk about a functioning primary market.[56]

In consequence, the overall securitisation activity was high during the crisis (but again, this mainly reflects retained transactions), with a peak in 2008 (EUR 711bn), and since then a continuous decrease. The *issuance* in Europe went down significantly over the recent years: by (-33%) from EUR 372bn in 2011 to EUR 251bn in 2012, and by (-28%) from 2012 to 2013, with an issuance of only EUR 181bn; the start of 2014 was weak with only EUR 18.5bn ((-43%) compared to the EUR 32.7bn in Q1/2013).

The most active markets 2013 in terms of issuance were the Netherlands (market share in 2013: 21%), UK (19%), Italy (15%) and Germany (13%). The overall reduction in collateral production is dominated by a reduced issuance of the UK Prime Residential Mortgage Backed Securities (RMBS)[57]. The main reason for this development in the UK is the availability of the "Funding for Lending Scheme", FLS (since August 2012) that provides potential UK RMBS originators with cheaper refinancing via the Bank of England. FLS aims at reducing the costs of banks' funding in exchange for commitments to lend more (to mortgagors and companies). The FLS had been originally foreseen to cease operations in January 2014, but the Bank of England and HM Treasury announced its one-year extension on 24 April 2013. The scheme will continue until January 2015, with incentives to boost lending in favor of SMEs.[58]

The retention rates are on a downward trend: For the full year 2012, the retention (see Figure 32) hovered around 66% (2011: 76%), and in 2013 it went further down to 58% - this trend seems to continue.[59] At first sight, the reduced retention rates look encouraging, but this is only true in relative terms, as the overall amounts issued went down (see also Figure 33), and the amounts placed with investors went down by another 10% (2012: EUR 84.4bn; 2013: EUR 76.4bn).[60]

Given the dominance of the securitisation of RMBS, *SMESec* remained a relatively limited but important segment of the European structured finance market (see Figures 33 and 34). The market share of SMESec 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. In 2013, the share of SMESec was 11% (see Figure 34). The SME related issuance in 2013 occurred mainly in Spain (48%), followed by Italy (39%), Portugal (7%) and Germany (7%).

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[56]For information, in July 2013, the ECB relaxed its collateral eligibility rules to reduce haircuts applicable to ABS in order to catalyse recent initiatives by European institutions to improve funding conditions for SMEs.

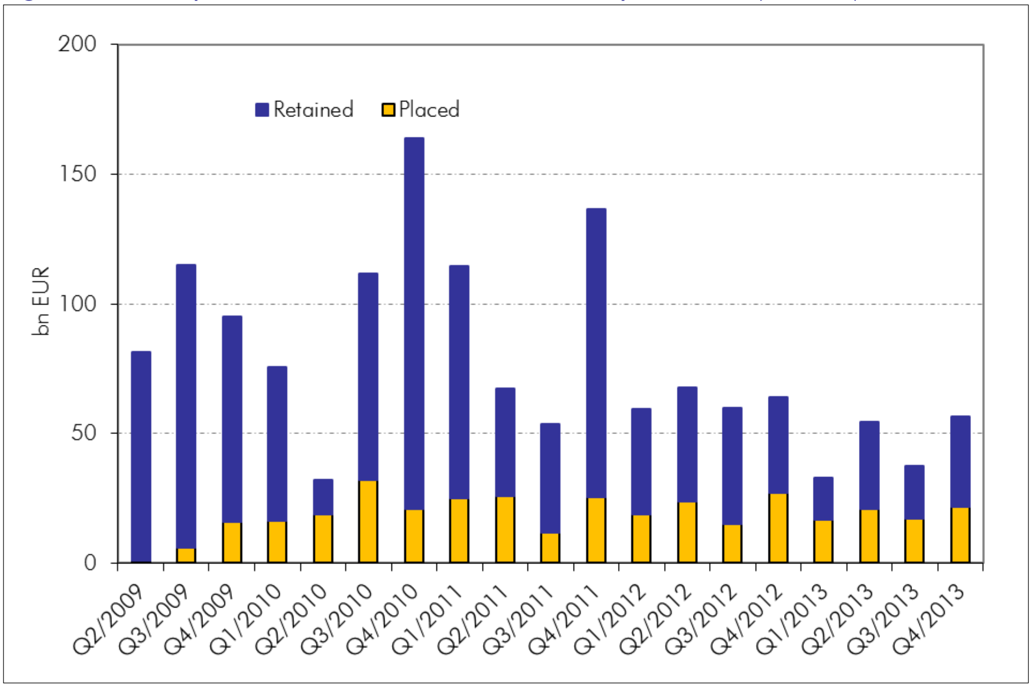
[57]A similar initiative is being rolled out in the Netherlands: the Dutch government's planned initiative to set up a national mortgage institute might further lower the MBS collateral securitization.

[58]Moreover, the Bank of England and HM Treasury announced changes to the terms of the FLS extension on 28 November 2013. The changes focus the FLS on business lending by removing the direct incentives to expand household lending in 2014. The FLS extension will thus provide continued substantial support for lending to businesses in 2014, with a strong focus on lending to SMEs (Bank of England, 2013). These adjustments will most likely (again) lead to an increasing role of UK RMBS in funding UK mortgage lending.

[59]The retention rate in Q1/2014 was only 26%, but – as mentioned above - based on low volumes.

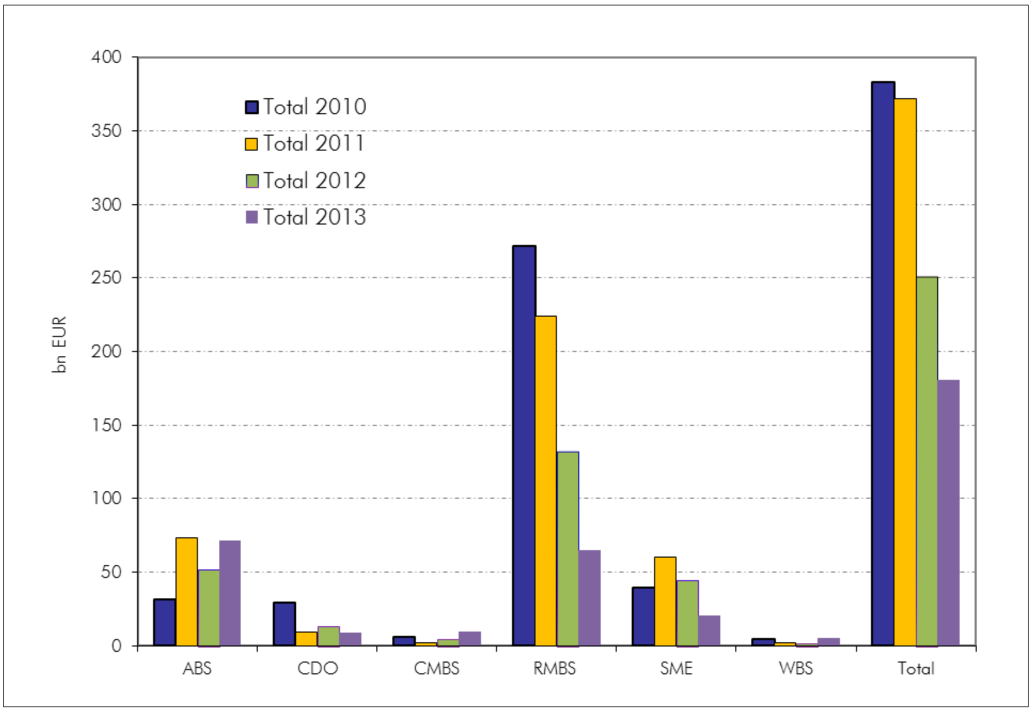
[60]Market participants estimate that currently only 50 to 60 investors are active in European primary markets, compared to three times that before the crisis (Global Capital, 2014).

Figure 32: European total securitisation issuance by retention (bn EUR)



Source: EIF, based on data from AFME

Figure 33: European securitisation issuance by collateral (bn EUR)[61]

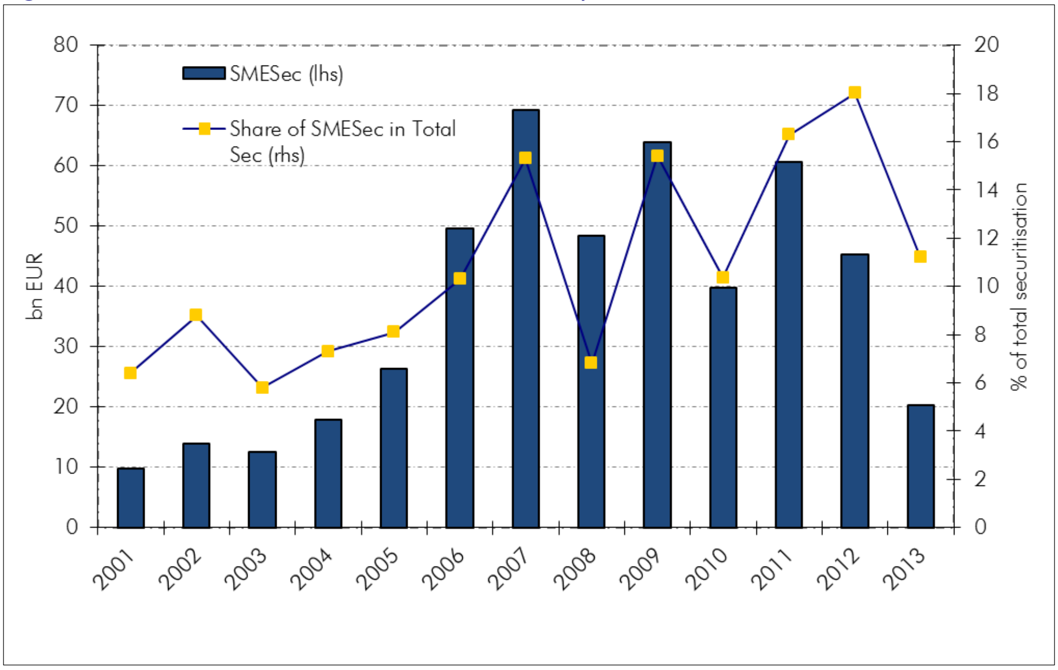


Source: EIF, based on data from AFME

[61]AFME definitions: European ABS issuance includes auto, credit card, leases, loans, receivables and other. European CDO issuance numbers only include issuance denominated in a European currency regardless of the country of collateral. A substantial percentage of CDOs are backed by multi-jurisdictional collateral. Historical CDO issuance totals have been revised due to periodic updates of the sector. WBS: whole business securitisation – a securitisation in which the cash-flows derive from the whole operating revenues generated by an entire business or segmented part of a larger business.

The issued volume of SME deals in 2013 was significantly lower compared to the year before (EUR 20bn compared to EUR 45bn in 2012 (-55%), a level similar to 2004 and 71% below the "peak times" of 2007. Q1/2014 started very weak, with only EUR 1.6bn (transactions in Italy and Portugal) - compared to EUR 9.1bn in Q1/2013. Moreover, as already mentioned, it is important to note that only a very small fraction of the issuance has been placed with investors: the nature of the SMESec market changed from a developing market (pre-crisis, with almost all transactions placed on the primary market) to a purely 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.

Figure 34: SMESec transaction volumes in Europe and share of SMESec in total securitisation

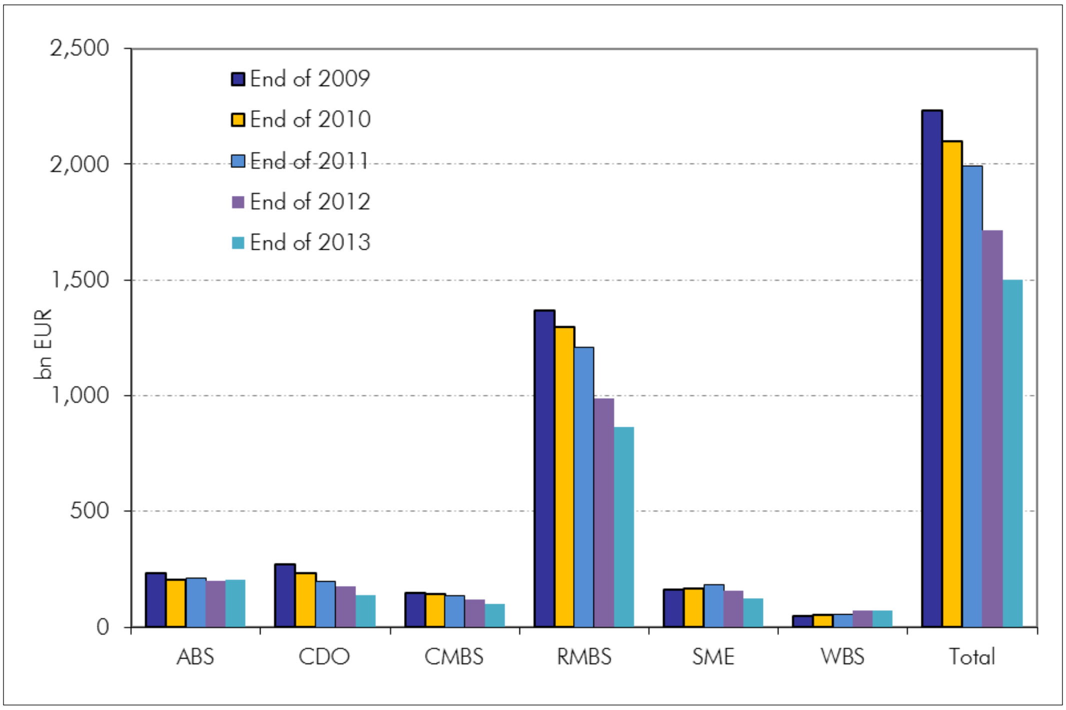


Source: EIF, own calculation, based on data from AFME and KfW

With regard to the *outstanding securitisation transactions*, compared to the end of 2012, the total outstanding decreased by almost 12% from EUR 1,713bn to EUR 1,504bn (end of 2013, see Figure 35); in Q1/2014 the outstanding further reduced to only 1,429bn. The regional distribution of the outstanding (as per end of 2013) remained almost unchanged with respect to the recent past: in terms of volumes, UK ranks first (29% of the EUR 1.504bn), followed by the Netherlands (18%), Spain (12%) and Italy (12%).

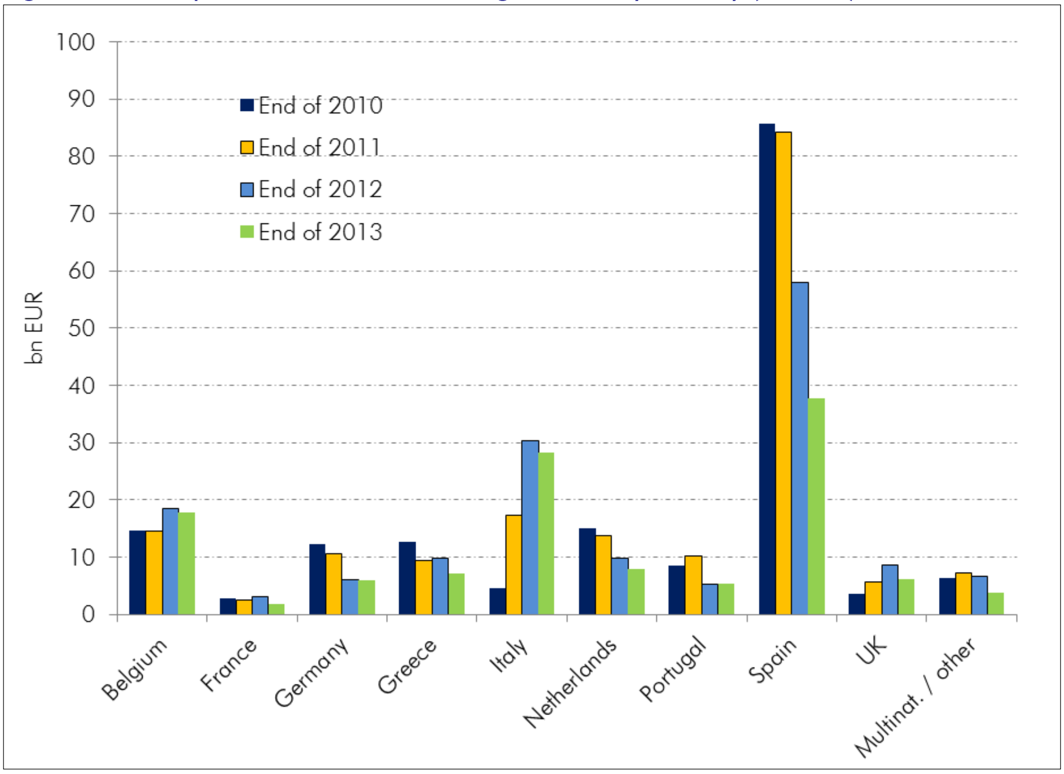
For SMESec, since the end of 2011, the outstanding volumes have decreased by around one third (from EUR 181bn to EUR 159bn (end of 2012), to EUR 122bn (end of 2013)); this trend further continued: the outstanding SME volumes at the end of Q1/2014 decreased to EUR 108bn. If the year-end volumes (EUR 122bn) of outstanding SMESec are broken down by country, the significance of the Spanish market is still visible, although the outstanding volumes have significantly decreased over the past years (see Figure 36).

Figure 35: European outstanding securitisation transactions (by collateral, bn EUR)



Source: EIF, based on data from AFME

Figure 36: European SMESec outstanding volume by country (bn EUR)



Source: EIF, based on data from AFME

5.2.2 SMESec performance trends

Despite the financial and sovereign crisis, the European securitisation market in general has performed relatively well in terms of losses so far. 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 short: the market started only towards the end of the 1990s – at the time, this segment was unknown to investors and rating agencies, and the technique of securitisation was also new to most of the originators. The related uncertainty was one of the reasons for mainly conservative structures in the general SMESec segment, and in particular the vintages originated in 2000 to 2004 had low default rates (Goldman Sachs, 2014).

According to the ECB (Mersch, 2014), depending on the study and starting date, European ABS' default rates range between 0.6 and 1.5% since the start of the financial crisis (compared to 9.3 to 18.4% for the US peers), European SME ABS are far below these levels with defaults in the area of 0.1%. Moreover, the fact that ABS, eligible for the Eurosystem operations, have lower impairment rates than non-eligible ABS "suggests that sensible asset and structural safeguards can go a long way to mitigating the risks of investing in ABSs" (Mersch, 2014).

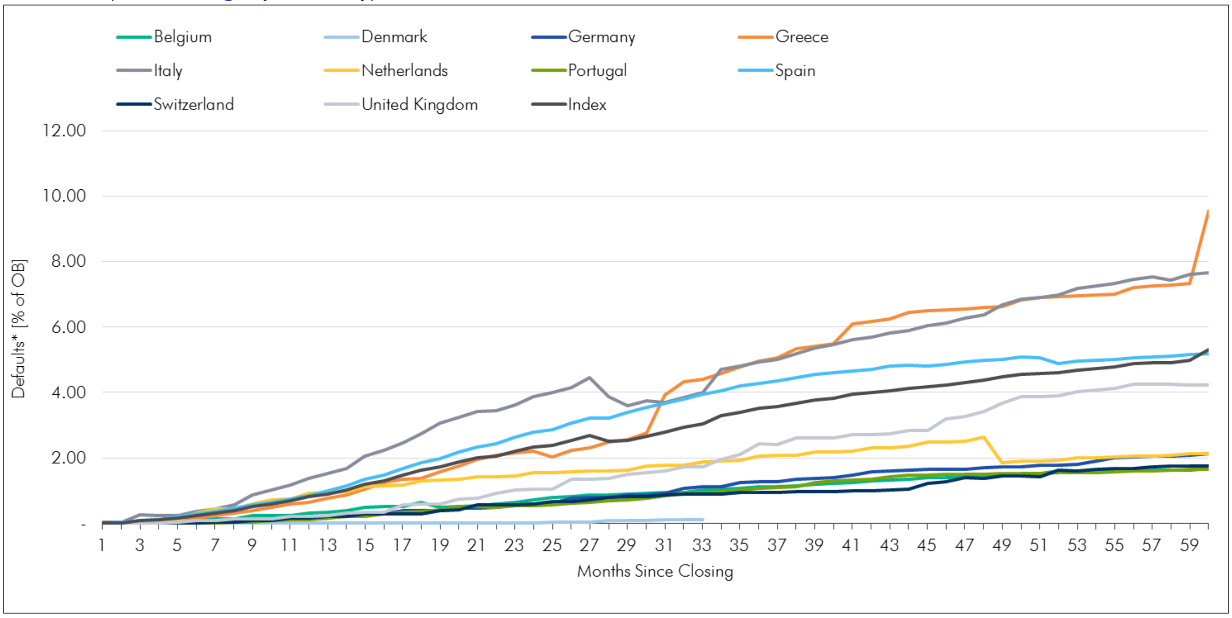
However, the sovereign crisis and weak macroeconomic fundamentals in many European countries had also negative effects on SME transactions, and it is expected that the credit quality of the existing portfolios in stressed markets will further deteriorate, as credit performance of SME portfolios is typically dependent on GDP growth trends. Moreover, many counterparties in SME-related transactions will continue to suffer from the on-going stress in the European banking system. In fact, the performance of SME ABS has deteriorated. For example, in the SMESec transactions rated by Moody's (in the EMEA[62] region), the 90-360 day delinquency rate rose from 2.13% in December 2011 to 4.91% in December 2012. This predominantly reflected the weakness in markets such as Portugal, Spain, and Italy (and based on a small number of badly performing transactions), but it decreased again in 2013 and further improved to a level of 2.6% in March 2014 (Moody's, 2013 and Moody's, 2014a).[63]

Figures 37 and 38 below 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).

[62]The "EMEA region" includes Europe, Middle East, and Africa; with regard to Structured Finance most of the transactions in this region are in Europe.

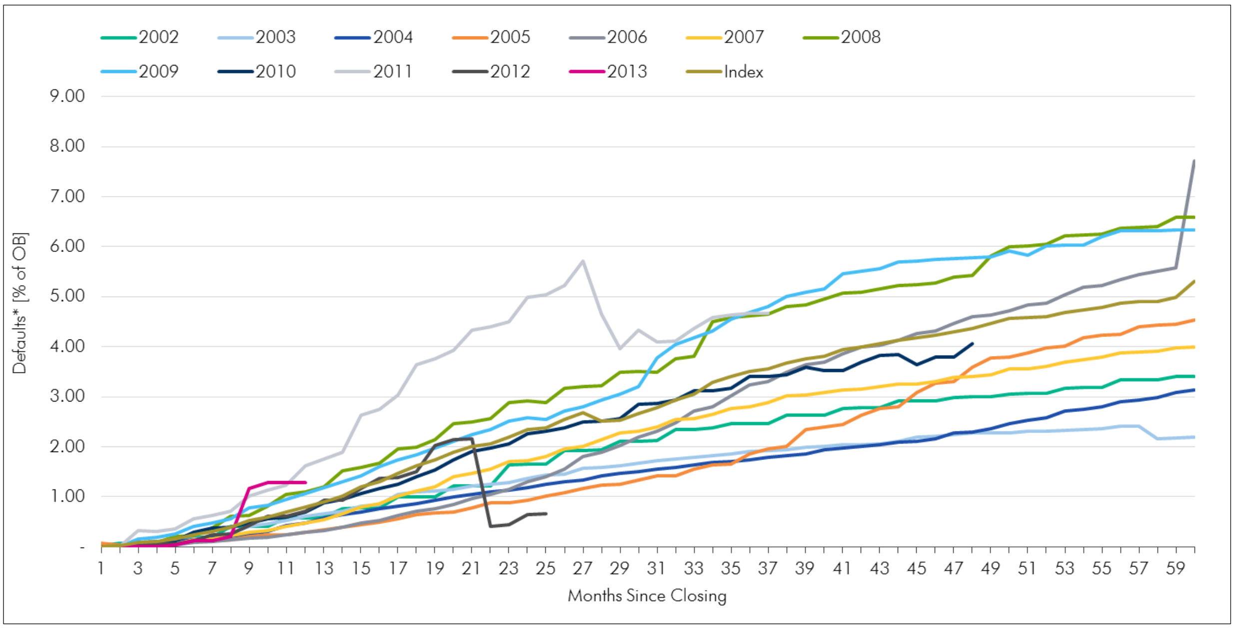
[63]For information: At the date of finalisation of this paper the respective 2013-year end data from Moody's has not yet been published.

Figure 37: EMEA ABS SME loan and lease cumulative credit events or defaults on original balance (seasoning by country)



Source: Moody's (2014a)

Figure 38: EMEA ABS SME loan and lease cumulative credit events or defaults on original balance (seasoning by vintage)[64]



Source: Moody's (2014a)

[64] Terminated transactions are included in the index calculation. 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 transaction rated by Moody's.

As explained in more detail in the related EIF working papers, the SMESec market has also been hit by a wave of downgrades due to weaker performance, as well as the rating methodology changes. Typically, AAA tranches show strong rating stability, but recently 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 (Fitch, 2013a), or they may be driven by downgrades of (not replaced) counterparties (whose rating is in turn affected by the respective sovereign ratings).[65]

The rating transition data shows that the downgrade pressure for SME transactions persists across all tranche levels. The example below (Table 4) shows the rating migration of SME Collateralized Loan Obligation (CLO) transactions (rated by Fitch, migration since transaction closing). For example, of all the tranches that have initially been rated AAA, 37% (by number) have paid in full (pif), 12% are still AAA, 19% moved down to AA etc. Meanwhile, there has been very limited upgrading, but no tranche was upgraded to AAA.

Table 4: Fitch European SMEs Rating Transition Matrix (May 2014)[66]

% of tranches		Current rating									
		PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf
Initial Ratings	AAAsf	37%	12%	19%	19%	8%	3%	1%	1%	0%	0%
	AAsf	16%	0%	31%	13%	9%	9%	16%	3%	3%	0%
	Asf	4%	0%	15%	43%	13%	9%	11%	4%	0%	2%
	BBBsf	4%	0%	0%	2%	13%	20%	13%	28%	15%	4%
	BBsf	9%	0%	0%	0%	5%	23%	18%	9%	32%	5%
	Bsf	0%	0%	0%	0%	25%	50%	25%	0%	0%	0%
	CCCsf	0%	0%	0%	0%	0%	0%	0%	20%	30%	50%
	CCsf	0%	0%	0%	0%	0%	0%	0%	0%	40%	60%
	Csf	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

Source: Fitch (2014)

5.3 Prospects

Given that SMEs have no direct access to the capital markets, funding limitations of banks and leasing providers have direct impact on SMEs' access to finance. With the deleveraging process underway at European banks, amplified by the increase in regulatory capital requirements, the supply of loans to SMEs has suffered, with related negative consequences for the economy. In particular in weaker economies, tight credit conditions often mean increasing real interest rates in combination with falling relative prices (Mersch, 2014).

[65] For example: According to Fitch, currently Italian SME CLO would have a stable rating outlook, if only transaction-specific points were considered, because Fitch expects deleveraging to offset further performance deterioration. However, the outlook is stable/negative due to the negative outlook of the sovereign (Fitch, 2013b).

[66] The addition sf indicates a rating for structured finance transactions.

In general terms, it is not exactly measurable to what extend current weaknesses in bank lending to SMEs are driven by demand- or by supply-side factors, and the picture is different from country to country. However, there is a risk that even in countries where weak bank lending is driven by the demand side it is, given the current environment, uncertain whether banks are able and/or willing to provide the necessary lending once the demand picks up (driven by economic recovery, respectively the expectation of the latter). Moreover, in an increasing risk-averse environment of credit allocation, lending might be allocated away from small and young firms (Mersch, 2014) as they are by nature more risky than their larger peers.

In this context, guarantee solutions and securitisation (or similar techniques) are important to access the capital markets. If public support can contribute to the re-emergence of the primary European SME securitisation market, it can be an important element to enhance access to finance for SMEs in Europe. In this context, not only the volumes for the intervention matter, but also the positive signalling effect, triggered by the public involvement and support, can be important.

There are many initiatives to support the revival of the SMESec market in Europe, including initiatives to improve transparency[67], i.e. the DataWarehouse / Loan Level Initiative, Prime Collateral Securities (PCS) Initiative,[68] and new disclosure requirements (e.g. by ESMA), and including direct support mechanisms. In two of our previous Working Papers[69] we mentioned already new initiatives to support SME lending and i.e. to revive the SMESec market. Box 5 below explains an important new initiative, the EIB Group Risk Enhancement Mandate.

Box 5: EIB Group Risk Enhancement Mandate (EREM)[70]

The European Council (2013a), (2013b) conclusions of June and October 2013 required an increase of the credit enhancing capacity of the EIF with the purpose of supporting the impaired financing of European SMEs; proposal was the capital increase of the EIF together with the EIB Group Risk Enhancement Mandate (EREM). The objective of this overall financial support package is to provide an increasing access to finance for SMEs and small midcaps, including through the revitalisation of the SME securitisation market, in the context of the economic crisis. The EREM was approved by EIB and EIF Boards in December 2013 and the EREM Framework Agreement was signed between EIB and EIF in March 2014.

The EREM contribution (EUR 4 billion from EIB supplemented by EUR 2 billion) will enable raising the credit enhancement capacities of EIF with a view to increasing access to finance for SMEs and small midcaps (defined as enterprises with up to 500 employees), mainly through financial institutions, including guarantee institutions and microfinance institutions. Instruments deployed under the EREM shall:

[67] Also the discussion concerning potential improvements in the availability of UK credit data, started recently by the Bank of England, targets improved transparency - although in a much broader sense (Bank of England, 2014).

[68] As far as SMESec is concerned, the EIB Group has been actively involved in these two initiatives from their inception.

[69] See Kraemer-Eis, Lang and Gvetadze (2013a, 2013b) and Kraemer-Eis, Passaris and Tappi (2013).

[70] This box has been prepared by Remi Charrier, EIF's Head of Strategic Development - Guarantees & Debt.

Box 5 continued:

- Contribute to the development of European capital markets instruments to the benefit of SMEs and small midcaps (SME Initiative, SME asset-backed securitisation, loan funds/mini-bonds, etc.), and
- Target specific areas in the fields of youth employment, microfinance, cooperative banks and other smaller financial institutions that do not have access to direct EIB financing, social, environmental and innovation impact, etc. as well as other areas agreed with EIB.

To achieve this in the most efficient manner, EIF will leverage on its catalogue of existing products, systems and procedures. EIF will also establish for each of EREM window a clear origination strategy and selection process in full coordination with the EIB to serve the market in an efficient manner. The EREM will focus on the 28 EU Member States and has the following windows (see as well Figure 39 for indicative amounts):

- ABS credit enhancement **(EREM window expected to be active mid-2014)**: the amounts made available under the proposed EREM will allow EIF to increase its capacity as credit enhancer of ABS tranches, both in terms of larger ticket size and broader scope in each individual SME securitization.
- Joint SME Initiative **(expected end-2014)**: guarantee scheme and securitisation scheme supported by European Structural and Investment Funds (ESIF) and EU instruments (COSME and Horizon 2020).
- Loan funds **(expected end-2014)**: to intervene in loan funds / debt funds associated with SMEs and small midcaps financing.
- Microfinance **(expected end-2014)**: to complement EIB and EIF financing of microfinance institutions.
- Cooperative banks and smaller institutions **(expected end-2014)**: to complement EIB financing of cooperative banks and smaller financial institutions.
- Social Impact Finance **(expected end-2014)**: to extend the offer of funding instruments to the actors in the social economy, notably social sector intermediaries such as social investment funds and social banks that are supporting social enterprises.
- Youth Employment Programme (YEP!) **(subject to availability of a first loss piece from European Commission or EU Member States)**: to support youth employment in Europe by building a link between the EIB Group's financing and the employment of young people through provision of guarantees for commercial loans to SMEs and small midcaps creating jobs and offering apprenticeships for young people.

Box 5 continued:

Figure 39: EREM potential volumes (2014-2020)

Source: EIF

However, the recovery of the European Structured Finance market will not only depend on the development of market fundamentals and the enhancement of investors' confidence, but also strongly on the direct and indirect impact from regulatory priorities. Hence, future/potential regulatory treatments of SMESec have to be duly analysed. For both, investors and originators, a stable and reliable regulatory framework is key.

Moreover, a holistic view should be taken in order not to stall the revival of the market, but to frame its development in an economically reasonable way. Importantly, the regulatory framework should reflect the actual risks of SMESec. While the majority of individual regulations that have been proposed are sensible when viewed in isolation, some of them might appear questionable when the overall picture of the regulatory wave is taken into account. A reasonable calibration of these measures would be in the long run even more important than an - now often discussed – purchase programme by the ECB.

Recently, Mario Draghi discussed measures to revitalise the ABS market in order to push lending (ECB, 2014a). The ECB continues to reflect on measures to revitalise the ABS market. However, Draghi stressed that a number of legal and regulatory parameters need to change, such as the recalibration of the Basel-related regulatory risk weights: they are not suitable to European securitized credit risks because they are instead based on systemic defaults experienced in the US subprime RMBS/CDO fallout. European ABS are traditionally simpler and more transparent than the subprime US products; moreover, the securitised assets have typically been originated by established financial institutions which abide by defined sets of underwriting policies and know-your-client standards. Finally, he said, rating caps on sovereign risks for ABS need to be reviewed, and third- party guarantees or risk taking would be needed in order to re-launch the ABS market on a broader scale (see as well UniCredit, 2014).

Box 6: High Quality Securitisation[71]

As already mentioned above, the stigma on securitisation proved hard to fade away. There have been multiple attempts aimed at restoring confidence in this asset class, and eventually trying to devise a "higher quality" securitisation. Most notably, the PCS initiative primarily intended to define a standard that would increase the liquidity of the market, thus spurring further issuance. On the other hand, high transparency and strict reporting requirements were the pillars backing the collateral frameworks that the European and English Central Banks run. Finally, ESMA's ruling on CRA3 had transparency as starting point for a better functioning of the ABS market.

As guarantees provider in SME transactions, EIF's approach is close to that of an investor, as the business ultimately entails forming a view on both the securitised assets' creditworthiness, and the transaction's structure. We believe transparency is a prerequisite for any structured transaction; however we consider "high quality" to be a concept that lies with a number of factors which do not confine to the securitised assets' characteristics. The following list provides an overview of what a "high quality SME ABS" could look like, according to our standpoint:

1. ASSETS: senior, first lien, fully disbursed loans to SMEs (as defined by EU recommendation 2003/361).
2. ORIGINATOR: experienced SME lenders, not pursuing an originate-to-distribute business, keeping on their balance sheet large SME exposures.
3. BORROWERS: not marked as in insolvency in the Central Bank's register.
4. LOANS / LEASES: not in severe arrears for the past 12 months. Standard amortizing, non-syndicated, non-inflation linked. Limits on the share of loans featuring balloon payments, or switching the interest rate. Loans pay at least semi-annually.
5. CONCENTRATION: limits on single group/region/industry and maturity concentration.
6. STRUCTURE: senior tranches, with an expected life lower than 5 years. Commingling and set-off considerations addressed by the structure. Cash reserve covering for both principal and interest, large enough to cover senior expenses for 2 IPDs. Default definition within 9 months missed payments. Excess spread trapping in favour of the senior on collateral deteriorating. Plain swaps, without scheduled notional, featuring replacement languages.
7. SERVICING: no interest suspension allowed, permitted variations clearly defined in volume and magnitude, back-up provisions in place.
8. DATA: the originator receives an A1 compliance score by the European Data Warehouse, the pool is audited on an either 99/1 or 99/5 basis.

We believe that SME ABS tranches sharing these features would be the best candidates for lower capital absorption charges, and for inclusion and favourable treatment in the computation of the Liquidity Coverage / Net Stable Funding Ratios.[72]

[71] This box has been prepared by Giovanni Inglisa from EIF's Securitisation team

[72] See for a general discussion concerning High Quality Securitisation AFME (2014c). Perraudin (2014) presents a statistical analysis of how securitisations satisfying key candidate characteristics for an High Quality Securitisation definition have performed in the past. He concludes that, holding rating constant, an High Quality Securitisation definition based on asset class, seniority, size and a no-originate-to-distribute flag, adds substantial information in identifying less risky and more liquid securitisations.

Furthermore, the ECB's Governing Council recently announced, it would intensify preparatory work on outright purchases of (simple and transparent) securities backed by loans to non-financial companies. If the ECB is going to start such purchases and how these could look like is still uncertain – consequently it is too early to speculate about potential impacts on the markets

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. Commerzbank's issuance of a structured SME covered bond in 2013 has attracted quite a lot of coverage and renewed the discussion of the participation of SME loans in the covered bond space, although this is a topic of hot debate at the moment. However, only in a few markets in Europe, bank bonds backed by SME receivables are covered by the national covered bond legislation, i.e. in Turkey, where EIF has actually been active in the SME covered bond space, and in Italy, where the respective law has been implemented in February this year. Moreover, discussions to introduce a respective regulation seem to place in other countries as well, e.g. Austria.

In France (see DZ Bank, 2014 and Bank of America/Merrill Lynch, 2014), a new funding vehicle (Euro Secured Notes Issuer, ESNI) under French law has been launched by five French banks (BNP Paribas, BPCE Group, Crédit Agricole, HSBC France, and Société Générale) with the objective to issue bonds backed by SME loans; each bank has its own compartment and in principle, the vehicle is open to other banks (also outside France). In April this year, a first pilot transaction was executed.

EIF has been following with keen interest those developments and is engaged in a dialogue with a number of parties to evaluate the potential involvement in future transactions.

6 Microfinance

6.1 Microfinance business environment

Inclusive Growth is one of the three key priorities of the Europe 2020 strategy and "[m]icrocredit 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." This statement, given in a European Commission (2012b) report, emphasises the social *and* economic objectives associated with microfinance, and makes it clear why it is such an important aspect of EU social and business policy objectives. In order to prepare for a further analysis of this topic, it is helpful to start with some definitions (see Box 7):

Box 7: 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 micro-enterprises. 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 Bendig et al (2012):

- *Microenterprise lending* = microlending 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 stabilization 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 issued so far two working papers, specifically dedicated to the European microfinance market (see Kraemer-Eis and Conforti, 2009 and Bruhn-Leon, Eriksson and Kraemer-Eis, 2012). In these studies, we found that there are wide spectra of final beneficiaries and financial intermediaries and concluded that there is no common microfinance business model in Europe – on the contrary, the market is highly fragmented and diverse, but with a trend towards efficiency, professionalisation, and self- sustainability. In the following sections we briefly explain important elements of the demand and supply side perspectives, as well as their combination.

6.2 Demand-side perspectives

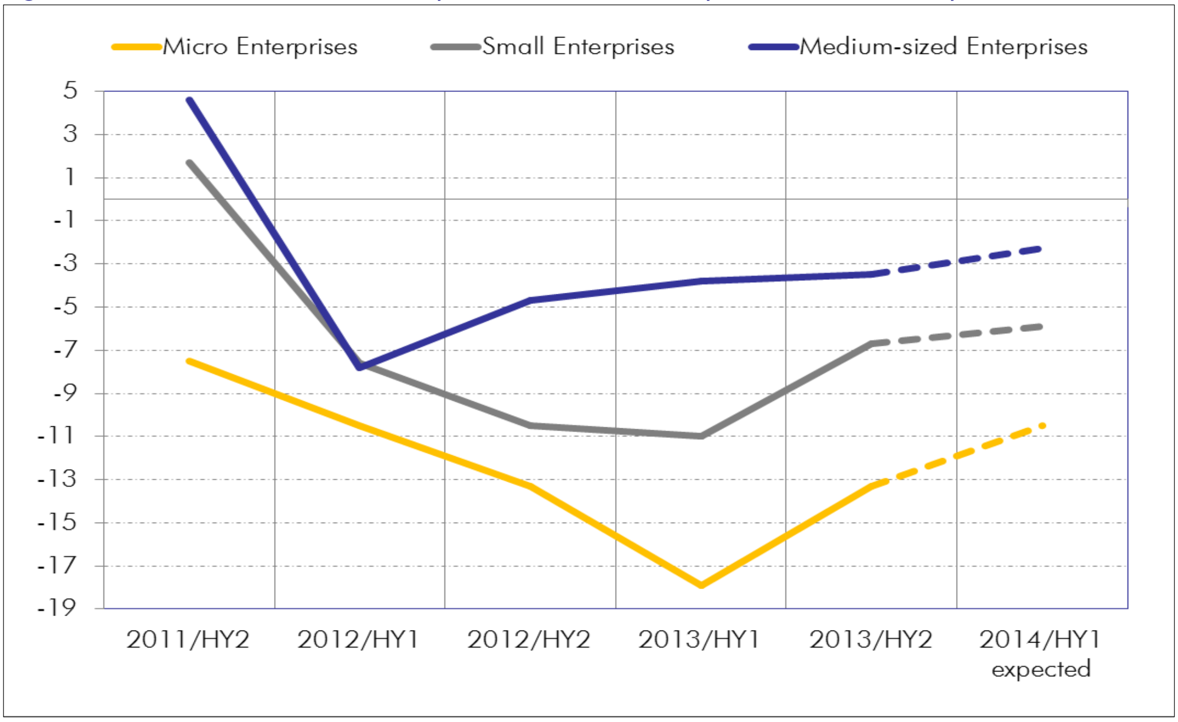
Microfinance in Europe consists mainly of microloans tailored to microenterprises (92% of all European businesses). It also includes people who would like to become self-employed but are facing difficulties in accessing the traditional banking services. Standardised, regularly available indicators to explain market developments for microfinance in Europe do not yet exist, or refer to Eastern Europe. Thus, we will focus in this section on the framework conditions for microfinance which are covered by the regularly updated Eurostat indicators for poverty and social inclusion, and by data on microenterprises.

6.2.1 The situation of micro-enterprises

The EU Craft and SME barometer shows that, on balance, microenterprises estimated their overall situation less favourably than other SMEs in the second half of 2013 (see Figure 40). However, microenterprises, on balance, expected some improvement in their business situation in the first half of 2014 ((-10.5%) compared to (-13.3%) in the second half of 2013). Similar results were reported for the survey questions on turnover, employment, and orders in the second half of 2013. According to the overall picture, microenterprises will continue facing more difficulties than other SMEs.

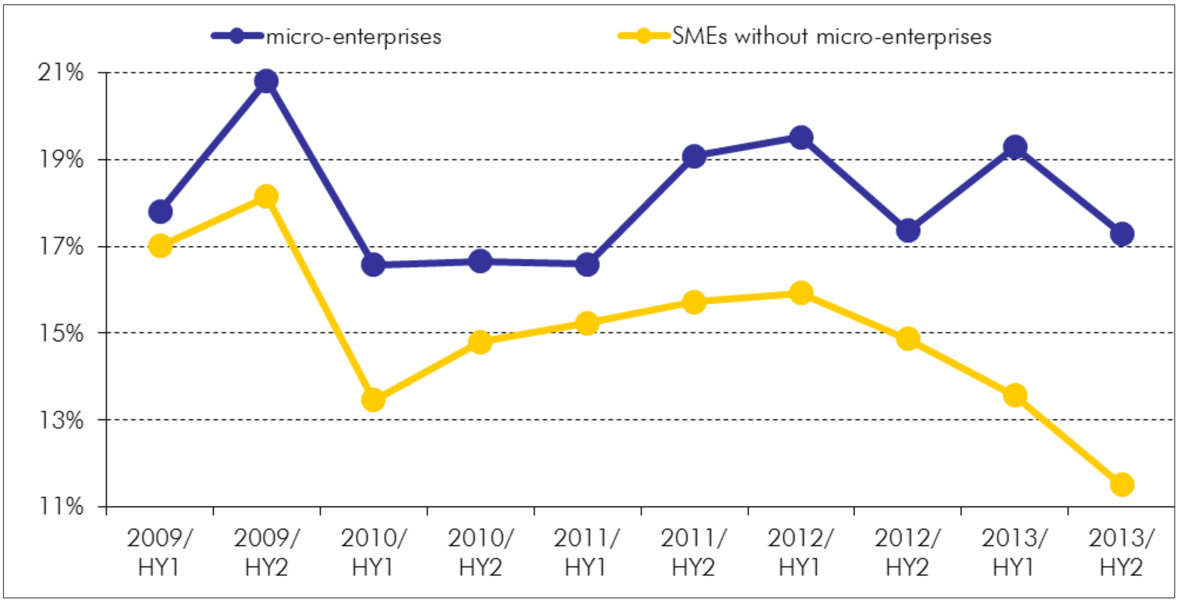
According to the data from the latest ECB survey on the access to finance of SMEs in the euro area (ECB, 2014c), the share of enterprises which see access to finance as their most pressing problem is larger among microenterprises than among other SMEs. Microenterprises reported "access to finance" as the second of their most pressing problems (while it is in the fourth place of the "most pressing problems" for small enterprises, and sixth for the medium and large ones). Compared to the previous survey wave, the percentage of companies listing access to finance as their most pressing problem has decreased (see Figure 41) for all enterprise size classes, except for microenterprises, while "finding customers" stayed the most frequently mentioned concern. The ECB (2014c) has also reported a drop in bank loan rejection rates for micro and medium-sized enterprises, and a rise for small-sized ones. However, the rejection rate is still the highest for micro firms (17%), compared to 12% for small firms and 6% for medium-sized firms.

Figure 40: Overall situation of European micro-firms compared to other enterprise size classes



Source: EIF, based on data from UEAPME Study Unit (2014)

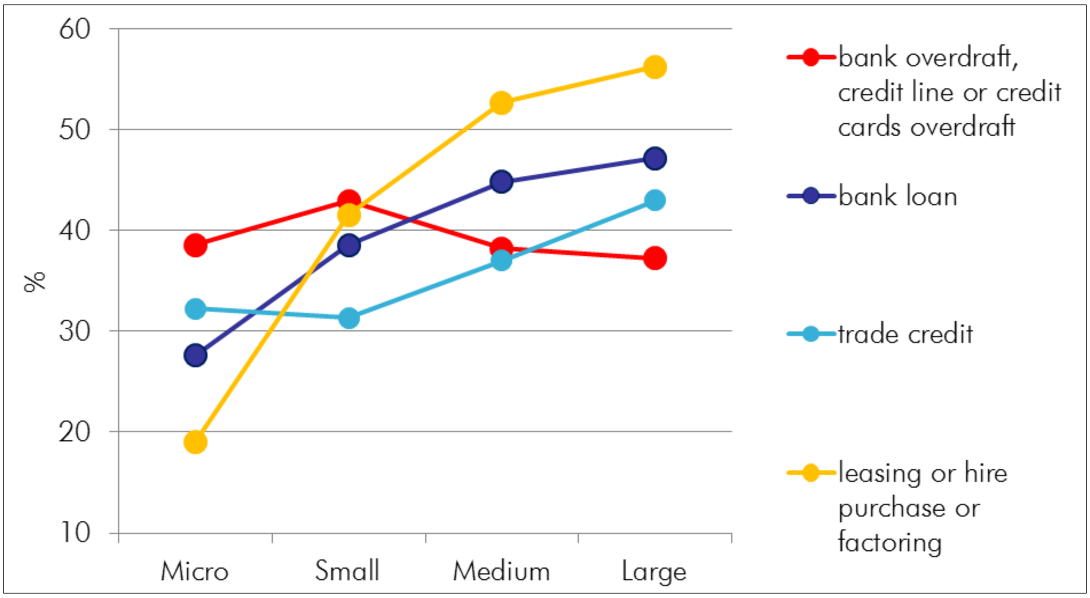
Figure 41: Share of enterprises reporting access to finance as their most pressing problem



Source: EIF, based on data from ECB (2014c), Statistical Data Warehouse

Difficult access to finance, in particular to bank loans, might be one key reason why microenterprises in Europe use bank loans and other external financing sources considerably less than other SME size classes, however micro enterprises, on balance, reported increased needs for bank loans. Figure 42 shows that, with the exception of "bank overdraft, credit line or credit cards overdraft", the usage of different financing sources on average typically increases with the size of the SME.

Figure 42: Enterprises having used different financing sources (by enterprise size class)
over the preceding 6 months (October 2013 to March 2014); percentage of respondents



Source: EIF, based on ECB (2014c) data

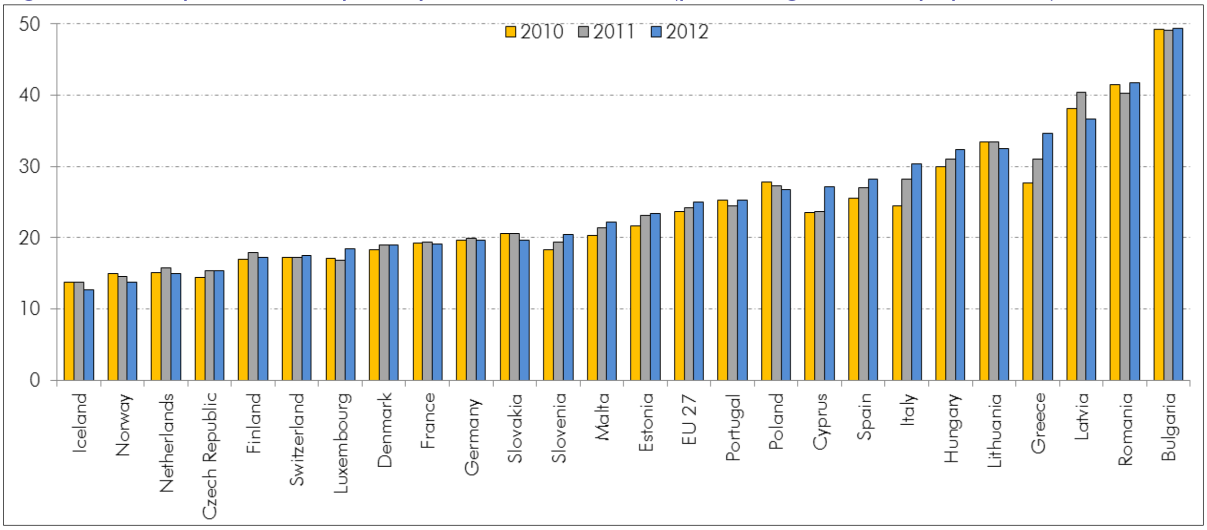
6.2.2 Potential business creators

In order to assess the likelihood of achieving the Europe 2020 poverty/social inclusion target, Eurostat has provided the indicator called "people at risk of poverty or social exclusion".[73] Figure 43 depicts the headline indicator, corresponding to the sum of persons who are at risk of poverty or severely materially deprived or living in households with very low work intensity (i.e. a combination of the three sub-indicators).[74] Central-Eastern Europe shows the largest incidence of poverty or social exclusion. When comparing 2012 to 2011 and 2010, the situation became worse in most of the countries. Within the EU, the highest risks of poverty or social exclusion are recorded for Bulgaria, Latvia and Romania. The countries on the right-hand side of the diagram include some of the relatively new entrants to EU and those countries that have suffered the most from the impact of the current sovereign-debt crisis, i.e. Greece, Italy, Spain, Portugal, and Cyprus.

[73] The indicator is a union of the three sub-indicators "People living in households with very low work intensity", "People at-risk-of-poverty after social transfers", "Severely materially deprived people" 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

[74] Persons 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

Figure 43: People at risk of poverty or social exclusion (percentage of total population)

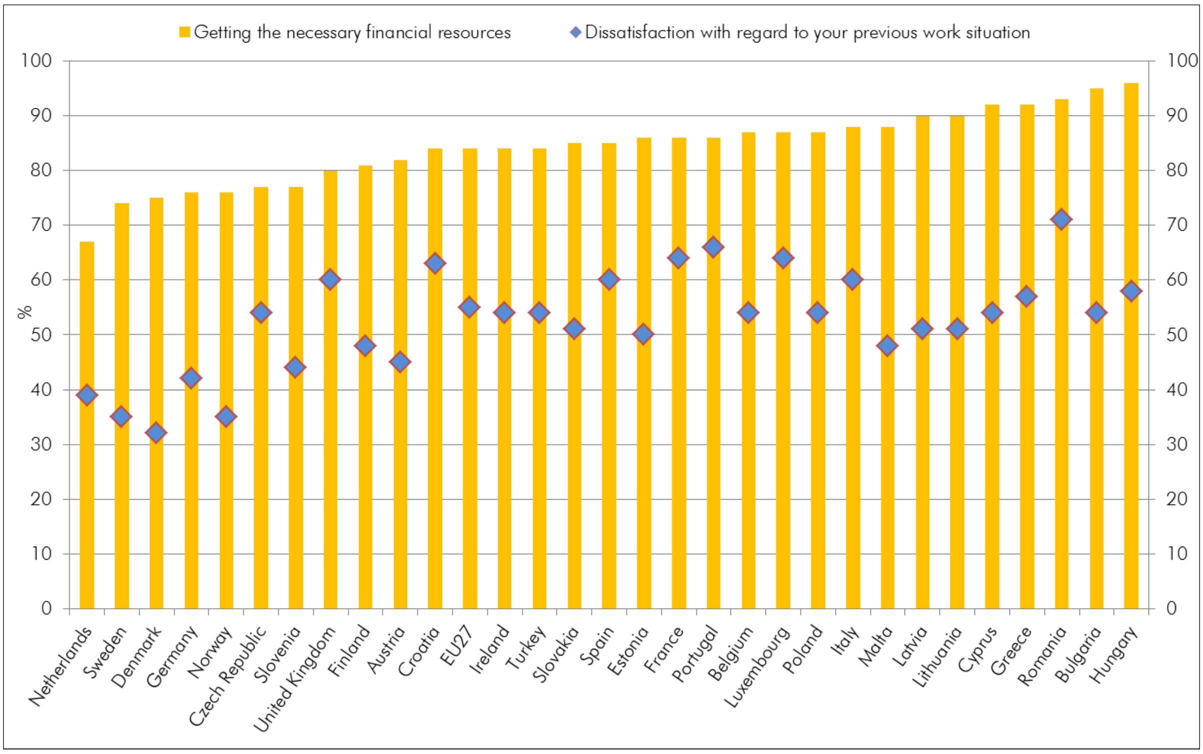


Source: EIF, based on data from Eurostat

People at risk of poverty are considered to be potential business creators. A decision to start a business often arises out of necessity (for example because of a lack of paid employment). The majority of entrepreneurs (especially young people) start businesses to improve their situation (OECD/European Commission, 2013). According to Figure 44, 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. Another important element that triggered their decision to start a business was getting the necessary financial resources. Moreover, in most of the EU countries, the proportion of respondents indicating importance of necessary financial resources has risen since December 2009.

As regards some Central-Eastern EU Member States, their relatively poor performance in social welfare indicators is one reason for the existence of a significant market for microfinance (i.e. commercial microfinance) in their respective economies. It also has to be borne in mind that in the European Union more than six million jobs were lost during the crisis and poverty has increased (Darvas and Wolff, 2014).

Figure 44: Drivers to start a new business or take one over (% of self-employed respondents)



Source: European Commission, 2012a

6.3 Supply side

As outlined in the specific microfinance-editions of our working paper series, the European microfinance market is still young and heterogeneous due to the diversity of legal frameworks, institutional environments and microfinance providers in European countries. 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. They range from microfinance associations to credit unions, cooperatives, Community Development Financial Institutions, non-bank financial institutions, government bodies, religious institutions, and Non-Governmental Organizations or Foundations. Useful categorisations of MFI business models can be done according to the "legal" classification, MFIs:

- with banking license,
- without banking licence (non-bank MFIs),

or according to the "nature" of the MFI:

- For-profit Small / Mid-sized microfinance institutions
- Mainstream banks operating microfinance windows
- Public entities operating microfinance windows
- Greenfield entities
- Dedicated microfinance vehicles

We cannot go into the details of these classifications here but refer to Bruhn-Leon, Eriksson and Kraemer-Eis, 2012.

According to the recent EMN (European Microfinance Network) survey (EMN, 2014), the microcredit provision in Europe showed a positive trend, in terms of the overall total value and the number of microloans. More precisely, the surveyed European MFIs disbursed a total of 207,335 microloans with a total volume EUR 1.26bn in 2013 (compared to 122,370 microloans disbursed with a volume of EUR 872m in 2011). Compared to the survey data from 2011, this shows an increase of 45% in the total value of microloans and 69% of the number of loans in 2013 reported by the surveyed MFIs. The average loan size also increased to EUR 9,234 in 2013 from EUR 7,129 in 2011 and reached a similar level compared to 2009 (EUR 9,641). With regard to future trends, MFIs expect less public support in the coming years, due to public budget restrictions. Other challenges that MFIs face are new competitors like crowdfunding and crowdlending platforms.

Despite the recent positive trends that the EMN member-MFIs reported, the overall situation in microcredit provision in Europe remains complex. Microfinance institutions have been affected by the adverse macro-economic conditions during the global financial and economic crisis, generally through significantly higher bad debt rates among their clients and in some cases through increased difficulties in accessing external sources of funding. With on-going problems in the banking sector, the target groups for microfinance are faced with tightening credit supply by mainstream banks due to their higher risk aversion and increasing need to de-leverage their balance sheets. We mentioned already above, that in an increasing risk-averse environment of credit allocation, lending might be allocated away from small and young firms as they are more risky than their larger peers. This refers by nature in particular to the segment of microfinance.

This reluctance on the part of mainstream lenders creates an opportunity for microfinance but also underlines the paramount importance of credit risk management in an industry that, in Western Europe at least, continues to be driven by socially-motivated investors and entities supporting microfinance as part of their social responsibility initiatives. This realisation has a significant impact on the pricing of financing instruments to such types of entities and has arguably served to undermine the development of viable microfinance models in terms of self-sustainability. Self-sustainability of microfinance models is critical for the industry to ensure long term availability of microfinance products for microfinance clients. The economic sustainability of microfinance intermediaries comes as a result of the balance between the income and the costs, which in turn are a function of the pricing policy (interest and fees), cost management (operational and financial costs and provisions), economies of scale and level of available subsidies of a particular institution. More information on the loan pricing by European microfinance institutions can be found in our previous ESBFO.

6.4 Is there a financing gap?

When looking at the business climate of microenterprises, even in a thriving economy, these smallest firms often have trouble in obtaining finance. Uncertainty and asymmetric information between the demand side (entrepreneur) and the supply side (financial institution) often create a perpetual structural difficulty for micro- as well as small- and medium-sized enterprises. We could even further simplify that: the smaller and younger a company is, the bigger its financing challenge. A recent empirical study also showed that firm size and age are significantly and positively correlated with improved access to finance (Öztürk and Mrkaic, 2014).

Without a track record or a long standing relationship with a financier, constrained by limited capital or collateral, the young and small companies seldom have an easy time finding the funds they need to grow. In times of crisis, like today, microfinance clients, be it as an enterprise or a self-employed, typically find capital even harder to obtain; not to mention the additional challenges faced by certain vulnerable groups such as ethnic minorities or female entrepreneurs. As mentioned above, this is as well shown by the SAFE (ECB, 2014c): proportionally more micro-enterprises perceive an increase gap in external financing than small or medium sized enterprises (see Figure 14, chapter 3.5).

The availability of data on the potential demand and target groups for microfinance in Europe is very limited. An often used and cited source is an estimation done by the European Commission (2007)[75] that estimates a potential demand of EUR 6.2bn from people at risk of poverty that might start a business (based on pre-crisis information). The study covers neither potential demand of micro start-ups by people that are financially excluded, but not at the risk of poverty, nor the demand from existing micro-enterprises.[76] Unterberg et al (2014) applied this methodology with updated data and arrived at an estimated potential demand of EUR 8.66bn. Such estimations cannot be precise and can only be seen as an indication, an order of magnitude, rather than a precise value. On the other hand, they show significant demand for this type of microfinance.

Concerning the demand for *microenterprise* lending and i.e. the high relevance of microfinance for start-ups and existing small enterprises, there is to our knowledge no recent EU-wide study available. However, many studies refer to the SME finance gap in Europe (e.g. Kraemer-Eis and Lang (2014b) for an overview). If we consider the importance of microenterprises in Europe, it can be assumed that a significant portion of this gap refers to microenterprises – and if banks continue to reduce their exposure to risky and small scale loans in the context of the on-going deleveraging and adjustment processes, this situation is expected to further worsen. In general, Unterberg et at (2014) state that their "estimations indicate that there was in the latest years (2010-2012) and still is a significant demand for microloans at the final beneficiary level, which is untapped by microcredit providers in the European Union."

The availability of data on the outreach of European MFIs to specific social groups and social impact indicators also remains limited. For policy makers and funders it is crucial to increase the knowledge and awareness about the social impact made and targeted by MFIs (EMN, 2014).

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[75]See European Commission (2007), pages 17-18. See also Kraemer-Eis, H. and Lang, F. (2014b).

[76]The methodology has as well been applied in several SME access to finance studies, performed by/on behalf of EIF. It is a transparent but simple calculation based on data on the working population, the people at risk of poverty, potential entrepreneurs and average loan sizes. See European Commission (2007) or Kraemer-Eis and Lang (2014b).

6.5 Concluding remarks

Microfinance is an important tool to overcome the effects of the financial crisis and to support sustainable and inclusive growth. It works across Europe, despite the differences in the microfinance business models in its constituent parts. Indeed, in many areas, the European microfinance market is still a very heterogeneous sector - especially with regard to the diversity of lending approaches. As often mentioned before: there is no common microfinance business model in Europe.

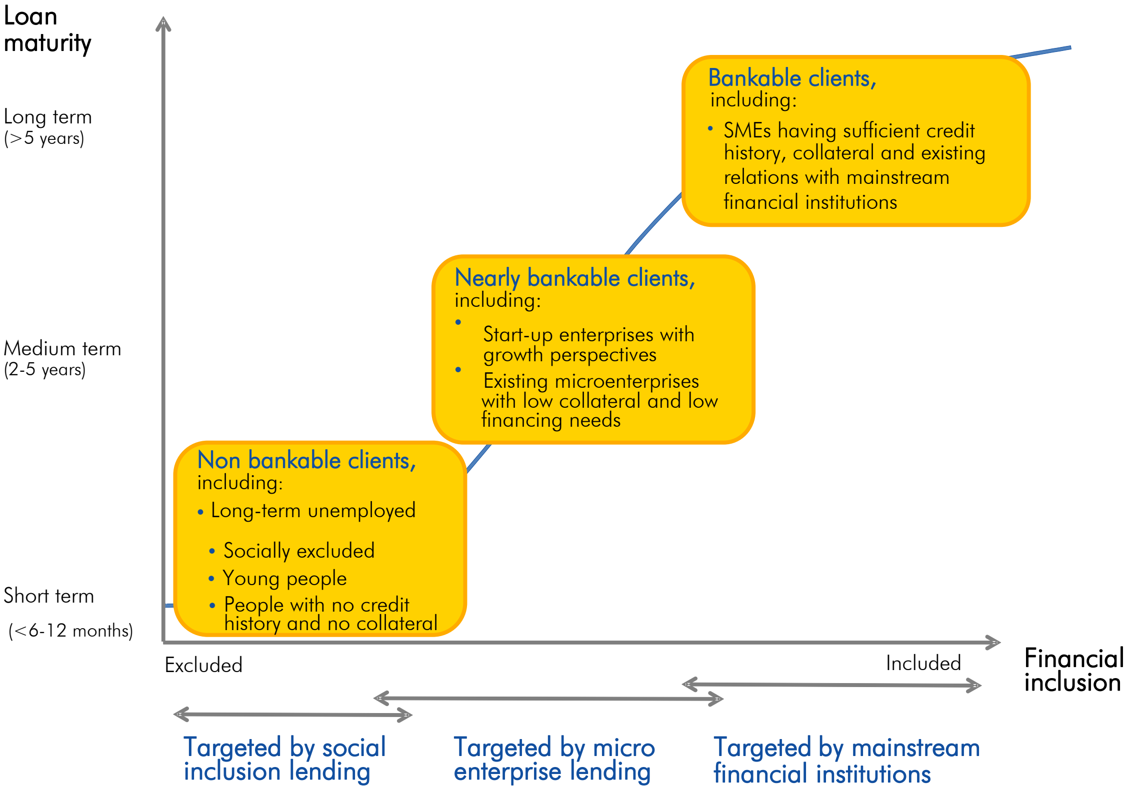
We cannot go into detailed deliberations of microfinance market failure here, but economic literature often discusses that in the area of access to finance for SMEs, a market imperfection/failure is not only present during a deep recession but also on an ongoing basis as a fundamental structural issue. Microenterprises, young companies or start-ups by definition have no track record, often only limited collateral, and no long-standing relationship with lenders. One could even generalise or simplify that: the smaller the company, the bigger the information asymmetry and thus the higher the transaction costs in relative terms. Hence, public support is justified, and the added-value for assistance on European level can also be substantiated (see for more details Bruhn-Leon, Eriksson and Kraemer-Eis, 2012).

The discussion above shows that the field of microfinance is very wide and that a split between *social inclusion lending* on the one hand, and *microenterprise lending* on the other hand, is pragmatic, necessary and useful. This distinction among the different types of the final recipients rests on the level of their financial inclusion and bankability. Figure 45 below shows the positioning of these two groups of microfinance clients in a financial market, including also the bankable clients for comparison.

As a consequence, public support mechanisms should also follow this route and should be tailored along this differentiation. On the one hand, addressing unemployment and poverty has to remain a high priority not only for its own sake, but because these problems undermine public debt sustainability and growth (Darvas and Wolff, 2014). On the other, the systematic difficulties for microenterprises in accessing debt and equity finance, compounded by the crisis, have to be mitigated.

The EMN (2014) survey showed a high diversity with regard to targeted social groups and societal policy goals. Two thirds of all surveyed MFIs reported that they included social impact in their mission, followed by job creation (58%), social (56%) and financial inclusion (50%). 85% of the surveyed MFIs reported that they include at least one dedicated employment goal as part of their mission. Overall, the supported micro enterprises and start-ups had a positive impact on at least 250.000 jobs in 2013.

Figure 45: The positioning of microfinance clients in a financial market



Source: see footnote[77]

With regard to EIF's main activities in the field of microfinance, the Progress Microfinance Fund (see Bruhn-Leon, Eriksson and Kraemer-Eis, 2012, for more information) aims at easing access to finance for micro-enterprises and the self-employed, including typical groups with difficulties in accessing the traditional banking system, such as women, youngsters, people belonging to a minority group or with a disability, etc. In 2013, the Progress Microfinance Fund has been deployed as planned and social impact achieved.

The table below provides a summary of non-financial information at final beneficiary level of Progress microfinance. The information is based on data reported by a total of more than 12,000 companies. The participation was not mandatory but a response rate of above 97% has been achieved, hence, figures presented can be considered representative for the Facility. The results show a significant outreach to unemployed people and to very young companies.

[77] Ex-ante assessment methodology for financial instruments in the 2014-2020 programming period. Volume III. Enhancing the competitiveness of SME, including agriculture, microcredit and fisheries (Thematic Objective 3). Study commissioned by the EIB, co-financed by the European Commission (DG REGIO) and assigned to a consortium led by PwC. Version 1.0. March 2014.

Table 5: Social outreach

male	62.94%	gender outreach	
female	37.06%		
outreach to unemployed persons		employed	46.40%
		unemployed	47.19%
		studying	0.37%
		inactive	4.77%
up to 3 years	58.14%	start-up creation	
up to 1 year	44.31%		
educational background		no formal education	2.48%
		primary education	10.76%
		secondary education	44.78%
		post-secondary education	21.70%
		university education	17.77%
under age 25	5.71%	age group	
between ages of 25 and 54	84.41%		
greater than age 55	9.85%		
disadvantaged persons		minority group	1.85%
		disabled	0.02%

Source: EIF

Strong efforts have been made in the first half of 2014 to commit the remaining budgetary commitments available for Progress guarantees. The second half of 2014 will focus more on origination of senior loans with existing and new financial intermediaries. The number of financial intermediaries will grow well beyond 50 in the course of 2014 with improved country coverage, including pending signings e.g. in Croatia and Sweden.

It is expected that around 185 m of new micro-credits have reached micro-borrowers as of end-March 2014, up more than 50% over the last six months alone.

7 Concluding remarks

Although there are signs of improvements, as shown above, the overall business environment of European SMEs is still in weak shape, and the imbalances between the EU Member States are still significant. While SMEs continue to face problems with access to finance, there are also significant differences from country to country in such fields as, for example, debt financing.

Against this broad backdrop, it is evident that public support continues to play a crucial role in enhancing access to finance for SMEs. However, as outlined in detail in our previous ESBFO, it is important "how" this support is provided: support mechanisms have to be designed in a way that they catalyse other sources of finance to the benefit of SMEs, and the decision to finance a company should be made by market-oriented professionals who make investment decisions on a business basis. This is also in line with the OECD (2014) argument that "[p]ublic financial institutions have an important role in fostering co-participation of the private sector in the lending markets through managing guarantees and in encouraging new public-private collaboration in equity instruments." This is the investment approach of the EIF – the core competency is to select financial intermediaries who in turn know their individual markets best. Indeed, the existing support measures have facilitated SME survival, development and success in many countries of the European Union, and – equally importantly – new public support initiatives are being prepared.

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 European Angels Fund, partnerships with corporate investors, or a Social Impact Accelerator - a first step in the EIB Group's strategy to pioneer the impact investing space and to respond to the wider EU policy aim of establishing a sustainable funding market for social entrepreneurship in Europe.

In the areas of *credit guarantees* and *securitisations*, EIF cooperates with a wide range of financial intermediaries, such as banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks, or other financial institutions providing financing to SMEs, or guarantees for SME financing. 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 can transform these illiquid loans into an asset class with adequate market liquidity – this can as well broaden the transmission mechanism of monetary policy while providing a lasting intermediation market for this segment (Brunnermeier and Sannikov, 2014). There are several initiatives to revive the SME securitisation market. However, there is currently significant uncertainty concerning the future regulatory treatments of securitisations. In our understanding, a holistic view has to be taken, and the impact of the "regulatory wave" duly analysed not to stall the market revival, but to frame its development in an economically reasonable way. In cooperation with the EIB and the European Commission, EIF is in the process of developping new guarantee and securitisation solutions, i.e. in the context of the – aforementioned new mandate EREM (see Box 5), the new central EU instruments, the new generation of Structural/Cohesion Funds, and the joint instruments (combination of ressources from European Structural and Investment Funds, COSME, Horizon 2020, EIB Group and national promotional banks).

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.

In all these efforts, EIF's goal is not just to provide capital or guarantees: it is also to help spreading best market practices, encourage collaboration and network building, and the creation of a sustainable financing eco-system to the benefit of SMEs, entrepreneurship, and innovation.

ANNEX

Annex 1: Private Equity Glossary

(selection, from EVCA)

- **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 organization 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 buyin 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

- **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 mechanism, interest sub-participation mechanism);

  (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.
- **Collateralized 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:** 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.
- **Mezzanine Risk:** Risk or tranche which is subordinated to senior risk, but ranks senior to the First Loss Piece.
- **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.
- **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 4: List of acronyms

- ABS: Asset Backed Securities
- AECM: European Association of Mutual Guarantee Societies
- AFME: Association for financial markets in Europe
- BA: Business Angels
- BAN: Business Angels Network
- BCI: Business Climate Indicator
- BLS: Bank Lending Survey
- BMWi: Bundesministerium für Wirtschaft und Technologie
- BoE: Bank of Enland
- bp: basis point(s)
- CDO: Collateralized Debt Obligation
- CGAP: Consultative Group to Assist the Poor
- CIP: Competitiveness and Innovation Framework Programme
- CLN: Credit Linked Note
- CLO: Collateralized Loan Obligation
- COM: European Commission (also: EC)
- CorIP: Corporate Innovation Platform
- COSME: Programme for the Competitiveness of enterprises and SMEs (COSME) 2014-2020
- EAF: European Angels Fund
- EBAN: European Business Angels Network
- EMN: European Microfinance Network
- EC: European Commission (also: COM)
- ECB: European Central Bank
- EIB: European Investment Bank
- EIF: European Investment Fund
- EMEA: Europe, Middle East, and Africa
- ESBFO: European Small Business Finance Outlook
- ESI: Economic Sentiment Indicator
- ESIF: EU Structural and Investment Fund
- EU: European Union
- EU27: the 27 EU Member States
- EU28: the 28 EU Member States
- EVCA: European Private Equity & Venture Capital Association
- FLPG: First Loss Portfolio Guarantee
- FLS: Funding for Lending Scheme
- FRSP: Funded Risk Sharing Product
- FYROM: Former Yugoslav Republic of Macedonia
- GDP: Gross Domestic Product
- GII: Global Insolvency Index
- HM / HMT: HM Treasury is the UK government's economic and finance ministry
- HY: Half Year
- IMF : International Monetary Fund
- IPO: Initial Public Offering
- IRR: Internal Rate of Return
- JEREMIE: Joint European Resources for Micro to Medium Enterprises
- LBO: Leveraged buy out
- LFA: Förderbank Bayern
- LP: Limited Partner

- MDD: Mezzanine Dachfonds für Deutschland
- MFG: Mezzanine Facility for Growth
- MFI (in the context of ECB): Monetary Financial Institutions
- MFI (in the context of microfinance): Microfinance Institution
- NFC: Non-financial corporation
- NRW. The development bank of North Rhine-Westphalia.
- OECD: Organisation for Economic Co-Operation and Development
- PCS: Prime Collateral Securities
- pif: paid in full
- PE: Private Equity
- R&D: Research and Development
- RMA: Research and Market Analysis
- RMBS: Residential mortgage backed securities
- RSFF: Risk Sharing Finance Facility
- RSI: Risk-Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps
- SAFE: Survey on the Access to Finance of SMEs in the euro area
- SIA: Social Impact Accelerator
- SDW: Statistical Data Warehouse
- sf: Structured Finance
- SME: Small and medium sized enterprise
- SMEG: SME Guarantee Facility
- SMESec: SME Securitisation (comprising transactions based on SME loans, leases etc.)
- SPV: Special Purpose Vehicle
- TLTRO: targeted longer-term refinancing operations
- TMT: Technology, including IT and Life Sciences (except drug discovery); Media, including Internet & Digital Media; Telecom Services
- UEAPME: European Association of Craft, Small and Medium-sized Enterprises
- UK: United Kingdom
- US: United States
- VC: Venture Capital
- VDB: Verband Deutscher Bürgschaftsbanken e.V.
- WBS: Whole Business Securitisation

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EIF's central mission is to support Europe's SMEs by helping them to access finance. EIF primarily designs and develops venture capital and guarantees instruments which specifically target this market segment. In this role, EIF fosters EU objectives in support of innovation, research and development, entrepreneurship, growth, and employment.

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