



European Small Business Finance Outlook

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Executive summary¹

This European Small Business Finance Outlook (ESBFO) provides an overview of the main markets relevant to EIF (equity², guarantees/securitisation, microfinance). It is an update of the ESBFO December 2014.

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. GDP growth remains sluggish and the labour market is still expected to register a double-digit unemployment rate.
- Many of the business/climate indicators have started improving in 2014 and confidence has increased. Bankruptcies decreased in Europe in 2014.
- The ECB Bank Lending Survey shows that, on balance, the reporting euro area banks have continued to ease their credit standards for SMEs.
- According to the European Commission's and the ECB's latest "Survey on the Access to Finance of Enterprises" (SAFE), difficulties in accessing finance moved down from being the fifth to the sixth most pressing problems for euro area SMEs compared to the previous survey round.
- Significant disparities in access to finance by country persist. In distressed countries, such as Greece and Ireland but also in the Netherlands, access to finance is a very pressing problem for SMEs, while in Germany or Austria only 7% of SMEs reported access to finance as the most pressing problem.
- The trend in lending to non-financial corporations (NFCs) in Europe has declined again. 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, 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 increases. In an increasingly risk-averse environment, the tendency not to lend to small and young firms is also increasing further, 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; we would like to express particular thanks to Juho Aminoff, Laurent Braun, Alicia Boudeau, Rémi Charrier, Jacques Darcy, Nick Dunster, Per-Erik Eriksson, David González Martín, Ulrich Grabenwarter, Carsten Just, Nicolas Koch, Eirini Koutra, Marco Natoli, George Passaris, Dario Prencipe, Simone Signore, Alessandro Tappi, Aglaé Touchard-Le Drian, Piyush Unalkat, Arnaud Vanbellinghen, and Thierry Wolff. We would also like to thank colleagues from AECM, AFME, Bureau van Dijk Zephus, Collier Capital, EBAN, the ECB, EMN, Euler Hermes, Eurochambres, the EVCA research team, Go4Venture Advisers, the IMF, Leaseurope, the OECD, and the UEAPME study unit for their support. All errors are of the authors.

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

Private equity:

- Following the severe crash of European private equity (PE) investment in 2008/2009, PE had partially rebounded over 2010-2011. However, the recovery then suffered a setback in 2012, but stayed well above the 2009 crisis trough.
- Some of the gap left by the slump in VC investment after 2008 has been filled in by business angel activity in recent years; their proximity to the market has been beneficial during this difficult period.
- In 2014, PE investment increased by 9%, compared to the year before, to EUR 41.6bn. Strong positive growth rates of investments were recorded in the growth capital (+42.4% to EUR 5.2bn) and the buyout segments (+6.7% to EUR 31.7bn) of the PE market. Venture Capital (VC) investments increased by 4.2% to EUR 3.6bn. Within the VC market segment, investments with a focus on the start-up (+4.1% to EUR 1.86bn) and later stage (+5.9% to EUR 1.62bn) picked up, while seed investments (-16.5% to EUR 99.6m) continued to decrease.
- The considerable recovery of total European PE *fundraising* in 2013 has suffered a setback in 2014; however, it still recorded the second largest amount since 2009. VC fundraising also decreased in 2014. In general, its recovery has by far not been that strong than what has been observed in the overall PE market over the last years.
- The *exit markets* have remained remarkably robust in 2014. The strong increase in total PE divestment activity in 2013 was followed by another record year in 2014; however, divestments in the VC segment decreased.
- Despite the recent positive developments, as mentioned above, PE and VC investment and fundraising activity as well as the number of PE and VC funds are not much higher than half the levels that were reached in the pre-crisis years. According to the EVCA figures, government agencies accounted for 35% of total VC fundraising in 2014, thereby continuing to support the market counter-cyclically in the current crisis.
- EIF market insight shows a number of VC-backed companies in the early-stage segment that show increasing revenues and are now achieving profitability, positioning them well for sustained organic growth and ultimate strong returns for investors.

SME Guarantees / Securitisation:

- Credit guarantees continue to be “the most widely used policy instrument [...] to ease SME access to finance” and to alleviate related market failures (OECD, 2015).
- 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.
- For 2014, AECM data reports a strong increase in the number of guarantees outstanding (incl. counter-guarantees) and a smaller increase in the total guarantee volume. Hence, the average guarantee size, which had increased during the years 2009-2011, has continued to follow a downward trend, probably due to a rise in guarantees with smaller amounts, as well as of short-term guarantees (i.e. working capital loan and bridge financing guarantees).

- Lower guarantee amounts are, inter alia, caused by weak economic activity and public budget cuts in some countries. Support from the European level can help to improve the situation at least on the supply side. In this respect, several new initiatives have been implemented, and others are under preparation.
- SME securitisation (SMESec) can form an important element in the efforts to enhance access to finance for SMEs in Europe.
- The SMESec market is still suffering from the crisis, however, the overall issued volume of SME deals in 2014 (EUR 33.3bn) was already significantly higher than in 2013 (+64%).
- Despite the financial and sovereign crisis, the European securitisation market has performed relatively well so far, with the SME segment showing low default rates.
- The reputation of the SME securitisation market segment is continuously improving; a destigmatisation is happening, and the general perception is shifting from one of “toxic waste” to a means that could help overcome the negative effects of the crisis.
- 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. Strong but smart regulation is needed.
- Transparency is a prerequisite for any structured transaction; the introduction of a properly defined concept of “high quality securitisation” could add substantial information, and such a definition should include SMESec transactions, as well as simple and transparent synthetic structures.
- The ECB’s support of the ABS market in general, and the SMESec market in particular, is important. The ECB started its new Asset Backed Purchase Programme (ABSPP) in November 2014. So far, the achieved volumes are not yet significant (i.e. compared to the Covered Bond purchase programme).

Microfinance:

- Microfinance is generally associated with social and economic objectives, and it is an important financing channel for financial inclusion and 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 for 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, microenterprises have perceived an increase in the external financing gap indicator. Moreover, the share of enterprises which see access to finance as their most pressing problem remained bigger among microenterprises than among their larger peers.
- The latest 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.

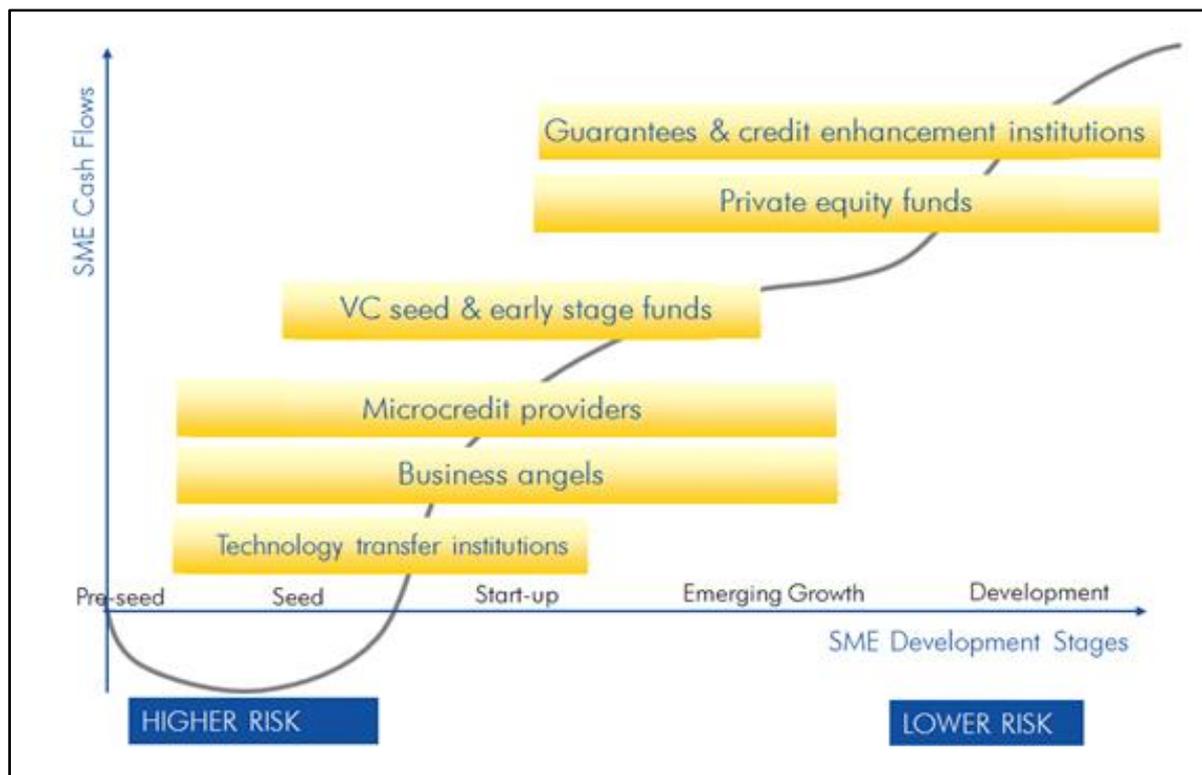
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1 Introduction

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 (equity³, guarantees/securitisation, microfinance). The present edition is an update of the ESBFO December 2014.

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 2014, the global economic outlook has remained broadly unchanged. The International Monetary Fund (IMF) has recently estimated 3.4% as global growth for 2014 (like for 2013). For 2015 and 2016, the IMF expects slight increases in global growth rates to 3.5% and 3.8% respectively. Compared to IMF's previous projections (October, 2014), the estimated growth rate has been increased by 0.1 percentage point for both 2013 and 2014 (IMF, 2015b).

The European Commission (EC) has also updated its projections for the European Union (EU), expecting a positive (+1.4%) growth rate for 2014, followed by higher growth in 2015 (+1.8%) and in 2016 (+2.1%), see Table 1. For 2014, the labour market is again expected to have registered a double-digit unemployment rate in the EU, while for 2015 slightly improved employment prospects are estimated. However, private and public consumption are both expected to expand moderately. As over the past three years, net exports have remained the most powerful growth driver in 2013. For the years 2014-2016, domestic demand is expected to take over as the main contributor to growth (European Commission, 2015d).

Table 1: Main features of the European Commission spring 2015 forecast for the EU

(Real annual percentage change, unless otherwise stated)				Spring 2015 estimates / forecasts		
	2011	2012	2013	2014	2015	2016
GDP	1.7	-0.5	0.0	1.4	1.8	2.1
Private consumption	0.3	-0.7	-0.1	1.4	2.1	1.9
Public consumption	-0.2	0.3	0.2	1.0	0.8	0.8
Total investment	2.0	-2.8	-1.5	2.5	2.6	4.2
Employment	0.1	-0.6	-0.4	1.0	0.9	1.0
Unemployment rate (a)	9.7	10.5	10.9	10.2	9.6	9.2
Inflation (b)	3.1	2.6	1.4	0.4	0.1	1.5
Government balance (% GDP)	-4.5	-4.2	-3.2	-2.9	-2.5	-2.0
Government debt (% GDP)	81.4	85.1	87.3	88.6	88.0	86.9
Adjusted current-account balance (% GDP)	-0.3	0.5	1.1	1.2	1.5	1.6
	Contribution to change in GDP					
Private and Public Consumption	0.2	-0.3	-0.1	1.0	1.4	1.3
Investment and Inventories	0.6	-1.2	-0.3	0.5	0.5	0.8
Net exports	0.9	1.1	0.4	-0.1	0.0	0.0

(a) Percentage of the labour force.

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

Source: European Commission (2015d)

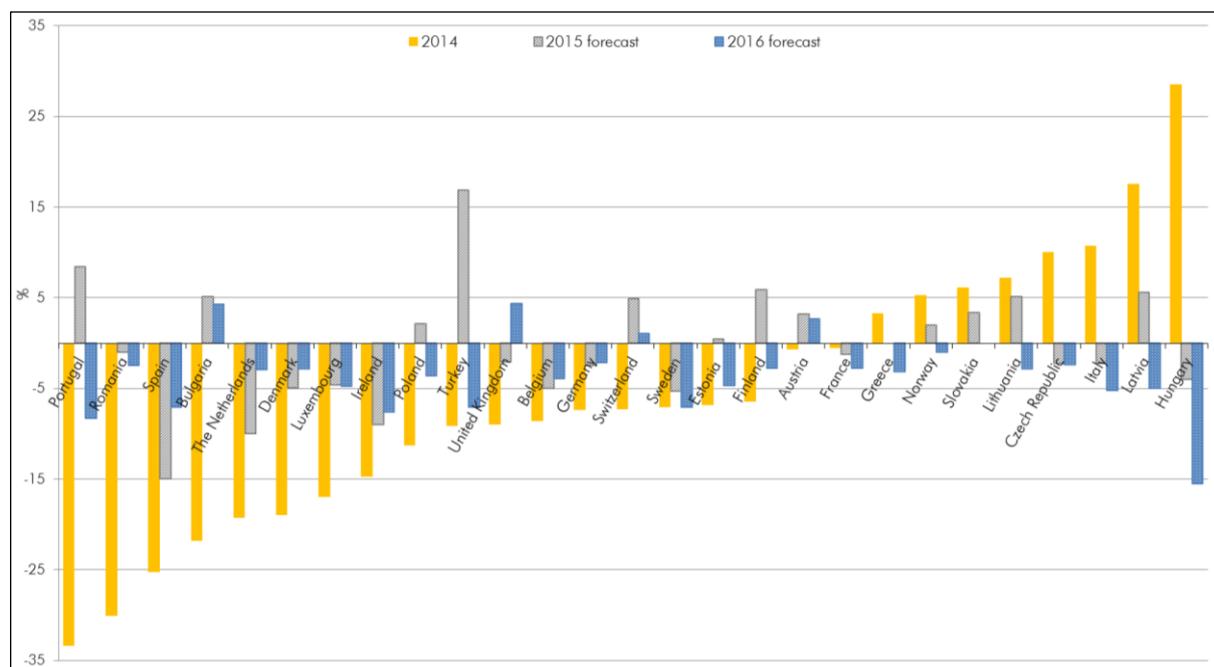
The recent results of the European Commission economic sentiment indicator (ESI) remained broadly stable for both, the EU and the euro area. The Business Climate Indicator (BCI) for the euro area has slightly decreased (European Commission, 2015b and 2015c).

The improvement in business conditions also affected the development of business insolvencies in Europe. For 2014, the Euler Hermes Insolvency Index shows a drop in Western Europe (-15%) and Central & Eastern Europe (-6%). For 2015 a decline is expected in Western Europe (-7%), while for Central & Eastern Europe an increase in the total number of insolvencies is expected (+15%), (Euler Hermes, 2015). Compared to Western Europe, the general economy and the insolvency situation in Central and especially in Eastern Europe were affected by the conflict between Russia and Ukraine and the associated trade embargo (Creditreform, 2015).

The disparities by country have remained prevalent (Figure 2). In 2014, double-digit increases in insolvencies were recorded in Hungary (+29%), Latvia (+17%) and in Italy (+11%). On the other hand, the most significant falls in the European insolvency indexes were recorded in Portugal (-33%), Romania (-30%) and Spain (-25%). For 2015, insolvencies are expected to decrease in Spain (-15%) and in the Netherlands (-10%). Moderate increases are expected for Portugal (+12%), Latvia (+6%) and Finland (+6%), (Euler Hermes, 2015).

See Box 1 for an overview of the relationship between insolvency systems and non-performing loans (NPL).

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



Source: Authors, based on data from Euler Hermes (2015)

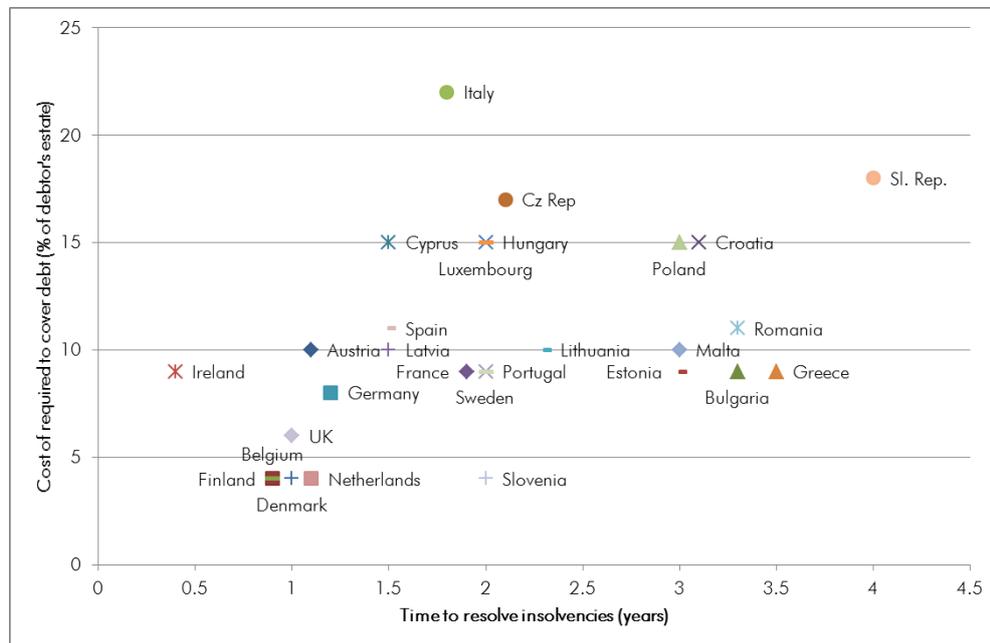
Box 1: Non-performing loans and insolvency systems as impediments to SME lending

High levels of non-performing loans in many European countries have a negative impact on bank lending, and subsequently on economic growth.⁴ According to EIB (2014), the stock of NPLs amounts to around EUR 800m in the Euro area and it has more than doubled since 2009, in particular in crisis hit countries, e.g. in Cyprus, NPLs make up around 50% of total gross loans, in Greece this value is around 34%.

Adequate insolvency frameworks are important in order to ensure an efficient management of NPLs. The World Bank “Doing Business” data confirms that for countries, that score well on their insolvency framework index, have higher levels of credit provided to the private sector by domestic financial institutions (World Bank, 2014). The EU and many Member States have undertaken steps to improve the situation (i.e. in the areas of insolvency reforms, banking supervision, debt restructuring, or direct government support to assist debt-distressed SMEs). However, according to the IMF, insolvency systems and out-of-court workout frameworks in Europe are still not sufficiently tailored to the needs in the SME space (Bergthaler et al., 2015).

Figure 3 shows that time and cost to resolve insolvency processes vary significantly between Member States. According to the data from the World Bank, clear outlier in terms of cost of insolvency processes⁵ is Italy, followed by the Slovak Republic and the Czech Republic. Concerning the time to resolve insolvencies, it takes the longest in the Slovak Republic, Greece, and Bulgaria (World Bank, 2014).

Figure 3: Time and cost to resolve insolvencies in EU Member States



Source: Authors, based on “Doing Business 2015” (World Bank, 2014)

⁴ See for an analysis of NPLs and their impact on SME lending and financial stability: OECD (2015) pages 69ff.

⁵ The cost required to cover debt is measured as percentage of estate value; it includes court fees, fees of insolvency administrators, lawyers’ fees, assessors’ and auctioneers’ fees and other related fees (for details and methodology please see World Bank (2014)).

Box 1 continued:

Increasing banks' ability to resolve or dispose non-performing loans can improve their lending capacity. The IMF encourages a comprehensive strategy covering a broad spectrum of reforms to accelerate restructuring and resolution, in particular tighter regulation of banks' NPL management, insolvency reforms to improve the efficiency of SME restructuring, a greater push for out-of-court workouts, and supportive macro and financial policies. The incentives for restructuring should be strengthened, and moral hazard issues should be addressed by ensuring speedy exits of non-viable SMEs (see Bergthaler et al., 2015). Moreover, the further development of markets for NPLs can form part of the solution.

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

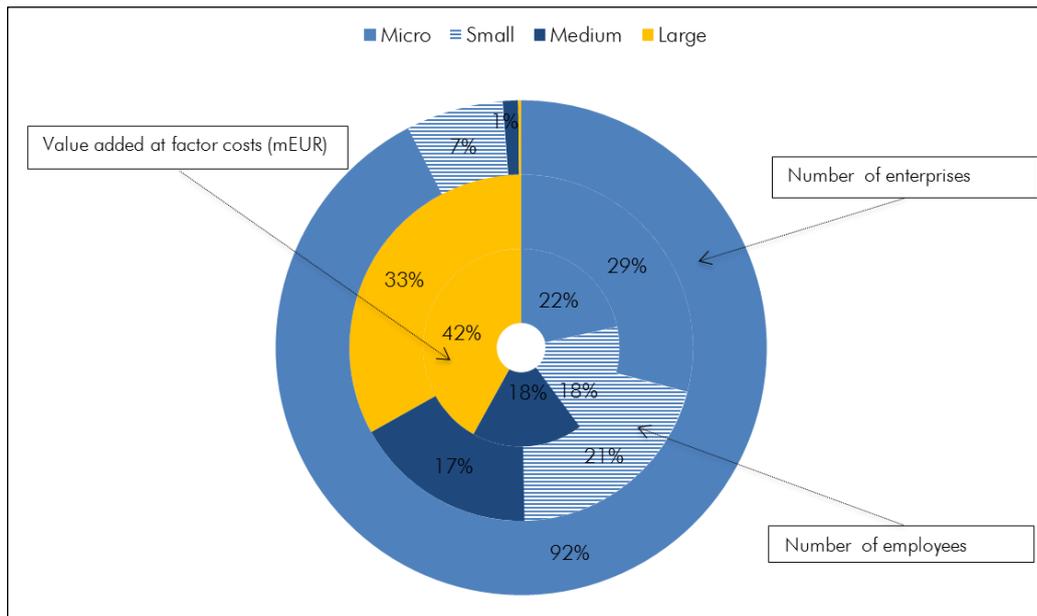
Source: European commission (2014a)

Small and medium-sized enterprises are often called the backbone of the European economy, contributing to job creation and economic growth. In 2013, more than 21.5m of SMEs in the European Union made for 99.8% of all non-financial enterprises, employed 88.8m people (66.9% of the total employment), and generated 58.1% of total added value (see Figure 4).⁶

⁶ 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

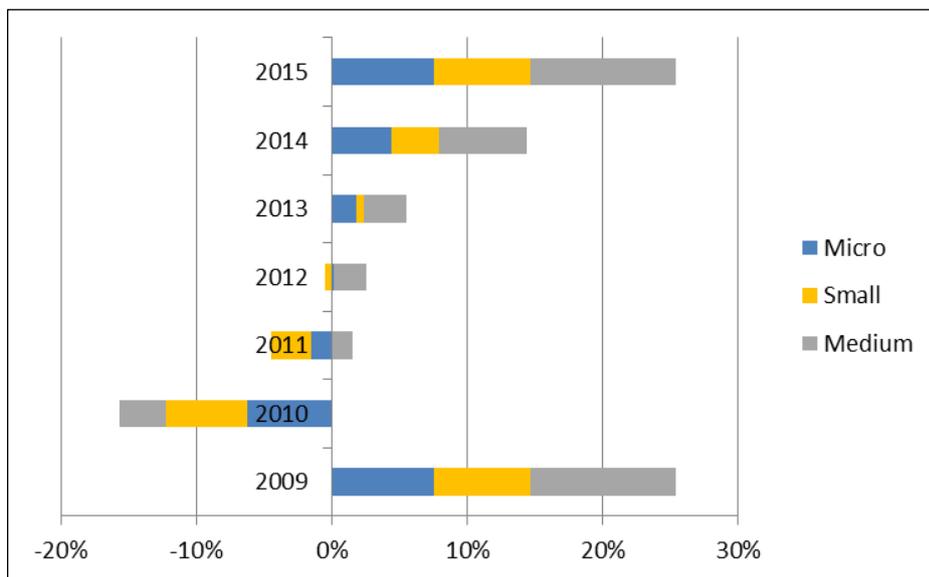
Figure 4: SMEs, Employment and Value added, 2013



Source: European Commission (2014a)

The European Commission's forecasts concerning the value added of SMEs in the EU are optimistic. The level of value-added produced by SMEs is expected to grow by 14% in 2014 and by 25% in 2015, compared to the 2008 level (see Figure 5).

Figure 5: Value added, 2011-2015, 2008=100

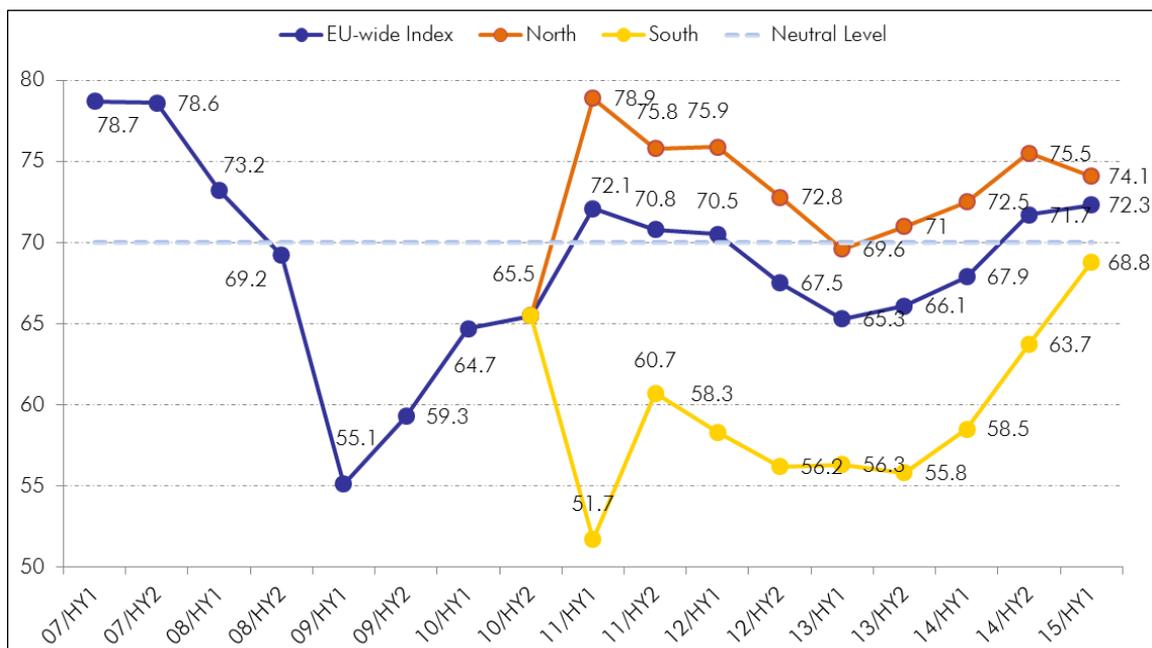


Source: European Commission (2014a)

3.2 SME business climate

The financial, debt and economic crisis had dramatically worsened the business environment of European SMEs since 2008, and in particular in those countries that had suffered the most of the crisis. However, in the recent past, some changes to the better have become visible, and SMEs' business climate - as analysed by UEAPME (UEAPME Study Unit, 2015) - has improved again. Significant progress was, inter alia, observed in the countries of the south/the periphery (Croatia, Cyprus, Greece, Ireland, Italy, Malta, Portugal, Slovenia and Spain). The SME Business Climate Index for these countries increased by 5.1 percentage points in the first half-year of 2015 (see Figure 6), which contrasts the 1.4 percentage point decrease in the countries of the north and the centre (Austria, Belgium, Bulgaria, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Romania, Slovakia, Sweden and UK). As a result, the imbalance between the two diverse country groups has diminished even more, with the current gap equal to 5.3 percentage points, compared to 11.8 percentage points in the second half-year of 2014. The EU-wide index still stands above the neutral level. However a small number of enterprises reported a positive business trend and a relatively large number of business indicated neutral results, "which proves that Europe's SMEs are more in a wait and see mode than in a growth one" (UEAPME Study Unit, 2015).

Figure 6: SME Business Climate Index⁷

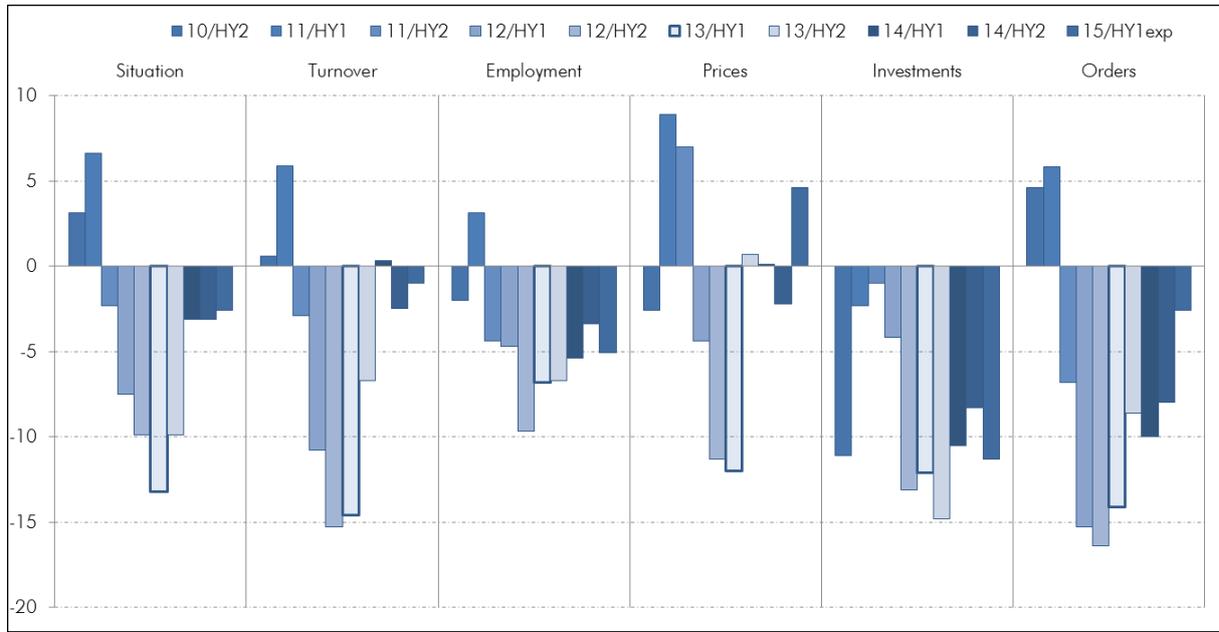


Source: Authors, based on UEAPME Study Unit (2015)

⁷ 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 as regards 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.

Figure 7 shows the balance of “positive minus negative” answers reported by European SMEs, according to UEAPME Study Unit (2015), with reference to situation, turnover, employment, prices, investments and orders on a semi-annual base, starting from the second half-year 2010, with the last column being expectations for the first half-year of 2015. Specifically, for the first half of 2015, all business indicators, except prices, are on balance expected to decrease.

Figure 7: Main Results of the EU Craft and SME Barometer HY1/2015⁸



Source: Authors, based on data from UEAPME Study Unit (2015)

The balance between the expectations and the final results for the second half of 2014 is shown in Figure 8. The indicator results for the second half-year of 2014 were significantly worse than expected. The biggest difference was observed in the orders for which the balance of expectations (3.9%) contrasts significantly with the balance of the actual reported results (-8.3%); see UEAPME Study Unit (2015).

The results of the recent Eurochambres (2015) Economic Survey⁹ point in a similar direction. According to this study, all economic indicators, including business confidence, show a clear improvement in outcomes in 2014. Improvements are expected for 2015, but at a slower pace.

⁸ The EU Craft and SME Barometer builds on the results of surveys that are conducted by UEAPME member organisations two to four times a year in different regions all over Europe. The 2015/HY1 results are based on about 120,000 questionnaires, with 30,000 answers received. The data for the most recent survey were collected between December 2014 and February 2015. The balanced figures mentioned in the text show the difference between positive and negative answers, with national results weighted by number of employees. The surveyed categories include overall situation, turnover, employment, prices, investment, and orders. For details see UEAPME Study Unit (2015).

⁹ 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 60,000 businesses in EU Member States and EU Candidate Countries on six economic indicators: business confidence, domestic sales, export sales, employment & investment. The Eurochambres Economic Survey has been conducted since 1993. For details on the methodology see Eurochambres (2015).

Despite the general positive expectations for 2015, great disparities in business confidence by country persist. Portugal, Latvia and Spain are the most optimistic for the year ahead. The highest level of pessimism was observed in Austria and in Slovakia.

Figure 8: Expectations of SMEs and real outcome for HY2/2014



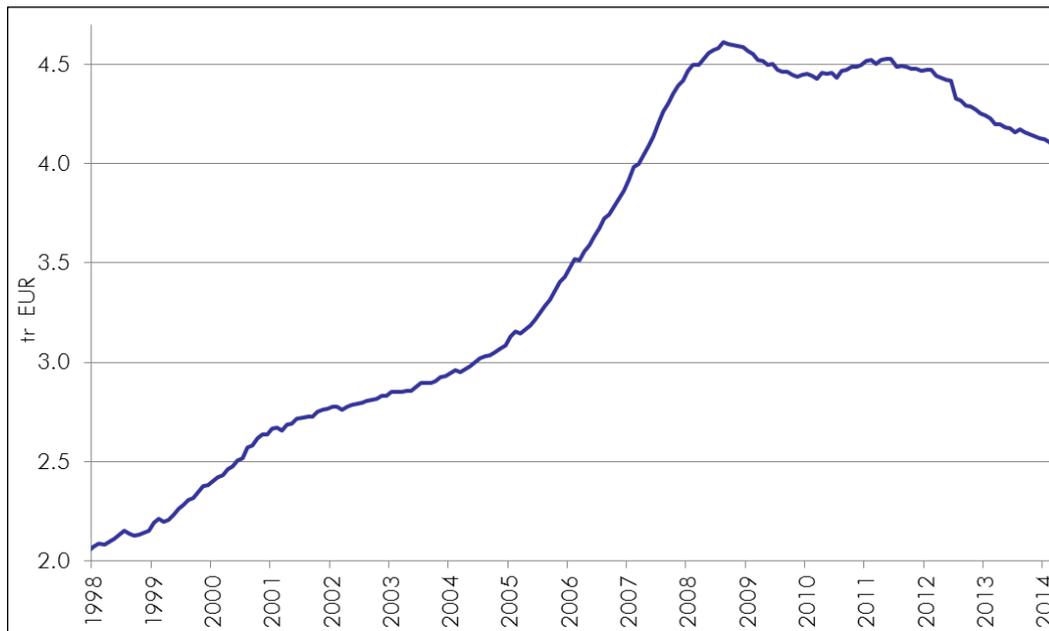
Source: Authors, based on data from UEAPME Study Unit (2015)

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 9). Compared to the peak of EUR 4.6tr reached at the beginning of 2009, the volume of outstanding loans has decreased by 11.5% to EUR 4.1tr in the Euro area in March 2015¹⁰.

¹⁰SME loan data do not exist at the European level. 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%.

Figure 9: Outstanding Loans to Non-Financial Corporations in the Euro Area



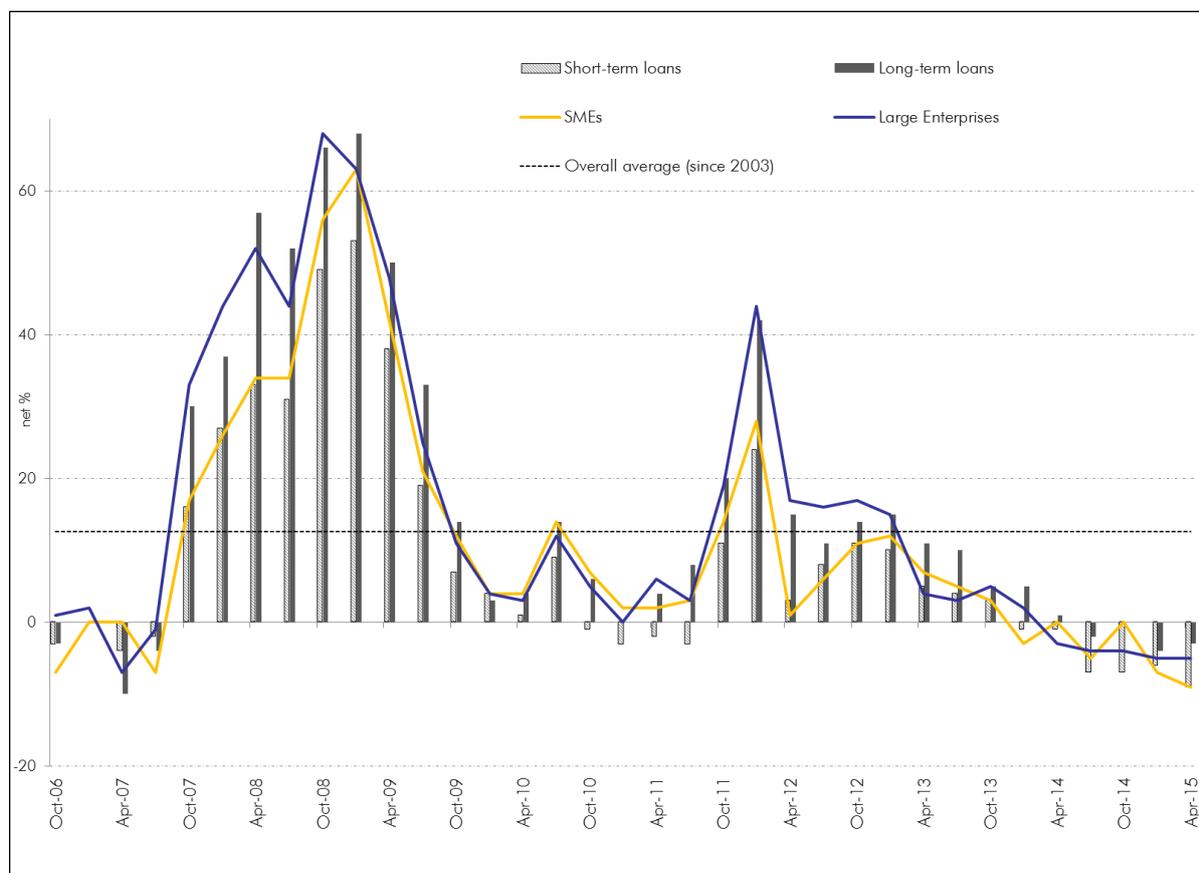
Source: Authors, based on data from ECB

The current status of bank lending has also been analysed in the ECB's latest Bank Lending Survey (BLS, see ECB, 2015b)¹¹: the net tightening of credit standards in the first quarter of 2015 still stands below its historical averages. Moreover, on balance, the reporting euro area banks have continued to ease their credit standards to non-financial corporations (NFCs). The survey shows that a net 9% of banks reported an easing in Q1/2015 (compared to 5% in the previous quarter). This is the fourth time in a row that banks reported, on balance, a net easing of credit standards, following the continuous net tightening that had been observed since 2007.¹² As shown in Figure 10, banks continued reporting a net easing of credit standards for SMEs (-7%, in Q4/2014 and -9% in Q1/2015), where the negative number indicates that the net percentages of banks contributed to an easing of credit standards (ECB, 2015b). According to the BLS, the credit standards improved, on balance, for both short-term and long-term loans.

¹¹This survey was conducted on 142 euro area banks and reports changes during the first quarter of 2015 (Q1/2015) and expectations of changes in the second quarter of 2015 (Q2/2015).

¹²Text 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: Changes in credit standards applied to the approval of loans or credit lines to enterprises (SMEs versus large enterprises)

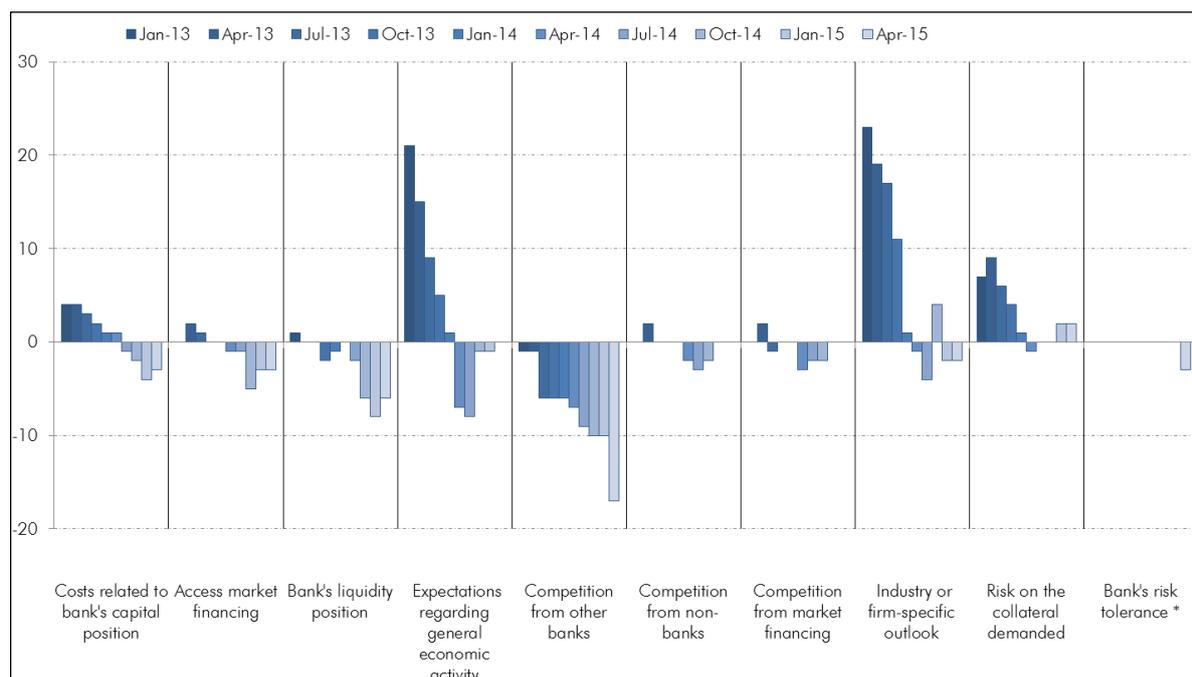


Source: Authors, based on data from ECB (2015b)

In Q1/2015, in net terms, all the factors including the costs related to bank's capital position and the expectations concerning the industry (or firm) specific outlook, contributed to the easing of credit standards for SMEs (with the exception of risk on the collateral demanded, which had a negative impact on the net easing of credit standards), see Figure 11. The net share of rejected applications for loans to enterprises decreased (-5%) in Q1/2015 according to the banks (ECB, 2015b).

Positive signs have also been observed in the demand for bank lending. According to the reporting banks of the ECB's Bank Lending Survey, net demand for loans to NFCs continued to be positive and recovered further in Q1/2015 (6%, and 18% in Q4/2014) remaining levels above its historical average. This was mainly driven by the low general level of interest rates in all large euro area countries. Concerning the projections for Q2/2015, banks expect a significant increase in demand (for all categories of loans), (ECB, 2015b).

Figure 11: Factors contributing to tightening credit standards for SMEs¹³



Source: Authors, based on data from ECB (2015b)

*Note: "Bank's risk tolerance" was introduced to BLS question nr. 2 in the previous survey.

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 1m) 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.

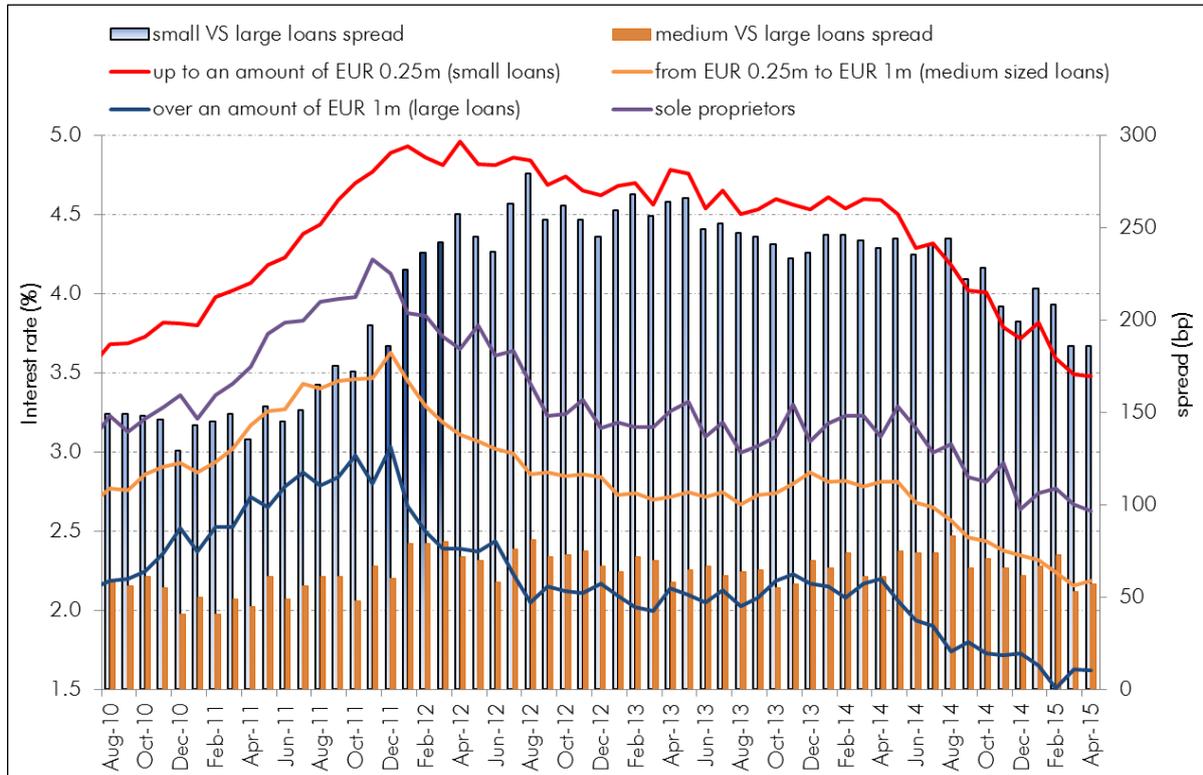
Loans of amounts over EUR 0.25m up to EUR 1m (medium-size loans) had a rather stable spread over loans of more than EUR 1m (large loans), averaging 64 basis points (bp) over the period from June 2010 to April 2015 (see Figure 12). In contrast, the interest rate spread between loans of up to EUR 0.25m (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. Afterwards, the spread had been rather stable until August 2014, averaging 249bp. Since then, the spread has significantly come down, i.e. to 186bp in April 2015.

Overall financing costs for euro area MFIs have continued to fall across most external financing sources. The aggregate improvement in financing conditions was driven by improving financial

¹³The 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.

market conditions and a better economic growth outlook. However, the difference between the loan pricing conditions for small and large firms remained high in more vulnerable countries, where SMEs remained more dependent on bank funding (ECB, 2015c).

Figure 12: Evolution of monetary financial institutions interest rates on new loans to non-financial corporations¹⁴



Sources: Authors, based on Huerga et al. (2012), ECB (2015d), ECB SDW, and own calculations

3.5 SMEs' Access to finance

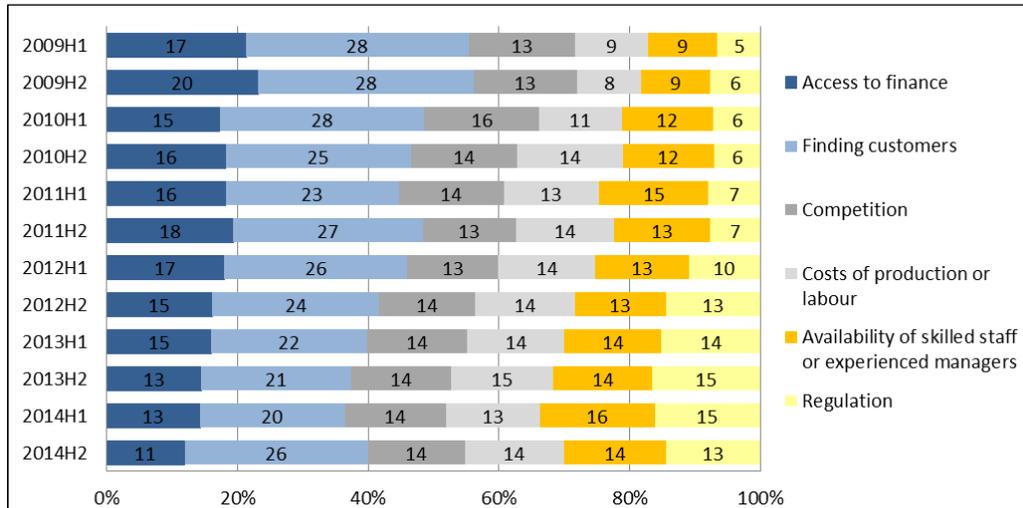
According to the ECB latest Survey on the Access to Finance of Enterprises (SAFE), covering October 2014 to March 2015 (European Commission, 2014b and ECB, 2015a)¹⁵, access to finance moved from the fifth to the sixth most pressing problem for euro area SMEs compared to the previous survey round. The percentage of companies that mention access to finance as their most pressing problem has dropped to a level of 11% (from 13%), see Figure 13.

¹⁴New 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.

¹⁵The European Commission and the European Central Bank decided in 2008 to collaborate on a survey on the access to finance of enterprises in the European Union, and they established The Survey on the Access to Finance of Enterprises (SAFE). SAFE ECB waves are run every 6 months, covering the Euro area countries. The SAFE Commission waves are published every year, covering all EU countries and other countries participating in the Entrepreneurship and Innovation Programme of the CIP.

Unsurprisingly, the divergence across the countries remained large. On the high side, 34% of the SMEs in Greece, 15% in Ireland and in the Netherlands, mentioned 'access to finance' as the most pressing problem, compared with around 7% of the SMEs in Germany and in Austria on the low side. 'Finding customers' remained the most frequently mentioned concern (ECB, 2015a).

Figure 13: The most pressing problem SMEs are facing

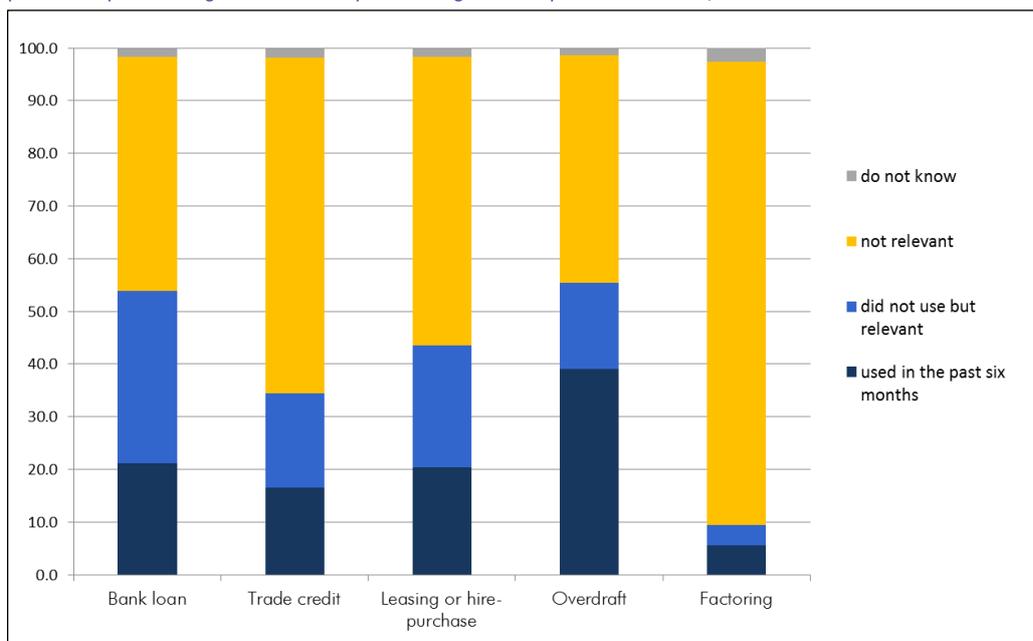


Source: Authors, based on SAFE, ECB (2015a), Statistical Data Warehouse

Looking at the most popular sources of debt financing for SMEs, the latest ECB survey (ECB, 2015a) identified bank products (bank overdraft, bank loans) as the most popular instrument (see Figure 14).

Figure 14: Sources of external financing of euro area SMEs

(over the preceding six months; percentage of respondent SMEs)

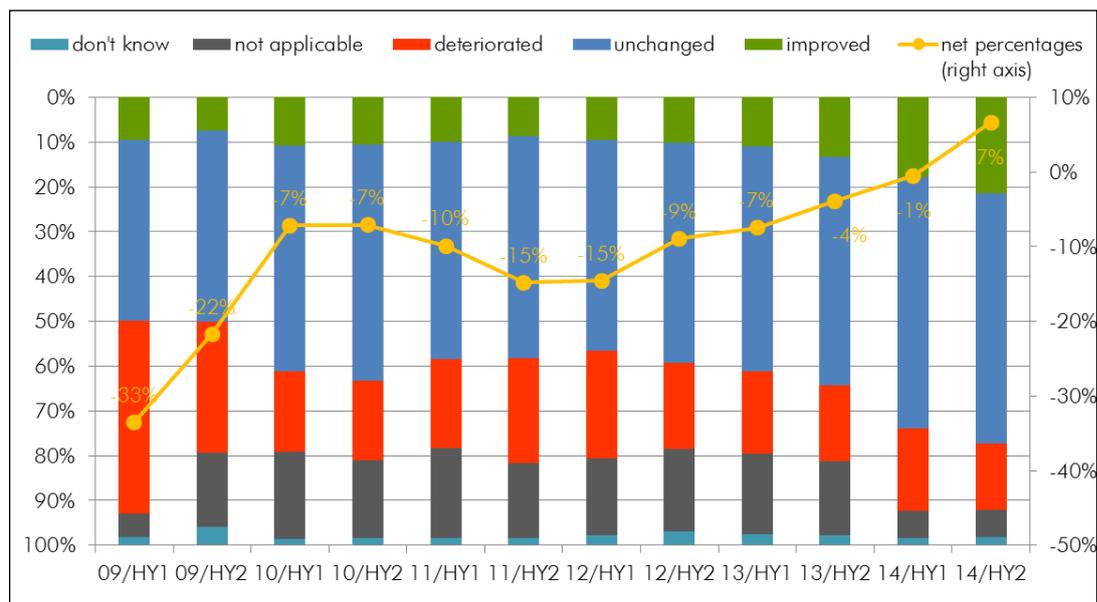


Source: Authors, based on ECB (2015a), Statistical Data Warehouse

During the reference period, the net percentage¹⁶ of SMEs, reporting a higher need for bank loans, has increased in comparison to the previous survey (+3% from +1%),(ECB, 2015a). At the same time, the net percentage of SMEs that perceived an improvement in the availability of bank loans increased significantly (see Figure 15).

Figure 15: Change in the availability of bank loans for euro area SMEs

(over the preceding 6 months; % of respondents)



Source: Authors, based on ECB (2015a), 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. Although, on balance, the negative impact was less pronounced compared to the previous period (-3% compared with -21%).

Euro area SMEs reported, on balance (+25%), a significant fall in interest rates. The net share of SMEs which observed increases in costs of financing other than interest rates (+26% from +35%) has decreased, albeit at high levels, at the same time, the net share of SMEs which observed increases in collateral requirements (+19% from +29%) has decreased.

The net percentages of SMEs reporting an increase in bank lending interest rates declined sharply in Italy (2% from 24%) but remained positive, while SMEs in Spain reported, on average, a decline in interest rates for the first time since the launch of the survey (-33% down from 1%). A decline was reported by even higher net percentages of SMEs in France (-47%), Belgium (-44%), and in Germany (-42%), (ECB, 2015a).

When looking at actual applications for external financing, the percentage of SMEs that applied for a bank loan between October 2014 and March 2015 has remained broadly unchanged (+30%) compared to the previous survey. The main reason for SMEs not to apply for a bank loan

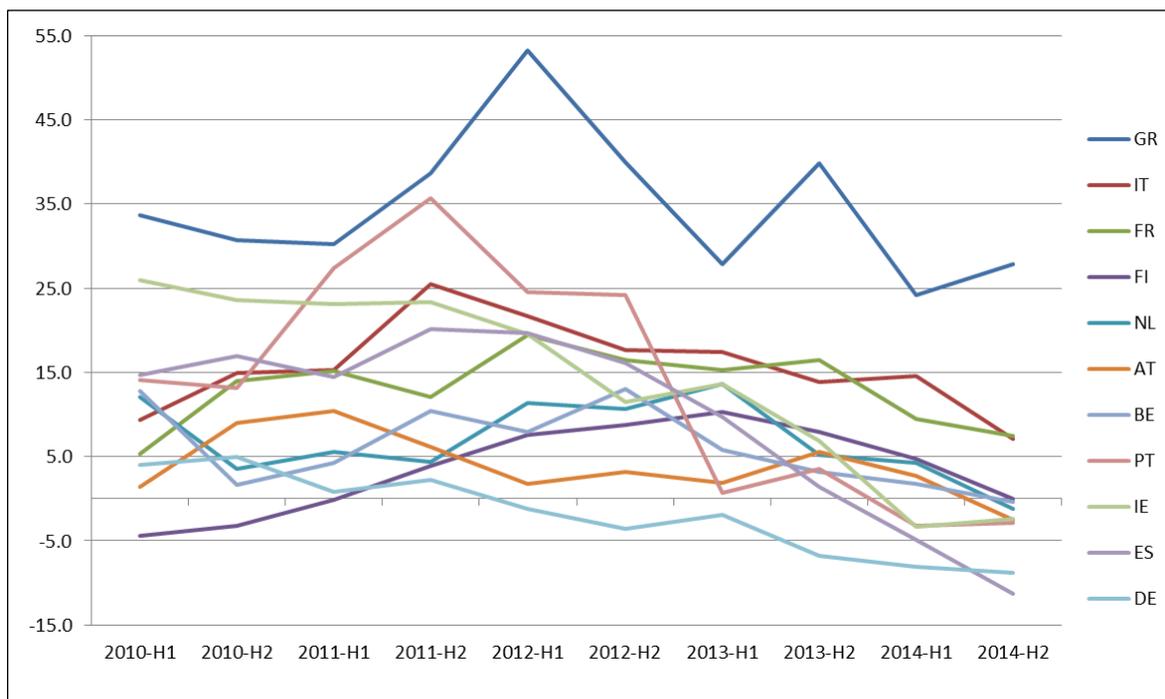
¹⁶“Net percentage” means the difference between the percentage of firms reporting an increase (or an improvement) for a given factor and that reporting a decrease (or deterioration).

still remains the availability of sufficient internal funds followed by fear of rejection (discouraged borrowers). The success rates of actual loan applications by SMEs have increased compared to the previous survey. 64% of the euro area SMEs reported that they had received the full requested amount (compared to 59% in the previous round). SMEs continued to report a higher rejection rate than large firms (+8% versus +2%).

Looking ahead, and on balance, the euro area SMEs expect a significant improvement in the availability of bank loans and bank overdrafts (11%, compared with 0%). In addition, SMEs expect an increase in the availability of internal funds.

Based on the SAFE data (demand-side data) a composite indicator on perceived changes in the needs and availability of external financing of firms can be calculated¹⁷: There are also disparities in the perception of external financing gaps across countries. At country level, Germany, Spain, Ireland and Portugal reported negative net balances (i.e. decreasing mismatch between financing needs and availability). The other countries reported positive net balances but with a clearly declining trend, except Greece, which perceived an increasing trend. The overall gap indicator for SMEs, decreased to zero (from 3% in the previous survey round), (ECB, 2015a), (Figure 16).

Figure 16: Perceived change in the external financing gap (by country)



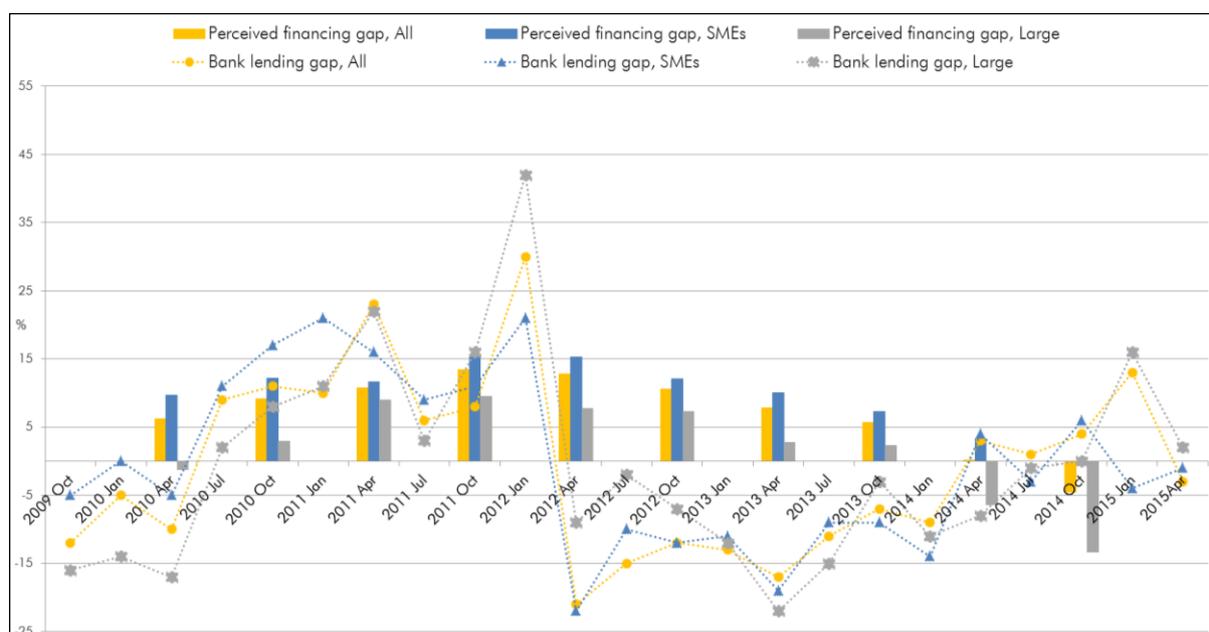
Source: Authors, based on ECB (2015a), Statistical Data Warehouse

¹⁷For 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.

The ECB's Bank Lending Survey (BLS) data allows us to calculate the gap from the supply side (albeit only for bank loans) and compare it to the gap from the demand side (the SAFE). 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. In 2010 and in 2011 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 17).

In 2012 and 2013, a mismatch in perceptions has been observed: on balance, SMEs perceived increasing gaps, while banks mostly perceived no changes in the gaps. In 2014 the perceived gaps in bank loans reported by the firms were again closer to the gaps perceived by the banks.

Figure 17: Perceived change in the external financing gap, reported by borrowers and lenders¹⁸



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

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

In cooperation with EIF RMA, Ilges (2015) analysed the interaction between the supply and the demand side in bank lending. We present key parts of this work in Box 2 below.

Box 2: Corporate lending and Financing Gap over the Business Cycle

In the aftermath of the recent economic and financial crisis, credit tightening has hit SMEs the hardest. A prevailing theory for such phenomenon is SMEs' typical lack of collateral, increasing their vulnerability to credit cycles (Kiyotaki and Moore, 1997). Moreover, SMEs' high risk profile, and particularly the lack of credit history of young enterprises, is a driver of bank's strategic credit rationing (see chapter 5.1 for a more detailed elaboration)

¹⁸On this figure the distinction between large enterprises and SMEs is based on annual sales as defined by the BLS.

Box 2 continued:

However, a crucial challenge for policy-makers and researcher remains the disentangling of demand-driven and supply-driven determinants, in order to assess how the two different sides react to changes in the macroeconomic environment.

Against this background, the recent work of Ilges (2015)¹⁹ builds and expands on the previous efforts of Holton et al. (2012), in combining demand-side micro-data on SMEs from the ECB SAFE with supply-side information from the ECB Bank Lending Survey (BLS) as well as country- and year-specific macroeconomic data. The panel, comprising semester data in 11 EU countries from 2009 to 2014, was thus employed in an analysis of the relationships between a) fluctuations in the macroeconomic environment and SMEs' access to finance conditions, and b) supply- and demand-side shifts. The multivariate regression setting also allows controlling for firm-specific characteristics.

A wide range of empirical evidence stands out, where the most striking result relates to the high degree of financial fragmentation measured across EU countries in terms of SMEs access to finance: *ceteris paribus*, SMEs from EU peripheral countries were found to be significantly more credit-constrained than core countries' SMEs, albeit with some noteworthy exceptions (e.g. the Netherlands).

At the macro level, the study is in line with its predecessor in highlighting a positive relationship between higher GDP growth and enhanced SMEs' access to credit. Moreover, a higher degree of private investments is also positively linked to more favourable access to finance conditions. Conversely, an increase in sovereign bond yields (proxy for interest rates level) shows a strong negative correlation with SMEs access to credit. With respect to private debt-to-GDP ratio, the study confirms previous findings of a negative relationship with SMEs' access to finance, mostly through credit supply factors. However, an interesting result is that higher government debt levels are not necessarily related to a worsening SMEs' access to finance. In fact, the relationship between these two variables is positive, albeit very small in magnitude.

In all, the behaviour of banks plays an expectedly significant role in small-medium firms lending dynamics. In particular, the study finds that a net tightening of credit standards is a significant predictor of firms' reported interest rates increases and loan availability deterioration, but not of loan rejection rates. This could imply that banks' decision to be more selective when granting loans affects lending conditions and the perception of firms more than actual rejection rates.

In the following chapters we are going to analyse specific market segments of external SME financing (i.e. private equity and venture capital, SME guarantees and securitisation, and microfinance).

¹⁹Thesis prepared by in cooperation with EIF RMA in fulfilment of the "Business Administration" M.Sc. at the University of Trier; this text box was prepared by Ricardo Ilges; the project and the box benefitted from significant input from Simone Signore and Dario Prencipe.

4 Private equity

4.1 Investment activity

Box 3: Introductory information on EVCA data

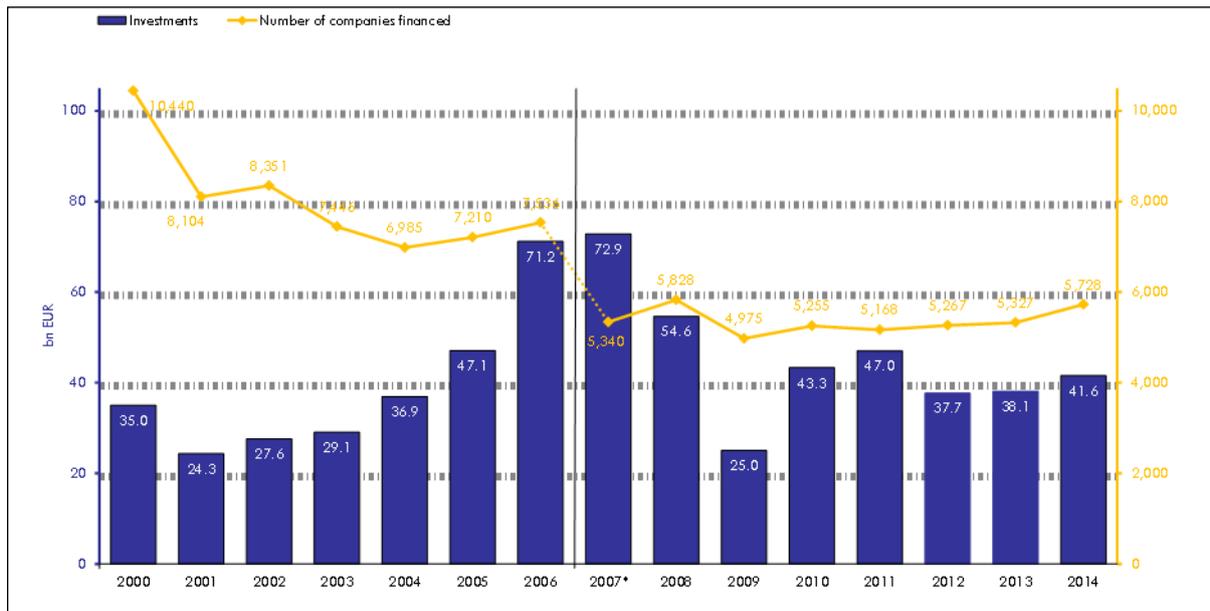
In this chapter, numbers, diagrams and statements are to a large extent built on statistics from the European Private Equity & Venture Capital Association (EVCA), and we would like to thank our colleagues from the EVCA research team for their support.

Please do also note that EVCA private equity (PE) statistics do not include infrastructure funds, real estate funds, distressed debt funds, primary funds-of-funds, secondary funds-of-funds and PE/VC-type activities that are not conducted by PE funds. This means that the activities of business angels and hedge funds as well as corporate acquisitions outside of dedicated corporate venture programmes are not included in the statistics. EVCA statistics can differ from the numbers reported by other data providers for the reasons just mentioned and due to, e.g., different definitions and interpretations of the PE fund and investment stages and geographical definitions (e.g. of “Europe”). See, also for more details, EVCA (2014) and (2015a) and the EVCA website (www.evca.eu).

Following the severe crash of European private equity (PE) investment in 2008/2009, PE had partially rebounded over 2010-2011. However, the recovery then suffered a setback in 2012, but stayed well above the 2009 crisis trough. In 2014, PE investment increased by 9%, compared to the year before, to EUR 41.6bn (see Figure 18). The number of companies that benefited from PE investment increased by 7.5% to 5,728. In terms of amounts invested, strong positive growth rates were recorded in the growth capital (+42.4% to EUR 5.2bn) and the buyout segments (+6.7% to EUR 31.7bn) of the PE market. Venture Capital (VC) investments increased by 4.2% to EUR 3.6bn. (Please note that the market segment Business Angels is not included in the EVCA statistics; see Box 3. As business angel financing is important for the financing of SMEs and innovation, we present more information in Box 4).

Within the VC market segment, investments with a focus on the start-up (+4.1% to EUR 1.86bn) and later stage (+5.9% to EUR 1.62bn) increased, while seed investments (-16.5% to EUR 99.6m) continued to decrease (see Figure 19).

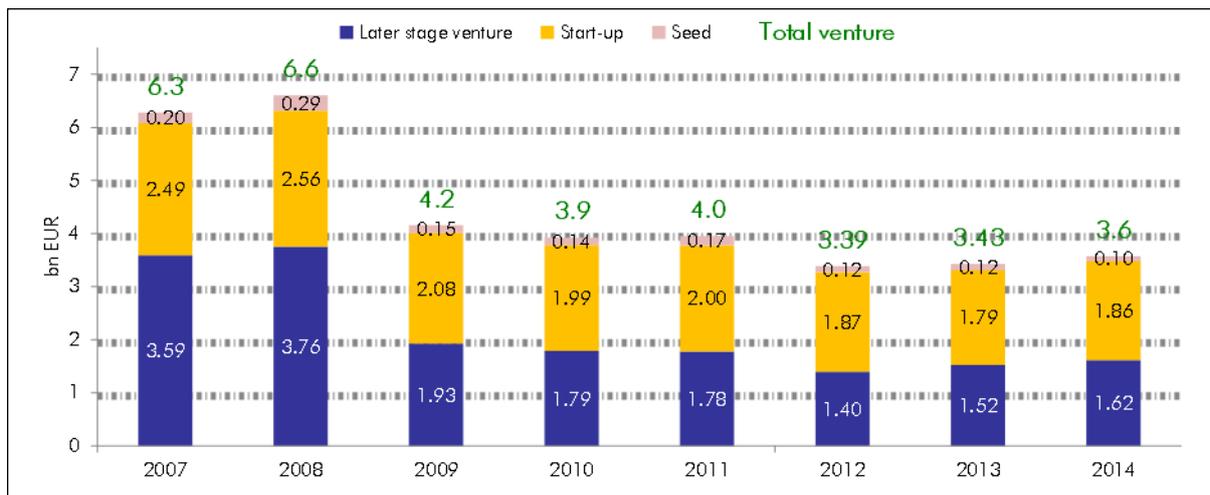
Figure 18: Investment activity by private equity firms located in Europe²⁰



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

Source: Authors, based on data from EVCA.

Figure 19: Venture Capital investment activity evolution in Europe



Source: Authors, based on data from EVCA.

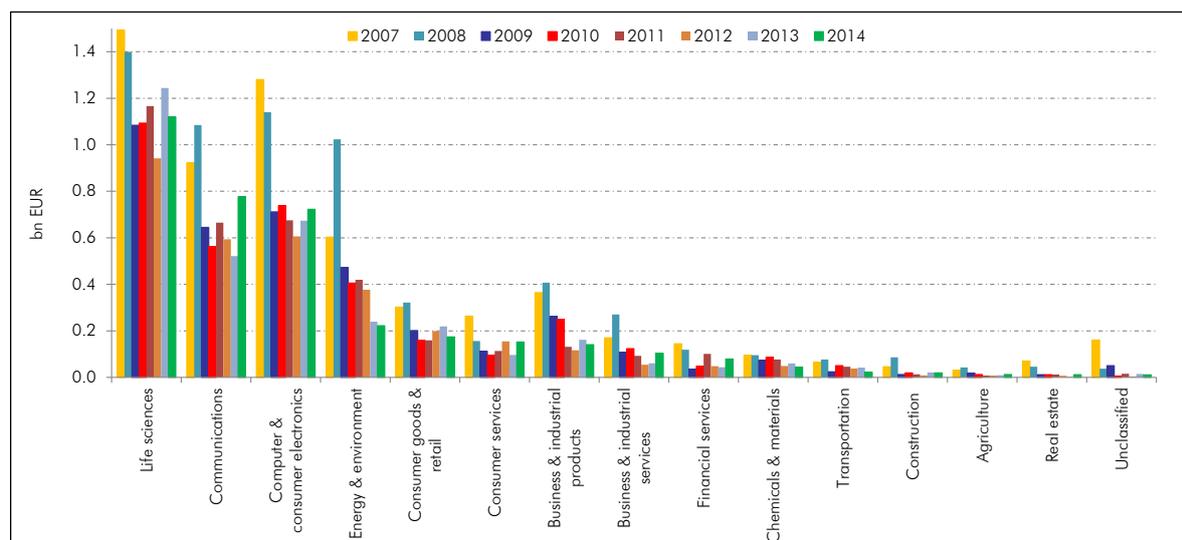
These developments were at least partially driven by the improvement in the general economic situation, from which private equity – and in particular the buyout sector being the biggest segment of the market – has benefited.

Recent developments in venture investment by sector are shown in Figure 20. In the EVCA statistics, the relative importance of sectors shows certain stability over time: life sciences, communications and computer/consumer electronics remained by far the most relevant industries for venture investment. The share of life science in total VC investment activity even increased from

²⁰The EVCA figures mentioned in this chapter show investment activity by PE firms located in Europe (“industry approach” or “office approach”). All investment figures are equity value, i.e. excluding leverage.

25% in 2007 to 31% in 2014. This is broadly in line with the results of a Collier Capital (2014) survey among investors in PE and VC funds (the so-called Limited Partners or LPs), 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”. However, in particular the developments in the IT sphere have had a substantial impact on *structural* developments in the VC market, which cannot be observed in the EVCA statistics. See chapter 4.4 on PE prospects for a more detailed elaboration.

Figure 20: Venture investment in Europe by sector, 2007-2014²¹



Source: Authors, based on data from EVCA

As already mentioned, the EVCA activity data cover fundraising, investment and divestment from PE and VC firms in Europe. Certain segments outside the definition that EVCA applies for the collection of its activity statistics are not covered, e.g. corporate acquisitions outside of dedicated corporate venture programmes and business angels’ activities. However, corporate venture capital (CVC), which typically can serve both an investing corporation’s financial and strategic goals (e.g. to enhance its innovative capacity or to tap into new markets)²², and business angel financing have gained importance in recent years. We present some information on business angels in Box 4. Referring to CVC, according to Global Corporate Venturing (2015), in Europe, Germany was the most active market in 2014 (with investments of around EUR 2bn (USD 2.3bn). Second most active market was the UK with corporate investments of around EUR 847m (USD 951m). The activity in the European markets is significantly lower than in markets like the US (around EUR 23.4bn or USD 26.3bn) – driven in particular by Google and Intel – or China (around EUR 8.9bn (USD 10bn) – driven by China-based internet companies like Alibaba, Tencent or Baidu (who are also active beyond their home country and in particular in the US).

²¹This diagram and the related text are based on market approach (i.e. by country of portfolio company), due to data availability.

²²See, for example, Giese, 2014 (thesis prepared in cooperation with EIF RMA in fulfilment of the “Business Administration” M.Sc. at the University of Trier). Data on CVC is scarce, in particular for Europe, but, for example, information presented by <http://www.globalcorporateventuring.com/> can give a flavour of the market developments.

Box 4: 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.²³

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 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, 2013b). 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.

Moreover, the so called "invisible market" makes a precise estimation of the angel market difficult. There are studies that the invisible part of the market is up to seven times greater than the visible part (CSES, 2012), while others estimate even a multiplier of around ten (EBAN, 2014). 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. EBAN²⁴ (2014), 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 (2014), 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 (2014) reported a slight increase in the average investment per BA to EUR 20.4k in 2013.²⁵ For a

²³For a general description of Business Angel financing we refer Kraemer-Eis and Schillo (2011) and to OECD (2011).

²⁴The European Trade Association for Business Angels, Seed Funds, and other Early Stage Market Players.

²⁵However, according to EBAN (2014), the business figures "are not representative of the entire European market", because they cover only a certain part of the visible market.

Box 4 continued:

different dataset, Zephyr, the M&A database published by Bureau van Dijk, recorded a strong increase in the total amount of visible BA investments to EUR 734m in 2014.

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 ongoing government support. Recent findings by Hellmann, Schure and Vo (2015) also suggest that public support for start-up financing should go beyond an exclusive support of (formal) venture capital, because additional policy measures for angel investors “would reach a different set of entrepreneurial companies that develop outside of the reach of venture capitalists”.

As a part of its support for this market segment, the EIF has implemented the European Angels Fund (EAF). The EAF is a co-investment fund to provide equity to business angels for the purpose of SME financing. It has been launched in March 2012 in Germany with an initial volume of EUR 70m and been increased and extended to Spain and Austria since then and currently reaches a volume of c. EUR 188m. EAF has already committed app. EUR 60m to BAs who have already drawn more than EUR 10m for co-investments in more than 60 SMEs since the launch of the programme. Further roll-out to other countries is foreseen and the launch of the program in the Netherlands and Ireland is scheduled for 2015. Aim of EAF is to co-invest with experienced business angels in order to build a joint portfolio over a time of 5-10 years.²⁶ Complementary approaches allowing to co-invest with a broader target group including less experienced business angels or syndicates, e.g. via managed co-investment funds, have occasionally already been made in the past and will be focused further in the future.

4.2 Fundraising activity

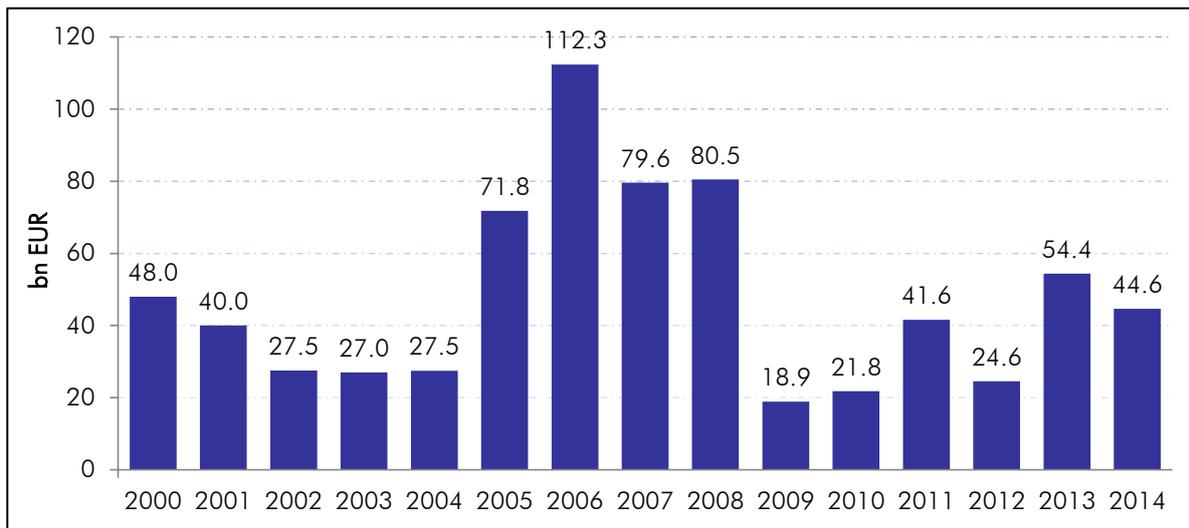
In 2014, total funds raised by private equity firms located in Europe decreased by 18% to EUR 44.6bn, compared to the year before and according to EVCA data (see Figure 21).²⁷ Despite this slump, European PE fundraising recorded the second largest amount since 2009. In fact, 2014’s PE fundraising level “is only surpassed by 2013’s post-crisis peak of EUR 54.4bn, which was heavily influenced by a small number of large funds raised” (EVCA, 2015b). According to Preqin (2015), which uses a PE definition that is different from EVCA’s, the positive fundraising developments observed during the recent years have led to a record amount of dry powder that is available for European PE investments.

²⁶More information on the EAF is available here: http://www.eif.org/what_we_do/equity/eaf/index.htm.

²⁷Figures show fundraising activity (incremental amounts raised during the year) by private equity firms located in Europe (“industry approach” or “office approach”), except where otherwise stated.

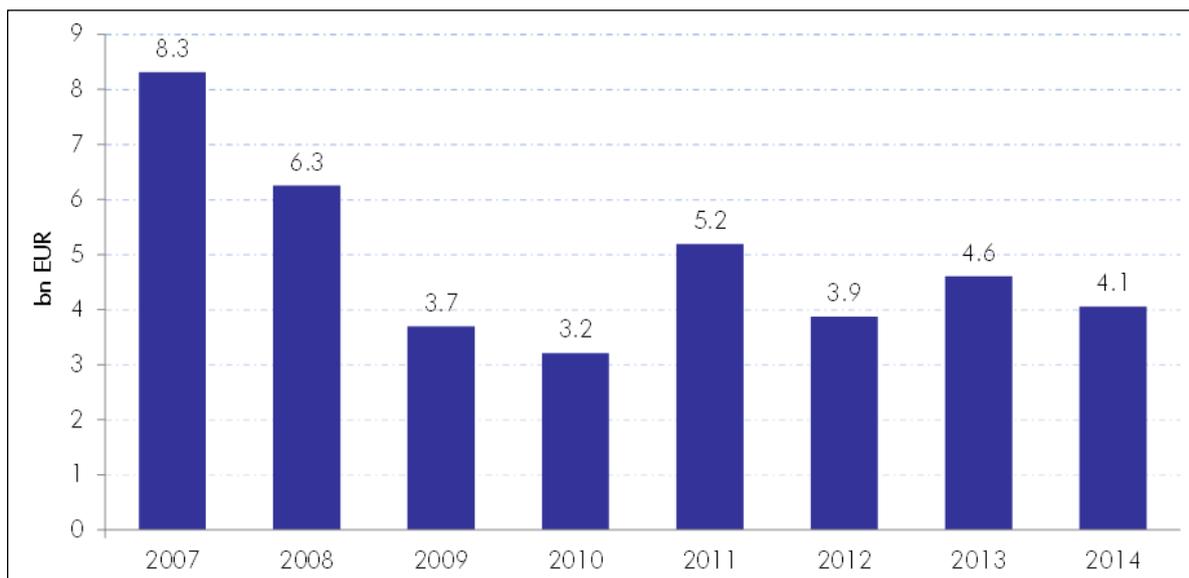
For 2014, the reduction in the total PE fundraising amount reported by EVCA, was mainly driven by the buyout sector (–23% to EUR 35.1bn), which by far forms the largest part of the market. Decreases in fundraising activity were also recorded for the venture (–12% to EUR 4.1bn) and the generalist²⁸ (–22% to EUR 1.4bn) market segments. In contrast, fundraising increased considerably in the growth capital (+69% to EUR 1.8bn) and the mezzanine capital (+49% to EUR 2.3bn) parts of the market.

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



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

Figure 22: Funds raised by VC funds located in Europe
(incremental amounts raised during year)



Source: Authors, based on data from EVCA.

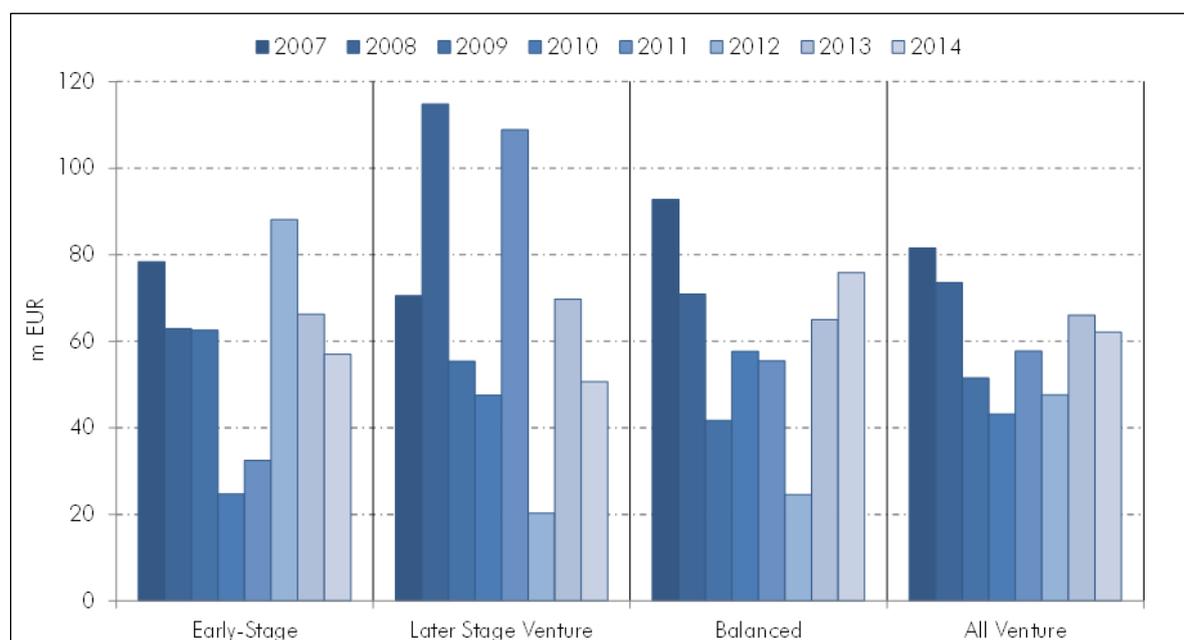
²⁸Funds with either a stated focus of investing in all stages of PE investment, or funds with a broad area of investment activity. (Source: EVCA.)

The drop in European VC fundraising (see Figure 22) can almost completely be explained by the lower activity of funds with a balanced stage focus (–42% to EUR 1.5bn), but fundraising amounts also decreased for the later stage (–9% to EUR 0.31bn). Fundraising in the early stage VC market segment grew by 32% to EUR 2.3bn. However, after its trough in 2010, the recovery of the total European VC fundraising activity has by far not been that strong than what has been observed in the overall PE market.

The average VC fund size has slightly decreased to EUR 62m (see Figure 23), based on 53 final VC fund closings reported in the EVCA statistics for 2014. Given the evidence in previous studies, which indicated that small fund size was one of the reasons for poor European VC performance (Kelly, 2011), the current finding might mean negative news. However, the average VC fund size is 44% larger than in the 2010 crisis trough. Moreover, EIF internal analysis 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. Larger fund size (as reported by EVCA statistics for funds with a “balanced” stage focus, i.e. venture capital funds focused on both early-stage and later-stage companies) would be a sign of more successful GPs and more careful due diligence by LPs.

Figure 23: Average VC fund size²⁹

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



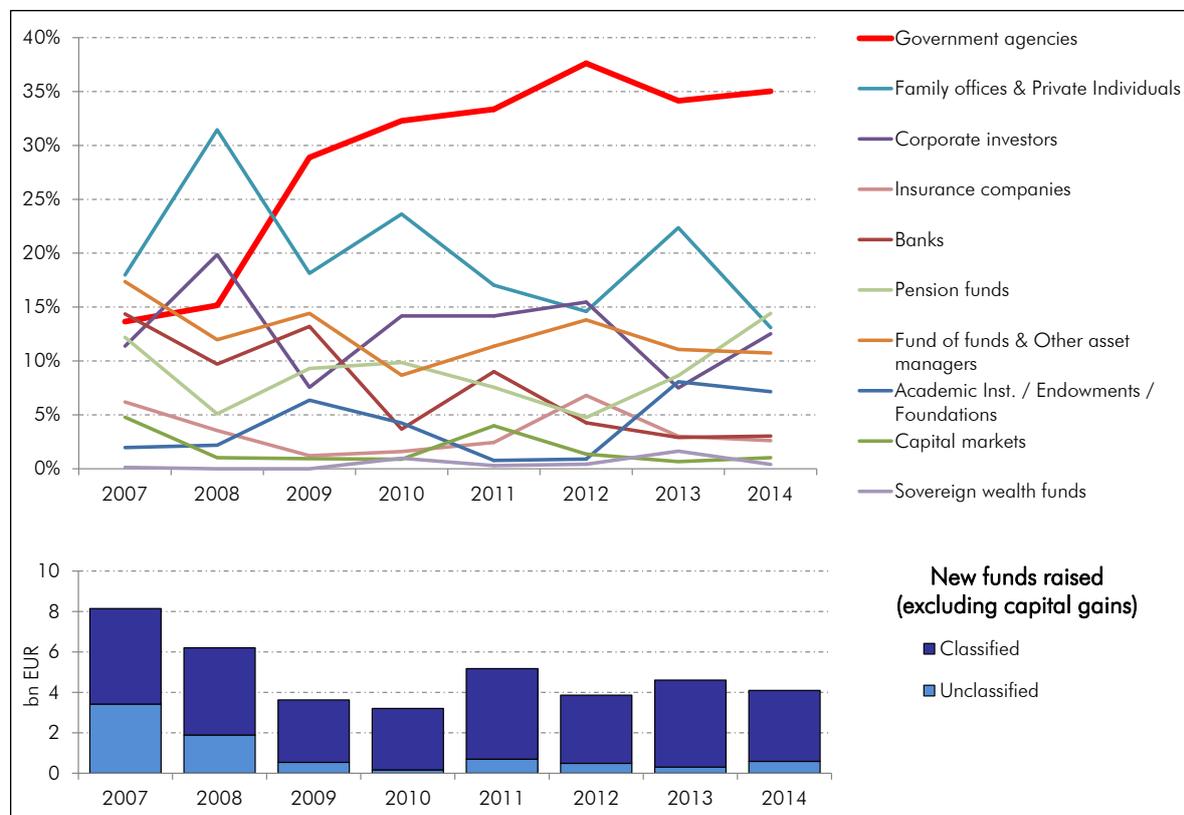
Source: Authors, based on data from EVCA

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 24). According to EVCA figures, government agencies accounted for 35% of total investors into venture capital funds in 2014. However, even if the importance of government agencies is unsatisfyingly high for the long term, it is noteworthy that government agencies continue to play their role and support the market in a counter-cyclical

²⁹Numbers based on 32 funds with an early-stage focus, 5 funds with a later stage focus and 16 funds with a balanced stage focus.

way, in particular in the times of an economic and financial crisis when total VC fundraising levels came down from EUR 8.3bn in 2007 to EUR 4bn in 2014. This led almost “naturally” to an increased share of government agency fund investors.

Figure 24: Investor base: Share of government agencies in VC fundraising³⁰



Source: Authors, based on data from EVCA

In order to put EIF’s activity in context, one needs to take into account that EIF’s commitments represented, for example, approx. 14% of total VC fundraising in Europe in 2014. Assuming that the average stake in each fund has ranged in the area of 30% implies that EIF has invested in about half of all VC funds launched in that year. Not even 30% of VC funds in which EIF invested since 2011 managed to close with their full target size until mid-2014, and the EIF’s investment brought the total commitment to a viable minimum fund size in nearly 60% of the cases.

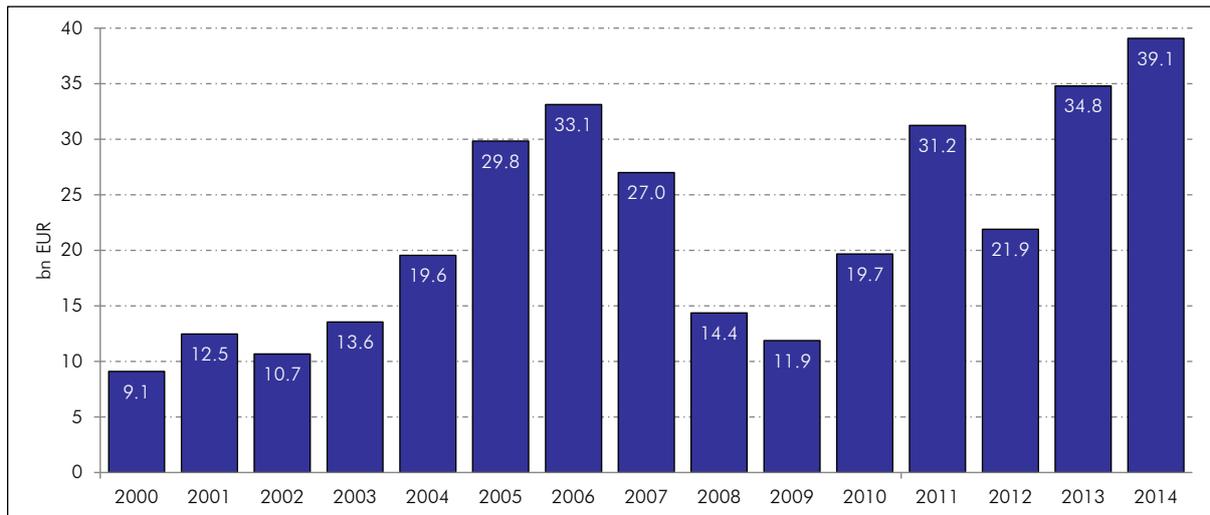
Moreover, it is important to see that many of the commercial VC funds being the pillars of Europe’s VC market today would not be there without having been kick-started by EIF. This clearly indicates EIF’s catalytic role for European VC, rather than a crowding-out effect. This view was confirmed in the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

³⁰Based on incremental amounts raised during year (in contrast to final closings only).

4.3 Divestment activity

The strong increase in PE divestment activity in 2013 was followed by another record year in 2014. According to EVCA data, total divestments by PE firms located in Europe increased by 12% to EUR 39.1bn (see Figure 25).³¹ That rise was mainly due to increased activity in the buyout (+12% to EUR 32.8bn) segment of the market, while divestments in the VC segment decreased (-16% to EUR 1.9bn).³²

Figure 25: Divestments (by amount at cost divested) by private equity firms located in Europe



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

Source: Authors, based on data from EVCA

A closer look at the details of the EVCA divestment statistics shows the strength of the exit markets in the recent past. As regards overall PE, the relative importance of write-offs has continuously decreased since 2010, except for a slight increase in 2013 (see Figure 26). Trade sales and sales to another PE house are still the most popular form of divestment. Together, they account for half of the total divestment amounts. Public offerings are the third most important form of divestment. In the buyout sector, the relative importance of write offs decreased to 8% of divestment amounts at cost. In the VC market, the relative importance of write-offs slightly increased to 18% of divestment amounts.

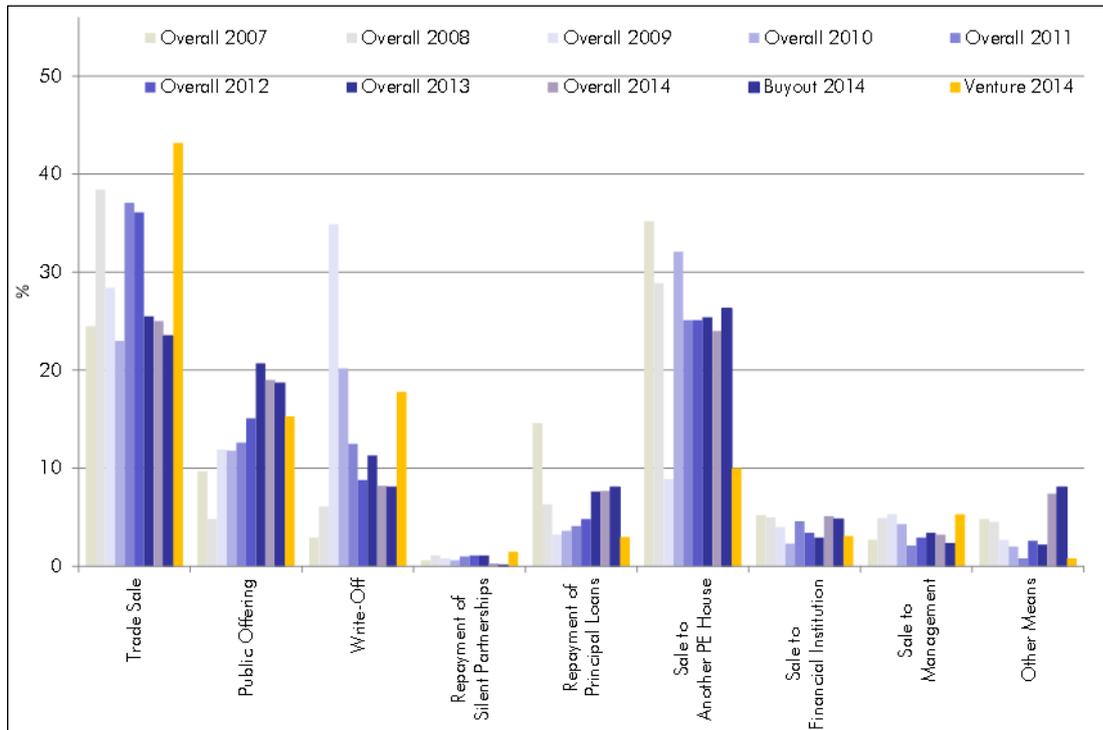
A positive sign for the VC exit market can be taken from the relatively stable share of public offerings in total divestments, which was at 15% (mainly consisting in a sale of quoted equity and to a much lower extent in IPOs) in 2014. Examples of recent exits of companies held by EIF-supported funds included, inter alia, IPOs of the German online retailer for baby and toddler products “Windeln.de”, the British online property portal Zoopla, the Danish prodrug developer Ascendis and the Belgian molecular diagnostics provider Biocartis.

³¹EVCA statistics show divestment amounts at cost, i.e. the total amount divested is shown as the total amount that had been previously invested, hence not including any profit on the investment.

³²The numbers for VC, buyout and growth divestments do not sum up to total PE divestments, as total PE divestments additionally include the rescue/turnaround and replacement capital market segments.

However, there are also warning voices as regards the current PE & VC valuations. According to Go4Venture Advisers (2015), it is an “inescapable fact that clues of overheating continue to accumulate”, not least because of a strong expansive monetary policy stance, and “this is of course a breeding ground for the next investment bubble”.

Figure 26: Divestment routes (shares)³³



Source: Authors, based on data from EVCA

4.4 Prospects³⁴

The relatively positive developments in European PE and VC activity figures were confirmed by confident outlooks reported in surveys among fund investors (see for an overview Kraemer-Eis, Lang and Gvetadze, 2014b). Moreover, Go4Venture Advisers’ early indicator, the European Tech Headline Transactions Index³⁵, has recorded, on average, strong increases in terms of investment

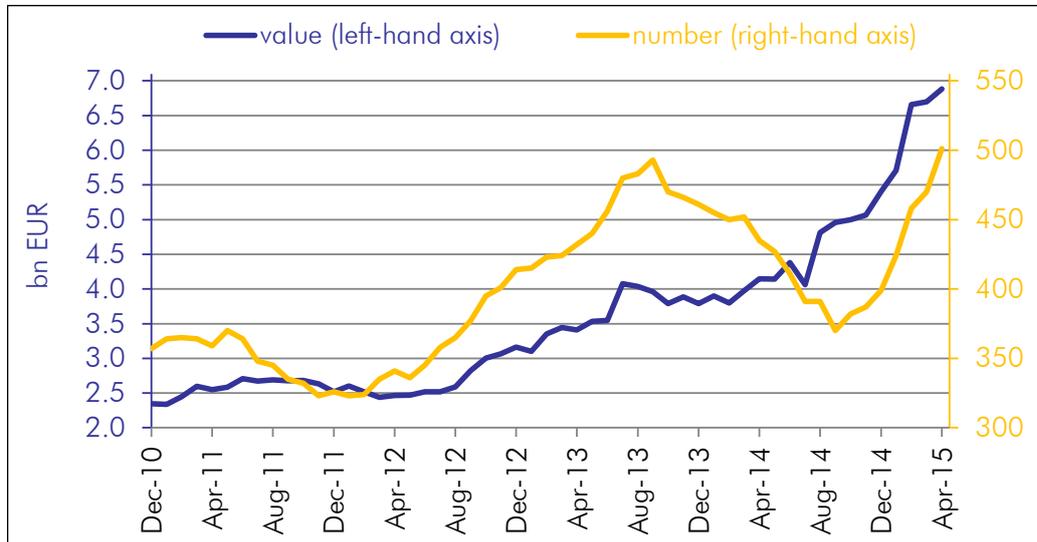
³³Based on amounts at cost divested; industry/office approach (i.e. divestments by funds located in Europe). “Overall” figures are *not* the weighted average of the “buyout” and “venture” figures, as “overall” figures additionally include the growth, rescue/turnaround and replacement capital market segments. In the EVCA data, the category “Public Offerings” includes divestment on flotation (IPOs) and sale of quoted equity.

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

³⁵Go4Venture 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’ (2013), Go4Venture Advisers’ (2015) and www.go4venture.com/research/.

values since summer 2012. In contrast, the number of deals had declined for a year since autumn 2013, before it started to pick up again (see Figure 27, which shows the index development on a 12-month rolling-horizon basis).

Figure 27: European Tech Headline Investment Transactions (12-month rolling horizon)³⁶



Source: Authors' calculations based on Go4Venture Advisers data.

However, the general economic situation, structural market weaknesses and various regulatory changes continue to make the general market environment challenging. According to a Preqin survey (Preqin, 2014), regulation, performance and the economic environment had been perceived as the biggest challenges that investors were facing, and similar findings were reported by Unquote Intelligence (2014). EVCA (2015c) provides a comprehensive overview of the regulatory initiatives and changes and their potential impact on PE/VC in Europe. We cannot go into a detailed assessment of all the different rule sets here (just to mention a few names, e.g., AIFMD, Solvency II, EuVECA, CRD IV and CRR, various taxation rules, and last not least the "Capital Markets Union" policy initiative). Besides regulatory initiatives, structural market weaknesses such as the difficult access of smaller companies to IPO markets (see, for example, EU IPO Task Force, 2015), limit the upside potential of the European VC market.

Moreover, the economic developments over the last years have resulted in significant structural changes in the global and European economic landscape. The digitalisation of the economy has led to a differentiation of market segments. Whilst companies in research-intensive sectors continue to follow more traditional growth models with capital-intensive development stages at the beginning of their life, companies in the digital space are able to start their activities with very limited resources but are exposed to unprecedented needs for funding in the internationalisation and globalisation of their business models. As a result, and depending of the sector and the business models of the companies, time-spans from start-up to global leader have shortened

³⁶In 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.

considerably and require companies to scale quickly to sustain the risk of seeing their business model being out-dated before they capture a significant market share.

On a global level, the VC market has adapted to this new diversity of its target sectors, which has led to a bifurcation of the market between sometimes relatively small funds with the aim of scouting emerging business models whilst a new class of giant VC funds expands globally from the US, providing large scale capital to businesses in their global market expansion. In the large scale technology growth capital space Europe has no established players, which explains why virtually every European funding round especially in digital technology growth capital is led by US VC growth capital funds.

In the shadow of companies driving or directly affected by the “digital revolution”, SMEs and mid-caps in traditional industries are reshaping their strategies for competing in a rapidly changing economic environment and are in need of flexible funding instruments with growth equity, mezzanine debt and hybrid debt to classical debt features.

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

However, when it comes to the question of policy support instruments, it has to be noted that the value of capital injected for funding Europe’s economic growth is not primarily driven by volume but by impact. This means that large-scale growth capital funds will make no difference to achieving the policy objectives for the EU’s competitiveness if they are not associated with the knowledge of how to grow businesses to global scale.

All these challenges continue to create access to funding problems in the European VC market. The difficulties for young innovative companies to access seed and early stage finance have increased over the past years, as VCs have become more risk-averse and focussed more on later stage investments (Wilson, 2015b). A Coller Capital (2013) study found that more than half of the global LPs believe that there are insufficient sources, other than VC, available to finance innovation and growth in Europe. This supports a view that public backing is needed in order to strengthen the market. We had outlined recent OECD findings on policy measures taken by governments to support seed and early-stage financing in previous issues of the ESBFO (see Kraemer-Eis, Lang and Gvetadze, 2013b, 2013c, 2014a and 2014b). Indeed, an Unquote Intelligence (2014) survey found that “public money remains absolutely critical to the European venture industry and is likely to remain so for the next five years”, and this has been particularly true for new funds, as most public funding bodies support first-time funds, while this is true for only

approximately half of private investors. Besides the additional funding volumes, public investors' participation in a PE/VC fund can also have a positive signalling effect on private investors, e.g. due to perceived strong due diligence requirements and an assumed relatively high stability of public LPs' commitment to a fund. These advantages seem to outweigh the potential disadvantages (e.g. a possibly negative impact on speed and responsiveness or imposed restrictions in the investment strategy of the fund) of public investors' participation.

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

A recent Coller Capital (2015)³⁷ survey finds that 73% of LPs believe that recent improvements in VC returns are mainly due to strong exit markets; however, 27% believe that the VC sector has also seen structural performance improvements. EIF market insight shows a number of VC-backed companies in the early-stage segment that show increasing revenues and are now achieving profitability, positioning them well for sustained organic growth and ultimate strong returns for investors. However, while in some cases performance is indeed driven by fundamental economic value, part of the upside performance may also be driven by higher demand due to dry powder looking for investments. This is to be looked at with caution. It is then, however, important to support those companies in their continued growth that have well-developing economic fundamentals, and to also help, through the support of financial intermediaries, additional and complementary businesses to maintain and strengthen the backbone of the European VC market, i.e. a strong and continued supply of new innovative companies. In addition, the VC ecosystem is

³⁷Coller 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 22nd edition (summer 2015) of the Global PE Barometer captured the views of 113 PE investors from round the world, surveyed in March-April 2015. According to Coller Capital (2015), 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".

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 can be more positive than the backward-looking statistics reveal.³⁸

In all, Europe therefore needs an integrated portfolio of funding instruments in support of the various segments of its SME and mid-cap landscape to foster the recovery from the 2008 financial crisis and to unleash the full potential of EU companies' competitiveness and their contribution to Europe's economic growth and innovation. Instruments should be complementary to existing initiatives in terms of sector, stage or geographic focus. However, the dynamics of recent economic developments e.g. in the area of the digital economy, has made the segmentation between early stage and late stage VC somewhat redundant. Policy instruments that create artificial boundaries of development stages of businesses could be prohibitive to an efficient VC market. Moreover, EU's VC markets show different development stages and so require different policy instruments. In less developed markets instruments may need to work strongly together with the actors in the informal VC markets (BAs, Incubators, TT Centres) and be complemented by flexible co-investment products to grow the domestic VC market. However, companies with global ambitions compete globally. Instruments investing in future industry leaders compete for investors who seek exposure to the best companies on a global scale, not with respect to a given geography. Therefore, giving flexibility in the geographic boundaries of policy instruments is not only key in retaining EU-based businesses in Europe but may attract non-EU based businesses to relocate to Europe. Based on these considerations, it appears vital to offer a flexibility of instruments adapted to diverse market conditions in the various geographies of the EU. Such should be implementable in a time and cost efficient manner. Moreover, in times of economic slowdown and scarcity of private capital the temptation grows to construct policy instruments that substitute the private sector. However, there is in fact a need to use public sector resources with the primary objectives of mobilising private sector capital, as clearly demonstrated, for example, by the leverage factor built in the Investment Plan for Europe (see Box 12 in the Concluding Remarks at the end of this document) and other instruments implemented by the EIF.

To summarise, it remains to be seen if the positive developments observed in the recent past could develop into a sustainable longer-term positive trend. As a reference catalytic investor in European venture and growth capital funds, EIF is actively working in that direction: 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. On the following pages; we describe several recent developments and EIF activities.

³⁸For 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 5: Mezzanine finance and lower mid-market

The lower mid-market and the mezzanine market are also demonstrating tangible signs of recovery, with increased volumes of liquidity, growing deal flow and heightened exit activity. The lower mid-market is increasingly becoming an attractive and active segment for investors. (Source: EIF, 2015a.)

EIF provides its core lower mid-market products (equity, hybrid debt-equity and mezzanine for SMEs and midcaps) as alternative sources of long-term finance to established businesses and later stage technology companies. In the current market context, debt/equity finance solutions proved highly successful, particularly for shareholding reorganisation, organic growth, restructuring or expansion.

In 2014, EIF signed a total of EUR 875m in 32 lower mid-market and mezzanine funds, an 18% increase on the previous year's results, and mobilised c. EUR 6.2bn of resources, demonstrating its crucial catalytic role in helping to maintain a viable and healthy SME and midcap-focused private equity market.

Moreover, the launch of the new Mezzanine Co-Investment Facility (MCIF) in 2014 expanded EIF's lower mid-market activity to co-investments in target companies. This EUR 100m programme enables EIF to co-invest in target companies alongside mezzanine funds supported under the debt-equity window of the EIB Risk Capital Resources (RCR) mandate. MCIF widens the spectrum of EIF investment products and leverages the efficiency of EIF's risk finance support for SMEs and midcaps, thereby enhancing their access to finance.

Going forward, EIF expects to develop further its lower mid-market investment activities in the private debt segment through the provision of equity and guarantee solutions under the EIB Group Risk Enhancement Mandate (EREM) mandate. For more information see the recent EIF Working Paper on institutional non-bank lending and the role of debt funds (see Kraemer-Eis, 2014).

EIF's activity in the equity sphere also includes the launch and extension of new and pilot initiatives, such as, for example, the European Angels Fund (EAF), which we described in Box 4 further above. Moreover, EIF is also active in the field of Technology Transfer in order to support the commercialisation of research know-how – see Box 6 for further information.

Box 6: Technology transfer activity

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. In 2014, the European TT segment continued its trend of increasing professionalisation, on the path of evolution towards a more mature setting. EIF has supported the continued development of operations within European countries with a more advanced TT infrastructure, whilst also providing support for those with an emerging TT expertise. Once again, an increase in the underlying deal flow from leading academic seed and licensing operators was observed and future TT investment funding is projected to remain strong and in line with an increasing market demand. In all, EIF invested EUR 111m in six technology transfer transactions in 2014.

Box 6 continued:

Investments in new technology transfer markets, including Portugal, were successfully committed and particular support was given to Turkey through the launch of the Technology Transfer Accelerator Turkey Fund. This initiative – co-financed by the EU and the Republic of Turkey under the Regional Development Component of the Instrument for Pre-Accession Assistance funds and managed by EIF – will help build up the technology transfer market in Turkey, with a particular focus on spillovers to the less developed regions of Turkey.

Discussions with the European Commission to set up a Technology Transfer finance facility have continued through 2014. Such an instrument would open up a new market for EIF and address the needs of a larger number of European TT players. In addition, it would provide a stimulus for the Proof-of-Concept phase of European research commercialisation and thereby provide an important funding bridge for the development of this nascent end of the TT spectrum. The overall amount of the facility remains a topic for further discussion. The trends seen through recent years are expected to continue through the coming year, during which EIF will continue with its policy of support for leading TT intermediaries whilst maintaining appropriate risk profiles and risk mitigation standards. EIF TT will look to continue to work alongside key TT co-financing stakeholders and stakeholders to provide support for the continued development of the sector. (Source: EIF.)

Another example of EIF's initiatives is the Social Impact Accelerator (SIA)³⁹, which has been started to satisfy the growing need of equity finance for support to social enterprises (see as well Box 6). 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.

Moreover, EIF is in the course of launching the new ERP-EIF Co-investment Growth Facility, a new co-investment product which is to be piloted in Germany under a new EUR 500m co-investment mandate financed 2/3 by the German Federal Ministry of Economic Affairs and Energy on behalf of the European Recovery Program (ERP) and 1/3 by EIF-managed resources. The ERP-EIF Co-investment Growth Facility is a complementary instrument to support German growth-stage technology companies on their pathway to scale through a co-investment scheme alongside VC funds managed by reputable VC managers. The goal is to provide the most promising growth-stage companies an access to capital in a time- and cost-efficient manner and to allow VC fund managers to leverage the position of their funds in larger funding rounds and thereby benefit from the full value potential of their outperforming portfolio companies. For EIF, the German Facility is also an important pilot for potential additional co-investment schemes, which could eventually help mitigate similar market needs in other European geographies.

The need for such a product is confirmed by recent EIF market insight, according to which growth-stage companies are experiencing a serious lack of growth (follow-on) funding in order to accelerate their international expansion and to strengthen their position against global competitors. Moreover, in an EIF survey among VC fund managers in Germany, 66% of the

³⁹More information on the SIA is available here: http://www.eif.org/what_we_do/equity/sia/index.htm.

participants saw a benefit from the availability of stable providers of co-investment capacity when addressing potential investment opportunities. 52% would have closed more investments if they could have relied on stable providers of co-investment capacity in the past (the share was notably high for managers of ICT funds at 71%). 57% of respondents listed too small fund size as one of the main reasons why they decided not to invest. 66% of participants saw a high or very high market need for such a co-investment product (Source: EIF.) Hence, not surprisingly, the recent Collier Capital (2015) survey finds that “most LPs expect co-investments to remain a fixed feature of the PE landscape”.

Box 7: 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.

A recent survey of impact investors, conducted by J.P. Morgan and the GIIN, revealed that over the past years, governments have provided support to the impact investment market through credit enhancement tools, tax credits and technical assistance to investees. Additionally, respondents, particularly from Western Europe, indicated that the relevant regulations and a better definition of “social impact” would be helpful to enhance activities in the sector (J.P. Morgan, 2015).

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.

True impact investors don’t necessarily see a trade-off between financial returns and social impact. The J.P Morgan/GIIN survey (J.P. Morgan, 2015) showed that over half of impact investors (55%) principally targets “competitive, market rate returns”, with the rest of respondents targeting “below market rate returns: closer to market rate” (27%) and “below market rate returns: closer to capital preservation” (18%).

Box 7 continued:

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 co-led by an EIF staff member from June 2010 to February 2013 suggests that net returns to investors of 5% to 10% are achievable, depending on the investments' target sectors (Source: EIF).

EIF activities

The 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 an 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.

Social impact funds in which SIA is invested are social impact funds supporting social enterprises, which are defined as economic entities having at the core of their business model the scalable resolution of a recurring social issue. The sectors in which those SMEs are active are typically, employment, education, social inclusion, public health, social housing, and consumer services. Within SIA's portfolio, there is also the first investment fund dedicated to financing social impact bond schemes.

Under SIA, EIF has to date approved EUR 57m to six social impact funds across the EU (2 in the UK, 1 in Italy, 2 in France and 1 in Germany). Two additional commitments have been approved by the EIF Board of Directors. Moreover, the pipeline of investment for the SIA is strong and shows a high market demand for a large and stable source of funding for social entrepreneurship across the EU.

The EIB has supported the initiative through a capital increase of the SIA, now reaching EUR 241m (further discussions with private investors are ongoing). Through the capital increase of the SIA, social impact investing has now become a mainstream pillar of EIF's business, expanding its operations to a broader array of European SMEs to ensure appropriate channelling of funds to the European economy backbone (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 EIB Group Risk Enhancement Mandate (EREM). The RCR

provides EUR 7bn to support technology and industrial innovation and targets early-stage to lower mid-market funds that specifically focus on EU-28, EU candidate, potential candidate and EFTA countries and on SMEs and midcaps. Under the RCR, EIF co-finances with its own funds. At the end of 2014, the RCR's outstanding volumes amounted to EUR 5.9bn, committed directly in 397 funds and mobilising over EUR 32.3bn of resources. The RCR mandate is intended to be increased from EUR 7bn to EUR 9.5bn in the context of the Investment Plan for Europe to the benefit of SMEs and midcaps in the EU-28 Member States. The EREM extends, inter alia, 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. (Sources for this and the following paragraphs: EIF, 2015a, EIF website and other EIF sources.)

On the European level, the "Single EU Equity Financial Instrument" supports European enterprises' growth, research and innovation from the early stage, including seed, up to the expansion and growth stages. This instrument is financially supported by "Horizon 2020", the new EU research programme for 2014-2020, and the "Programme for the Competitiveness of Enterprises and SMEs" (COSME). The equity arm of COSME, which is under the responsibility of the EC Directorate-General for Growth, is the COSME Equity Facility for Growth (EFG) and targeting growth-stage SMEs. The equity component of InnovFin – EU Finance for innovators, a joint EIB Group (EIB and EIF) and EC (Directorate-General Research and Innovation) initiative under Horizon 2020, will be implemented in conjunction with the COSME EFG, with focus on early-stage SMEs as well.

Under the SME window of the Investment Plan for Europe (see the Box in the Concluding Remarks at the end of this document), equity products are foreseen to be implemented, including an increase of the RCR mandate by EUR 2.5bn as well as EUR 1.0bn yet to be defined but likely with a larger target, especially on growth stage and co-investment, including a joint platform with national promotional institutions.

Moreover, EIF supports private equity instruments by implementing funds raised from national and regional third-party mandators (JEREMIE, ERP, IVCI, PVCI, NEOTEC, DVI etc.). The Joint European Resources for Micro to Medium Enterprises (JEREMIE) is one of the instruments that have defined EIF's regional development strategy since 2007. It was developed by the European Commission and EIF. With JEREMIE, EU Member States have the opportunity through their national or regional managing authorities to use part of their Structural Funds to provide risk financing to SMEs. Another recent example of EIF's country-specific activity is the Dutch Venture Initiative (DVI), which is a fund of funds that supports SMEs in the Netherlands by investing in funds focused on fast-growing innovative or high-tech businesses.⁴⁰

⁴⁰More information on country-/region- and sector-specific initiatives is available here: http://www.eif.org/what_we_do/resources/index.htm.

5 SME guarantees and SME Securitisation in Europe

5.1 SME guarantees

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, 2014b, for a recent overview of market failures in SME lending and mitigation techniques). There are several reasons for this. One of them is the disproportionality between the extent, and hence the cost, to assess a relatively small company's application for finance and the potential revenue. Whereas the credit assessment contains a certain fixed cost element (i.e. independent of the size of the finance requested), the revenue is, *inter alia*, dependent on the amount. The aforementioned issue is even reinforced by the asymmetric information (in the case of debt: information gap between lender and borrower – and the availability (and quality) of information about smaller – and in particular younger – enterprises is typically even worse than for the bigger and more established companies), combined with uncertainty, which causes agency problems that affect debt providers' behaviour (see Akerlof, 1970, Jaffee and Russell, 1976, Stiglitz and Weiss, 1981, and Arrow, 1985).⁴¹ This results in an insufficient supply of credit (an analogue argumentation is valid for equity financing), which can be particular true in the case of SME financing (OECD, 2006).⁴²

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

Guarantee mechanisms, "whereby should the borrower default the guarantor compensates a pre-defined share of the outstanding loan" (OECD, 2014b), 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

⁴¹ 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.).

⁴² Stiglitz and Weiss (1981) argued that under certain circumstances credit rationing can be rational for banks.

programmes” (OECD, 2014b). Therefore, loan guarantee programs continue to be “the most widely used instrument at governments’ disposal to ease SME access to finance” (OECD, 2015).

Referring to the countries in Central, Eastern and South-Eastern Europe (CESEE), the Working Group on Credit Guarantee Schemes (CGSs) in CESEE, established under the European Bank Coordination Initiative (Vienna Initiative 2) undertook in 2014 an analysis of the role of SME Credit Guarantee Schemes in the respective region (VIWGCGS, 2014). The findings and conclusions are in line with other studies (e.g. OECD, 2013 and 2014b) and emphasize the importance of and the strong demand for SME CGSs in the region. Moreover, best practices for the design and operational characteristics of schemes have been identified that can be generalised as well for other parts of Europe.

In the context of this work, a sub-project concerning measuring the economic additionality of CGSs has been performed, using a specific guarantee programme (MAP, Multi Annual Programme for Enterprise and Entrepreneurship) that has been financed by the European Commission and implemented by the EIF. This sub-project found, inter alia, positive effects on the number of employees (at the level of the companies, benefitting from the guarantees), as well as positive effects on the total factor productivity. This sub-project will be presented in detail in a forthcoming joint working paper of the European Commission and EIF, which is summarised in Box 8 below.

Box 8: The economic impact of EU guarantees on credit to SMEs: evidence from CESEE countries⁴³

The use of Public Credit Guarantee Schemes (PCGSs) is particularly widespread, across both OECD and non-OECD economies, as a direct policy tool to alleviate SMEs’ financial distress, and has recently intensified to address the repercussions of the financial crisis on financial and product markets. Estimates by OECD (2015) on 14 EU members indicate an amount of – certainly underestimated – around 200 billion provided to SMEs in 2007-2013, capable of generating a tenfold amount of financing.

Yet despite its policy relevance, SME financial support in general, and credit guarantee schemes in particular, have hardly been the subject of rigorous academic research, partly due to data scarcity. Consequently, policy makers across the EU lack a reliable impact assessment of these programmes on final SME beneficiaries. The problem is not peregrine: the credit guarantee policy has been sometimes criticised for failing to reach its target groups (SMEs), and particularly in a slow growth period in the EU, national and European institutions bear the responsibility of focusing on the most effective support measures to ensure tangible added value and efficient use of taxpayers’ money.

The study carried out by Asdrubali and Signore (2015, forthcoming), a joint European Commission and EIF working paper, aims to fill this gap. The authors performed an impact assessment of the EU SME Guarantee Facility (SMEG)'s loan window under the Multi-Annual Programme for Enterprise and Entrepreneurship, and in particular for Small and Medium-sized Enterprises (MAP), focussing their attention on CESEE countries' beneficiaries.

⁴³This text box was written by Simone Signore from EIF’s Research & Market Analysis team.

Box 8 continued:

Their paper combines propensity scores and difference-in-differences estimation in order to evaluate the effect of having received a MAP-guaranteed SME loan on firm performance (employment, production, profitability and factor productivity) against a control group of comparable firms. Results offer several insights: the EU SME Guarantee Facility in the CESEE region had, on average, a significant positive effect on firms' employment: beneficiary firms were able to increase their workforce by 17.3%, compared to the control groups, within the first 5 years following the issuance of the guaranteed loan. Moreover, by the fifth year after the signature date, the turnover of MAP beneficiaries had increased by 19.6%, compared to non-beneficiary companies. MAP beneficiaries also faced a temporary setback in productivity, with respect to their peers, an effect that could be due to allocative inefficiencies following the MAP-induced increase in their production factors. Such gap was, however, partially absorbed over the medium run.

By breaking down the sample by country, signature year, size and age classes, the authors find that micro and young SMEs have benefited the most from MAP-guaranteed loans in terms of economic additionality. Overall, findings suggest that the EU SME Guarantee Facility has been successful in bringing significant positive effects on beneficiary firms in CESEE Countries.

Market information concerning CGS in Europe is gathered by AECM, the European Association of Guarantee Institutions.⁴⁴ These data covers SME guarantees and counter-guarantees provided by AECM members (in the case of counter-guarantees, the – typically public – counter-guarantor takes over the risk from the guarantor, up to a predefined share of the guarantee. See Kraemer-Eis, Lang and Gvetadze, 2013a, and OECD, 2013). In the following we provide information about the countries with at least one AECM member to show the state and development of this important market segment.

Market size

Key figures, based on *outstanding guarantees* on SME loan portfolios as at 31.12.2014⁴⁵, are presented in Table 3. In terms of total amounts of guarantee and counter-guarantee activities, the core countries are Italy (EUR 33.4bn), France (EUR 18.1bn), Germany (EUR 5.8bn), Turkey (EUR 5.1bn) and Spain (EUR 4.4bn). Italy also has the highest total *number* of outstanding guarantees (1,057,470), followed by: France (742,744), Turkey (318,880), Poland (242,273) and Portugal (81,621). The total number of SME beneficiaries in the portfolios of the AECM members amounted to almost 2.6m.

⁴⁴We thank our colleagues from AECM for their support. AECM has currently 41 members in 20 EU Member States plus Bosnia and Herzegovina, Kyrgyzstan, 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.

⁴⁵For data availability reasons, AECM statistics include the business figures of the largest Italian AECM member with a time lag of one year. For similar reasons, older data were used for AECM members from Poland, Slovenia and one Belgian member. These disclaimers apply as well for the diagrams and tables presented throughout this chapter.

Table 3: Outstanding guarantees and counter-guarantees⁴⁶ on SME⁴⁷ loan portfolios⁴⁸ and resulting average guarantee size in 2014⁴⁵ by country

Country	Guarantee and counter-guarantee			Guarantee activity			Counter-guarantee activity		
	Volume [k EUR]	Number	Average guarantee size [k EUR]	Volume [k EUR]	Number	Average guarantee size [k EUR]	Volume [k EUR]	Number	Average guarantee size [k EUR]
Austria	828,622	5,717	144.9	828,622	5,717	144.9			
Belgium	761,332	10,488	72.6	736,573	8,942	82.4	24,759	1,546	16.0
Bosnia-Herzegovina	8,072	64	126.1	8,072	64	126.1			
Bulgaria	108,182	1,234	87.7	107,299	1,218	88.1	883	16	55.2
Czech Rep.	645,627	7,044	91.7	645,627	7,044	91.7			
Croatia	160,734	1,416	113.5	160,734	1,416	113.5			
Estonia	115,550	1,262	91.6	115,550	1,262	91.6			
France	18,139,706	742,744	24.4	17,281,482	692,990	24.9	858,224	49,754	17.2
Germany	5,761,025	48,199	119.5	5,761,025	48,199	119.5			
Greece	245,810	7,673	32.0	245,810	7,673	32.0			
Hungary	1,358,055	42,276	32.1	1,318,062	42,223	31.2	39,993	53	754.6
Italy	33,399,702	1,057,470	31.6	20,078,000	941,075	21.3	13,321,702	116,395	114.5
Kyrgyz Rep.	448	317	1.4	448	317	1.4			
Latvia	98,024	454	215.9	98,024	454	215.9			
Lithuania	508,376	7,150	71.1	213,616	3,739	57.1	294,760	3,411	86.4
Luxembourg	917	41	22.4	917	41	22.4			
Netherlands	1,911,428	18,301	104.4	1,911,428	18,301	104.4			
Poland	2,009,137	242,273	8.3	1,925,858	234,857	8.2	83,279	7,416	11.2
Portugal	2,934,500	81,621	36.0	2,934,500	81,621	36.0			
Romania	1,598,484	21,153	75.6	1,453,011	16,750	86.7	145,473	4,403	33.0
Russia	132,993	1,601	83.1	132,993	1,601	83.1			
Spain	4,350,377	30,903	140.8	4,350,377	30,903	140.8			
Slovenia	230,506	2,053	112.3	230,215	2,007	114.7	291	46	6.3
Turkey	5,145,991	318,880	16.1	5,145,991	318,880	16.1			
Total	80,453,598	2,650,334	30.4	65,684,233	2,467,294	26.6	14,769,364	183,040	80.7

Source: AECM (provisional figures)

Compared to the value of economic activity, guarantees are relatively important (measured by the volume of outstanding guarantees in portfolio as a percentage of GDP) in Italy (2.1%), Portugal (1.7%), Lithuania (1.4%), Hungary (1.3%) and Romania (1.1%), as shown in Figure 28.⁴⁹ According to the OECD (2013), guarantees are particularly relevant “in those countries where a network of local or sectoral guarantee institutions is well established”.

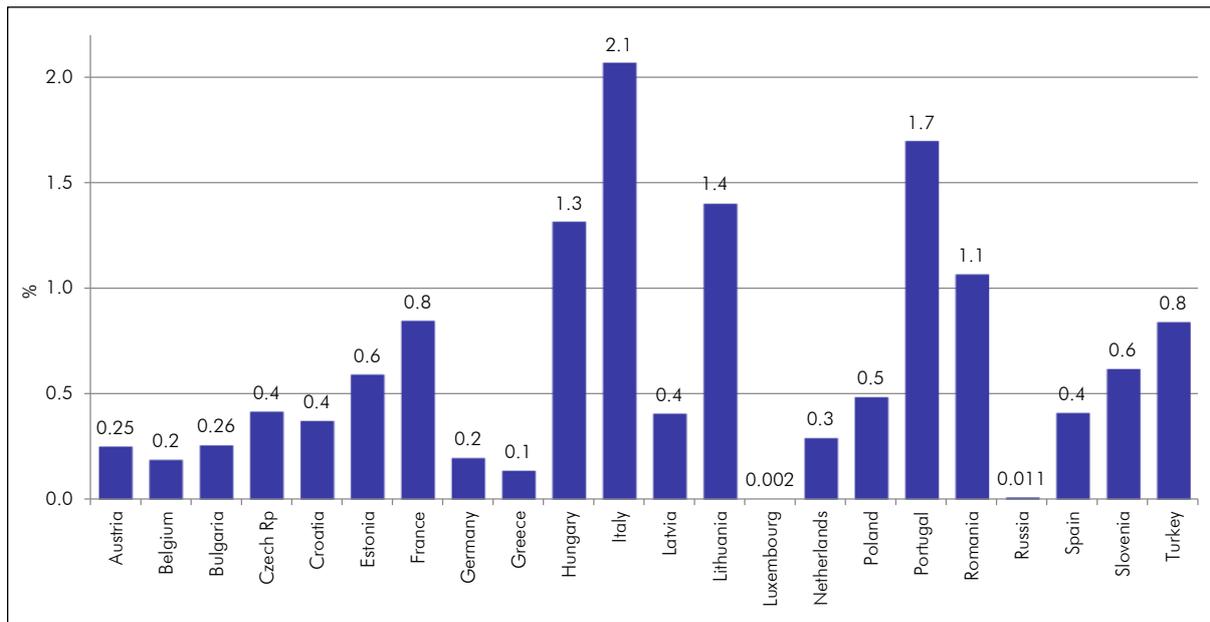
⁴⁶In Romania and Slovenia, some AECM members provide counter-guarantees to other AECM members; in these cases, the summing-up of guarantee and counter-guarantee activities leads to a double-counting of the underlying guaranteed loans. However, for consistency of the data shown in the table, these were not cleaned accordingly.

⁴⁷In 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. In the case of Austria, project-related guarantees, which can also cover non-SME financing, are included since 2014.

⁴⁸In the case of some AECM members, guarantees or counter-guarantees cover *portfolios* of loans or guarantees; however, in most cases, they cover *single/individual* loans/guarantees.

⁴⁹Here and in the following, all figures include guarantee, counter- and co-guarantee activities.

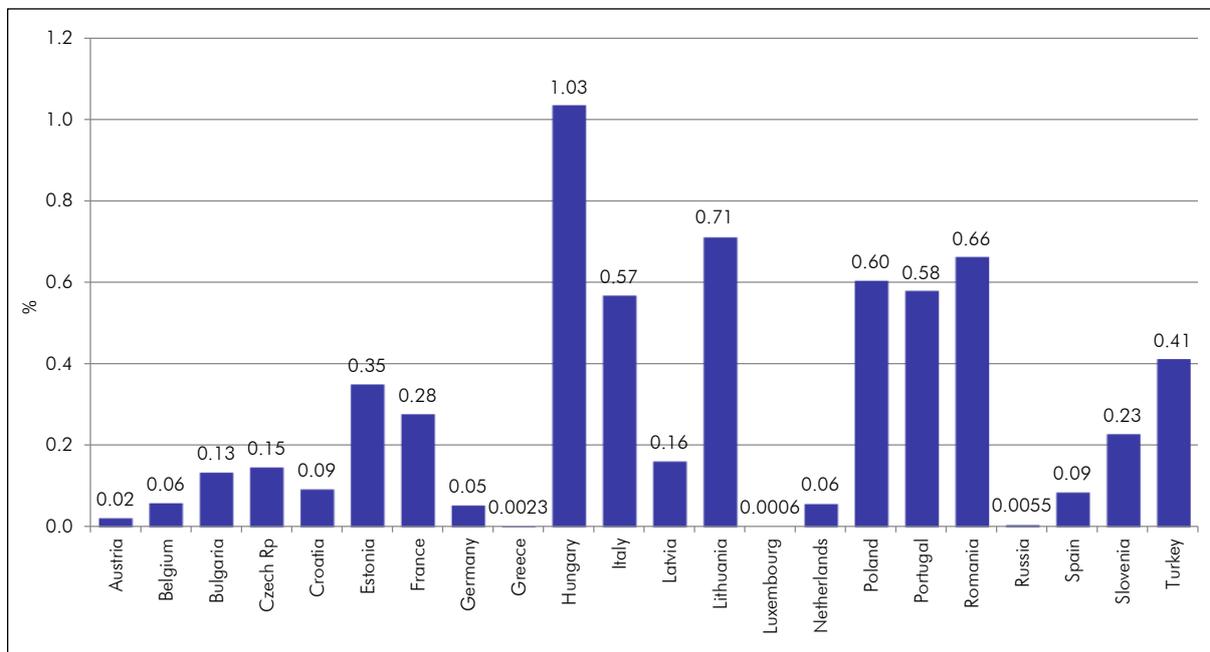
Figure 28: Volumes of outstanding guarantees in portfolio scaled by GDP, 2014 data



Source: AECM (provisional figures).

The guarantee activity in 2014 was strongest, related to GDP, in Hungary, Lithuania, Romania, Poland, Portugal and Italy (see Figure 29).

Figure 29: Volumes of guarantees granted in 2014 scaled by GDP



Source: AECM (provisional figures).

Market activity in 2014

Guarantees outstanding

In 2014, according to preliminary AECM data, the total volume of outstanding guarantees and counter-guarantees in portfolio, increased by 5%, compared to the previous year. At the same time, the number of outstanding guarantees and counter-guarantees reported by AECM increased by 22%.

The observed development, which was more favourable for the number of guarantees than for the total volume, is reflected in the average guarantee size. After the beginning of the financial crisis, the AECM statistics had shown an upturn from EUR 34.1k in 2008 to EUR 40.2k in 2011. Since then, the value dropped back again towards the levels reached in prior years. In 2014, the average guarantee size has further decreased to EUR 30.4k.

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, which have in general smaller amounts, and bridge-financing guarantees, e.g. for the extension of an already provided guarantee). Short-term guarantees generally (for the AECM members) cover less than 12 months. In addition to this development, according to AECM, some members are 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.

The volume of new guarantees provided per year was reported to be at the level of EUR 27.2bn in 2014 (EUR 24.5bn of guarantee activity plus EUR 2.7bn of counter-guarantee activity). In terms of numbers, 657,677 new guarantees were issued in the course of 2014. AECM members supported almost 320k new SME⁵⁰ beneficiaries in 2014.

Drivers of the 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 growth of economic output, SMEs business, investments, the related need for finance, and, hence, their implied demand for guarantees – are all low. At the same time, in some countries, tightening restrictions on public

⁵⁰Number 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 number of new SME partners of guarantee institutions per year.

budgets and high financial risk perceptions are weighing heavily on guarantee supply. Consequently, public support on the European level, as typically provided through the EIF, could improve the situation, if only on the supply side. In some countries, e.g. Germany, the weak development of guarantees has also been explained by relatively favourable financing conditions, and so lesser need for guarantees, following the large 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.

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 intermediaries, EIF can effectively provide both financing to SMEs and guarantees for SME financing. Apart from EIF guarantees for securitised SME financing instruments (see chapter 5.2), EIF offers guarantees/counter-guarantees for portfolios of micro-credits, SME loans or leases.

EIF manages several mandates on behalf of the EIB, the European Commission (EC) and national and regional Managing Authorities. Among the EC mandates, the EIF manages the Loan Guarantee Facility (LGF) under the Programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME) and the InnovFin SME Guarantee Facility under Horizon 2020. Both facilities are windows of the Single EU Debt Financial Instrument, which is financially supported by COSME and Horizon 2020 in order to support growth, research and innovation of European enterprises. Guarantees play as well an important role in the Investment Plan for Europe – also called the Juncker Plan. We cover this topic in the concluding remarks at the end of this document.

Through COSME LGF, EIF offers guarantees and counter-guarantees, including securitisation of SME debt finance portfolios, to selected financial intermediaries (e.g. guarantee institutions, banks, leasing companies, loan/debt funds⁵¹ etc.) to help them provide more loans and leases to SMEs. By sharing the risk, COSME guarantees allow the financial intermediaries to expand the range of SMEs they can finance, facilitating access to debt finance for many SMEs which might be having difficulties in accessing the traditional banking system. Until May 2015, 8 agreements have been signed in 6 different countries enabling SME financing up to EUR 2.6bn. COSME LGF is a successor to the SME Guarantee Facility (SMEG), successfully implemented by EIF, on behalf of the EC, under the Competitiveness and Innovation Framework Programme (CIP) in the period 2007-2013.⁵² Until December 2014, more than 367,000 SMEs were supported under CIP SMEG, and 73 agreements with 57 intermediaries were signed in 24 countries. The loan amount that CIP SMEG has so far generated for SMEs was in the order of EUR 19.3bn.

⁵¹See Kraemer-Eis (2014) for more information on institutional non-bank lending and the role of Debt Funds.

⁵²Source: EIF. For more information on the COSME LGF see http://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/index.htm. For more information on the CIP SMEG see http://www.eif.org/what_we_do/guarantees/cip_portfolio_guarantees/index.htm.

The InnovFin SME Guarantee Facility is part of “InnovFin – EU Finance for Innovators”, an initiative launched by the EC and the EIB Group in the framework of Horizon 2020. EIF, acting as the implementing body, covers a portion of the losses incurred by the financial intermediaries on loans, leases and guarantees. In this way, the EU and EIF allow the provision of more debt financing to research-based and innovative SMEs and small mid-caps (up to 499 employees). Until May 2015, 13 agreements have been signed in 12 different countries enabling SME financing up to approximately EUR 1.8bn. The InnovFin SME Guarantee Facility builds on the success of the Risk Sharing Instrument (RSI), developed under FP7, the 7th EU Framework Programme for Research and Technological Development (2007-2013), managed and implemented by EIF. The RSI Facility for Innovative and Research oriented SMEs and small Mid-Caps had been launched in 2011. It 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. RSI complemented the scope of the Risk Sharing Finance Facility (RSFF), which has been managed by the EIB and has mainly addressed large corporates. RSI proved that it could address current market needs and was speedily introduced to financial intermediaries with absorption and deployment to SMEs following swiftly. As of December 2014, 40 operations (including 4 increases) with 36 different intermediaries in 18 countries had been signed, totalling approximately EUR 1.6bn, which enables SME financing of up to EUR 3.3bn. So far EUR 1.3bn of financing has effectively been provided to 2,353 SMEs and small mid-caps in 2,625 transactions.

Moreover, EIF continues to deploy its financial products in order to catalyse European Structural and Investment Funds. In doing so, EIF capitalises on its experience with JEREMIE (Joint European Resources for Micro to Medium Enterprises), a joint initiative developed by the European Commission in co-operation with the EIB Group and other financial institutions to enhance cohesion across the EU in the 2007-2013 programming period. JEREMIE was developed with a view to enabling SME financing in countries less supported by “traditional” EIF products, namely risk-sharing loans and portfolio guarantee instruments under JEREMIE⁵³. Under the JEREMIE First Loss Portfolio Guarantee (FLPG), EIF has covered part of the credit risk relating to a new portfolio of loans and/or leases granted by a financial intermediary to SMEs. Moreover, EIF has further implemented risk-sharing loan products, the Portfolio Risk Sharing Loan (PRSL), and the Funded Risk Sharing Product (FRSP), whereby EIF has provided funding to banks for the financing of new portfolios of SME loans (such loans to be co-financed by the financial institutions), and has shared part of the credit risk related to the portfolios. As at November 2014, the impact, based on these products, is about to reach a total SME portfolio originated of almost EUR 1.8bn.

Looking forward, EIF has been entrusted with a dedicated EIB Group Risk Enhancement Mandate (EREM; we had given a more detailed overview in Kraemer-Eis, Lang, and Gvetadze, 2014a), 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 from EIF) that will back, inter alia, additional guarantees to be issued by EIF over the next seven years.

⁵³The JEREMIE initiative offered 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 could 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 see: http://www.eif.org/what_we_do/resources/jeremie/index.htm

In general, it is the objective to increase coherence and consistency of the instruments. While EREM is 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 in the course of being implemented: 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 (European Structural and Investment Funds, ESIF) to achieve rapid and significant impact. Spain has been the first country to implement this new EU initiative, contributing an amount of EUR 800 million out of its European Structural and Investment Funds. This amount will be leveraged with commercial lending through a risk sharing mechanism, so that more SMEs will benefit from European resources on advantageous terms. It is expected that at least EUR 3.2 billion of new SME financing will be supported under this programme in Spain (see EIF, 2015b)⁵⁴. Moreover, a *Cultural and Creative Sectors guarantee facility* (under the Creative Europe Programme) is under development for roll-out in 2016.

Many of EIF's guarantee products are also available for leasing providers as leasing is an important financing tool for SME. We provide background information about SME leasing in the following Box.

Box 9: The use of leasing among European SMEs⁵⁵

In this box, we present key findings from the report "The Use of Leasing Amongst European SMEs" (Oxford Economics, 2015), which was prepared for Leaseurope, the European Federation of Leasing Company Associations. The report is an update of an earlier issue (Oxford Economics, 2011), of which we had presented the results in detail in two publications (see Kraemer-Eis and Lang, 2012 and 2014). The 2015 survey was conducted among 2,950 SMEs from 8 European countries and 9 industries over September/October 2014.

The results of the survey show that 42.5% of all SMEs used leasing in 2013 (compared to 40.3% in 2010) demonstrating that leasing is an increasingly vital source of finance for many of these firms in Europe, in particular for micro and small enterprises. SMEs expected a further increase in their use of leasing for 2014. SME access to bank loans also grew in 2013 after experiencing significant constraints during the financial crisis, while leasing use remained relatively stable over that time. The main reason to choose leasing was a perceived better price than that of other financing forms.

The survey also reveals that the use of leasing varies more by country than by sector. In fact, the proportion of Dutch, French and German SMEs' use of leasing increased notably since 2010, while Spanish and Italian firms' use declined. The use of leasing among Polish, Swedish and British firms has remained fairly stable since 2010.

⁵⁴More information on the SME Initiative in Spain can be found here http://www.eif.org/what_we_do/guarantees/sme_initiative/smei_spain/index.htm.

⁵⁵Source: Oxford Economics and Leaseurope (2015) and Leaseurope.

Box 9 continued:

Of those SMEs that did not use leasing in 2013, 26% reported using it in the past. Micro-enterprises and countries which suffered more from the crisis (Spain and Italy, in this sample) exhibited the largest shares of such “former lessees”. SMEs in these countries also reported a generally lower use of leasing in 2013 than in 2010.

SMEs use leasing to finance a greater portion of their investment than larger businesses. In 2013, SMEs financed 18.9% of their total investment via leasing, up from 16.7% in 2010. Penetration rates grew across all SME size classes, with micro firms posting the largest increase. SMEs expected leasing penetration rates to rise in 2014, while the penetration rates were expected to decline for cash/equity and all forms of bank lending. Leasing penetration rates for SMEs in France, Germany, Poland and the UK were high at between 20-30% in 2013. The UK and Germany, having large well performing leasing markets, and Poland, with a relatively young but high growth leasing sector, saw substantial increases in SME penetration rates since 2010. On the other hand Italy and Spain saw large declines during this time period.

SMEs lease an extremely broad range of assets, indicating that almost all types of goods can be financed by leasing. According to the survey, in 2013, vehicles remained the most frequently leased asset type across all countries and economic sectors compared to 2010 and together with machinery and industrial equipment dominated SME’s total equipment leasing expenditure.

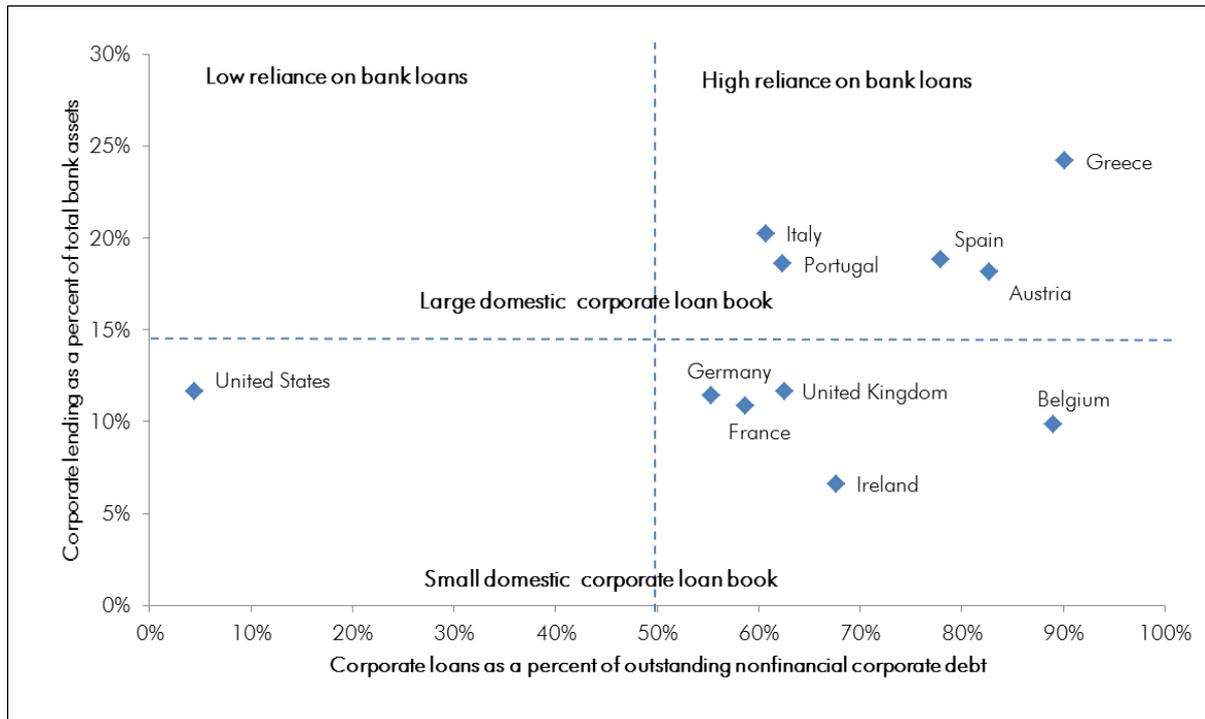
According to the survey, lessees invested, on average, more than twice the amount of non-lessees. Lessees are also more likely to be exporters and/or growth SMEs than non-lessees. The share of companies that expected to invest more in 2014 than in 2013 was larger among those companies that had used leasing in 2013 than among the non-lessees.

Oxford Economics (2015) estimates that at the EU level leasing was responsible for financing around EUR 104bn of SME investment in fixed assets in 2013 and was expected to finance nearly EUR 121bn in 2014, with medium-sized and micro enterprises contributing a larger amount than companies in the “small” size class.

5.2 SME Securitisation

European SMEs depend very much on bank financing (see Figure 30). ECB president Mario Draghi mentioned in an often quoted statement that “in the United States 80% of credit intermediation goes via the capital markets. [...] In the European situation it is the other way round. 80% of financial intermediation goes through the banking system” (Draghi, 2013).

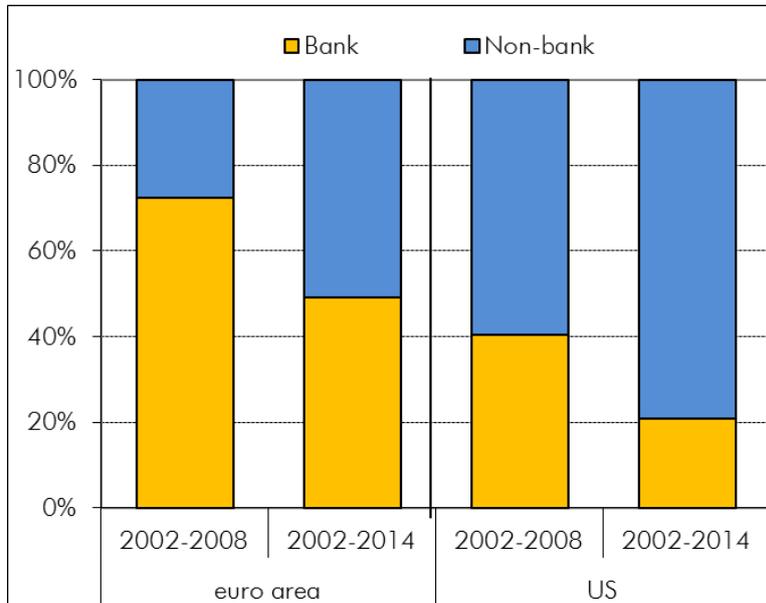
Figure 30: Reliance on bank financing by non-financial corporations (in %)



Source: Authors, based on IMF (2012) and updated information for 2014.

As outlined in more detail in Kraemer-Eis (2014), this ratio is moving towards more capital market action: Cour-Thimann and Winkler (2013) state that external financing of the non-financial corporate sector (financing other than retained earnings) is dominated by bank financing (in the euro area). However, as the authors point out, this split refers to the stock - in terms of flows the figures fluctuate significantly; in particular as the corporate sector can to some extent substitute bank lending with other sources of finance. This possibility exists for SMEs only to a very limited extent. During the crisis part of the declining bank lending was offset by an increase in capital market funding (see Figure 31): debt securities issued by corporations (but also quoted shares issued) increased. But, “such substitution is primarily possible for large corporations; it is less so for small and medium-sized firms, which constitute the bulk of employment and activity in the euro area” (Cour-Thimann and Winkler, 2013).

Figure 31: Funding of non-financial corporations in the euro area and the United States (shares in accumulated debt transactions)



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

Against this background, a well-functioning securitisation market can be a way to easing supply problems by helping banks diversify their funding and achieve capital relief. Euro area banks are holding a large stock of relatively illiquid loans that could be transformed into liquid assets through securitisation. SMESec can provide indirect access to the capital market for SMEs – making SME loans “liquid”. However, as we will see later, SME securitisation (SMESec)⁵⁶ placed with investors currently represents only a very small portion of the total placed Asset Backed Securities (ABS) issuance and there is for the time being only a very limited primary market.

5.2.1 Market activity⁵⁷

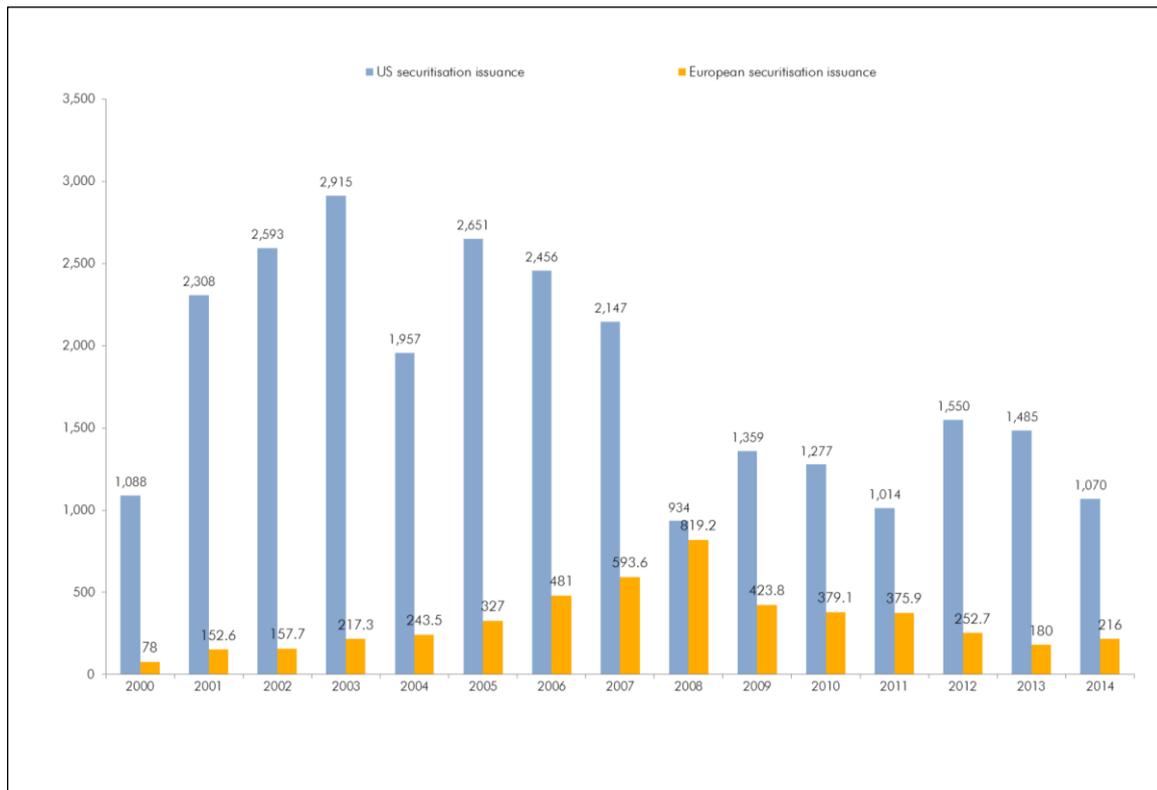
The European securitisation market had grown steadily from the beginning of the previous decade until the outbreak of the crisis. However, the European market is much smaller than its US peer (see Figure 32).⁵⁸

⁵⁶The 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 (2014b).

⁵⁷If not flagged otherwise, the data source is AFME, the Association for Financial Markets in Europe (i.e. AFME, 2015a).

⁵⁸The ECB’s asset repurchase or “repo” facility allows (among other assets) Asset Backed Securities to be used as collateral for funding.

Figure 32: Securitisation issuance Europe versus US (annual issuance 2000 - 2014, bn EUR)



Source: Authors, based on data from AFME/SIFMA

During the crisis, issuance remained initially at high levels (compared to pre-crisis values) in Europe, but these volumes were almost exclusively driven by the eligibility of ABS as collateral for ECB liquidity operations; then the overall market activity decreased to the 2003/2004 levels, in particular due to regulatory uncertainties⁵⁹ and tighter euro system collateral rules.⁶⁰

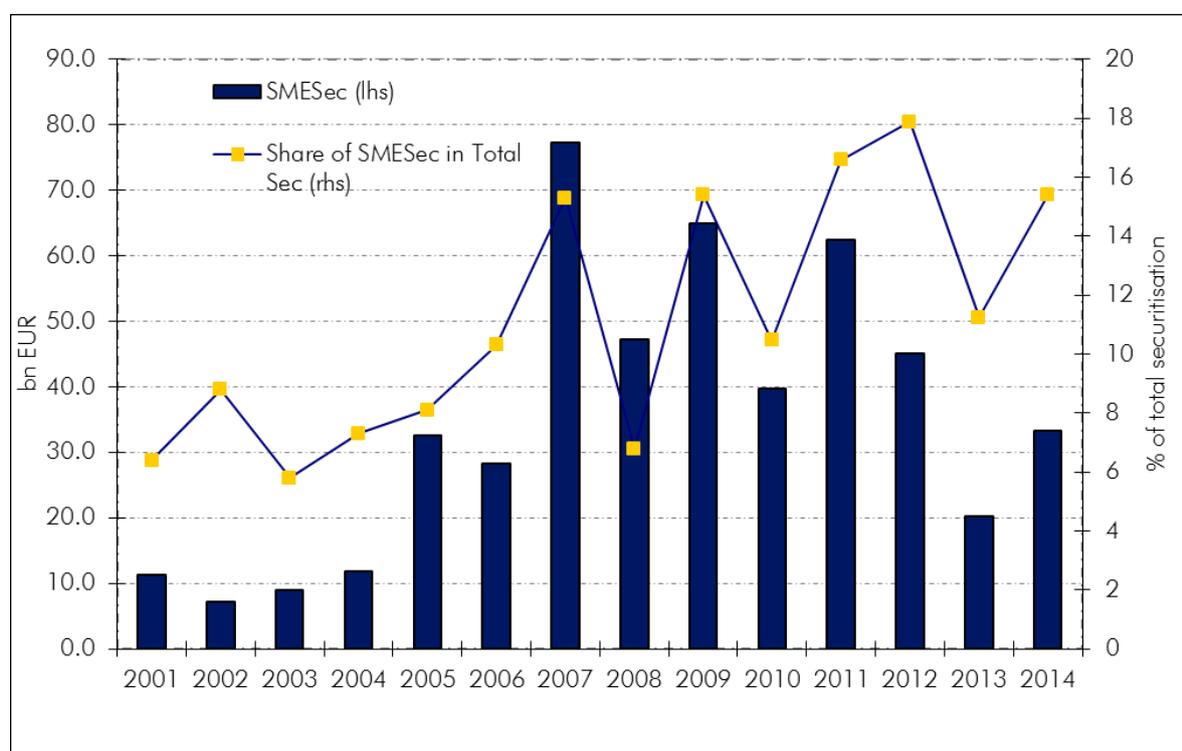
The most active markets in 2014 in terms of *overall securitisation issuance* were France (market share: 23%), UK (23%), Spain (13%), the Netherlands (12%), Italy (9%) and Germany (9%). In line with the shrinking volumes, also the number of active market participants is declining: there is a reduced number of active securitisation professionals, i.e. at investors, issuers, rating agencies, agents and brokers (Bank of America/Merrill Lynch, 2015a).

⁵⁹ See for details concerning the regulatory developments e.g. Wehinger and Nassr (2015) and Segoviano et al. (2015).

⁶⁰ In Q1/2015, overall securitisation issuance in Europe amounted to EUR 33.9bn, a decrease of 43.1% from Q4/2014 (EUR 59.6bn) and a significant increase of 70.4% from Q1/2014 (EUR 19.9bn). Of this, EUR 18.2bn was placed, representing 53.7%, compared to EUR 24.1bn placed in Q4/2014 (representing 40.4% of EUR 59.6bn) and EUR 14.6bn placed in Q1/2014 (representing 73.4% of EUR 19.9bn). See AFME, 2015b.

SMESec issuance is still suffering from the crisis, however the overall issued volume of SME deals in 2014 (EUR 33.3bn) was already significantly higher than in 2013 (see Figure 33). 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 (while SMESec activity decreased slightly less). In 2014, the share of SMESec was 15%. During the crisis, also the large volumes of synthetic SMESec transactions (see also later Box 10 on synthetic securitisations), that were evidenced pre-2007 on SME portfolios dominated primarily by German SMEs on the back of KfW's PROMISE program, virtually disappeared. Rating downgrades, based on revised rating agency criteria (i.e. counterparty and country ceiling criteria, without grandfathering), on downgrades of counterparties involved in the transactions, and on negative credit trends, contributed to the overall negative market sentiment.

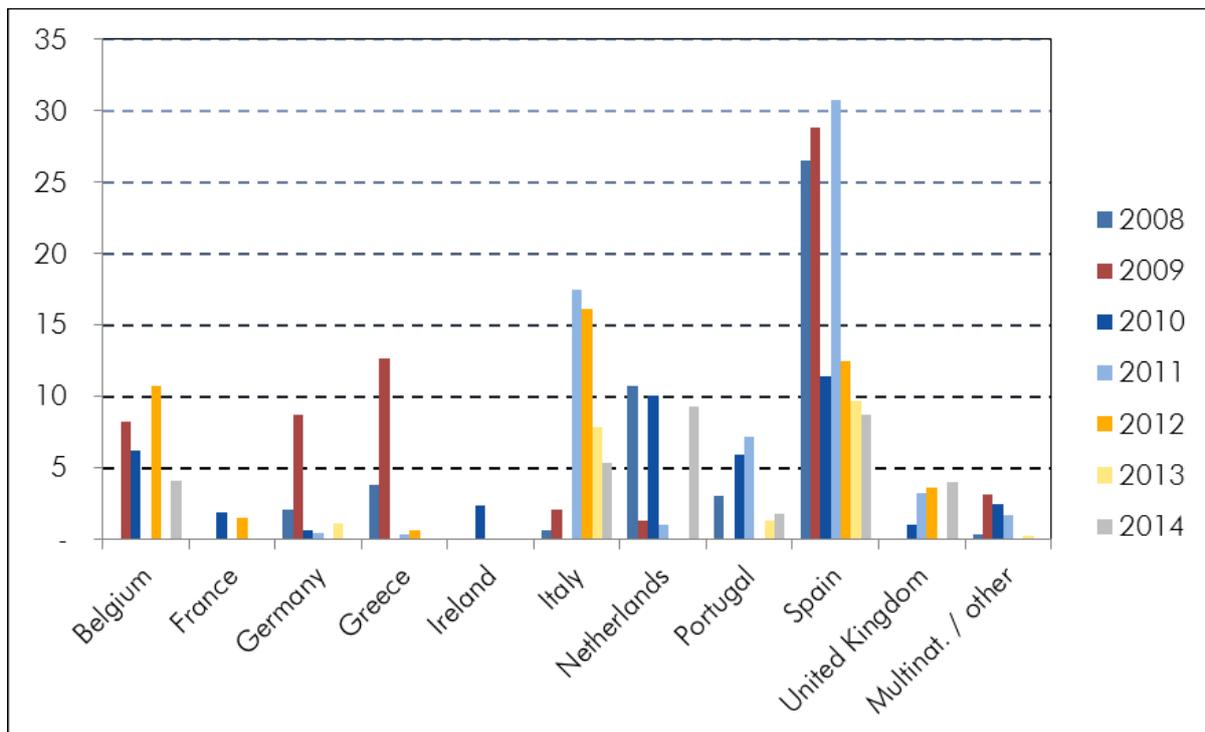
Figure 33: SMESec issuance in Europe (volume and share of total securitisation, bn EUR and %)



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

In terms of countries, the market activity is concentrated: The SME related issuance in 2014 occurred only in the Netherlands (EUR 9.3bn, 28% of SME issuance), Spain (EUR 8.8bn, 26%), Italy (EUR 5.3bn, 16%), Belgium (EUR 4.1bn, 12%), UK (EUR 4bn, 12%) and Portugal (EUR 1.8bn, 5%) – see as well Figure 34 for an overview of the SMESec issuance by country during the crisis.

Figure 34: European SMESec issuance in Europe during the crisis (by country, in bn EUR)

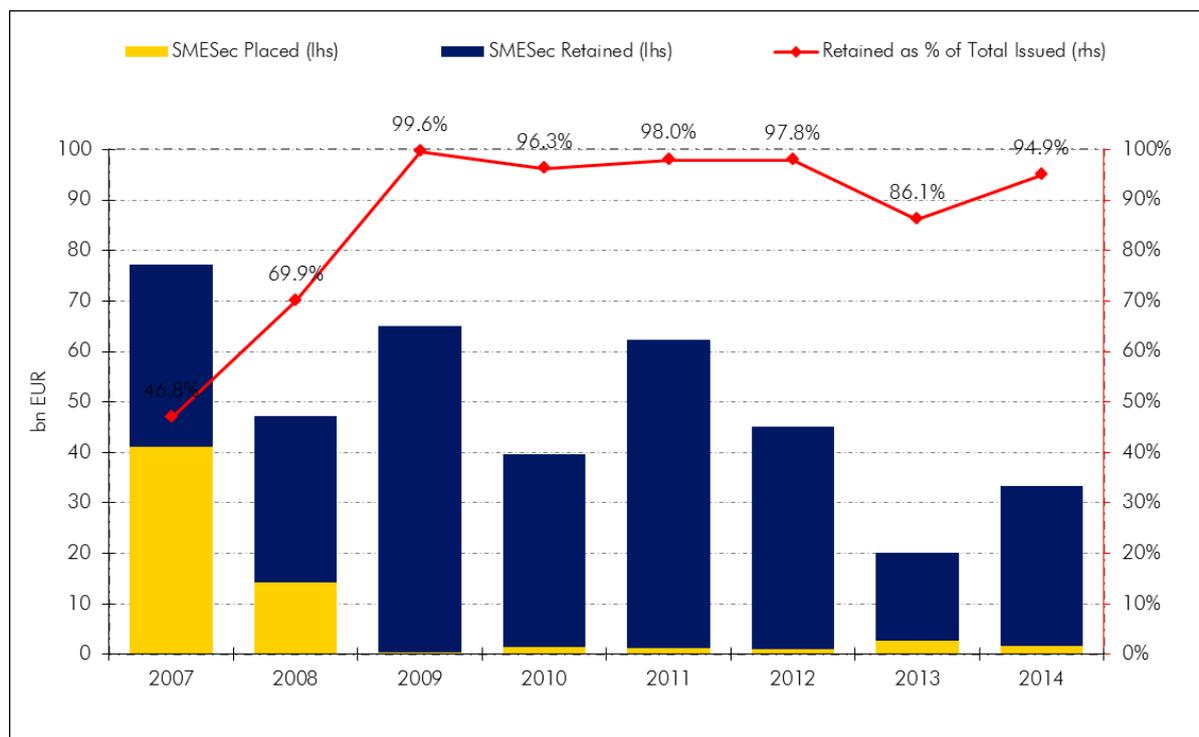


Source: Authors, based on data from AFME

As already mentioned, it is important to note that only a very small fraction of the issuance has been placed with investors (see Figure 35): the nature of the SMESec market changed from a developing market (pre-crisis, with most transactions placed in the primary market) to a purely retained/ECB repo-driven market during the crisis (with almost no placement on the primary market). This shift led to liquidity drying up and originators accepting higher all-in costs as, in addition to the credit enhancement, the repos envisage considerable haircuts to the face value of the notes. Public issuance is still hindered in particular by the regulatory framework (and related uncertainties) that makes transactions less attractive for originators and investors – as well as by ECB eligibility rules under the repo-collateral framework that favour alternative instruments (such as sovereign bonds or secured or unsecured bank debt (Scope, 2015)).

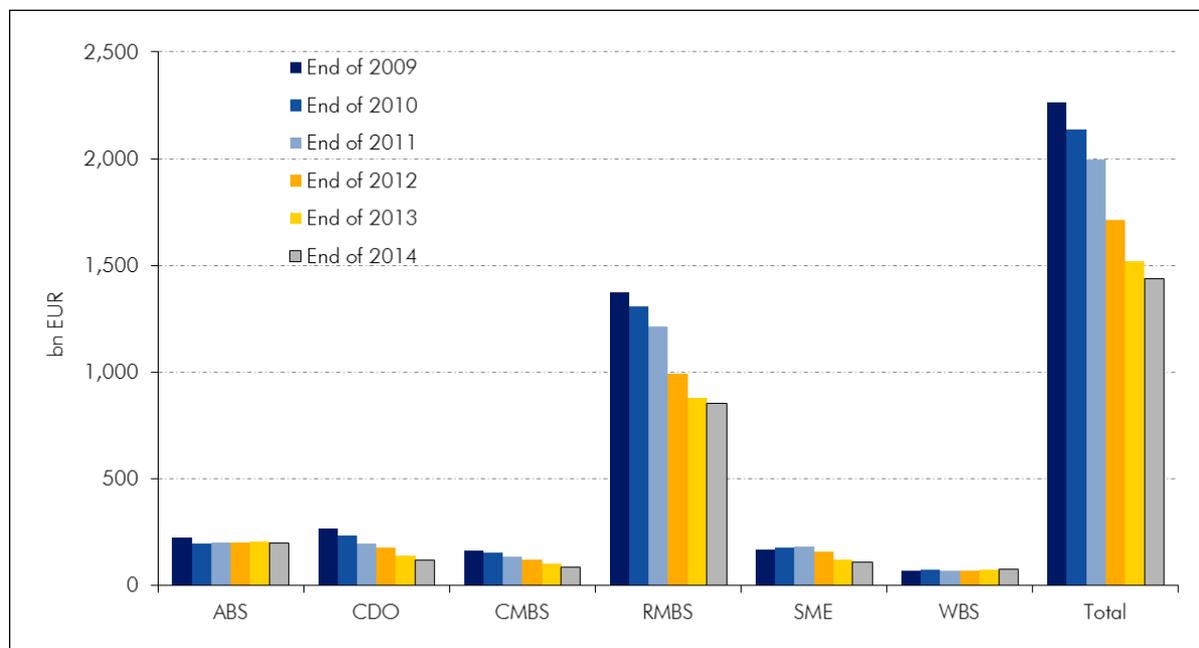
Due to low new activity levels, the volume of *outstanding securitisation transactions* (see Figure 36) is on a downward trend (negative net supply). Compared to the end of 2013, until end of 2014, the total outstanding decreased by another 6%. Since the end of 2011, the volume of outstanding SMESec transaction decreased by 41%, from EUR 182bn to EUR 107bn (end of 2014).

Figure 35: European SMESec by retention (bn EUR and %)



Source: Authors, based on Wehinger and Nassr (2015) and updated data

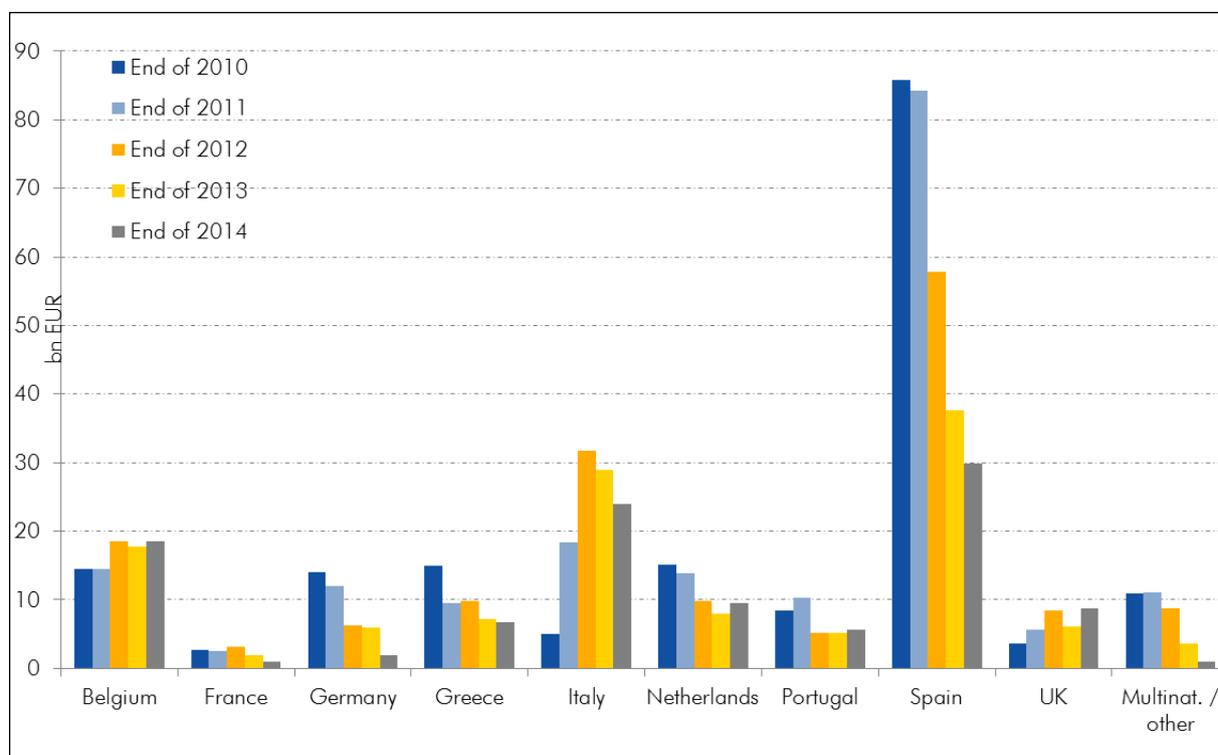
Figure 36: European outstanding securitisation transactions by collateral (bn EUR)



Source: Authors, based on data from AFME

If SMESec volumes per end of 2014 are broken down by country (see Figure 37), the Spanish (28%) and Italian (22%) markets together count half of the overall outstanding – despite decreasing volumes - followed by Belgium (17%), and the UK (9%).

Figure 37: European SMESec outstanding volume by country (bn EUR)



Source: Authors, based on data from AFME

5.2.2 SMESec performance trends

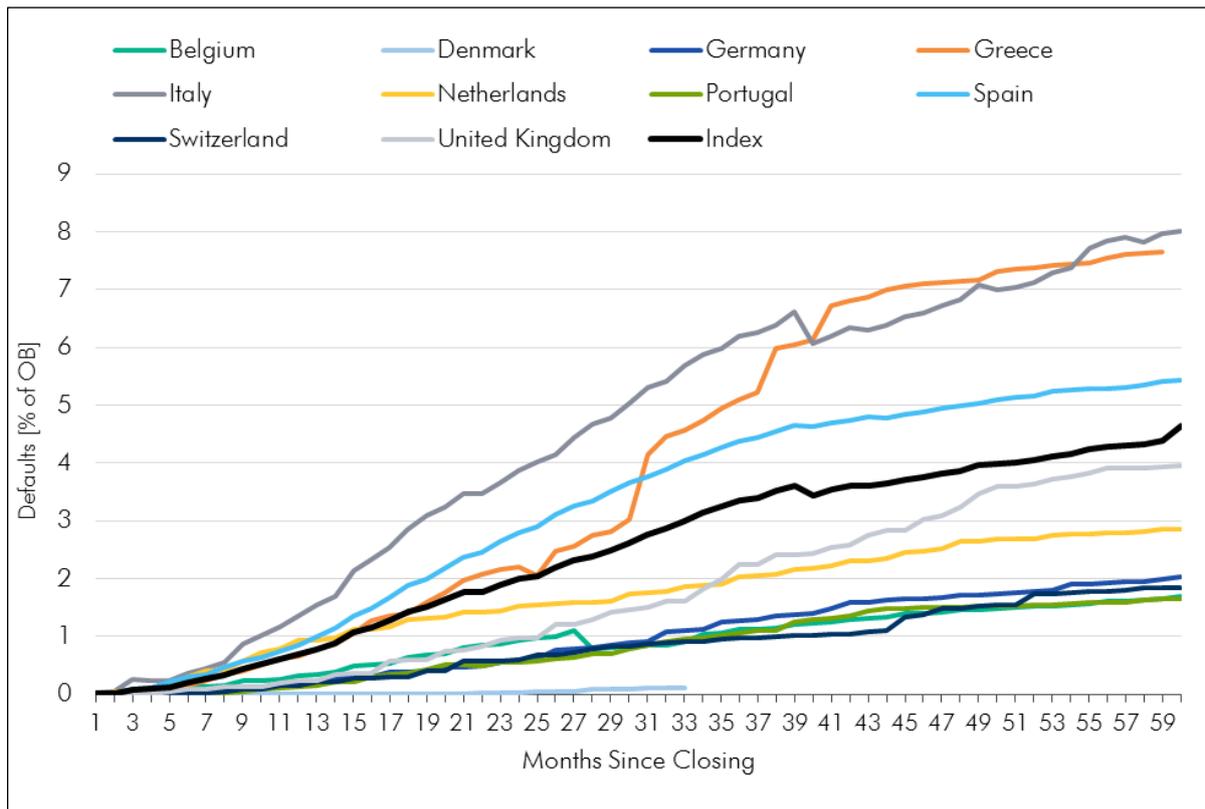
Despite the financial and sovereign crisis, the European securitisation market in general has performed relatively well with comparatively low default rates.⁶¹ The low losses are not only based on the typically high granularity, diversification and seasoning of these transactions, but also on the structural 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 relatively unknown to investors and rating agencies (based on the novelty of the applied tools, but as well based on the heterogeneity of SMEs/SME loans), and the technique of securitisation was also new to most of the originators – and many banks were not in a position to securitise SME loans (as a simple example: the originators' IT infrastructure has to be able to cover securitisation transactions). As a consequence - on the one hand - before the crisis started, the overall SMESec volumes were small compared to the overall securitisation market – and the market had not had much time to develop. On the other hand, the

⁶¹With some exceptions, i.e. the non-granular hybrid transactions (German Mezzanine CDOs). For more details see Kraemer-Eis, Passaris and Tappi (2013).

uncertainty was one of the reasons for the relative conservative structures in the general SMESec segment – and this led to good SMESec performance in Europe, i.e. compared to other segments of the securitisation market (and i.e. compared to the US).⁶² Figures 38 and 39 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).

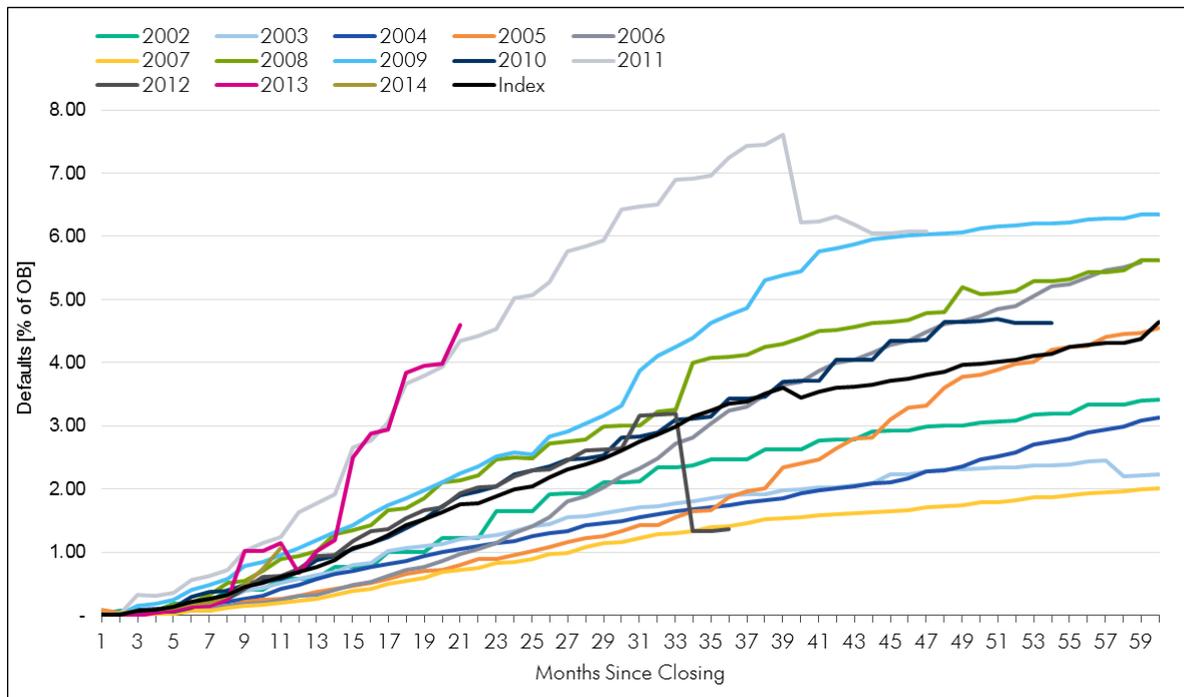
Figure 38: EMEA ABS SME loan and lease cumulative credit events or defaults on original balance (seasoning by country)



Source: Moody's (2015)

⁶²According to Standard & Poor's (2014), only 1.58% of European Structured Finance notes (rated by Standard & Poor's) outstanding in mid-2007 had defaulted by mid-2014. The cumulative default rate for SMESec transactions was at 0.55% – for comparison: the cumulative default rate for US Structured Finance notes was at 19.3%, the one for CDO of ABS was at 41.08%. See also EBA (2014) for an analysis of historical credit performance of the securitisation market.

Figure 39: EMEA ABS SME loan and lease cumulative credit events or defaults on original balance (seasoning by vintage)⁶³



Source: Moody's (2015)

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 (crisis-driven) performance effects in the underlying portfolios, as well as the rating methodology changes. Typically, AAA tranches show strong rating stability, but during the crisis also AAA and AA tranches migrated downward. This was mostly driven by downgrades of the respective country/sovereign ratings, and the limitation by the country ceilings, or they may be driven by downgrades of (not replaced) counterparties (whose rating is in turn affected by the respective sovereign ratings).

The rating transition data shows that the downgrade pressure for SME transactions persists across all tranche levels. The example below (Table 4) shows the rating migration of SME Collateralised Loan Obligation (CLO) transactions (rated by Fitch, migration since transaction closing). For example, of all the tranches that have initially been rated AAA, 49% (by number⁶⁴) have paid in full (pif), 10% are still AAA, 16% moved down to AA etc. Meanwhile, there has been very limited upgrading, but no tranche was upgraded to AAA.

⁶³Terminated 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 transactions rated by Moody's.

⁶⁴Relative to the number of tranches in a given initial rating category.

Table 4: Fitch European SMEs Rating Transition Matrix (May 2015)⁶⁵

% of tranches	Current rating									
	PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf
Initial Ratings										
AAAsf	49%	10%	16%	14%	8%	2%	1%	0%	0%	0%
AAsf	14%	0%	43%	11%	5%	11%	11%	3%	0%	3%
Asf	4%	0%	22%	35%	9%	13%	11%	2%	2%	2%
BBBsf	5%	0%	0%	5%	14%	16%	11%	23%	20%	7%
BBsf	5%	0%	0%	5%	0%	29%	14%	10%	33%	5%
Bsf	0%	0%	0%	0%	20%	40%	0%	0%	40%	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 (2015)

5.2.3 Prospects

In general, a well-functioning securitisation market can be essential in helping financial intermediaries broaden their funding base, achieve capital relief and ultimately, increase their SME financing. But overall, the SMESec market in Europe is underdeveloped (AFME and BCG, 2015). There are many advantages of SMESec – for banks, for investors, and – most importantly – for the SMEs (see for a detailed discussion Kraemer-Eis et al, 2010, Wehinger and Nassr, 2015, Bank of America/Merrill Lynch, 2015, or Aiyar et al., 2015). At first sight, the advantages are mainly for banks and investors, but these benefits can channel through to a positive effect on SME's access to finance and hence to the SMEs themselves. A recovery and development of the primary securitisation markets could play a role in unlocking credit supply and economic recovery. However, this will only be to the benefit of SMEs if the freed-up capital / fresh liquidity is going to be used to finance the real economy (i.e. for new SME lending).

A compelling case can be made for public assistance to enhance access to finance for SMEs (market failure based on information asymmetries, high transaction costs, and spill-overs – exacerbated by the credit crunch in many economies associated with the financial crisis), and for supporting the SMESec European market (for details, see Kraemer-Eis, Passaris and Tappi, 2013). 15 years ago, public support in the form of national programmes (e.g. FTPYME in Spain and PROMISE in Germany) and EIF-support on supranational level already contributed significantly to the emergence of a European SMESec market. For the re-emergence of a primary European SME securitisation market official sector support is as well required (Aiydar et al., 2015) – and it could form an important element in the efforts to enhance access to finance for SMEs in Europe. In this context, not only does the supplied volume matter, but the positive signalling effect, triggered by the public involvement and support, could be equally important. Hence, the EIB Group fully supports the European Commission's desire to support a sustainable high quality securitisation market in Europe – as also stated in the context of the establishment of a Capital Markets Union (CMU).⁶⁶

⁶⁵The addition sf indicates a rating for structured finance transactions.

⁶⁶See the EC's papers concerning "Building a Capital Market Union (European Commission, 2015e, f) and "An EU framework for simple, transparent and standardised securitisation" (European Commission, 2015a).

This CMU is a long-term project, while the necessary revival of the securitisation market should happen faster. The EIB Group has maintained its presence and support of the SMESec market during the whole period of the recent economic turmoil. This has been manifested by the launch of several initiatives in the securitisation domain, namely (i) the EIB Group ABS Initiative for SMEs, (ii) the Joint SME Initiative with the European Commission and (iii) securitisation mezzanine risk cover under the EREM (EIB Group Risk Enhancement Mandate) ABS Credit Enhancement window. So far, the EIB Group support to the European SME securitisation market amounts to more than EUR 16bn (EIB purchases of SME related ABS and EIF guarantees for SMESec).

In November last year, the ECB started its Asset Backed Purchase Programme (ABSPP)⁶⁷. The overall objective is to enhance the transmission of the monetary policy, support the provision of credit to the euro area economy and, as a result, to provide further monetary policy accommodation. The ECB's support of the ABS market in general, and the SMESec market in particular, is a positive step, however, the programme so far has not achieved significant volumes. As per 01.06.2015, EUR 7.21bn have been bought by the ECB (EUR 1.56bn in the primary market, EUR 5.65 in the secondary market), compared to around EUR 85.11bn under the Covered Bond Purchase Programme (source: ECB⁶⁸). Even though ECB's activity in the primary market recently started to rise, the overall market impact of the ABSPP is so far very limited. It is worth pointing out that as part of the original ABSPP, there was a provision for the purchase by the ECB of mezzanine tranches of ABS securitisations with an eligible guarantee. As of this moment, further details of this programme have not been announced and it appears that there has not been much progress on that front as yet.

In order to revitalise the SMESec market, significant changes to the regulatory environment (i.e. liquidity risk standards and capital requirements) would be necessary in order to avoid unintended negative impacts – from both perspectives, issuers and investors. A more holistic view than in the past is required and regulations should not be introduced with a silo perspective, as this prevents the ability of the market to develop and start functioning properly again. Strong, but smart regulation is needed.

Insufficient regulatory differentiation is not the only impediment to SMESec, but it is the main obstacle. Other issues are (inter alia) the cost of issuance, fragmented national insolvency and debt enforcement regimes, and the lack of harmonized credit information (see for more details Aiyar et al., 2015). Banks are generally willing to use securitisation – but given the current market environment, their interest is not driven by funding demand (as there are cheaper alternatives available), but by the motivation to achieve regulatory capital relief to boost their capital base and allow themselves to re-ignite their lending to their respective SME sectors. This is particularly important for those banks that are allowed by the regulator to use their internal rating models for purposes of regulatory capital allocation (Internal Rating Based banks). Up until the end of last year, each securitisation transaction needed to have the approval of the respective national regulator. Following the creation of the Single Supervisory Mechanism (SSM), the ECB is progressively assuming responsibility for the banking supervision in the euro area from the

⁶⁷See our previous ESBFO for a summary, see as well for more information Möglich, 2015 (in German), or Bank of America/Merrill Lynch, 2015b.

⁶⁸<https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html>.

national regulators. One of the key prerequisites for a revival of the SMESec market is an efficient and rapid implementation of the new supervision mechanisms.

With regard to the fine-tuning of the various regulations, no dramatic improvements are currently foreseeable. Mitigation of the originally unintended negative effects can be achieved through the creation of High Quality Securitisations (HQS), which should comprise of structures that are simple, transparent and efficient and which should receive preferential regulatory treatment. Transparency should be a prerequisite for any structured transactions. Hence, a particular focus should be put on the promotion of simple structures and well-identified, transparent underlying asset pools with predictable performance.⁶⁹ Naturally, an adequate, clear, and pragmatic definition of HQS is key to achieve its potential – and such a definition should include transactions backed by SME portfolios, as well as the consideration of synthetic transactions whose underlying assets display the required criteria (see Box 10).

Box 10: Can synthetic SMESec be HQS?⁷⁰

As described in earlier EIF working papers, in *synthetic transactions* traditional securitisation techniques are combined with Financial Guarantees or Credit Default Swaps (CDSs) in order to provide credit protection on a pool of loans. In SME transactions, typically the credit risk of a selected reference portfolio of loans (but not the loans themselves, which remain on the balance sheet of the originator - there is no change in ownership of the underlying portfolio) is transferred to the capital market through the issuance of notes (Credit Linked Notes), classified by risk categories (Kraemer-Eis, et al., 2010).

In general, there is a variety of different synthetic structures, e.g. based on granular portfolios / concentrated portfolios, funded / not funded, CDS against whole pool / individual tranches, based on managed / static pools, and also squared transactions (e.g. CDS on different ABS), etc. These approaches vary significantly in terms of complexity, transparency, and standardisation – a synthetic securitisation can be rather simple and rather standardised, but as well highly complex and intransparent. Hence, it is not reasonable to speak of synthetics as ONE single market segment.

Synthetic securitisations have typically lower administrative costs than their cash peers, as well as less legal and operational complexity (Moody's, 2014). Although different concerning several characteristics, in terms of risk, synthetic transactions do not differ significantly from their cash deals, as they are "usually designed to replicate the exposure of cash deals" (Moody's, 2014).

⁶⁹In our June-2014 ESBFO, we outlined what high quality SMESec could look like; see: http://www.eif.org/news_centre/publications/eif_wp_24.pdf. Proposed attributes of HQS in Europe are as well described in IMF (2015a) and Aiyar et al. (2015).

⁷⁰We use here HQS as term – in the current discussion, also other terminologies are used in the same context, e.g. STS (simple, transparent, and standardised) securitisation, used e.g. by the ECB, or STC (simple, transparent and comparable) securitisation, used by BCBS-IOSCO, or SST (simple, standard and transparent) securitisation, used by the European Banking Authority.

Box 10 continued:

Synthetic transactions were used in the past - mainly until the crisis - in a number of European countries and based on different asset classes. According to Bank of America/Merrill Lynch (2015), most of the synthetic issuance in Europe came from the CDOs and RMBS sectors, in particular driven by the transactions under KfW's Promise (SME transactions) and Provide (RMBS) platforms. These transactions were typically rather standardised bank balance sheet CDOs. The same source confirms that there is "no conclusive general evidence that synthetic securitisations have performed credit-wise worse than comparable traditional securitisations, yet performance has varied significantly across asset classes and structures." The authors find similar performances in synthetic SME ABS transactions compared to their cash peers, in particular as the performance of the underlying exposures is the key performance driver – then mitigated or magnified by structural features (Bank of America/Merrill Lynch, 2015c).

The current discussion around HQS focusses on structural features, in particular simplicity, transparency, and standardisation, as well as on quality criteria for the underlying assets. For synthetic SMESec, the latter can be generally the same compared to cash transactions. Concerning the structural features, strict criteria can be defined in order to achieve simple, transparent, and standardised transactions in the spirit of HQS that should receive preferential regulatory treatment. These criteria should in particular be related to the definition of the credit event, the credit protection payment timing and amount, the avoidance of moral hazard (in particular referring to the role of the calculation agent), waterfall features, as well as collateral and counterparty risk in funded synthetic transactions (see for more details Moody's, 2014 and Bank of America/Merrill Lynch, 2015c).

Against this background – the answer to the introductory question of this Box is: "yes it can"!

6 Microfinance market

6.1 Microfinance business environment

“Microcredit is generally recognised [...] as an effective financing channel for job creation and social inclusion, which can attenuate the adverse effects of the current financial crisis while contributing to entrepreneurship and economic growth in the EU” (European Commission, 2012b). In Europe, microfinance consists mainly of micro-loans (less than EUR 25,000) tailored to microenterprises (92% of all European businesses) and people who would like to become self-employed but are facing difficulties in accessing the traditional banking services. Throughout the EU, 99% of all start-ups are micro or small enterprises, and one third of those were launched by unemployed people. In order to prepare for a further analysis of this topic, it is helpful to start with some definitions (see Box 11):

Box 11: What is “micro”?

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

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

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

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

- **Microenterprise lending** = 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 stabilisation of microenterprises with a growth perspective. The maximum loan sizes go up to 25,000 EUR (or even higher in some cases).
- **Social inclusion lending** = lending to self-employed individuals that are excluded from banking services, due to their socioeconomic status of being socially excluded or (long term) unemployed and/or belonging to financially excluded population groups like ethnic minorities or young people. The average loan sizes are relatively low, meant to support basic income creating activities.

EIF has published two working papers so far that specifically cover the European microfinance market (see Kraemer-Eis and Conforti, 2009 and Bruhn-Leon, Eriksson and Kraemer-Eis, 2012). In these studies, EIF 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.

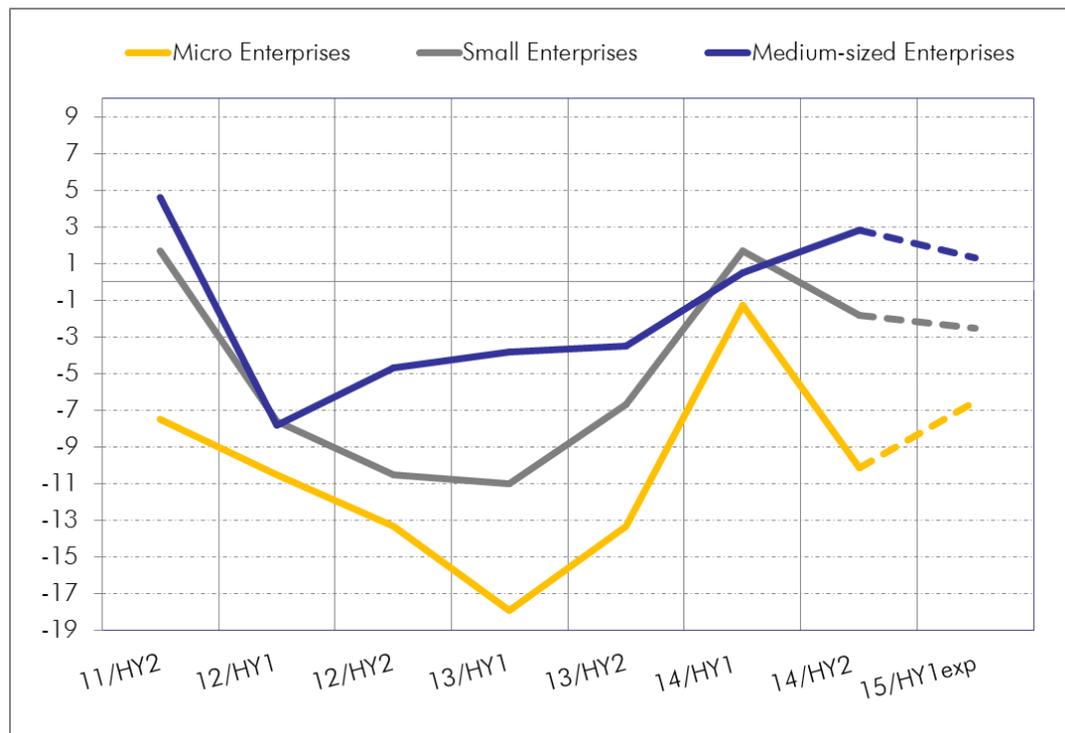
6.2 Overall situation and demand-side perspectives

Standardised, regularly available indicators to explain market developments for microfinance in Europe do not exist yet, or refer to Central-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 Business environment and access to finance of microenterprises

The UEAPME EU Craft and SME Barometer (see UEAPME Study Unit, 2015) shows that, on balance, microenterprises estimated a significant deterioration of their overall situation (-10.1%) while small enterprises reported a smaller deterioration and medium-sized companies reported an improvement of their overall situation in the second half of 2014 (see Figure 40). Moreover, expectations in the previous survey round for the second half of 2014 exceeded realised outcomes.

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

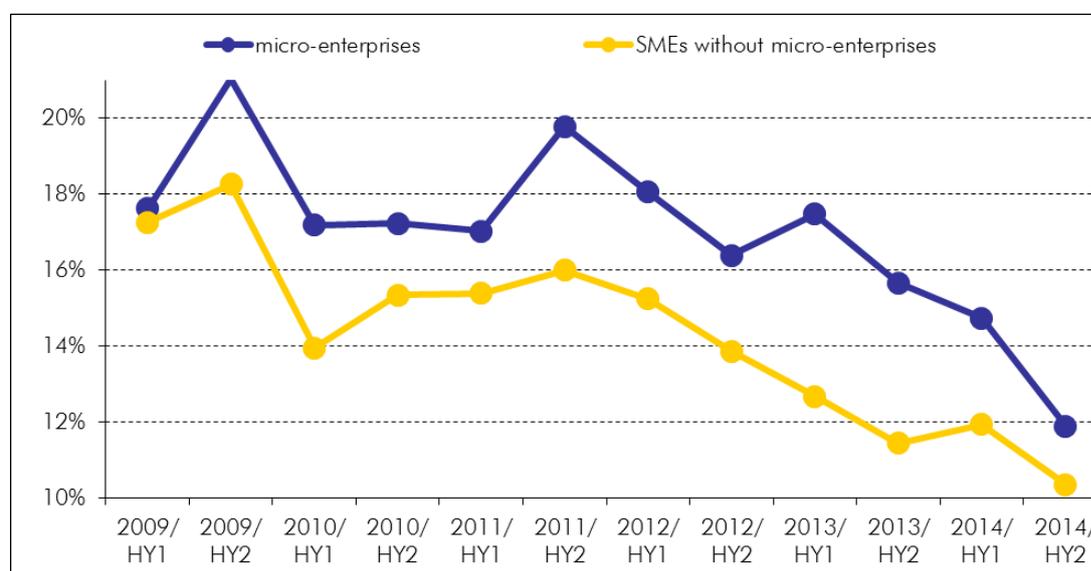


Source: UEAPME Study Unit (2015)

For the first half of 2015, microenterprises, on balance, expected negative changes (-6.5%) in their overall situation. Similar results were reported for the survey questions on turnover, employment, and orders in the second half of 2014 and changes are negatively foreseen for the first part of 2015. 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 enterprises in the euro area (ECB, 2015a), the share of enterprises which see “access to finance” as their most pressing problem remained bigger among microenterprises than the share among other SMEs (Figure 41). “Finding customers” stayed the most frequently mentioned concern. The ECB (2015a) also reported a rise in bank loan rejection rates for micro and small enterprises, and a drop for medium-sized ones. The rejection rate is still the highest for micro firms (13%), compared to 8% for small firms and 3% for medium-sized firms.

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

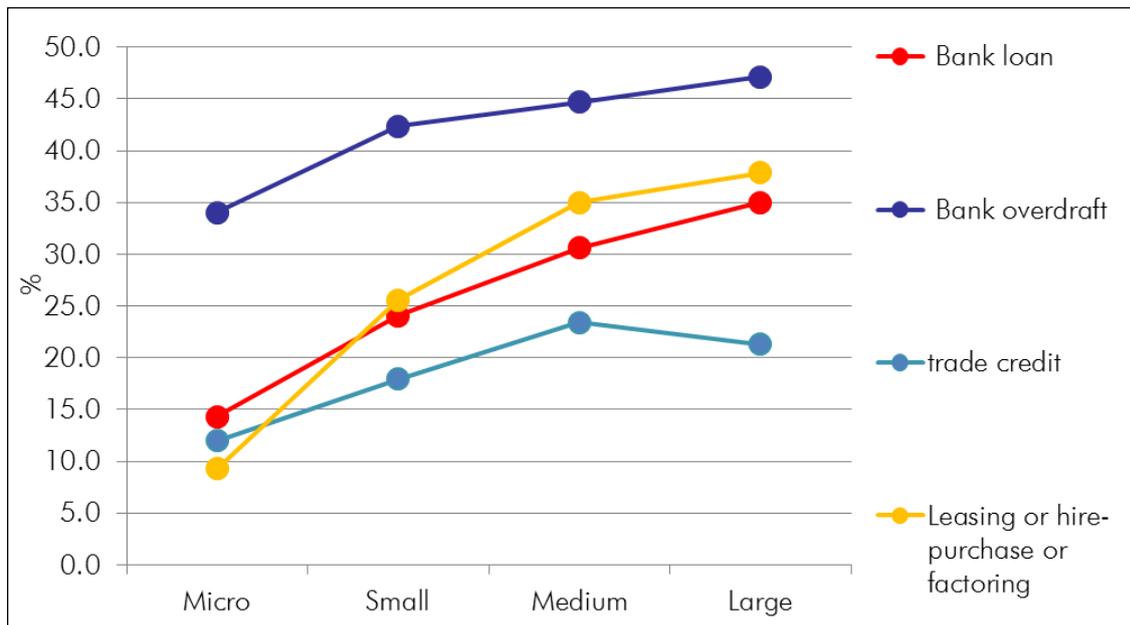


Source: Authors, based on data from ECB (2015a), Statistical Data Warehouse

Microenterprises, on balance, reported increased needs for bank loans, however, they use bank loans and other external financing sources considerably less than other SME size classes, presumably due to difficult access to finance. Figure 42 shows that, with the exception of “trade credit”, the usage of different financing sources on average typically increases with the size of the SME (ECB, 2015a). Among the reasons why bank loans are less relevant for microenterprises, they reported insufficient collateral or guarantee and high interest rates or price.

Despite the increased needs for bank loans, 10 percent of microenterprises did not apply for a loan due to fear of rejection (discouraged borrowers); such discouragement is often related to higher costs charged by banks on smaller loans (Ferrando and Mulier, 2014).

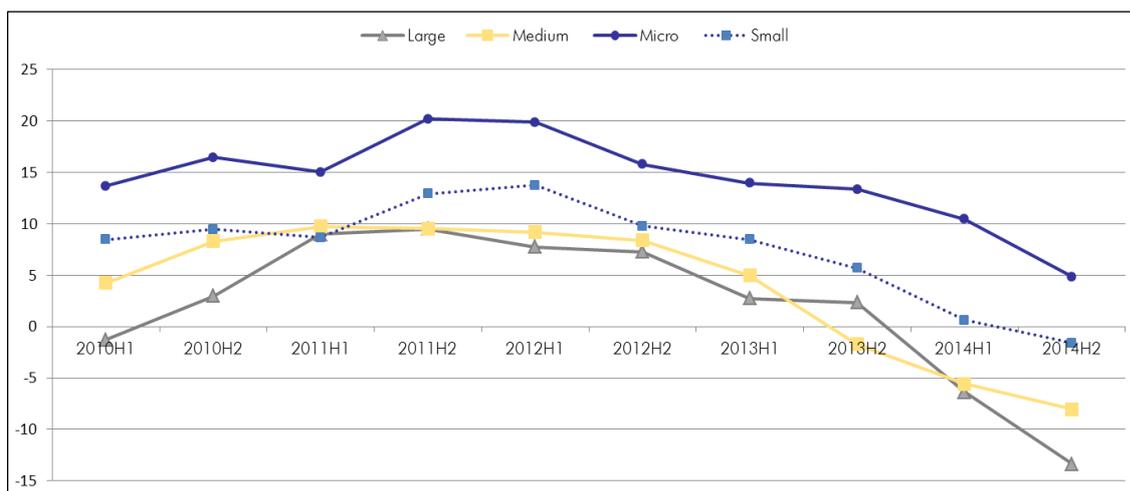
Figure 42: Different financing sources used by enterprises (by enterprise size class)



Source: Authors, based on ECB (2015a) data.

According to the ECB's SAFE survey (ECB, 2015a), microenterprises still perceive an increasing gap in the external financing (5% down from +10% in the previous survey period), (see Figure 43).

Figure 43: Perceived change in the external financing gap (by firm size)

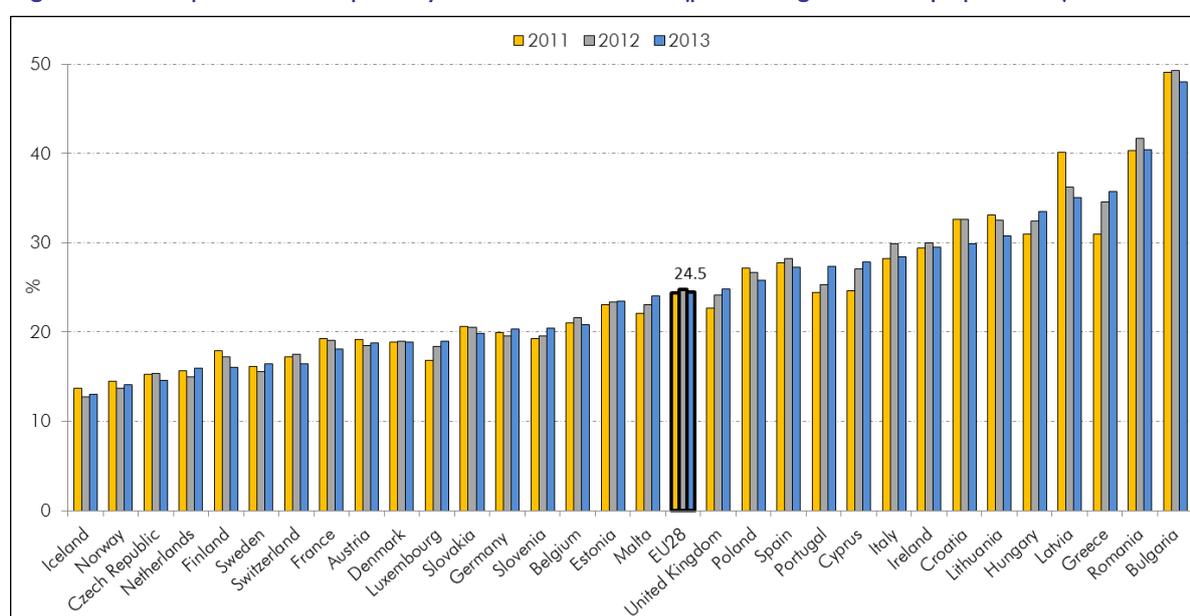


Source: Authors, based on ECB (2015a), Statistical Data Warehouse

6.2.2 Necessity-driven business creation

In order to assess the likelihood of achieving the Europe 2020 poverty/social inclusion target, Eurostat has provided an indicator called “people at risk of poverty or social exclusion”.⁷¹ Figure 44 depicts the headline indicator, corresponding to the sum of persons who are at risk of poverty after social transfers, or severely materially deprived, or living in households with very low work intensity (i.e. a combination of the three sub-indicators).⁷² When comparing 2013 to 2012 and 2011, the situation became worse in many countries. Within the EU, the highest risks of poverty or social exclusion are recorded in Bulgaria, Romania, Greece and Latvia. The countries on the right-hand side of the diagram include some of the relatively new entrants to the EU and those countries that have suffered the most from the impact of the current sovereign-debt crisis, i.e. Greece, Italy, Cyprus, Portugal and Spain.

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



Source: Authors, 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, but considerations regarding the availability of the necessary finance or the dissatisfaction in current work situation also play an important role. The majority of

⁷¹ 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

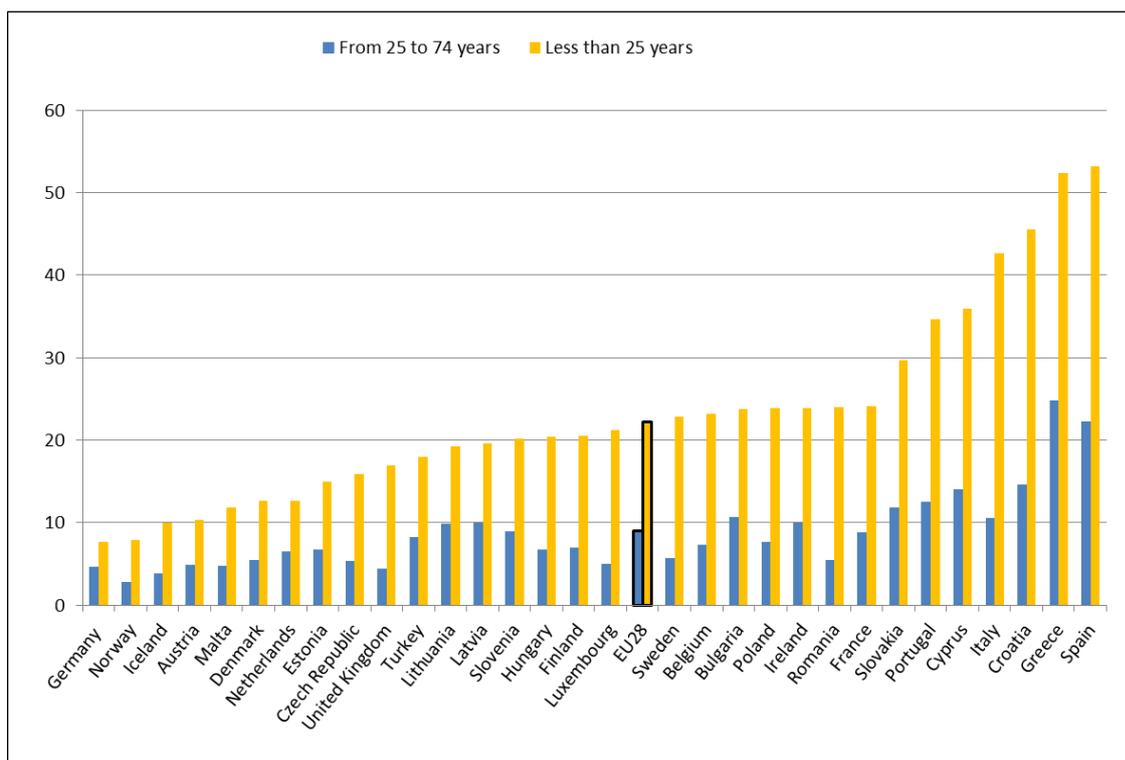
⁷² Persons are only counted once, even if they are present in several sub-indicators. At risk-of-poverty are persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers). Material 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=t20_20_50

entrepreneurs start businesses to improve their situation (OECD, 2014a).⁷³ “People starting businesses from unemployment face the same principal barriers to business start-up as other entrepreneurs – lack of finances, lack of human capital and lack of social capital”, but typically they face tighter financial constraints than other entrepreneurs, in particular as they have lower levels of saving (OECD/The European Commission, 2014); this refers even more to young start-uppers.

Poor access to finance creates barriers not only for existing microenterprises or self-employed people, but also for unemployed people who intend to become self-employed or create an enterprise (OECD/European Commission, 2014). Unemployment is one of the main challenges in Europe (Figure 45). Especially devastating is unemployment among young people, for whom time spent in unemployment increases the risk to be socially excluded and decreases not only current but also lifetime earnings. For many of them, self-employment can be a solution to end their unemployment – and microfinance can be a tool to support such business creation. Indeed, 3% of unemployed people in 2011 in the EU became self-employed in 2012 (OECD/European Commission 2014).

Figure 45: Unemployment rate by age groups, 2014



Source: Authors, based on data from Eurostat

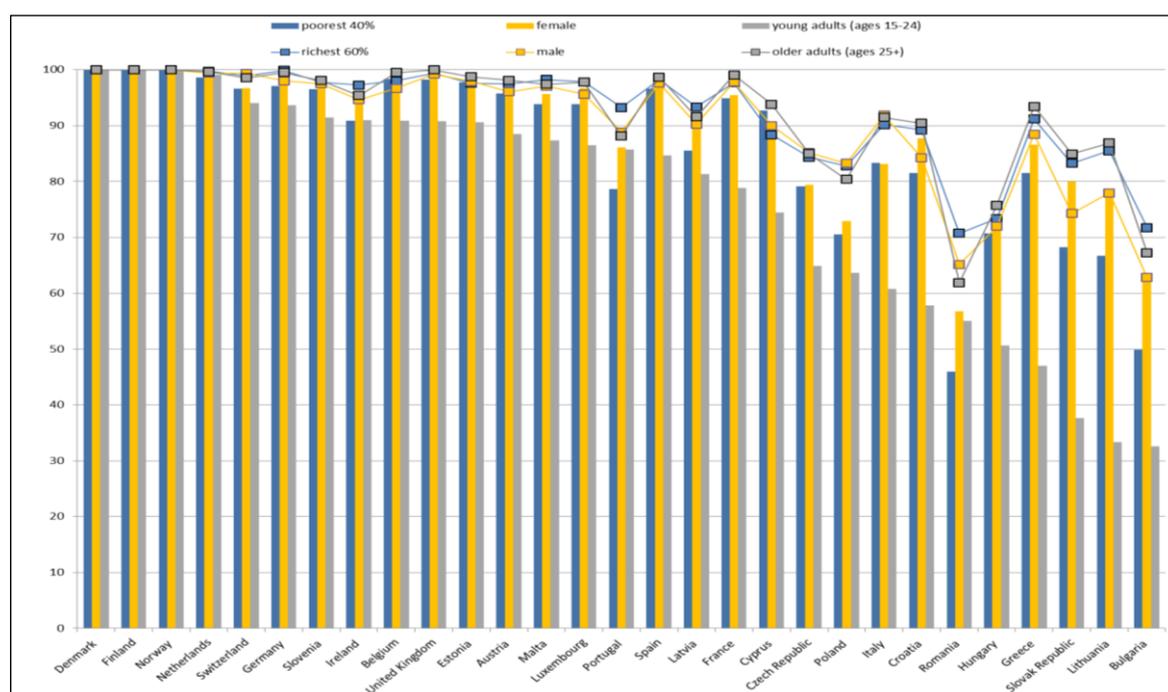
⁷³According to the Eurobarometer Survey on Entrepreneurship (European Commission, 2012a), in most countries of the EU, the majority of self-employed people found dissatisfaction with their previous work very important in their decision to start a business.

Financial inclusion, at its most basic level, starts with having a bank account. The Global Findex, the financial inclusion survey⁷⁴ showed gaps in the financial inclusion across the various social groups and how those gaps vary country by country.

In countries like Denmark, Finland, and Norway, 100% of the respondents reported having accounts in financial institutions, no matter to which social groups did they belong, while lower levels of bankability were reported in countries such as Romania, Bulgaria and Hungary. The highest gap in account penetration between adults in the poorest 40 percent of households and those in the richest 60 percent was observed in Romania (25%) and in Bulgaria (21%). In most of the countries, a lower percentage of women reported to own an account compared to men.

Significant gaps in account ownership were observed when comparing different age groups. The gap in account penetration between young adults (ages 15–24) and older adults (age 25 and above) ranges from no difference in Northern European countries to 54% in Lithuania, followed by Slovakia (47%) and Greece (46%), (Figure 46).

Figure 46: The percentage of respondents who report having an account at a bank or another type of financial institution



Source: Global Findex Database

The recent social impact reporting under the Progress Microfinance Facility (see Box 12), managed by the EIF, shows the strong socioeconomic focus of the Facility. The results show that for 61.2% of natural persons benefitting from loans under the Facility, a move out of a situation of unemployment or inactivity was facilitated through establishment of a start-up business.

⁷⁴The Global Financial Inclusion (Global Findex) database, launched by the World Bank in 2011, provides comparable indicators showing how people around the world save, borrow, make payments, and manage risk. The indicators in the 2014 Global Financial Inclusion (Global Findex) database are drawn from survey data covering almost 150,000 people in 143 economies - representing more than 97 percent of the world's population.

Box 12: Social impact reporting under the Progress Microfinance Facility

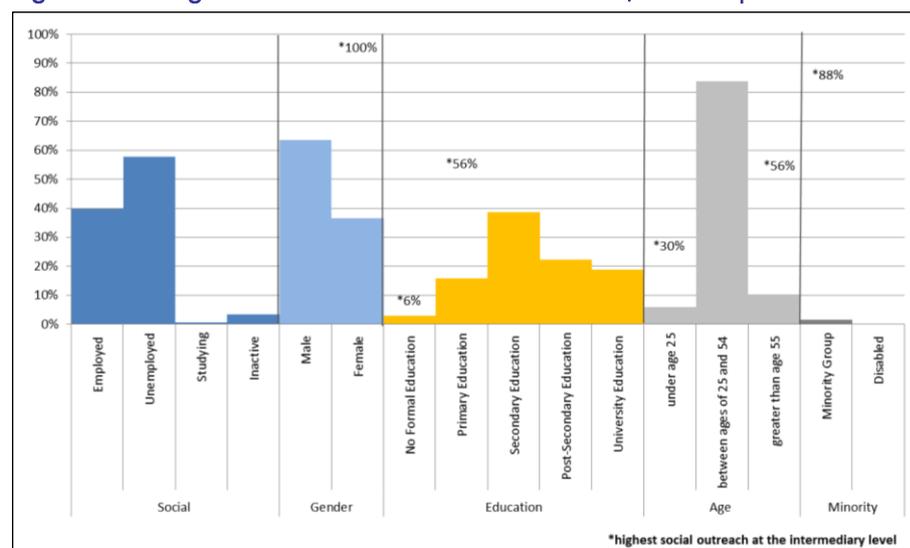
The European Progress Microfinance Facility is a microfinance initiative which aims at increasing access to finance for individuals who are at risk of social exclusion. The Facility also supports microenterprises, including those providing jobs for the unemployed or the disadvantaged (more information about the Facility is provided at the end of this chapter).

This overview aims at highlighting the socioeconomic profile of Final Beneficiaries receiving loans under the Progress Microfinance Facility. This information is made available through the participating intermediaries which on an annual basis provide data to EIF as part of the social impact reporting exercise, the most recent having as cut-off date 30 September 2014. The data set covers contributions by 44 Intermediaries, which so far have financed more than 30,000 final beneficiaries under the Facility.

Figure 47 below provides a summary of non-financial information at final beneficiary level of the Facility. These figures indicate that the clear majority of individual micro-borrowers which received support under the Facility so far were either unemployed or inactive at the time they received their loan. These aggregate figures suggest that at Facility level, considerable outreach to females was achieved. Moreover, the highest incidence (100%) of female loan recipients relative to males at the individual intermediary level was observed in Portugal.

A total of 1.6% of micro-borrowers across the Facility has reported themselves as belonging to a disadvantaged group. These figures suggest minimal impact at Facility level with respect to outreach to these particular at-risk social groups⁷⁵. As for outreach to minority groups at the individual intermediary level, the highest percentage (88%) was reported in Spain. Moreover, considerable outreach to disadvantaged age groups as well as to people with low or no education was achieved.

Figure 47: Progress Microfinance Social Outreach, natural persons



Source: EIF

⁷⁵With respect to outreach to minority groups and the disabled, often information from natural persons is omitted. Individuals do not identify themselves as a minority or a disabled. For example, in France, statistics on minority status is not permitted under the national legal framework.

6.3 Supply side

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 within their general SME lending activity, the spectrum of European microcredit developers includes many profit-oriented and non-profit associations: microfinance associations, credit unions, cooperatives, Community Development Financial Institutions (CDFIs), non-bank financial institutions (NBFIs), government bodies, religious institutions and Non-Governmental Organisations (NGOs).

The latest EMN survey⁷⁶ shows 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. In 2013, a minimum of 121,270 microenterprises and start-ups were estimated to have been supported by the surveyed organisations which resulted in an impact on at least 250,000 jobs throughout Europe.

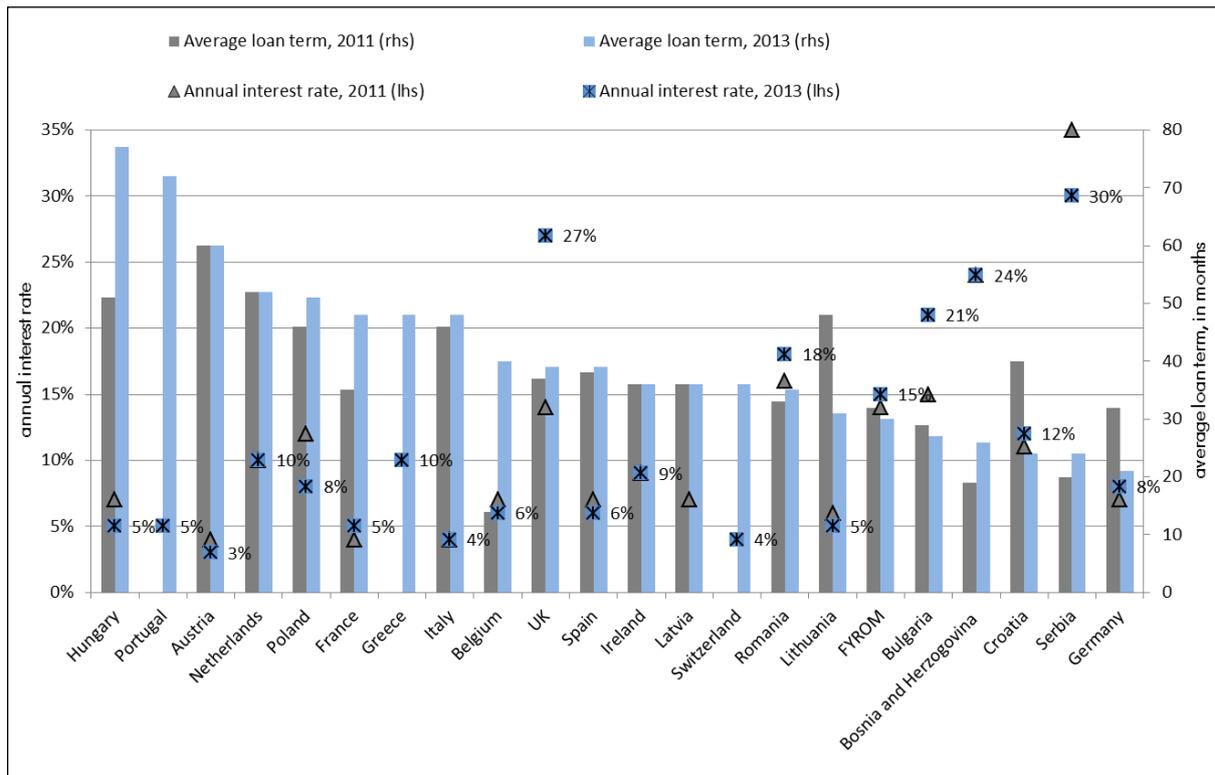
According to the EMN survey, the microcredit provision in Europe showed a positive trend, in terms of the overall total value and the number of microloans. More precisely, the surveyed European microfinance institutions (MFIs) disbursed a total of 207,335 microloans with a total volume EUR 1.26bn in 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).

In addition to the diversity of institutional environments and microfinance providers, the characteristics of microloans are much diversified across countries. According to EMN (2014), the average interest rate among the surveyed microfinance providers was 10% in 2013 (11% in 2011), but ranging from 5% in France, Italy, Austria and Switzerland, to 27% in the UK, and even higher in non-EU Balkan states (Figure 48).

Similarly, the spread of average loan durations varies across countries. Long loan terms can be found in Hungary (77 months), Portugal (72) and Austria (60 months). Typically, shorter loan terms are observed in countries with high average interest rates and low average loan volumes, with the exception of Germany, mainly in Balkan states (EMN, 2014).

⁷⁶The European Microfinance Network (EMN)'s *Overview of the microcredit sector in the European Union for the period 2012-2013* is based on a survey among 150 MFIs in 24 countries. 447 MFIs have been contacted, 150 contributed data, which equals an overall response rate of 34%. The study has been supported by EIF. The analysis is performed only biyearly and we refer here to the latest available version from 2014.

Figure 48: Microcredit conditions in Europe



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

The differences in average interest rates are typically related to differences in the legal framework, MFI business models, pricing policies, refinancing cost, cost structure and the level of subsidies. Without usury laws or interest rate ceilings in place, the interest rate usually decreases in the loan size (EMN, 2012, 2014). Micro-loans are usually offered with a special focus on social inclusion. Higher interest rates (“high” compared to “standard” lending business) for micro-loans typically reflect the non-subsidised, cost-covering business models (often MFIs in the central-eastern part of the EU), while the lower interest rates are reflecting higher prevalence of social microfinance, corporate social responsibility initiatives, and MFIs with subsidised, partly grant-dependent business models (often in the western part of the EU). Typically, for-profit-institutions charge higher interest rates (cost coverage) and grant larger loans (economies of scale). However, it is important to note that a profit orientation is not inconsistent with a socially oriented investment strategy. In fact, the micro-loan business model, if operated on sustainable terms in the long run, inherently requires relatively high interest rates on the microloans (Bruhn-Leon, Eriksson and Kraemer-Eis, 2012).

6.4 Microfinance prospects

Difficulties in access to finance are particularly pronounced for micro-enterprises and other target groups of micro-finance. Despite the recent positive trends reported by MFIs belonging to EMN, 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 ongoing 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. In an increasingly 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 and have small financing needs which are difficult to cover in a cost-efficient manner by mainstream funding providers. This refers by nature in particular to the segment of microfinance.

Microfinance can be an important contribution to overcome the effects of the crisis for some specific groups and in particular to support inclusive growth. However, the perspectives of the sector with regard to growth and self-sufficiency are limited, if microfinance providers do not have access to stable funding.

Moreover, with regard to future trends, MFIs expect less public support in the coming years, due to public budget restrictions. The MFIs have prepared to develop more efficient and lean processes, and to reduce the costs for the provision of microloans and to look for additional funding sources (EMN, 2014). Furthermore, collaboration between MFIs and crowdfunders as well between MFIs and banks might increase.

According to EMN (2015), crowdfunding may offer MFIs different scenarios for collaboration: (i) crowdlending platforms could successfully be used to finance microfinance activities and attract potential investors. (ii) MFIs can act as intermediaries between the platforms and microfinance seekers. The mechanism might allow MFIs to use their expertise by pooling and disbursing the raised money on the platform. (iii) MFIs' involvement in the crowdfunding platform could widen financial inclusion. The poorest might still remain beyond the platform as they usually lack computer and business skills, which are necessary to attract potential investors. MFIs could assist them when choosing the most suitable crowdfunding model and could even supplement the raised money up to the desired amount in case needed. (iv) MFIs could completely transfer their activities to the crowdfunding and P2P platforms in order to increase outreach. However, such a complete transformation would most probably change the original mission of the MFI.

Collaboration and partnership between MFIs and banks already exists. MFIs borrow from banks to finance their micro-lending or operating activities. On the other hand, banks benefit MFI screening and monitoring technologies and better tailored products to the clients. The main challenge is alignment of objectives of MFIs and banks. "Cooperation can be improved through long term commitments, the creation of multi-bank partnerships models, larger decision power given to MFIs, decreased complexity of the partnerships, increased awareness of banks about microfinance and standardisation of methods and criteria employed" (Cozarenco, 2015).

Against the background of the current difficult framework conditions, support on a European level has become even more important – via funding, guarantees and technical assistance to a broad range of financial intermediaries, from small non-bank financial institutions to well-established microfinance banks – in order to make microfinance a fully-fledged segment of the European financial sector.

We discussed the rationale for public support in the microfinance area in one of our previous working papers (i.e. in Bruhn-Leon, Eriksson and Kraemer-Eis, 2012), and explained the chosen approach for the Progress Microfinance mandate as support on European level – via the EIF. The intervention logic is based on the market structure and its significant diversity. It seeks to maximise outreach through a flexible investment approach in terms of eligible types of investments and types of financial intermediaries. The key target group are non-bank MFIs, but the range of financial intermediaries is extended also to banks with good outreach to microfinance clients, such as cooperative banks or micro-banks.

Results show so far that non-bank MFIs have been the most active lenders over the first four years of Progress Microfinance, as their main focus is micro-lending, unlike banks. Moreover, many non-bank MFIs have made use of the flexibility under Progress Microfinance to provide funding and risk coverage denominated in local currency. Progress Microfinance covers 20 countries as of end-2014 with two additional countries (Estonia and Hungary) likely to be added in early 2015. Progress Microfinance had as of end-September 2014 mobilised around EUR 274m of new financing to eligible micro-borrowers. The long-term target under the facility of providing EUR 500m of new micro credits to minimum 46,000 micro-borrowers is still within reach.

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

7 Concluding remarks

Although there are signs of improvements, as shown above, the imbalances between the EU Member States are still significant. A large fraction of SMEs continues to face major problems with access to finance, and there are, in particular, significant differences from country to country in such fields as, for example, debt financing.

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. 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 (2014b) 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 EU, and – equally importantly – many new public support initiatives have been started, and several others are under preparation. In all these efforts, EIF’s goal is not just to provide capital or guarantees: it is also to help spreading best market practice, encourage collaboration and network building, and the creation of a sustainable financing eco-system to the benefit of SMEs, entrepreneurship, and innovation.

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. They include: banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks, and other financial institutions that provide financing or financing guarantees to SMEs. Given that SMEs have no direct access to the capital markets, banks are typically the most important source of external SME finance. Hence, funding limitations of banks have direct impact on SME lending capacity. For loans to SMEs, a standardised, highly transparent and quality-controlled securitisation market could transform these illiquid loans into an asset class with adequate market liquidity – this can also 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 this context, the introduction of a properly defined concept of “high quality securitisation” can add substantial information and such a definition should include SMESec transactions, as well as simple and transparent synthetic transactions.

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.

Additional support for European enterprises is available under the new “Investment Plan for Europe”. On November 26, 2014, the European Commission has launched this plan, under which the EIB Group and the European Commission are working together to mobilise EUR 315bn of investment in strategic infrastructure and companies. The Investment Plan for Europe should catalyse private sector investment and create growth and jobs for a more competitive Europe. An essential part of the Investment Plan put forward is to set up a new European Fund for Strategic Investments (EFSI), see Box 13 for more information. At the time of finalising this Working Paper, the European Parliament and the Council of the EU had adopted the regulation establishing the EFSI. The regulation is expected to enter into force in early July (see Council of the EU, 2015, and European Parliament, 2015).

According to the related European Commission (2014f) communication, the EFSI “will support risk finance for SMEs and mic-cap companies across Europe, relying on the European Investment Fund [...] for the operational implementation. This should help them overcome capital shortages by providing higher amounts of direct equity, as well as additional guarantees for high-quality securitisation of SME loans. This is an effective way to kick-start job creation and growth, including the recruitment of young people. The EIF is highly experienced in these kinds of activities. The European Fund for Strategic Investments should thus serve to scale up the activities of the EIF and, in doing so, create new channels for NPBs [National Promotional Banks] to develop their own activities in this area. This will come on top of existing activities for SMEs initiated by programmes such as COSME and Horizon 2020, which will notably already provide significant sources of funding in 2015.”

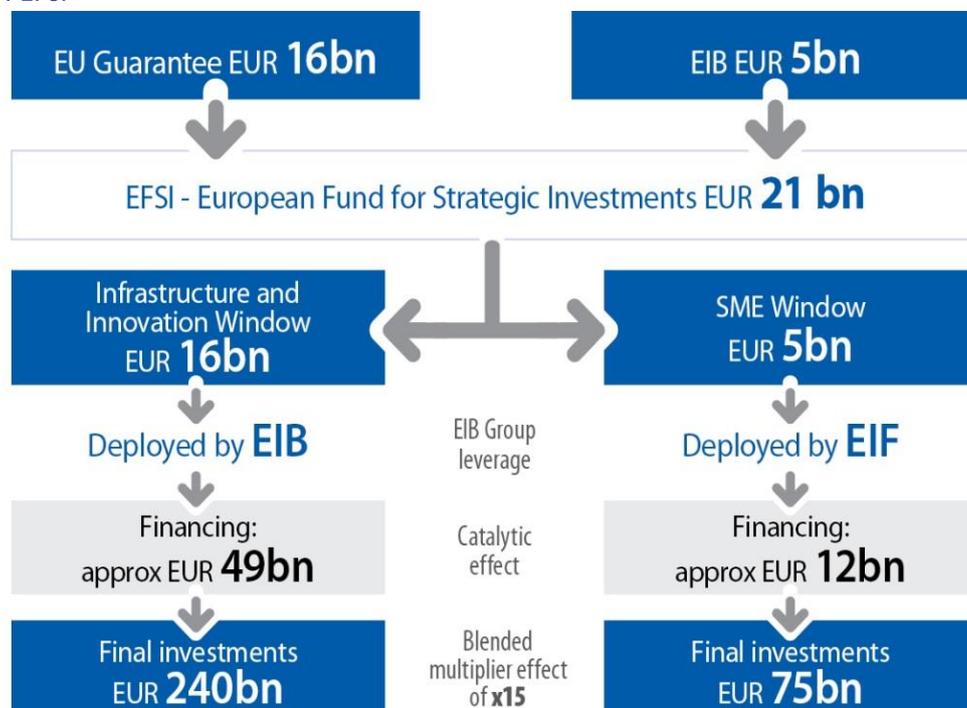
Box 13: The European Fund for Strategic Investments (EFSI)

The global economic and financial crisis has hampered investment in infrastructure, innovation and the private sector. As part of the *Investment Plan for Europe*⁷⁷, the European Fund for Strategic Investments (EFSI) aims to unlock investment by addressing market gaps and mobilising private resources. By taking on some of the risk, the EIB Group can help increase the appetite to invest. The EIB Group will provide loans and other financial products that will be partly covered by an EU budget. As there is abundant liquidity in the market, sound projects and risk-absorbing financial products will be able to attract more funding, especially from private investors.

EFSI will be integrated into the EIB Group and transactions supported by EFSI will be subject to the normal transaction cycle and governance. It will be launched soon following the recent adoption of the EU Regulation (see further above), which establishes EFSI. In the meantime, the EIB Group will use existing capital to start pre-financing operations.

EFSI is a strategic partnership between the EC and the EIB Group. The EIB Group will contribute EUR 5bn to the new initiative, alongside a EUR 16bn guarantee from the EU budget (see Figure 49). The SME window will be implemented by the EIF through agreements between the EIF and financial intermediaries signed in 2015-2018. The financial support must be additional to what will have been delivered under the existing and already foreseen programmes in the period 2015-2018.

Figure 49: EFSI



Source: EIB Group

⁷⁷ See for more information: <http://www.eib.org/about/invest-eu/index.htm>

Box 13 continued:

Against the background that there is already a strong market demand for existing EIF products and that a rapid deployment of the initiative is key, the implementation starts with “more of the same”, i.e. established equity products and portfolio guarantees (COSME and InnovFin-type); over time additional instruments are foreseen to be implemented (uncapped guarantees, securitisation).

Technically, the SME window is financed through a EUR 2.5bn increase of the Risk Capital Resources (RCR) mandate from EIB to EIF for equity financing, a EUR 1.25bn EFSI guarantee to accelerate the implementation of the InnovFin SME and COSME SME guarantee programmes, and a EUR 1.25bn EFSI guarantee for equity financing, guarantees and SME securitisations. The RCR increase was approved in April this year by the EIB and EIF Boards and the amendment of the RCR contract is under negotiation at service level with a target signature in mid-2015. Already four equity transactions have been signed in anticipation of such RCR increase (in Germany, France and Italy).

The front loading of the InnovFin SME and COSME SME guarantee programmes was approved in April by the EIF Board, including a EUR 0.5bn warehousing capacity by EIF. Several transactions are already in preparation, of which the first was signed as the first one under EFSI on 12th of May with the French public investment bank bpifrance (a subsidiary of Caisse des Dépôts). The guarantee agreement will increase lending to innovative SMEs and small mid-caps in France. As indicated, the transaction was signed even before EFSI was formally established. This reflects the EIB Group’s commitment to respond swiftly to calls from Member States, the EC and the European Parliament for a rapid launch of concrete initiatives under EFSI.

Further signatures should follow soon, as reflected by EIF’s substantial deal pipeline. The additional equity, guarantee and SME securitisation products under EFSI are currently being discussed with the European Commission with the view to be launched end of 2015/early 2016. It is foreseen that the equity product shall notably include a co-investment platform with National Promotional Institutions.

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 organisation such as a bank, investment company, mutual fund, insurance company, pension fund or endowment fund, which professionally invest, substantial assets in international capital markets.
- **Internal rate of return (IRR):** The IRR is the interim net return earned by investors (Limited Partners), from the fund from inception to a stated date. The IRR is calculated as an annualised effective compounded rate of return using monthly cash flows to and from investors, together with the Residual Value as a terminal cash flow to investors. The IRR is therefore net, i.e. after deduction of all fees and carried interest. In cases of captive or semi-captive investment vehicles without fees or carried interest, the IRR is adjusted to create a synthetic net return using assumed fees and carried interest. For the avoidance of doubts: IRR means the financial IRR and not the economic IRR, i.e. it does not account for any externalities.
- **IPO (Initial public offering):** The sale or distribution of a company's shares to the public for the first time. An IPO of the investee company's shares is one the ways in which a private equity fund can exit from an investment.
- **Later stage:** Expansion, replacement capital and buyout stages of investment.
- **Leverage buyout (LBO):** A buyout in which the New Company's capital structure incorporates a particularly high level of debt, much of which is normally secured against the company's assets.
- **Limited Partnership:** The legal structure used by most venture and private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the management firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). The general partner receives a management fee and a percentage of the profits. The limited partners receive income, capital gains, and tax benefits. The general partner (management firm) manages the partnership using policy laid down in a Partnership Agreement. The agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.
- **Management fees:** Fee received by a private equity fund management company from its limited partners, to cover the fund's overhead costs, allowing for the proper management of the company. This annual management charge is equal to a certain percentage of the investors' commitments to the fund.
- **Mezzanine finance:** Loan finance that is halfway between equity and secured debt, either unsecured or with junior access to security. Typically, some of the return on the instrument is deferred in the form of

rolled-up payment-in-kind (PIK) interest and/or an equity kicker. A mezzanine fund is a fund focusing on mezzanine financing.

- **Multiples or relative valuation:** This estimates the value of an asset by looking at the pricing of “comparable” assets relative to a variable such as earnings, cash flows, book value or sales.
- **Pooled IRR:** The IRR obtained by taking cash flows from inception together with the Residual Value for each fund and aggregating them into a pool as if they were a single fund. This is superior to either the average, which can be skewed by large returns on relatively small investments, or the capital weighted IRR which weights each IRR by capital committed. This latter measure would be accurate only if all investments were made at once at the beginning of the funds life.
- **Portfolio company:** The company or entity into which a private equity fund invests directly.
- **Pre seed stage:** The investment stage before a company is at the seed level. Pre-seed investments are mainly linked to universities and to the financing of research projects, with the aim of building a commercial company around it later on.
- **Private Equity:** Private equity provides equity capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies (also called venture capital), to expand working capital, to make acquisitions, or to strengthen a company’s balance sheet. It can also resolve ownership and management issues. A succession in family-owned companies, or the buyout and 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 3: List of acronyms

- ABS: Asset Backed Securities
- ABSPP: Asset Backed Securities Purchase Programme
- AECM: European Association of Mutual Guarantee Societies
- AFME: Association for financial markets in Europe
- AIFMD: Alternative Investment Fund Managers Directive
- BA: Business Angel
- BAN: Business Angels Network
- BCG: Boston Consulting Group
- BCI: Business Climate Indicator
- BLS: Bank Lending Survey
- BMWi: Bundesministerium für Wirtschaft und Technologie
- bn: billion
- BoE: Bank of England
- bp: basis point(s)
- CDFIs: Community Development Financial Institutions
- CDO: Collateralized Debt Obligation
- CESEE (countries): (countries in) Central, Eastern and South-Eastern Europe
- CGAP: Consultative Group to Assist the Poor
- CGS: Credit Guarantee Scheme
- CIP: Competitiveness and Innovation Framework Programme
- CLN: Credit Linked Note
- CLO: Collateralized Loan Obligation
- CMU: Capital Markets Union
- COM: European Commission (also: EC)
- COSME: Programme for the Competitiveness of enterprises and SMEs (COSME) 2014-2020
- CRD: Capital Requirements Directive
- CRR: Capital Requirements Regulation
- CVC: Corporate Venture Capital
- EAF: European Angels Fund
- EBA: European Banking Authority
- EBAN: European Business Angels Network
- EC: European Commission (also: COM)
- ECB: European Central Bank
- EFG: Equity Facility for Growth
- EFSI: European Fund for Strategic Investments
- EFTA: European Free Trade Association
- EIB: European Investment Bank
- EIF: European Investment Fund
- EMEA: Europe, Middle East, and Africa
- EMN: European Microfinance Network
- EREM: EIB Group Risk Enhancement Mandate
- ERP: European Recovery Program
- 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
- EUR: Euro
- EuVECA: European Venture Capital Fund Regulation
- EVCA: European Private Equity & Venture Capital Association

- FPLG: First Loss Portfolio Guarantee
- FRSP: Funded Risk Sharing Product
- FTPYME: Fondos de Titulización de activos para Pequeñas Y Medianas Empresas (Asset Securitization Funds for SMEs)
- FYROM: Former Yugoslav Republic of Macedonia
- GDP: Gross Domestic Product
- GP: General Partner
- HICP: Harmonised index of consumer prices
- HM / HMT: HM Treasury is the UK government's economic and finance ministry
- HQS: High quality securitisation
- HY: Half Year
- ICT: Information and communications technologies
- IMF: International Monetary Fund
- IPO: Initial Public Offering
- IRR: Internal Rate of Return
- IT: Information Technology
- JEREMIE: Joint European Resources for Micro to Medium Enterprises
- k: thousand
- LBO: Leveraged buy out
- LFA: Förderbank Bayern
- LGF: Loan Guarantee Facility
- LP: Limited Partner
- m: million
- MAP: Multi Annual Programme for Enterprise and Entrepreneurship
- MCIF: Mezzanine Co-Investment Facility
- 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
- NBFIs: Non-bank Financial Institutions
- NFC: Non-financial corporation
- NGO: Non-Governmental Organisation
- NPB: National Promotional Bank
- NPL: Non-performing loan
- NRW: The development bank of North Rhine-Westphalia.
- OECD: Organisation for Economic Co-Operation and Development
- PE: Private Equity
- PFB: Public Funding Body
- pif: paid in full
- PRSL: Portfolio Risk Sharing Loan
- PVCI: Portugal Venture Capital Initiative
- Q: Quarter
- RCR: Risk Capital Resources
- 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 Enterprises
- sf: Structured Finance
- SIA: Social Impact Accelerator
- SME: Small and medium sized enterprise
- SMEG: SME Guarantee Facility
- SMESec: SME Securitisation (comprising transactions based on SME loans, leases etc.)
- SPV: Special Purpose Vehicle

- SSM: Single Supervisory Mechanism
- TMT: Technology, Media, Telecom
- TT: Technology transfer
- TTF: Technology Transfer Finance Facility
- 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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