



European Small Business Finance Outlook

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Helmut Kraemer-Eis
Frank Lang
Wouter Torfs
Salome Gvetadze



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Helmut Kraemer-Eis heads EIF's Research & Market Analysis.

Contact: h.kraemer-eis@eif.org

Tel.: +352 248581 394



Frank Lang is Senior Manager in EIF's Research & Market Analysis team.

Contact: f.lang@eif.org

Tel.: +352 248581 278



Wouter Torfs is Research Officer in EIF's Research & Market Analysis team.

Contact: w.torfs@eif.org

Tel.: +352 248581 752



Salome Gvetadze is consultant to EIF's Research & Market Analysis team.

Contact: s.gvetadze@eif.org

Tel.: +352 248581 360

Editor

Helmut Kraemer-Eis, Head of EIF's Research & Market Analysis

Contact:

European Investment Fund

37B, avenue J.F. Kennedy, L-2968 Luxembourg

Tel.: +352 248581 394

http://www.eif.org/news_centre/research/index.htm

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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 June 2015.

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

Market Environment:

- The general economic environment continues to improve, although recovery is still fragile: investment contribution to economic growth is still relatively limited.
- Driven by the expansionist monetary policy of the European Central Bank (ECB), the cost of borrowing continues to decline, but Euro-aggregates mask significant country-level differences in the costs of finance.
- The overall SME business climate also continues to improve; however, in accordance with the investment projections of the IMF, SMEs remain sceptical about their investment climate.
- Although aggregate borrowing costs remain low, the difference between the interest charged on small loans and large loans hardly declined, and in some countries (Lithuania, Estonia and the Netherlands) has even increased.
- According to the ECB's SAFE survey, over the first half of 2015, SMEs did not consider access to finance to be the most important problem; however, a lack of availability of publicly supported financing instrument was believed to contribute negatively to the overall financing climate. In particular the comparison with the responses of large firms leads us to suspect SMEs still face significant financing restrictions. Furthermore, access to finance differs greatly across countries. SMEs in peripheral countries face more stringent financing conditions than elsewhere in Europe.

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, Christelle Dirand, Per-Erik Eriksson, Cyril Gouiffes, Ulrich Grabenwarter, Giovanni Inglisa, Carsten Just, Eirini Koutra, Pablo Millan Cantero, Marco Natoli, Christine Panier, George Passaris, David Pin, David Gonzalez Martin, Dario Prencipe, Simone Signore, Alessandro Tappi, Bjorn Tremmerie, Piyush Unalkat, and Arnaud Vanbellingen. We would also like to thank colleagues from AECM, Bureau van Dijk Zephus, Coller Capital, EBAN, the EBF, the ECB, EMN, Euler Hermes, Eurochambers, the EVCA research team, Go4Venture Advisers, Leaseurope, Rien Wagenvoort and the UEAPME study unit for their support. All errors are of the authors.

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

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

Private equity:

- Following the severe crash of European private equity (PE) investment in 2008/2009, it had partially rebounded over 2010-2011. Following a setback in 2012, the recovery continued in 2013 and 2014, albeit at lower levels. According to preliminary Invest Europe data, PE investments further increased in the first three quarters of 2015. At the same time, VC investments have also considerably improved, however they are still far below the pre-crisis heights.
- 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.
- PE fundraising has substantially recovered in 2015, as shown by the preliminary Invest Europe data. Particularly strong fundraising increases were recorded for funds with a focus on the mezzanine and growth capital stages of the market as well as for generalist funds. For European VC fundraising, the figures so far also indicate strong growth. This was mainly driven by funds with a later stage focus.
- The exit markets have remained remarkably strong in 2015. This follows two years for which the Invest Europe statistics had already recorded the highest PE divestment amounts ever. However, there are warning voices of potential overheating, and downward adjustments have already been observed in some market segments.
- Despite the recent generally positive developments, as mentioned above, PE and VC investment and fundraising activity as well as the number of PE and VC funds are 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.

SME Guarantees:

- Credit guarantees continue to be “the most widely used policy instrument [...] to ease SME access to finance” and to alleviate related market failures (OECD, 2016).
- 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 the first half of 2015, AECM preliminary data reports a considerable increase in new guarantee issuance and a smaller increase in the total number of guarantees. Hence, the average size of new guarantees issued increased.
- Those countries with generally high guarantee activities also recorded substantial positive growth rates in the first half of 2015, with Germany being the only exception, which could be partially due to the relatively favourable financing conditions, and limited need for guarantees.

SME Securitisation:

- Overall, the SMESec market in Europe is underdeveloped and strengthening this market can be an effective way to facilitate the flow of funds to the real economy, while not creating too much distortion.
- The reputation of the SME securitisation market segment is improving; a de-stigmatisation is happening, and the general perception is shifting towards a means that could help overcome negative effects of the crisis. The importance of securitisation has also been confirmed by the Ecofin Council in its meeting early December 2015.
- Although the fog is slowly lifting, regulatory uncertainty is still to be seen as the main impediments and negative spill-overs from a non-holistic regulation approach lead to unintended consequence that hinder market development. Reasonably defined criteria for high quality securitisations can be a way out of this dilemma.
- In terms of new issuances, the SMESec market is still relatively weak. The issued volume of SME deals in HY1/2015 was only EUR 19.3bn, representing 11% of the overall securitisation issuance (compared to EUR 33.3bn in HY1/2014, 15% of overall).
- Despite the financial and sovereign crisis, the European securitisation market has performed relatively well so far, with the SME segment showing low default rates.

Microfinance:

- Microenterprises are important contributors to employment. Especially in the countries with high unemployment rates, microenterprises act as a driving force fostering job creation. Despite the important role of microenterprises in employment and value added creation, overall business environment remains unfavorable for them.
- 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 important problem remained higher among microenterprises than among their larger peers.
- Access to finance is crucial not only for existing microenterprises, but also for those who are eager to create a business in order to escape poverty or unemployment and contribute to job creation. Aside the financial support, unemployed people are often in need of acquiring the necessary skills for success through coaching and mentoring.
- Microfinance is an important tool to overcome the effects of the crisis for some specific groups and in particular to support inclusive growth. Aside from these financial products and services, many European MFIs provide non-financial services as well.
- The latest EMN survey reports a remarkable growth both in the overall total value and the number of microloans provided by the surveyed Microfinance Institutions. With regard to future trends, MFIs expect less public support in the coming years, due to public budget restrictions.

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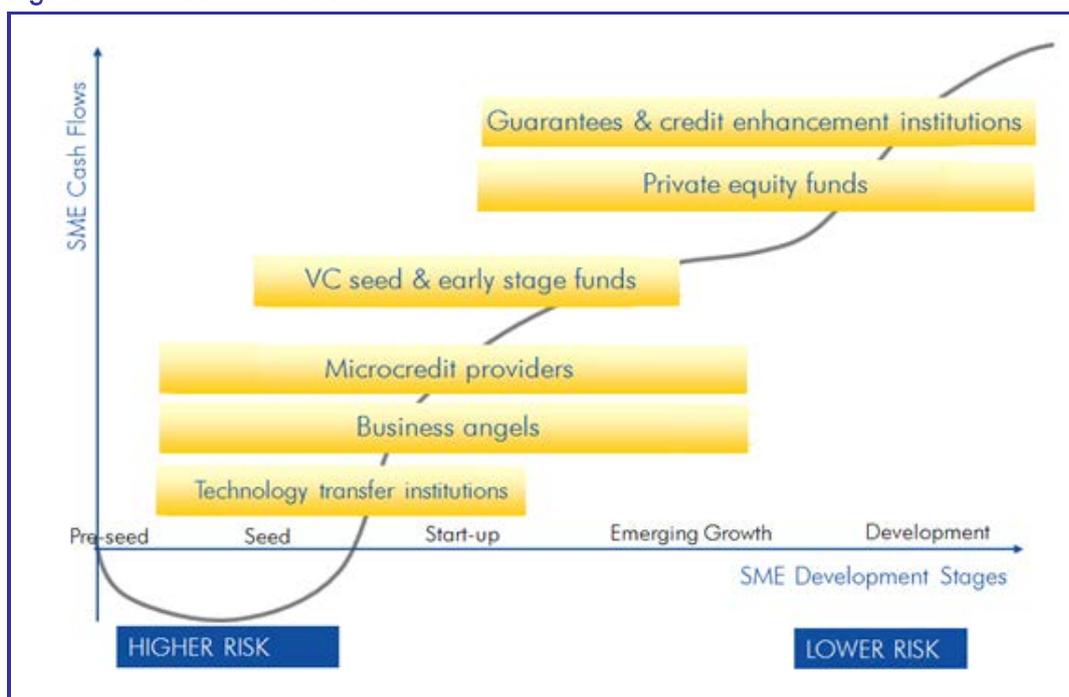
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1 Introduction

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 (equity⁴, guarantees, securitisation, microfinance). The present edition is an update of the ESBFO June 2015.

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

⁴ Please see footnote 2 concerning the term "equity finance".

2 General economic environment

2.1 Economic outlook

Since the publication of the previous ESBFO in June 2015, the global economic outlook has improved marginally. In line with the IMF's forecasts, the global economy grew by 3.4%, a minor improvement over 2013, when global growth amounted to 3.3%. For 2015, the IMF expects global growth to slow down to 3.1%. This forecast was slightly adjusted downward from the World Economic Outlook published in spring, when global growth for 2015 was estimated at 3.5%. For 2016, the IMF expects the world economy to grow at a rate of 3.6% (IMF, 2015). The European Commission (EC) has also updated its EU projections, expecting a positive growth rate for 2015 (+1.9%). This trend is expected to continue through 2016 (+2.0%) and 2017 (+2.1%), see Table 1. Accordingly, unemployment continues its downward trend. For 2015 it is expected to enter single digit territory (9.5%) for the first time in four years. The EC (2015a) further predicts that private consumption growth will pick up significantly (+2.1%), increasing by 80 basis points from 2014, while public consumption will grow at 1.3%. Although price levels are expected to remain constant throughout 2015, inflation expectations for 2016 and 2017 rise to 1.1% and 1.6%, respectively. While domestic demand remains the most important driver of EU growth, the EC expects the Juncker plan to boost the relative contribution of investments in 2016 and 2017.

Table 1: European Commission winter 2015 forecast for the EU

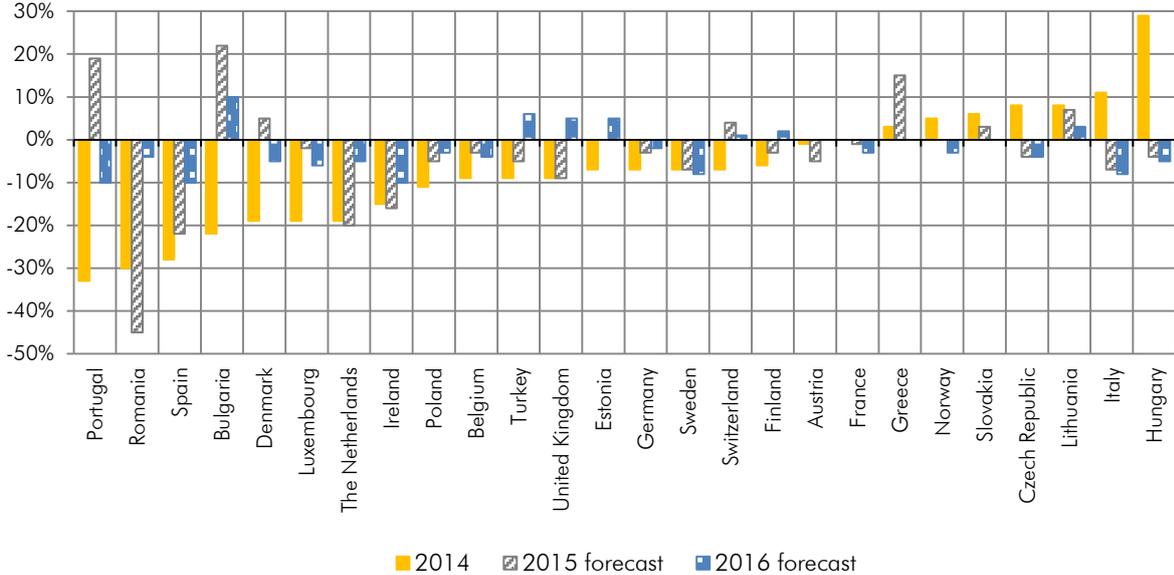
(Real annual percentage change, unless otherwise stated)				Spring 2015 estimates / forecasts		
	2012	2013	2014	2015	2016	2017
GDP	-0.5	0.2	1.4	1.9	2.0	2.1
Private consumption	-0.7	-0.1	1.3	2.1	2.0	1.8
Public consumption	0.3	0.2	1.2	1.3	0.8	1.0
Gross fixed capital formation	-2.8	-1.5	2.5	2.9	3.5	4.4
Employment	-0.6	-0.4	1.0	1.0	0.9	0.9
Unemployment rate (a)	10.5	10.9	10.2	9.5	9.2	8.9
Inflation (b)	2.6	1.4	0.6	0.0	1.1	1.6
Government balance (% GDP)	-4.2	-3.2	-3.0	-2.5	-2.0	-1.6
Government debt (% GDP)	85.1	87.3	88.6	87.8	87.1	85.8
	Contribution to change in GDP					
Private and Public Consumption	-0.3	0	0.9	1.5	1.4	1.2
Investment and Inventories	-1.3	-0.1	0.5	0.4	0.8	0.9
Net exports	1.1	0.3	-0.1	0.1	-0.1	0

(a) Percentage of the labour force.

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

Source: European Commission (2015a)

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



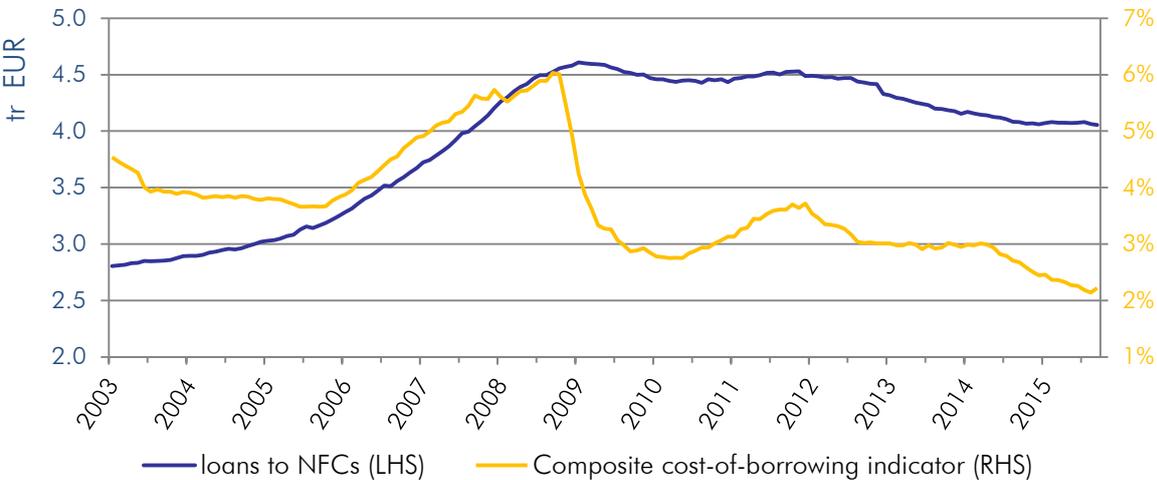
Source: Euler Hermes (2015)

The business environment improvement has spurred a decline in European insolvencies. The Euler-Hermes Insolvency Index (Euler Hermes, 2015), which measures the year-to-year percentage change in the number of insolvencies, registered a decrease in the number of insolvencies in Western Europe by 16%. Also in Central and Eastern Europe insolvencies went down, but the reduction was less pronounced (-3%). Figure 2 plots the Euler-Hermes Insolvency Index for different European countries and shows how the regional aggregates hide a significant amount of spatial heterogeneity. Within most of the Eurozone, the number of insolvencies stabilised or dropped significantly. The Iberian Peninsula strongly outperformed the European average as Portugal and Spain experienced a significant drop in corporate insolvencies (33% and 28%, respectively). Not all Eurozone countries performed equally well. Italian insolvencies, for example, increased by 11%. There are also strong national disparities within Eastern Europe: Hungary experienced the strongest insolvency increase (+29%), whereas Romania and Bulgaria performed much better (-30% and -22%, respectively).

2.2 Financial environment

Figure 3 illustrates the evolution of outstanding loans to NFCs. Bank lending to non-financial corporations (NFCs) in the Euro Area has been declining since 2009. By the end of 2014, the first signs of recovery emerged and over the following months bank lending to NFCs appeared to have found a bottom. In the past six months, however, it has become apparent that a definite conclusion of a trend reversal is still premature: the amount of outstanding loans to NFCs remains stagnant and has been hovering right above the EUR 4 trillion thresholds for over a year. Over that time period, NFC’s borrowing costs continued to decline. By August 2015, the cost indicator reached a record low, dropping an additional 57 basis point from its August 2014 level. In September, the indicator increased again by 8 basis points, the most significant increase since October 2013.

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

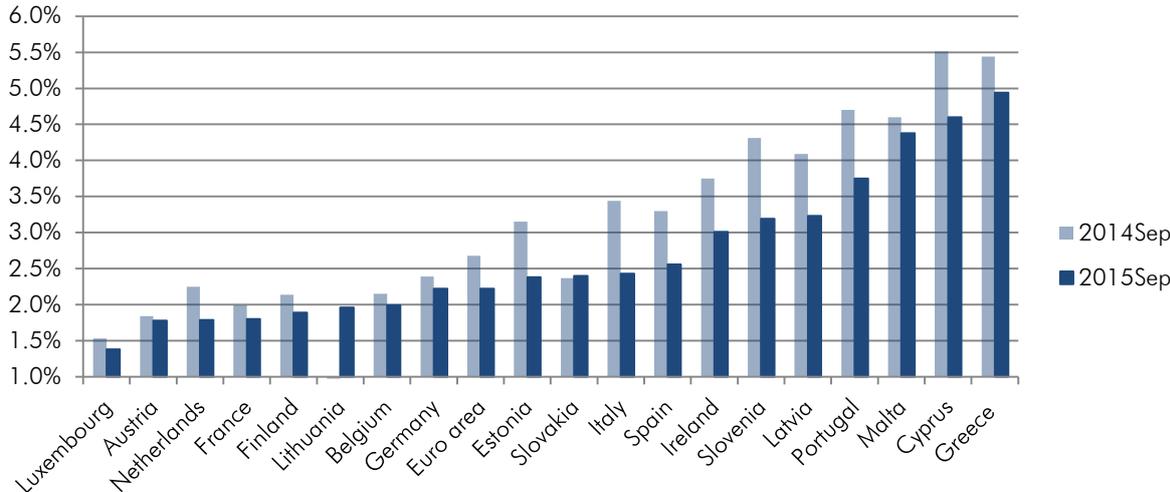


*The composite cost indicator is a volume-weighted average of interest rates on new loans with different maturities. For an elaborate overview of the methodology, see ECB (2013)

Source: ECB Data Warehouse

The aggregate cost-of-borrowing indicator illustrated in Figure 3 masks a significant amount of underlying cross-country variation within the Euro Area. This cross-country divergence in NFCs borrowing costs was triggered by the financial crisis (EC, 2013). There are little surprises at the top of the list (see Figure 4), which marks Greece, followed by Cyprus and Malta, as the most expensive countries to borrow. NFCs that operate these high costs countries face a competitive disadvantage on export markets. On the other side of the spectrum, there is Luxembourg, Austria and the Netherlands, where bank lending to NFCs is significantly cheaper. NFCs’ borrowing costs declined in all countries over the past twelve months.

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



Source: ECB Data Warehouse

3 Small business economic environment

3.1 SME's economic outlook

SMEs are defined by the European 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):

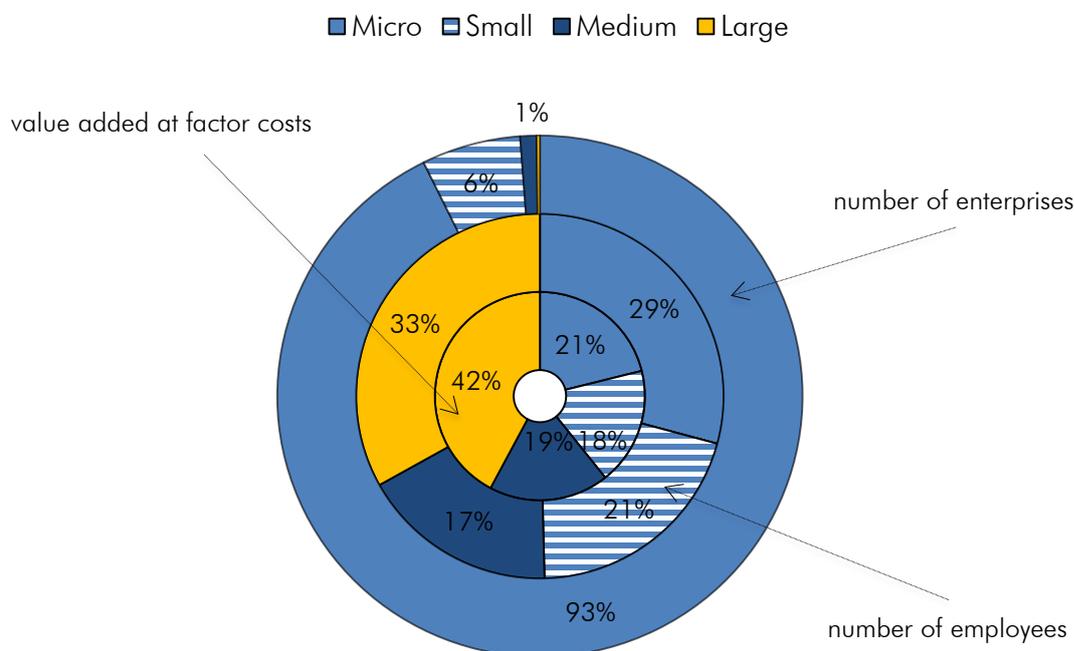
Table 2: EU definition of SMEs⁵

	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 (2015b)

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

Figure 5: SMEs, Employment and Value added in the EU, 2014

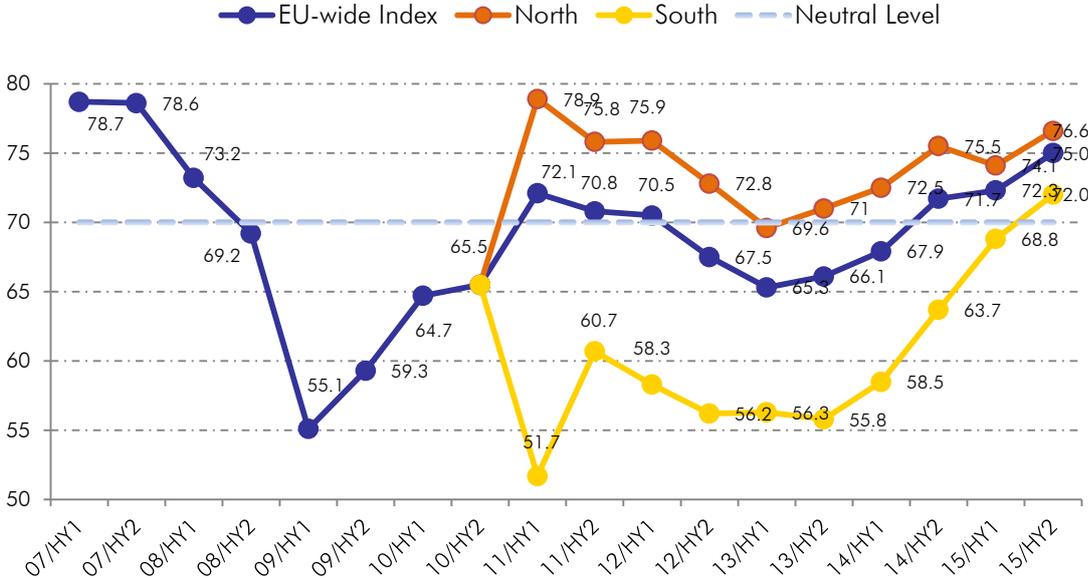


Source: European Commission (2015b)

⁵ In the context of defining enterprise categories, often also the category of midcaps is mentioned in between the categories of SMEs and corporates. We define midcaps as enterprises with a minimum of 250 and a maximum of 2,999 employees; moreover, there is the sub-category of small midcaps, with a maximum of 500 employees.

In line with the general economic predictions of the EC, the UEAPME study unit (2015) concludes as well that the SME business climate is recovering. Most notably in the southern/peripheral countries,⁶ where the crisis hit hardest, significant improvements have taken place. In the second half of 2015, the SME Business Climate Index for these countries continued its positive trend and further increased to 72 (Figure 6). Also in the North and the Centre⁷ of Europe SME business climate improved, be it less pronounced, allowing for a convergence with the periphery of Europe.

Figure 6: SME Business Climate Index⁸



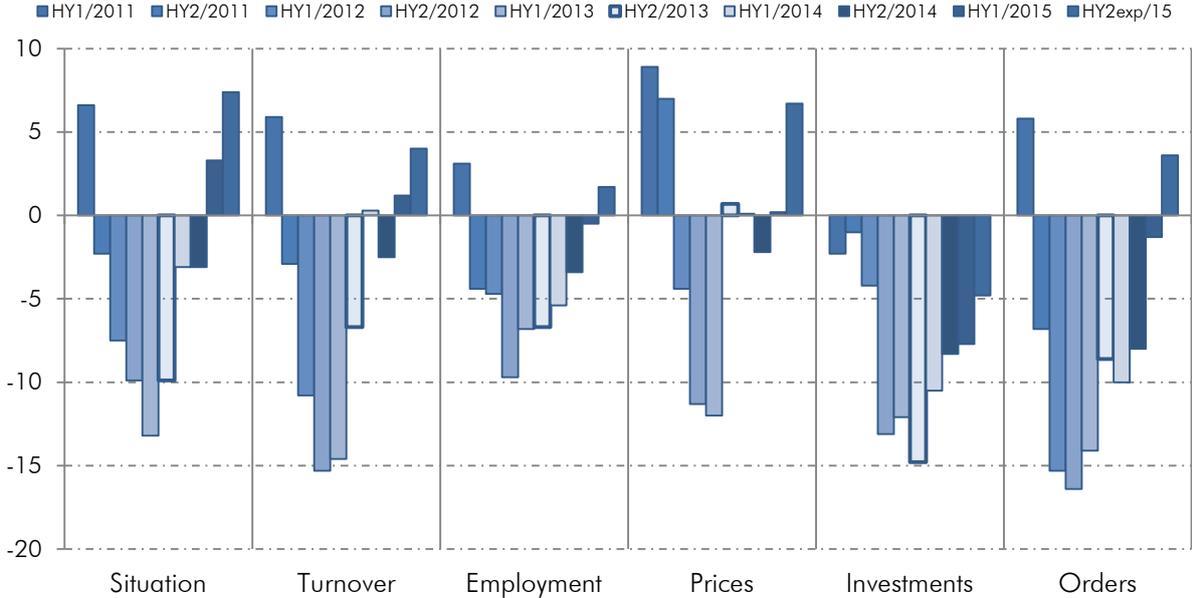
Source: UEAPME Study Unit (2015)

Based on a survey conducted by member organisations, UEAPME constructs the semi-annual EU Craft and SME Barometer. The Barometer provides information on SMEs’ perception on the current and future economic environment. Figure 7 plots net responses⁹ for a number of different categories, such as the overall economic situation, turnover, employment, prices, investments and orders. During the first half of 2015, SMEs were generally positive about the overall economic situation they were facing. Their optimism seems to have been driven mainly by stronger turnover figures. With regards to employment and orders, SMEs remained on the fence. The investment climate was still predominantly perceived as negative, although the situation continues to improve. SMEs initial pessimism about the economic climate for 2015Q1 went largely unfounded. All categories turned out more positive than anticipated. While the European SMEs were still in a ‘wait-and-see-mode’ in the beginning of 2015, the ECB’s QE-program managed to restore entrepreneur’s confidence for the second half of the year (UEAPME Study Unit, 2015). SMEs updated their expectations for the second half of 2015 accordingly and are now more optimistic about the near economic future. Interestingly though, they remain sceptical about the investment

⁶ Croatia, Cyprus, Greece, Ireland, Italy, Malta, Portugal, Slovenia and Spain.
⁷ Austria, Belgium, Bulgaria, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Romania, Slovakia, Sweden and UK.
⁸ The UEAPME SME Business Climate Index is calculated as the sum of positive and neutral answers with regards to the overall situation for the business, averaged over the current situation and the expectations for the next period.
⁹ The net response is calculated as the share of positive minus negative responses.

climate, while expecting inflation to increase. The results of the recent Eurochambres (2015) Economic Survey¹⁰ point in a similar direction. According to this study business confidence, investments, employment, domestic demand, clearly improved in 2015. General business confidence is expected slightly to decline in 2016. Large disparities in business confidence by country persist. Greece and Germany are the most pessimistic for the year ahead, while the highest level of optimism was observed in Estonia, Latvia and Portugal.

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



Source: UEAPME Study Unit (2015)

3.2 SME’s financial environment

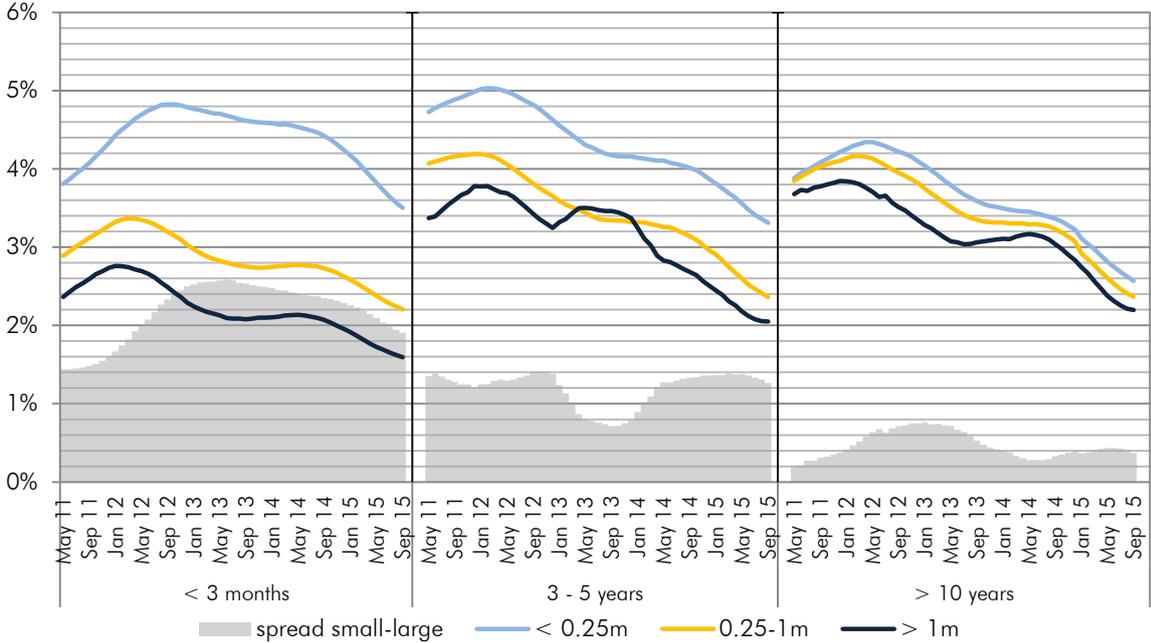
3.2.1 Borrowing costs

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

¹⁰ The Eurochambres Economic Survey is a European qualitative survey of business expectations for the year ahead. Conducted annually by the Chambers of Commerce and Industry, and coordinated by Eurochambres, the survey records the expectations of approximately 59,000 businesses in EU Member States and EU Candidate Countries on six economic indicators: business confidence, domestic sales, export sales, employment & investment. The Eurochambres Economic Survey has been conducted since 1993. For details on the methodology see Eurochambres (2015).

Figure 8 illustrates interest rate levels for different loan sizes, by maturity. The graph highlights several interesting findings: First, over all maturities, small loans are burdened with a higher interest rate. This is somewhat surprising, as traditional finance theory suggests that *-ceteris paribus-* the risk of default increases with loan size (Stiglitz, 1972). Two factors could explain why the inverse relationship between loan size and the interest rate breaks down in the case of bank lending to NFCs. In the presence of fixed screening costs, small loans will carry a higher interest rate. Alternatively, smaller lenders could possess different characteristics (Moore and Craigwell, 2003), or use the borrowed funds for different, riskier, financing purposes, such as funding working capital, instead of long term investment projects. In particular loans with short maturities come with a large loan size spread. Over the past six months, however, this spread has been declining for all maturity classes. Second, over the past six months, only financing costs for small loans have continued to decline. Interest rates for large loans stayed relatively constant or even increased for longer maturities. Third, Figure 8 exposes an anomaly in the maturity spread of small loans. As a general rule, liquidity decreases with loan maturity. Long term loans will therefore carry higher interest rates. This reasoning indeed holds for medium-sized and large loans. For small loans however, short term lending is actually more expensive than long term lending. This could be explained by the presence of a fixed lending costs element, related to screening, or the specific characteristics of small lenders. This negative maturity spread is depicted in greater detail in Figure 9, which compares short term (<3 months) to long term (>10 years), for different loan sizes. The maturity spread for small loans turned negative in early 2012 and remained like this up to this day.¹¹

Figure 8: Interest rates by loan size and maturity, and the interest rate size spread



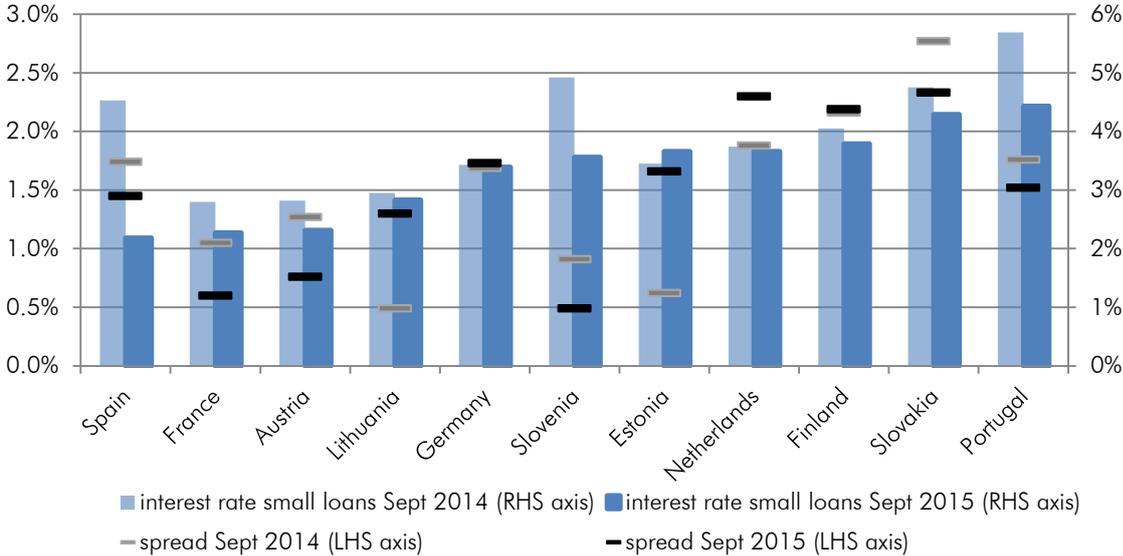
*Note: the graph depicts the 12 month backward moving average floating interest rates charged by banks on loans to NFCs (other than revolving loans and overdraft)

Source: ECB Data Warehouse, authors' calculations

¹¹ The diverging behaviour of small and large loans is consistent with the findings of Wagenvoort et al (2010).

In sum, while overall borrowing costs continued to decline, the financial environment faced by SMEs differs significantly between countries. This holds especially true for small firms, as evidenced by diverging financing costs for SMEs and large differences in the size spread of bank lending.

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



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

Source: ECB Data Warehouse, authors' calculations

3.2.2 SME financing from the banks' perspective

The ECB's latest Bank Lending Survey (BLS, see ECB, 2015b)¹² allows to analyse the current state of the SME lending market from the perspective of the banks. This supply-side survey informs about banks' perception on credit standards for NFC-lending. This information is reported for different firm-size classes. Figure 11 illustrates how banks perceive the change in credit standards they uphold for NFCs applying for a loan.¹³ It plots the quarterly net change in credit standards, which is calculated as the difference between the sum of the percentages of banks responding "tightened considerably" and "tightened somewhat", and the sum of the percentages of banks responding "eased somewhat" and "eased considerably". Over the second and third quarter of 2015, credit standards continued to ease for both large and small firms for the seventh consecutive quarter. SMEs continued to experience a more pronounced credit easing than their larger counterparts.

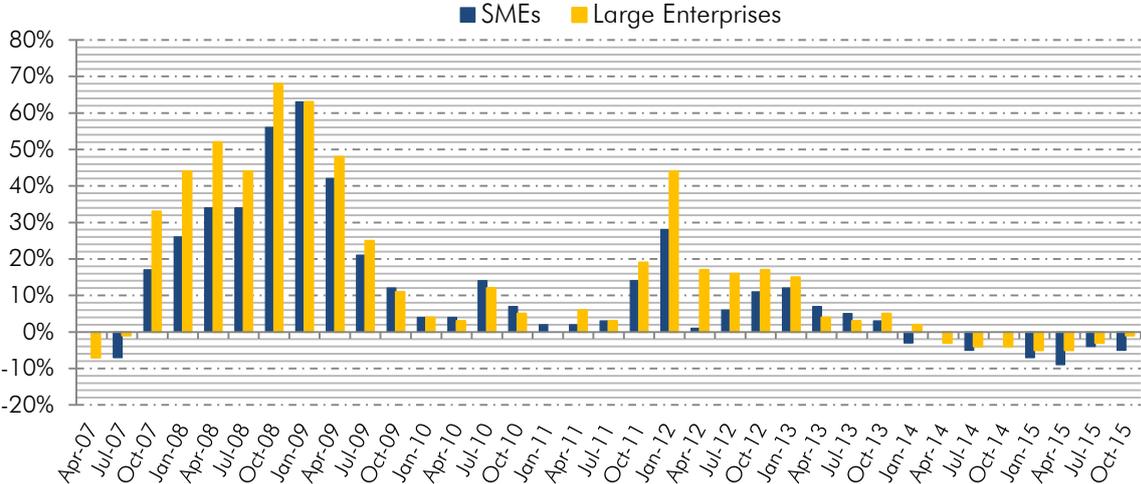
Figure 12 illustrates the factors that drove the change in credit standards for SME lending. For Q3/2015, nearly all factors contributed to the credit easing. Banks' risk tolerance, however, somewhat decreased. For Q4/2015, all factors are expected to push for a continued easing of SME credit standards. Banks appear particularly optimistic about the general economic environment and the industry or firm-specific outlook. This is consistent with the favourable growth

¹² This 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).

¹³ Banks are requested to answer the following question: 'Over the past three months how have your bank's credit standards as applied to the approval of loans or credit lines to enterprises changed?'

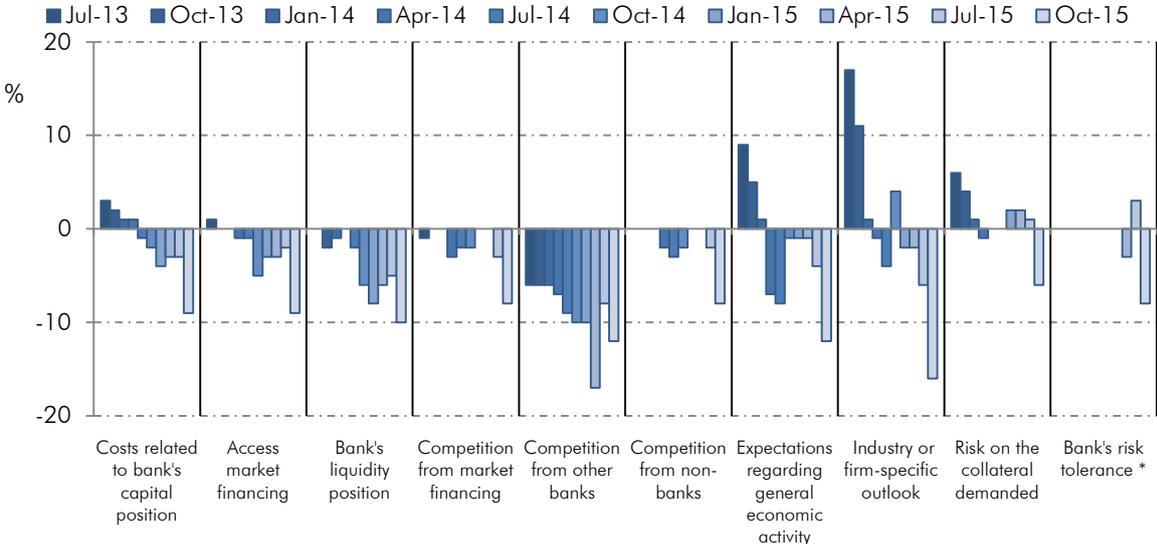
projections of the EC and the IMF. This optimism is reflected in the fact that the rejection rate of NFC's loan applications remained constant throughout Q3/2015, while at the same time SME's loan demand increased considerably. Banks are expecting loan demand to increase further in the final quarter of 2015.

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



Source: ECB Bank lending survey (ECB, 2015b)

Figure 12: Factors contributing to tightening credit standards for SMEs¹⁴



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

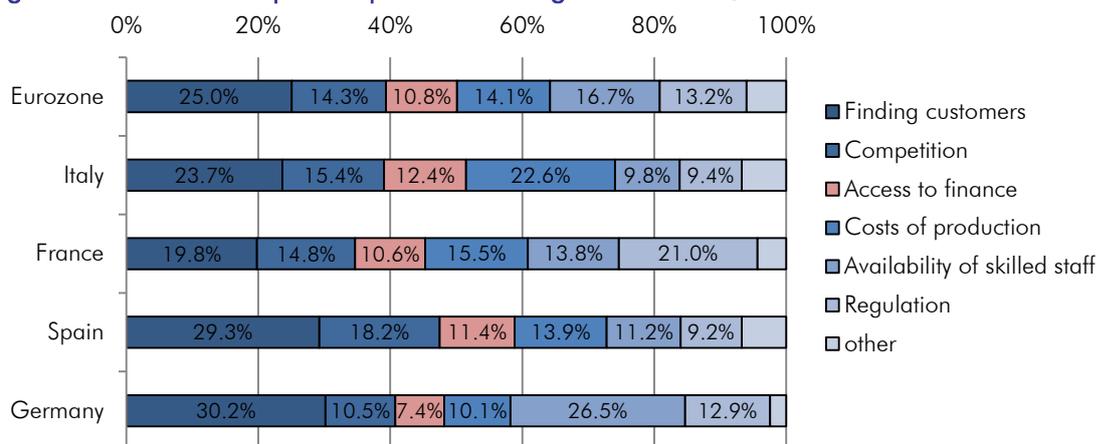
Source: ECB Bank lending survey (ECB, 2015b)

¹⁴ Banks were requested to answer the following question: Over the past three months, how have the following factors affected your bank's credit standards as applied to the approval of loans or credit lines to enterprises? The graph reports net percentage contribution of each factor to the tightening or easing of credit standards. The net percentage is defined as the difference between the percentage of banks reporting that the given factor contributed to a tightening and the percentage reporting that it contributed to an easing.

3.2.3 SME financing from the SME's perspective

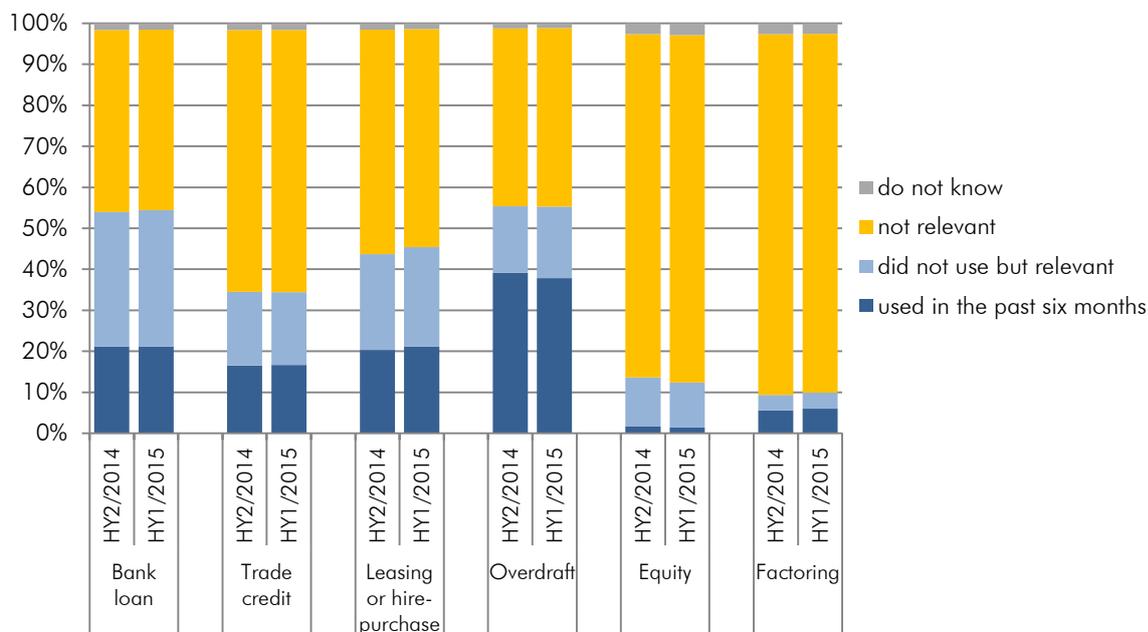
Having discussed the bank's supply side perspective of the lending market, this section turns to the demand side and reports the most important results of the latest Survey on the Access to Finance of Enterprises (SAFE). Figure 13 illustrates the most important problems faced by SMEs over the first half of 2015, for the Euro Area and the four largest economies.¹⁵ As was the case for HY2/2014, SMEs did not consider access to finance their most important problem. For the Eurozone, 10.8 percent of SMEs reported access to finance as their most important problem. Within Europe, significant country heterogeneity exists: the number of SMEs reporting access to finance as their most important problem is 68 percent higher in Italy, than it is in Germany, for example.

Figure 13: The most important problems facing SMEs in HY1/2015



Source: ECB SAFE (ECB, 2015a)

Figure 14: Sources of external financing of Euro Area SMEs

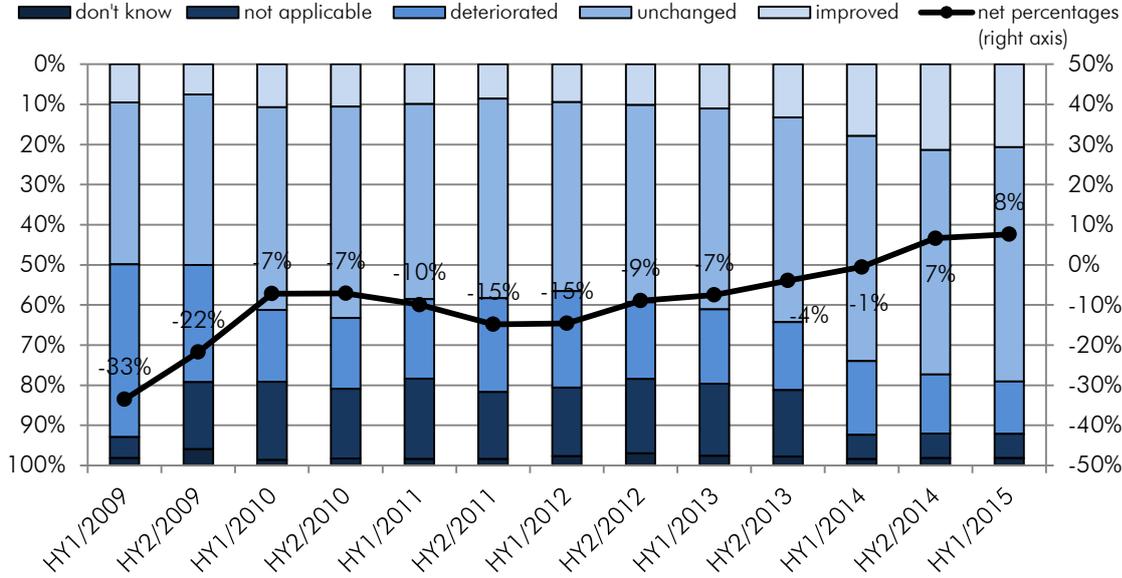


Source: ECB SAFE (ECB, 2015a)

¹⁵ Unfortunately, due to a break in the dataserries, a time series comparison is no longer possible.

Over the first half of 2015, no significant changes occurred with respect to the relative importance of the different funding sources used by Euro Area SMEs (Figure 14). Bank products (loans and overdraft) remained the most popular financing products for SMEs in HY1/2015. Also the availability of bank loans (Figure 15) did not change significantly compared to the previous period. Box 1 elaborates on the specific financing patterns of SMEs.

Figure 15: Change in the availability of bank loans for Euro Area SMEs



Source: ECB SAFE (2015a)

Box 1: Financing patterns of European SMEs

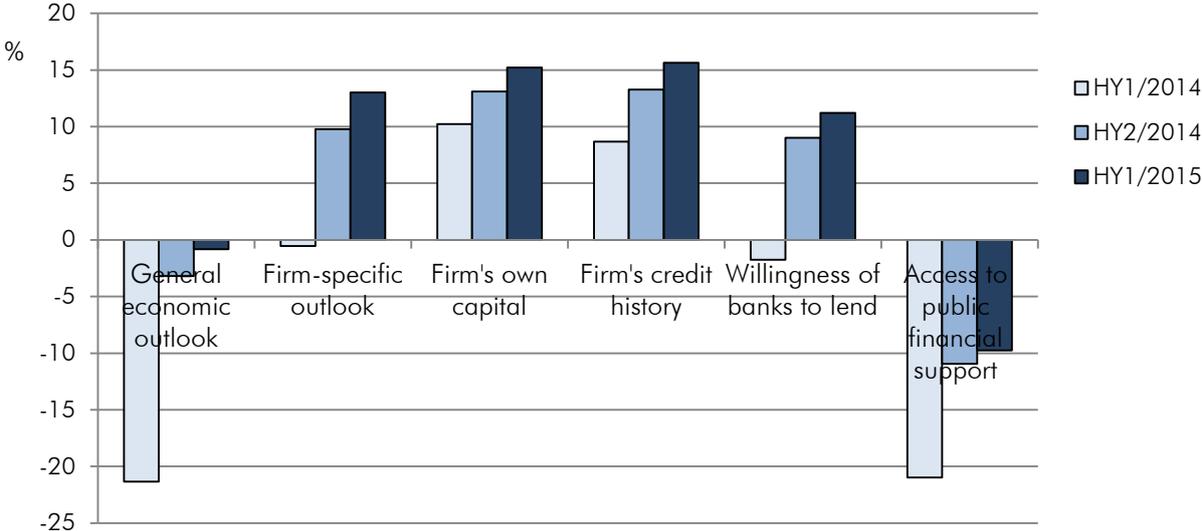
Even though research in SME financing has strongly increased over the recent years, the financing patterns of SMEs in Europe are still not well analysed. Empirical studies have shown that firm-, product-, industry-, and country-specific factors influence the financing of SMEs. However, there are only few studies with a holistic perspective taking into account the interrelationships between different financing instruments and their determinants.

In a new EIF Working Paper, Moritz et al. (2015) provide an integrative perspective of SME financing patterns by identifying and analysing in detail the use of various financing instruments by SMEs. The paper takes a holistic approach by performing a cluster analysis including 12,726 SMEs in 28 European countries. The results reveal that SME financing in Europe is not homogenous but that different financing patterns exist. The cluster analysis identifies six distinct SME financing types: mixed-financed SMEs, state-subsidised SMEs, debt-financed SMEs, flexible-debt-financed SMEs, trade-financed SMEs and internally-financed SMEs. These SME financing types differ according to the number of financing instruments used and the combinations thereof. Furthermore, the SME financing types can be profiled according to their firm-, product-, industry- and country-specific characteristics. The findings can support policy makers in assessing the impact of policy changes on SME financing and in designing financing programs tailored to the specific needs of SMEs across Europe.

This new EIF Working Paper is one result of a successful research cooperation that EIF’s Research & Market Analysis (RMA) has established with the Chair of Management at the University of Trier. A follow-on project, building on the findings of the presented analysis and financially supported by the EIB Institute under the Knowledge Programme, is underway.

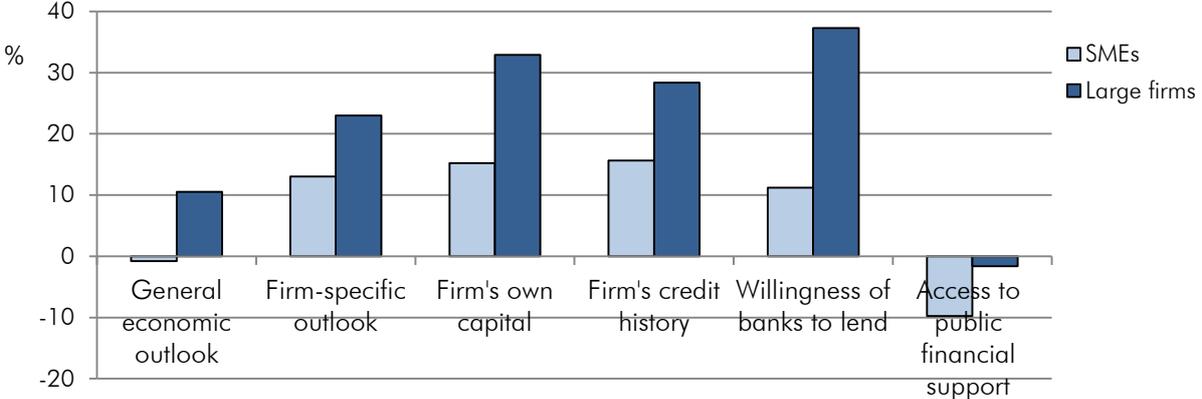
The SAFE survey also informs on the factors which SMEs believe to drive the availability of external financing. Figure 16 illustrates their responses and show that relatively little has change since HY1/2014. In HY1/2015, SMEs continue to believe lack of access to public financial support negatively impacts the availability of external financing. Although the other factors are currently positively contributing to SMEs' availability of external finance, Figure 17 shows stark differences between SMEs and large firms.

Figure 16: Change in factors driving the availability of external financing to Euro Area SMEs



Source: ECB SAFE (ECB, 2015a)

Figure 17: Change in factors driving the availability of external financing to Euro Area SMEs (SMEs vs large firms)



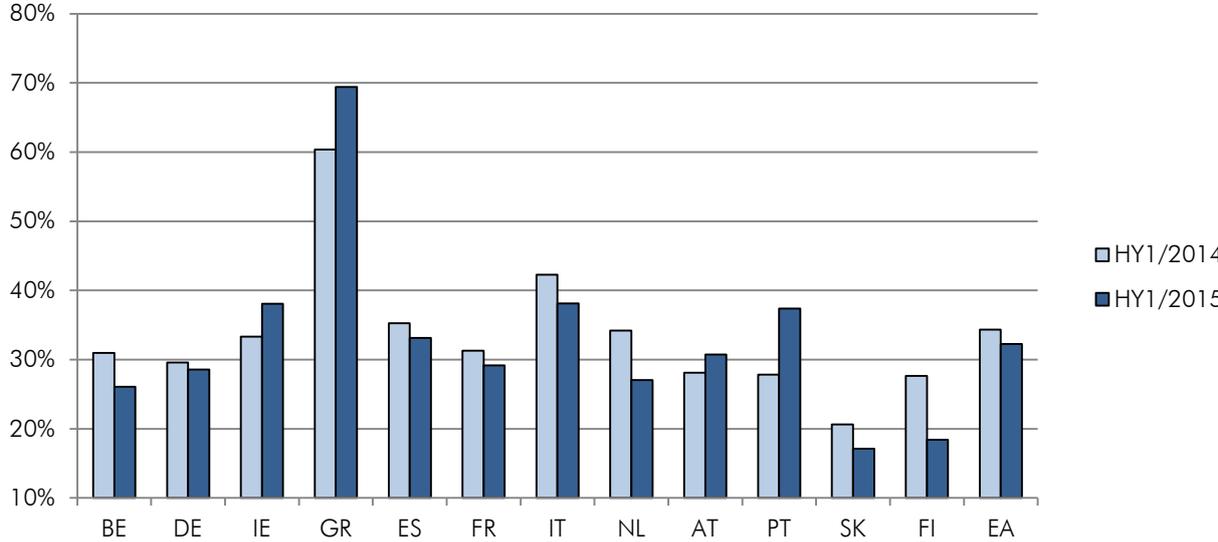
Source: ECB SAFE (2015a)

Figure 18 provides more insight into the within-Euro Area heterogeneity in the perceived importance of financing. It plots per country the percentage of SMEs that considers access to finance as *highly important*.¹⁶ For the aggregate Euro Area, 32 percent of SMEs reports access to finance as highly important. This percentage varies widely by country, with Greece clearly leading the ranking (70%), topping the second in line by over 30 percentage points (Italy, 38%).

¹⁶ Rating it 7 or higher on a scale of 10.

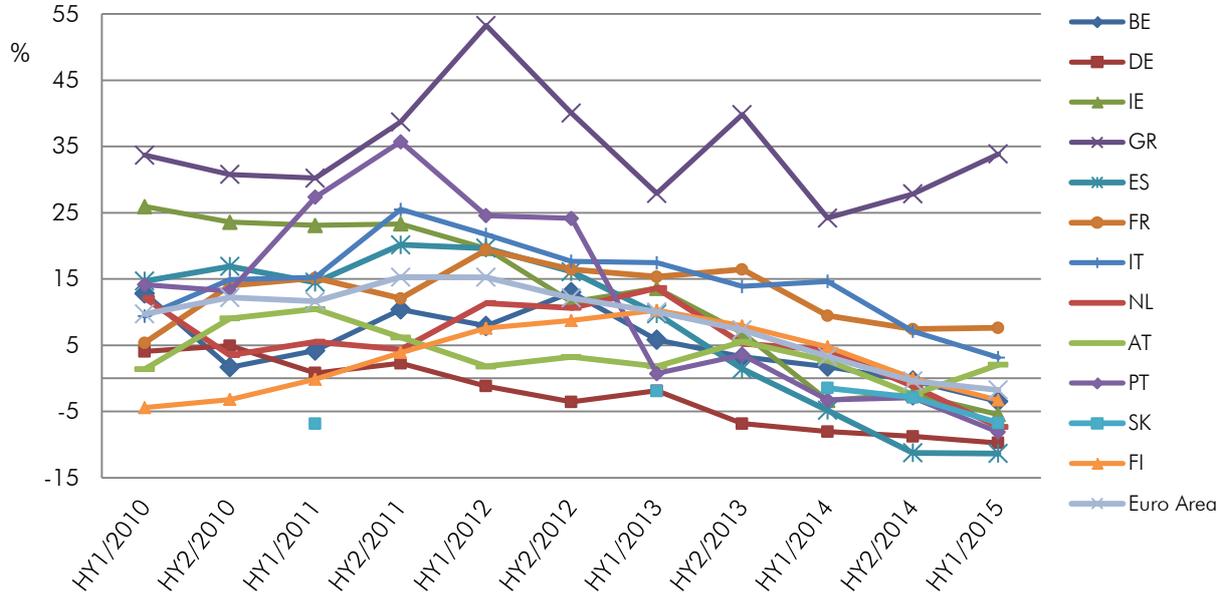
Comparing HY1/2015 to HY1/2014, the financing situation of SMEs further diverged within the Euro Area, deteriorating significantly in Greece and Portugal, while improving slightly in Belgium and Italy.

Figure 18: Percentage of SMEs ranking access to finance as highly important



Source: ECB SAFE (2015a)

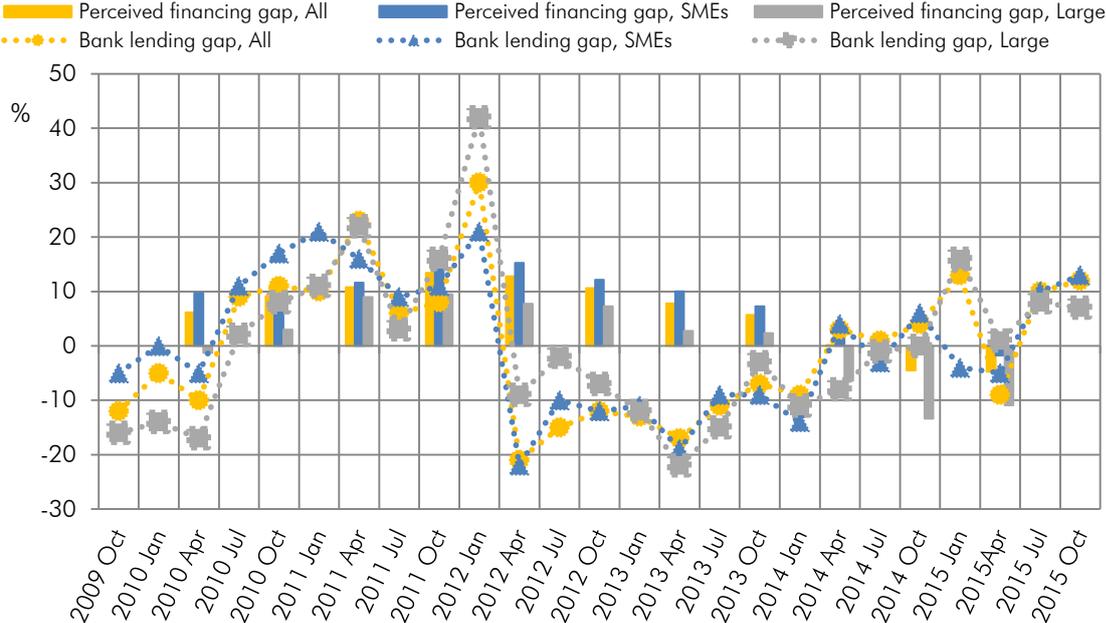
Figure 19: The change in SMEs' perceived external financing gap



Source: ECB SAFE (2015a)

These conclusions are to a large extent consistent with the evolution of changes in SMEs' perceived external financing gaps, illustrated in Figure 19.¹⁷ For example, the percentage of Dutch SMEs' reporting access to finance as highly important decreased over the past year, which is reflected in a sharper decline in their perceived financing gap. For the Euro Area as a whole, the perceived change in the external financing gap turned further negative, implying that Euro Area SMEs see a decline in the mismatch between financing demand and supply. The rate at which Greek SMEs perceived financing gap grows accelerated further in HY1/2015. Apart from Greece, only French, Italian and Austrian SMEs still report a growing gap in external financing.

Figure 20: 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

The ECB's Bank Lending Survey (BLS) data allows 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 20). In 2012 and 2013, a mismatch in perceptions occurred. While SMEs reported a perception of increasing gaps, banks, on the contrary, did not perceive any significant changes in the financing gap. In 2014 the

¹⁷ For each of the five financing instruments (bank loans, trade credit, equity, debt securities, bank overdraft), an indicator change in a perceived financing gap takes the value of 1 (-1) if the need increases (decreases) and availability decreases (increases). If firms perceive only a one-sided increase (decrease) in the financing gap, the variable is assigned a value of 0.5 (-0.5). The composite indicator is the weighted average of the financing gap related to the five instruments. A positive value of the indicator suggests an increasing financing gap. Values are multiplied by 100 to obtain weighted net balances in percentages.

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

perceived gaps of banks and SMEs started to converge. This continued to be the case during the first half of 2015.

Although the general economic outlook might have improved, the fragility of the recovery is evidenced by SMEs' pessimism on their future investment climate. Illustrative here is that the SAFE survey results reveal that access to finance remains to be a significant problem for many SMEs. Furthermore, it is noteworthy how aggregate Euro-level improvements mask sizeable country-level differences in SMEs' financing conditions. In particular the situation in Greece remains worrisome, but caution is warranted also for the other peripheral countries.

4 Private equity

4.1 Investment activity

4.1.1 Private equity funds

Box 2: Introductory information on Invest Europe data

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

Please do also note that Invest Europe private equity (PE) statistics do not include infrastructure funds, real estate funds, distressed debt funds, primary funds-of-funds, secondary funds-of-funds and PE/VC-type activities that are not conducted by PE funds. 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. Invest Europe 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”).

All Invest Europe figures for 2015 are based on the first three quarters of 2015 (“2015/Q1-Q3”). Conclusions from quarterly Invest Europe data should be drawn much more carefully than when interpreting annual data. A significant number of funds report business figures to Invest Europe only in the fourth quarter of a year. Thus, annual data can differ to a relatively large extent from the data of the first three quarters of a year, and quarterly figures should be seen as having preliminary character. In addition, and in order to make reasonable assessments for the recent past, we often have compared the 2015/Q1-Q3 data with 2014/Q1-Q3 data that had been reported at a comparable time (i.e. in November 2014). These data may differ from 2014/Q1-Q3 figures that are reported today (which we also occasionally mention in footnotes), due to data revisions that have been carried out in the meantime.

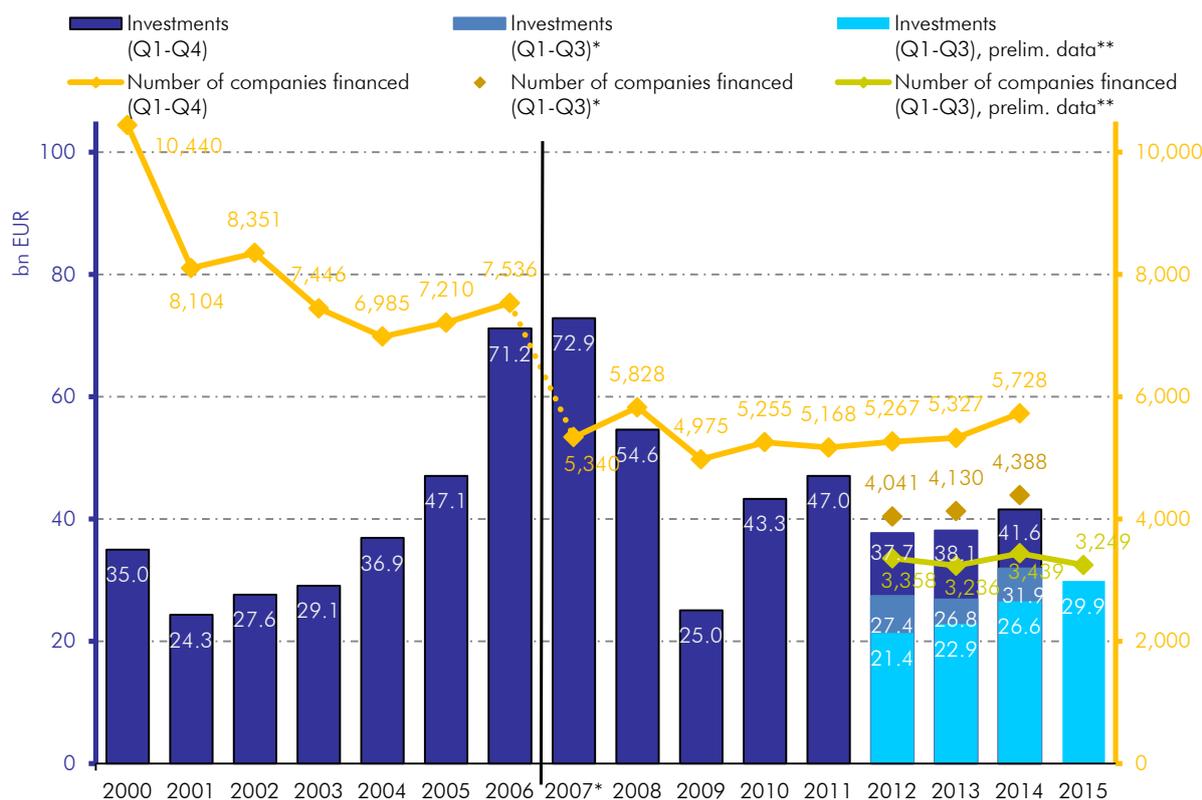
Invest Europe activity statistics are based on the PEREP_Analytics database, which monitors a total of 1,963 eligible PE firms representing EUR 545bn of capital under management, as of 31.12.2014. For Q3/2015 the database recorded 618 PE firms with EUR 377bn of Capital under Management (as of 31.12.2014) that were active in fundraising, investments or divestments in Europe. (For comparison: For Q3/2014 the database recorded 622 PE firms with EUR 347bn of Capital under Management, as of 31.12.2013.)

See, also for more details, Invest Europe (2015a), EVCA (2015), EVCA (2014) and the Invest Europe website (www.investeurope.eu).

Following the severe crash of European private equity (PE) investment in 2008/2009, it had partially rebounded over 2010-2011. Following a setback in 2012, the recovery continued in 2013 and 2014, albeit at lower levels. In the first three quarters of 2015, investments by PE funds located in Europe amounted to EUR 29.9bn, according to preliminary Invest Europe data (see Figure 21). This is an increase by 13%, compared to the EUR 26.6bn that had been reported at the same time of the previous year (i.e. the preliminary data as at Nov. 2014).¹⁹ In contrast, the Invest Europe data indicate a decrease in the number of companies financed to 3,249 in the first three quarters of 2015. However, it remains to be seen if this will be confirmed by the final data.

¹⁹ Based on revised data as available at Nov. 2015, PE investments amounted to EUR 31.9bn in the first three quarters of 2014.

Figure 21: Investment activity by private equity firms located in Europe²⁰



*As reported at November 2015.

**As reported at November of the respective year.

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

Source: Authors, based on data from Invest Europe.

The share of investments in the buyout sector over total PE investment amounts increased to 78%, while the shares of growth capital, rescue/turnaround and replacement capital investments have slightly decreased.

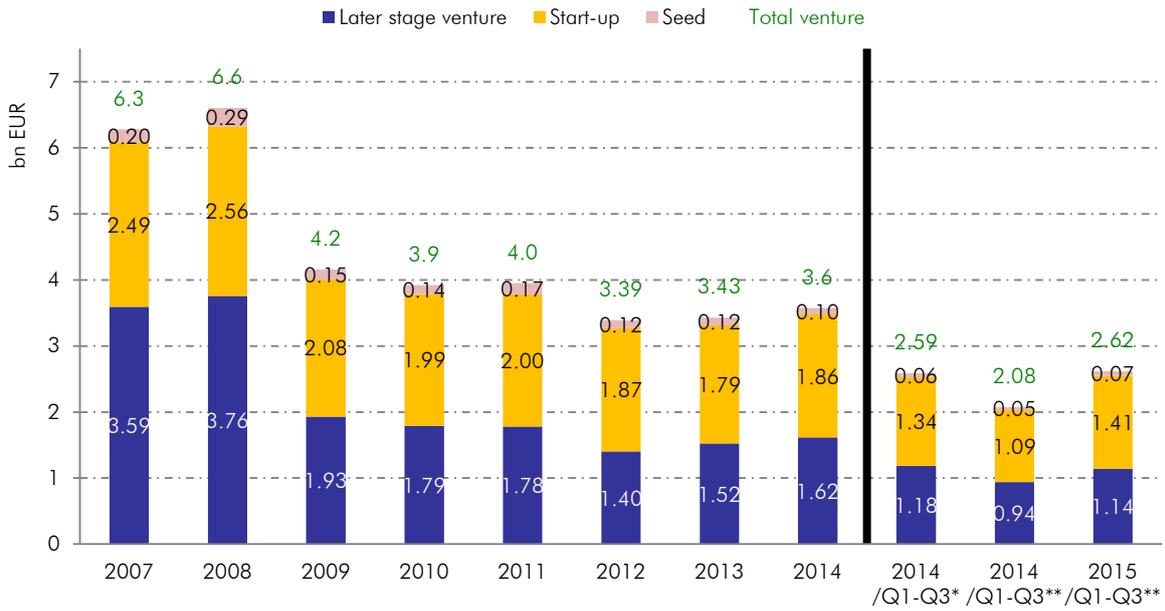
Total VC investments amounted to EUR 2.62bn in the first three quarters of 2015. They have thus increased by 26%, when compared to the figures that had been reported at the same time of the previous year.²¹ All venture capital market segments (i.e. seed, start-up and later stage) have so far recorded stronger investments in 2015 (see Figure 22). These developments were at least partially driven by the improvement in the continued economic recovery and the ample liquidity in the markets, from which private equity has also benefited.²²

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

²¹ I.e. when compared to preliminary data as at November 2014. Based on data available at November 2015, VC investments amounted to EUR 2.59bn in the first three quarters of 2014.

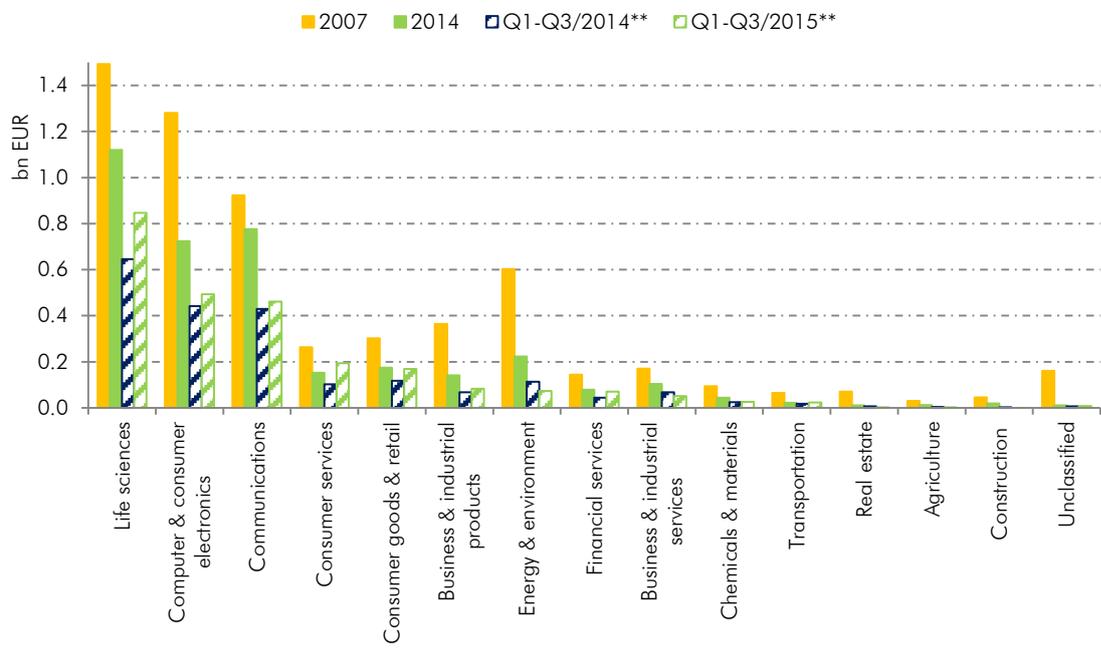
²² Please note that investment activities of Business Angels are not included in the Invest Europe statistics, see Box 2. As business angel financing is important for the financing of SMEs and innovation, we present more information in chapter 4.1.2.

Figure 22: Venture Capital investment activity evolution in Europe



* As reported at November 2015.
 **Preliminary data as reported at November of the respective year.
 Source: Authors, based on data from Invest Europe.

Figure 23: Venture investment in Europe by sector, 2007, 2014 and 2015²³



**Preliminary data as reported at November of the respective year.
 Source: Authors, based on data from Invest Europe

²³ This diagram and the related text are based on market approach (i.e. by country of portfolio company), due to data availability.

Recent developments in venture investment by sector are shown in Figure 23. In the Invest Europe statistics, the relative importance of sectors shows certain stability over time: life sciences, computer/consumer electronics and communications remained by far the most relevant industries for venture investment. The *share* of life science in total VC investment activity even increased from 25% in 2007 to 31% in 2014 and to 34% in the first three quarters of 2015. This is broadly in line with the results of a Coller Capital (2014) survey among investors in PE and VC funds (the so-called Limited Partners or LPs), according to which LPs were “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 Invest Europe statistics. See chapter 4.4 on PE prospects for a more detailed elaboration. Moreover, according to Invest Europe, market participants have observed more and more growth stage investments as follow-on investments in venture backed companies, which mean additional contributions from the PE industry that are not shown in VC investment statistics, but contribute to the growth stage investment statistics. For example, in 2014 more than EUR 1bn in growth stage investments was received by venture-backed companies, according to Invest Europe.

In order to shed some more light on the relationship between VC and start-ups, Brinckmann (2015) recently analysed, in cooperation with EIF RMA, the effect of entrepreneurs’ profiles on the performance of VC-backed start-ups. We present key parts of this work in Box 3 below.

Box 3: Influence of entrepreneurs’ profiles on the performance of VC-backed start-ups

Start-ups and start-up founders are a key driver of innovation and economic growth (Carree and Thurik, 2003). However, a long standing question in this area relates to the determinants of start-ups’ success, specifically from the perspective of the founding team.

Several studies have in the past highlighted the role of human capital (i.e. knowledge and skills of entrepreneurs) on the performance of innovative firms (see Unger et al., 2011 for a meta-analysis). The recent work of Brinckmann (2015)²⁴ adds to this vast literature by focusing on the role of human capital in the success of EIF-backed start-ups in the DACH region. The study adopts an innovative approach, collecting characteristics of entrepreneurs’ educational and professional background from social media platforms (e.g. LinkedIn), and using these to explain the performance of the start-up, as measured by quarterly valuations reported by VC investors. The final dataset includes 279 DACH start-ups invested by EIF-supported VC funds in the years 1997 to 2014.

The main findings of this work strongly support the hypothesis that prior founding experience positively affects the current start-up’s performance: start-up teams with at least one experienced entrepreneur tend to be more successful than novice entrepreneurial teams. Moreover, a characteristic feature of the analysed start-ups is the absolute dominance of male founders, although findings indicate increased performances of founding teams with at least one female member.

²⁴ Thesis 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 Philipp Brinckmann; the project and the box benefitted from significant input from Simone Signore and Dario Prencipe.

Box 3 continued:

Interestingly, the often-assumed relationship between education, as a key predictor of human capital, and the venture's success cannot be supported. A potential reason for this might be the high homogeneity of educational profiles among the analysed DACH start-ups, perhaps caused by the highly selective screening process of venture capital investors.

The work of Brinckmann (2015) is part of a broader project currently carried by EIF. The project aims to assess the performance of start-ups benefitting from EIF-backed VC investments and, ultimately, the economic impact brought by such investments. A series of publications centred on this key policy area is foreseen in the upcoming months.

4.1.2 Business angels and corporate venture capital

As already mentioned, the Invest Europe activity data cover fundraising, investment and divestment from PE and VC firms in Europe. Certain segments outside the definition that Invest Europe applies for the collection of its activity statistics are not covered, e.g. corporate acquisitions outside of dedicated corporate venture programmes and business angels' activities. However, corporate venture capital, 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)²⁵, and business angel financing have gained importance in recent years.

Referring to *corporate venture capital (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); it should be noted that the Global Corporate Venturing figures differ from Invest Europe's, due to different methodological approaches). 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).

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

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

²⁵ See, 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 corporate venture capital is scarce, in particular for Europe, but, for example, information presented by <http://www.globalcorporateventuring.com/> can give a flavour of the market developments.

BAs differ from VC funds, which primarily invest third parties' funds (e.g. institutional investors'). Angel-financed companies are typically in earlier stages of their development and the holding periods of BA investments are typically shorter than the corresponding periods in VC funds (Kraemer-Eis and Schillo, 2011). BAs' transaction costs are relatively low, which allows them to invest on a lower scale. They are geographically more dispersed than VCs and often invest in local markets. Moreover, BAs are very 'hands-on' investors, providing also services beyond financing (e.g. mentoring, business advice and access to networks), hence they can play a central role in the start-up ecosystem, in particular for innovative firms (OECD, 2016).

According to several studies, BAs have a positive impact on the growth of the firms they invest in, their performance, and survival (Lerner et al., 2015; OECD, 2016). The success of the investees seems to be strongly based on the services beyond financing that BAs provide (Kerr et al., 2011). There is evidence that BAs are relatively resilient to changing market cycles (OECD, 2016), and angel investments in early-stage high-growth companies tended to increase over the past years, as VC funds migrated to less risky later-stage investments (Kraemer-Eis, Lang and Gvetadze, 2013b).

However, there are difficulties in measuring the size of the business angel community, the main ones being identification and definition. BAs 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. The European Trade Association for Business Angels, Seed Funds, and other Early Stage Market Players (EBAN), for example, reported an average increase in the number of Business Angel networks of 17% over the past years to 468 in Europe in 2013, with estimated investments by the approximately 28k BAN members of EUR 554m (EBAN, 2014). 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 2013.²⁶ For a 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 1.6bn in 2015 so far (January to November), compared to EUR 737m in the whole year 2014.

²⁶ However, 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.

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., showed for the UK that angel investment activity has held up since the onset of the crisis and they emphasise the economic significance of this market segment. Moreover, they underline the need for ongoing government support. Recent findings by Hellmann, Schure and Vo (2015) also suggest that public support for start-up financing should go beyond an exclusive support of (formal) venture capital, because additional policy measures for angel investors “would reach a different set of entrepreneurial companies that develop outside of the reach of venture capitalists”. Hence, “the central role of BAs is increasingly recognised by policy makers [...], and initiatives to support angel activities have expanded in recent years as part of a broader shift towards policies that aim to make equity-type instruments more widely available for start-ups and SMEs” (OECD, 2015c). According to the OECD (2016), public-private co-investment schemes are able to catalyse the private market, “but only if the existing angel market is sufficiently well developed, so that a sufficient number of investor-ready deals can be financed and the government does not have to be overly engaged in matching supply and demand for early-stage equity”. EIF aims at meeting such criteria for efficient public support schemes for BA investments (see Box 4 for details of EIF’s activities in this area).

Box 4: EIF activities in the field of Business Angel financing

As a part of its support for SME financing through Business Angels (BAs), the EIF has implemented the European Angels Fund (EAF). The EAF is a co-investment fund to provide equity to BAs 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, Austria, Ireland and the Netherlands since then and currently reaches a volume of c. EUR 253m. EAF has already committed app. EUR 65m to BAs who have already drawn more than EUR 13m for more than 90 co-investments in SMEs since the launch of the programme. Further roll-out to other countries is foreseen and the launch of the program in Italy and Denmark is scheduled for 2016. Aim of EAF is to co-invest with experienced BAs in order to build a joint portfolio over a time of 5-10 years.

In addition to EAF, EIF also invests into institutional fund set-ups with an angle on BA investments, including funds with involvement of BAs in the investors base and fund governance or funds aiming to co-invest with BAs or BA syndicates. With a view to further develop this approach, a new mandate has been launched in 2015. The Business Angels ICT pilot under the Horizon 2020 InnovFin facilities with an initial volume of EUR 30m aims to support of Business Angels investing predominantly in start-ups, innovative SMEs and small midcaps with a particular focus on CEE countries who aim at commercializing new ICT-related products and services across Europe.

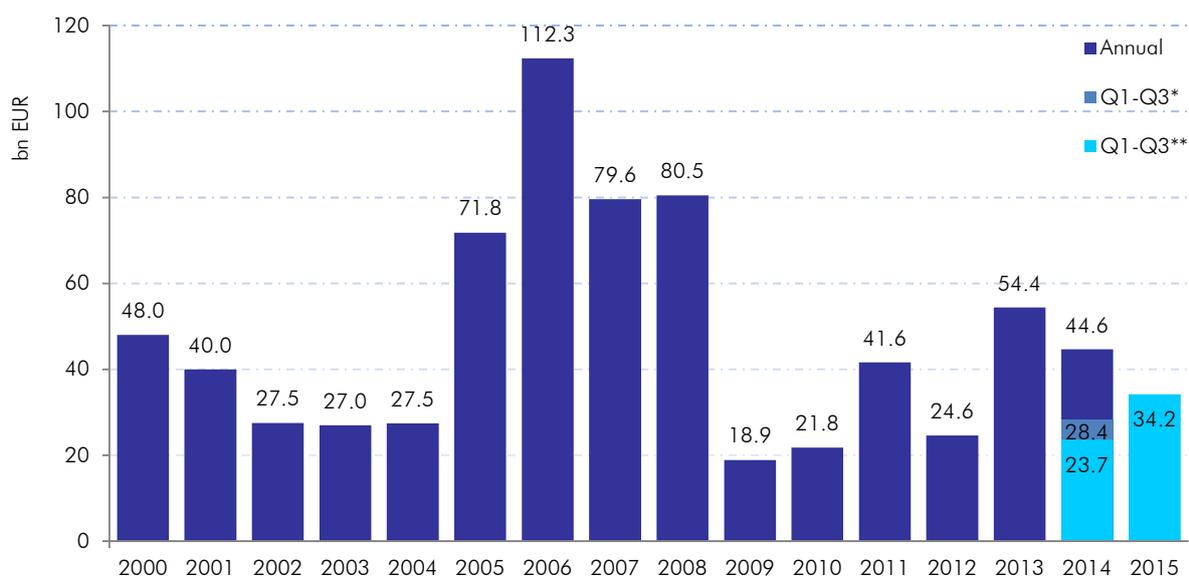
More information is available on the EIF website here:

- EAF: <http://www.eif.org/eaf>;
- InnovFin BA ICT pilot: http://www.eif.org/what_we_do/equity/single_eu_equity_instrument/innovfin-sme-vc/index.htm.

4.2 Fundraising activity

PE fundraising has substantially recovered in 2015, as shown by the preliminary Invest Europe data. In the first three quarters of the year, total amounts raised by PE firms located in Europe increased by 44%, compared to the figures that had been reported in November 2014 for the first three quarters of 2014 (see Figure 24).²⁷

Figure 24: Funds raised by private equity funds located in Europe (incremental amounts raised during year)



*As reported at November 2015.

**As reported at November of the respective year.

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

Source: Authors, based on data from Invest Europe

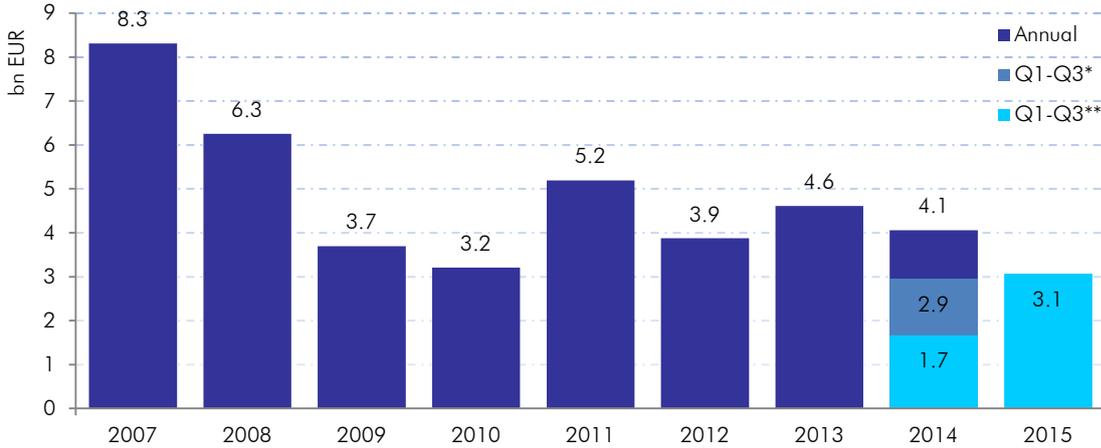
According to Invest Europe (2015a), funds located in the UK and Ireland concentrated about 53% of the total PE fundraising, a level higher than during the same period last year. Fund managers in the Nordics were the second in line (22%), followed by funds based in France and the Benelux countries (18%). Southern Europe accounted for 4% followed by the Germany, Austria and Switzerland (3%) and Central and East Europe (1%).

Particularly strong fundraising increases were recorded for funds with a focus on the mezzanine and growth capital stages of the market as well as for generalist funds²⁸. In all three market segments, the total amounts raised until the end of September already exceeded by far the amounts raised during the whole year 2014. Funds with a buyout focus, which by far represent the largest share of the PE fundraising amounts, also recorded significant increases.

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

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

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

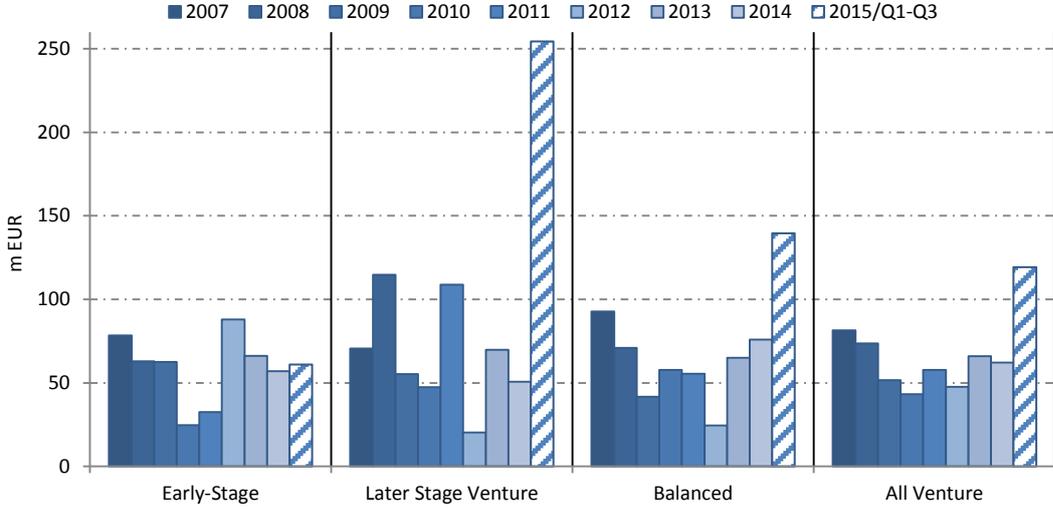


*As reported at November 2015.
 **As reported at November of the respective year.

Source: Authors, based on data from Invest Europe

For European VC fundraising, which amounted to EUR 3.1bn in the first three quarters of the year, the figures so far also indicate strong growth (see Figure 25). This was mainly driven by funds with a later stage focus.

Figure 26: Average VC fund size²⁹ (based on final closings, cumulative amounts raised since inception)



Source: Authors, based on data from Invest Europe

The average VC fund size has substantially increased to EUR 119m (see Figure 26), based on 20 final VC fund closings reported in the Invest Europe statistics for the first three quarters of 2015. Given the evidence in previous studies, which indicated that small fund size was one of the reasons for poor European VC performance (Kelly, 2011), the current finding might mean positive news.

²⁹ Numbers based on 11 funds with an early-stage focus, 4 funds with a later stage focus and 5 funds with a balanced stage focus.

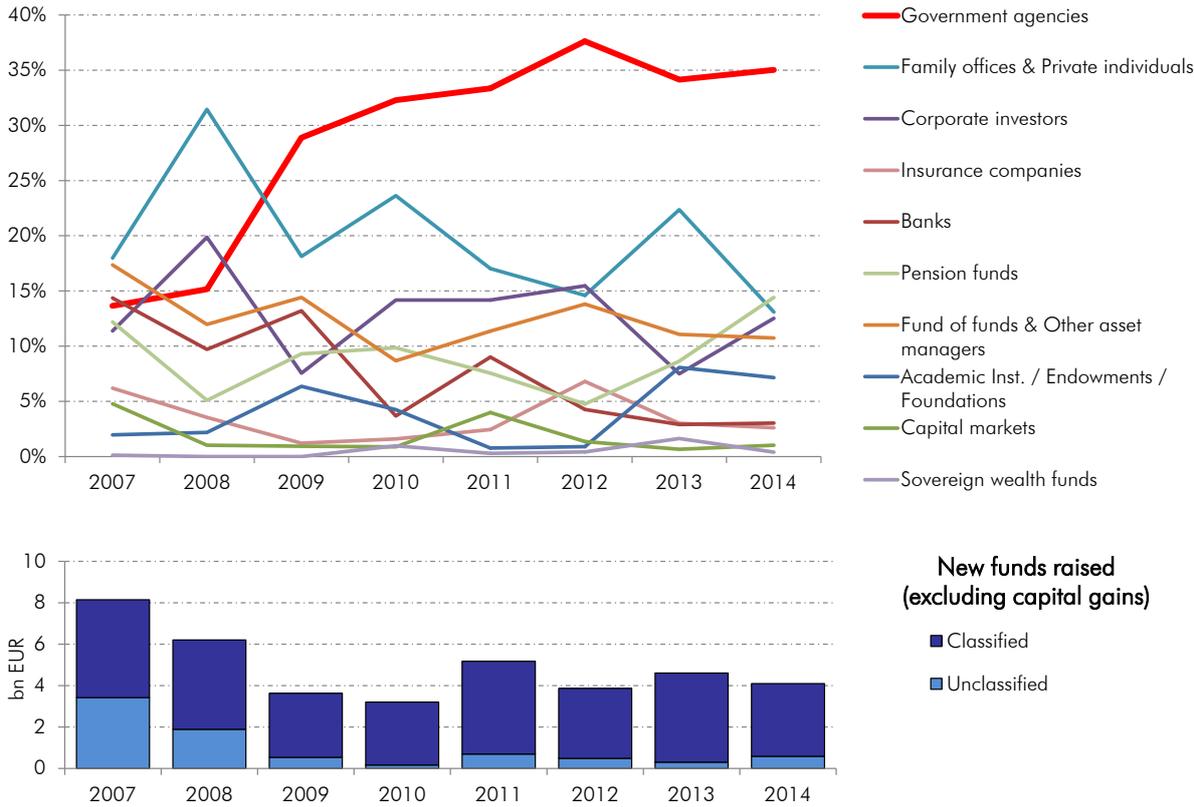
Hence, the recent development in the average fund size could indeed indicate that the European VC market is developing positively. However, the preliminary figures for 2015 should not be overstated, in particular when looking at the results for the different stages of the VC market, as they are based on the relatively small number of final fund closings that were reported to Invest Europe so far. In particular, for later stage venture the statistics for the first three quarters of 2015 currently show only four final closings. Hence, it remains to be seen if the trend indicated by Invest Europe preliminary statistics will be confirmed by the final data. To be noted that EIF internal analysis suggests that larger funds are often managed by teams that previously had smaller funds that performed well. Thus, the size would be a consequence rather than a cause. Larger fund size would be a sign of more successful GPs and more careful due diligence by LPs. Moreover, further EIF internal analysis suggests a positive relation between relative fund size compared to peers of a same vintage and performance. Together with the former argument, this may indicate that achieving a larger fund size is associated to a certain market validation. Helping promising teams in demonstrating their investment skills and getting market validation in a smaller first time fund is consequently a way to help with the next fundraising of such manager, and hence the VC ecosystem.

A sign of investors' still cautious sentiment for VC as a consequence of the crisis is the shift in the investor base, which has been going on during the past years (see Figure 27). According to Invest Europe figures, government agencies accounted for 35% of total investors into venture capital funds in 2014 (more recent data on the investor base is not yet available.) 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 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 4.1bn in 2014. This led almost "naturally" to an increased share of government agency fund investors. It remains to be seen in the annual statistics if the recent increase in VC fundraising, which the Invest Europe figures indicate so far for 2015, has also led to a change in the "market share" of public investors.

In order to put EIF's activity in context, a calculation performed by EIF in 2014 can be taken into account. 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. Moreover, EIF is supporting an increasing share of first-time teams, and many VC funds in which EIF invested successfully managed to close with their full target size.

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

Figure 27: Investor base: Share of government agencies in VC fundraising³⁰



Source: Authors, based on data from Invest Europe

4.3 Divestment activity

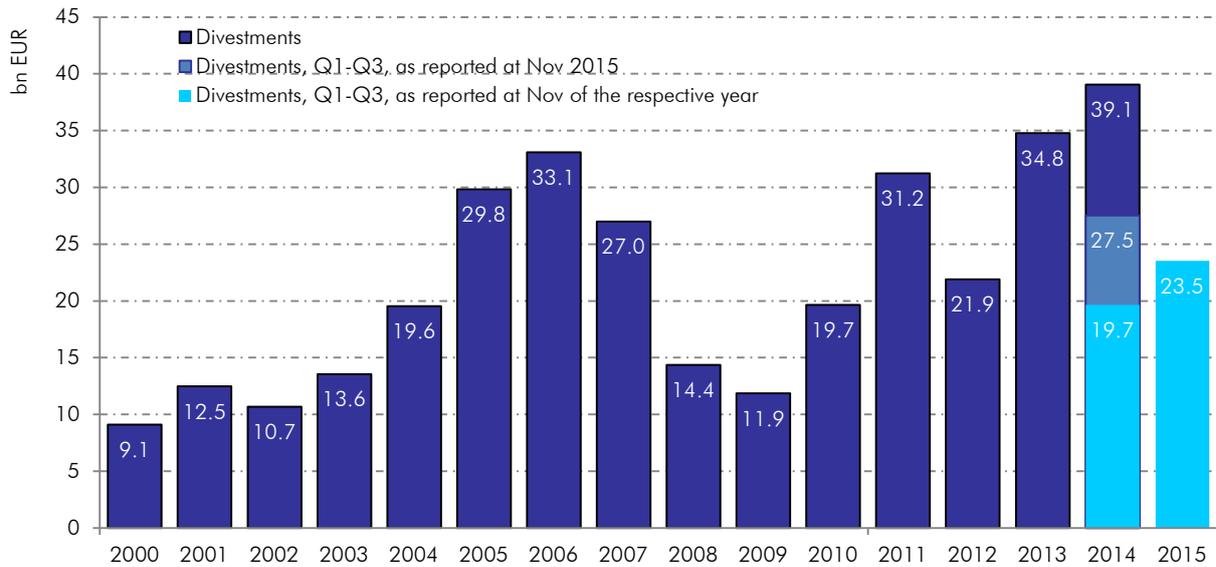
The exit markets have remained remarkably strong. In the previous two years, Invest Europe statistics had already recorded the highest PE divestment amounts ever. In the first three quarters of 2015, total divestments by PE firms located in Europe amounted to EUR 23.5bn, which is an increase by 20% compared to the value that had been reported for the first nine months of 2014 at a similar time of the previous year (see Figure 28).³¹

A closer look at the details of the Invest Europe divestment statistics shows the remarkable strength of the exit markets in the recent past. As regards overall PE, the relative importance of write-offs has continuously decreased since 2010, except for a slight increase in 2013 (see Figure 29). Trade sales and sales to another PE house together account for more than half of the total divestments amounts. Moreover, the share of public offerings has considerably increased to more than a quarter of all divestments in the first three quarters of 2015, due to significantly stronger sales of quoted equity. In the VC market, the relative importance of write-offs has also decreased, while trade sales surged over the first three quarters of the year.

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

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

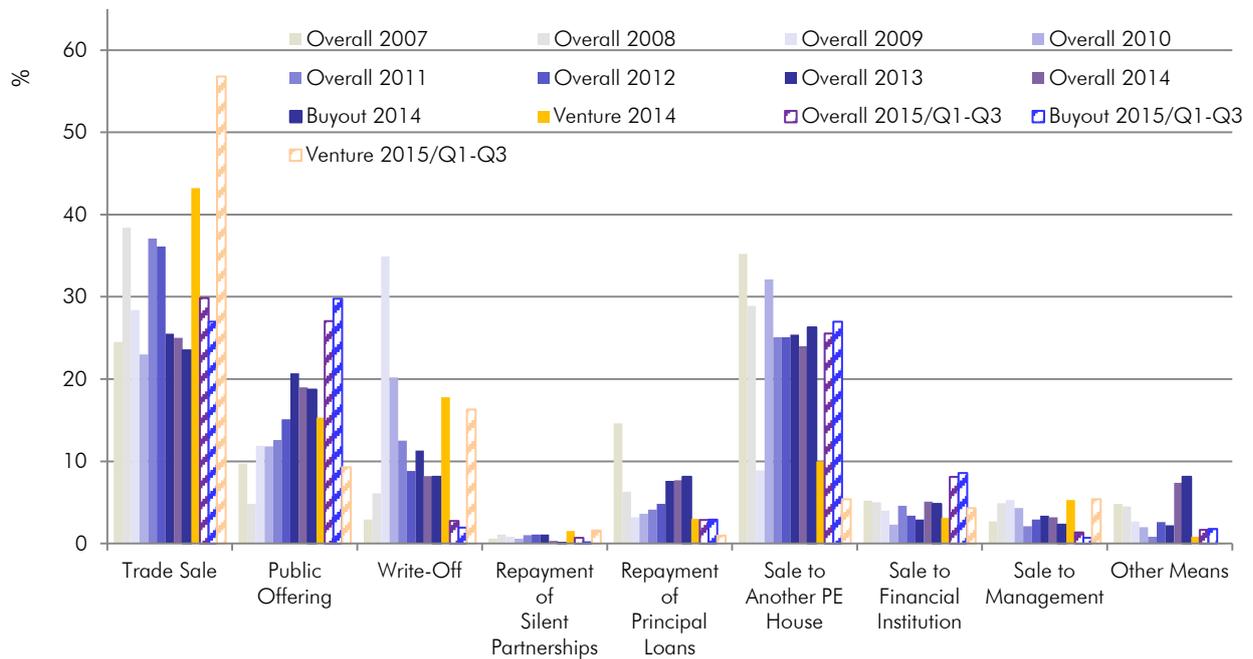
Figure 28: Divestments (by amount at cost divested) by private equity firms located in Europe



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 Invest Europe

Figure 29: Divestment routes (shares)³²



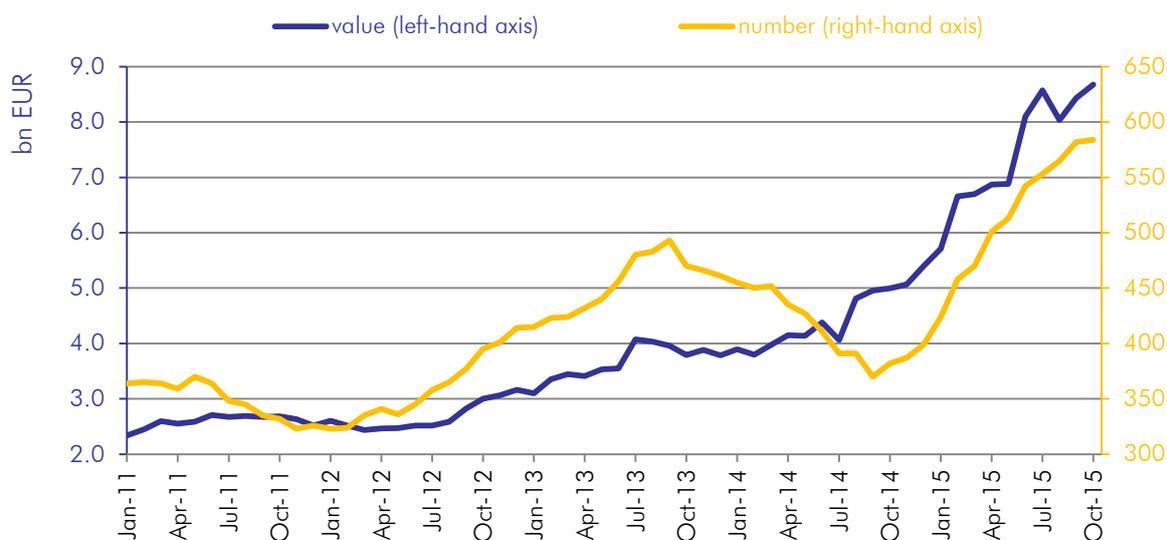
Source: Authors, based on data from Invest Europe

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

4.4 Prospects³³

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 Index³⁴, has recorded, on average, strong increases in terms of investment values since summer 2012. In contrast, the number of deals had declined for a year since autumn 2013, before it started to pick up again (see Figure 30, which shows the index development on a 12-month rolling-horizon basis).

Figure 30: European tech headline investment transactions (12-month rolling horizon)³⁵



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

However, PE investors' assessment of the market situation has considerably changed. According to a recent Preqin survey (Preqin, 2015), valuations, deal flow and fee pressure were perceived as the biggest challenges that investors were facing. This is quite a remarkable turn from the situation a year and a half ago, when regulation, performance and the economic environment had been Limited Partners' key concerns (Preqin, 2014). Warning voices of possible overheating have been uttered since some time (e.g. Go4Venture Advisers, 2015a), because of the strongly expansive monetary policy stance that has led to ample global liquidity and low interest rates. In line with this, fundraising and liquidity are to be found only at the lower end of the investors' biggest challenges

³³ We are grateful to several colleagues for very helpful comments and discussions. In particular, we would like to thank Uli Grabenwarter for an extensive written contribution to this subchapter.

³⁴ Go4Venture's European Tech Headline Transactions Index "is a derivative index" which is "compiled [...] based on the deals reported in major trade publications and news feeds [...] as an early indicator of evolutions in the private investments market for European TMT companies. [...] TMT is defined to include Technology, including IT and Life Sciences (except drug discovery); Media, including Internet & Digital Media; Telecom Services (alternative operators only)". For this and more information on definition and methodology see www.go4venture.com/

³⁵ In the two lines in the diagram, each data point shows the sum of the total value of deals (blue line) and the sum of the total number of deals (yellow line) observed in the month to which the respective data point is related and over the 11 months prior to that data point. For example, in July 2013, the total value of deals observed during the period from August 2012 to July 2013 amounted to EUR 4.1bn, and a total number of 480 deals were observed during the same period.

ranking (Preqin, 2015), while high asset prices are seen as the main risk to PE performance over the coming years (Coller Capital, 2015b). Moreover, according to Go4Venture Advisers (2015b), there is already an increasing evidence of a market adjustment for late-stage companies, i.e. declining valuations and more write-downs, and percolation through earlier stages can be expected; although, at the moment, a soft landing is expected rather than a crash.

Regulation is still among investors' key concerns, albeit at a lower rank than before. Invest Europe (2015b) 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, EuVECA, ELTIF, Solvency II, CRD IV and CRR, MiFID II/MiFIR, UCITS V, various taxation rules, and last not least the "Capital Markets Union" policy initiative). Besides regulatory initiatives, structural market weaknesses such as the difficult access of smaller companies to IPO markets (see, for example, EU IPO Task Force, 2015), limit the upside potential of the European VC market.

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

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

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

Geographically, Europe is a far less homogenous VC market than the US. Whilst the core markets in Europe (UK, France, Scandinavia and to some extent and in some sectors Germany) have seen some recovery since 2008, other geographies continue to struggle with the size of their domestic VC market which is in no relation to their share in the aggregate GDP of the EU (notably Italy and Spain). Sizable differences in the development of the VC markets prevail, especially in the

peripheral parts of the EU where markets not only suffer from subcritical size but equally from EU's very fragmented institutional investor base. On the one hand, for most market segments especially in the early stage VC segment proximity between the VC fund managers and their target portfolio companies is essential. On the other, Europe lacks to a large extent the market segment of international pan-European VC growth capital funds that are able to effectively support companies in their global market penetration effort. However, when it comes to the question of policy support instruments, it has to be noted that the value of capital injected for funding Europe's economic growth is not primarily driven by volume but by impact. This means that large-scale growth capital funds will make no difference to achieving the policy objectives for the EU's competitiveness if they are not associated with the knowledge of how to grow businesses to global scale.

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

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

venture capital should go beyond an exclusive support of VC funds (see Hellmann, Schure and Vo, 2015), but rather aim to attract equity financing to Europe also from other sources, such as angel investors and crowdfunding (see Wilson, 2015a; see also Aubrey et al., 2015, for related policy recommendations to support growth firms).

According to a recent Coller Capital (2015a) survey, 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 developing, including the emergence of more and more successful incubators and accelerators (see chapter 4.6.2 for more details). Should these trends continue, the potential returns of early-stage companies would have significantly positive impacts on the performance of VC investing.

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

4.5 EIF initiatives

The private equity and venture capital markets have shown remarkable positive developments in the recent past. However, several risks have also been observed and it remains to be seen if a sustainable longer-term positive trend can become prevalent. 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. 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 chapter 0, or the Social Impact Accelerator (SIA).

SIA is the first pan-European public-private partnership for social impact investing. It has been launched by the EIF with the collaboration of two private sector investors (DB Impact Investment and Crédit Coopératif). SIA is an initiative which addresses the growing need for equity and hybrid finance to support social enterprises through investments in social impact funds. (see Box 5 for a general description of the financing of social enterprises.) 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 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 82m to eight social impact funds across the EU (2 in the UK, 1 in Italy, 3 in France and 2 in Germany). 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 and two additional investors (SITRA and Bulgarian Development Bank) have supported the initiative through a capital increase of the SIA, now reaching EUR 243m. 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; more information on SIA is available here: http://www.eif.org/what_we_do/equity/sia/index.htm).

Box 5: Financing social enterprises

The European Commission views a Social Entrepreneur (SE) as someone who voluntarily commits his entrepreneurial talent to mobilise private resources with the primary aim of creating social value, while essentially operating in a market driven environment. Operating in a market driven environment has implication for the capital decisions made by SEs. While NGOs are highly dependent on grants as their primary source of financing, SEs are to a large extent self-sustainable and rely strongly on the sustainability of their business model to raise funding.

Spiess-Knafl and Jansen (2013) analyse the financing decisions of social enterprises and discuss at length the unique aspects of the *Social Financing*. Because of SEs' non-conventional, social objectives, they argue that *Social Finance* is characterised by a number of distinct features. First, there often is a missing link between return and risk. Traditional investments compensate higher risk with a higher expected return. Because an important part of SEs' output is of a non-monetary nature, this link breaks down for social investments. Second, the pecking-order theory, which predicts the preference of enterprises over different sources of finance, does not hold for social enterprises. Although equity is a crucial element in the financing mix of Social Enterprises, their governance structure and primacy of their social mission might induce them to prefer debt financing over equity financing. This is because the objectives of traditional equity investors might not be aligned with the SE's mission – which requires the emergence of a new generation of professional social impact investment funds specialised in providing equity financing to SEs. In addition, although it is not their primary source of financing, grants might still play some role in the funding structure of some SEs. The unpredictable nature of those grants could affect their eligibility for different market-based capital sources. A third unique aspect of SEs relates to the heterogeneity in their potential capital providers.

Spiess-Knafl and Jansen (2013) distinguish between three types of investors: those with market-rate financial return expectations (traditional banks or equity investors), investors that value the social element of the return and hence have reduced financial return expectations (social venture capital funds or ethically orientated banks) and finally, investors without financial return expectations (donors or foundations). A heterogeneous mix of investors pursuing different objectives could be a source of conflict and deter the optimal functioning of the SE.

It could also lead to a crowding out effect, where grant donations are reduced in response to increased market based funding, which could in turn affect the investing decisions of those market investors. The authors argue that these unique aspects of *Social Finance* make that SEs face distinct *capital market imperfections*:

1) *Missing secondary market for equity investments*

A survey conducted by GHK revealed that 75% of questioned investors agreed or strongly agreed that functioning secondary equity markets are lacking. This is consistent with statistics that show that social enterprises rely relatively heavy on debt as a financing instrument. Excessive reliance on debt can prove to be an obstacle for growth, as it restricts innovation and risk-appetite among social entrepreneurs.

2) *High fixed costs of investment*

Transaction costs associated with social investments are relatively high due to the nature of SE business objectives. Next to traditional knowledge about the financial situation of an organisation, analysts also need to be aware about the social elements of the investment's return. Combined with low average investment amount, this results in high fixed costs share, even more so than is the case for normal SMEs. This in turn leads to a structural gap where investors will search for alternative low-cost investments.

Box 5 continued:

3) Mismatch in existing supply and demand

While SEs see lack of finance as one of the main obstacles for growth, investors often state that they face a shortage of investment opportunities. The mismatch between existing supply and demand was reconfirmed by the GHK survey, in which nearly all investors agreed with the statement that supply and demand are not sufficiently met. Supply and demand mismatch can be driven by informational deficiencies or geographical disconnect between both sides of the market. The latter cause is likely to be especially relevant in case of SE, who often operate on a highly localised basis (Santos, 2012).

The EIF is well positioned to address the above listed market failures, by leveraging on its sectoral expertise and international geographical scope. Currently, the EIF supports social enterprises under the SIA and EaSi programs (see chapter 4.5 and 6.4 for more detailed description of the programs). An elaborate discussion on EIF's activities in the social enterprise sector will be provided in a forthcoming working paper.

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 approx. 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. Building on the successful experience of the EUR 1.7bn ERP-EIF Facility, the ERP-EIF Co-investment Facility opens up a new growth stage funding source for VC fund managers investing in Germany and whose funds are supported by the ERP-EIF Facility.

The need for such a new 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. According to a Coller Capital (2015a) survey, "most LPs expect co-investments to remain a fixed feature of the PE landscape". In an EIF survey among VC fund managers in Germany, 66% of the participants saw a benefit from the availability of stable providers of co-investment capacity when addressing potential investment opportunities. 52% would have closed more investments if they could have relied on stable providers of co-investment capacity in the past (the share was notably high for managers of ICT funds at 71%). 57% of respondents listed too small fund size as one of the main reasons why they decided not to invest. 66% of participants saw a high or very high market need for such a co-investment product (source: EIF). This is even more relevant, as currently the large majority of LPs seems to believe "that the LP community lacks the necessary

investment skills, experience and processes to make successful co-investments”, according to the most recent Collier Capital (2015b) survey.³⁶ Time constraints, a limited understanding of co-investment performance drivers, and the inability to recruit staff with the requisite skills were cited as “the main challenges preventing LPs from making successful co-investments”.

To pursue its equity activities, EIF continues to invest 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 also 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 has been increased from EUR 7bn to EUR 9.5bn as part of the contribution of the EIB to the Investment Plan for Europe in July 2015 to the benefit of SMEs and midcaps in the EU-28 Member States; as of November 2015, more than EUR 1bn of such increase has been committed to private equity funds. 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.

Under the SME window of the Investment Plan for Europe (see Chapter 7), equity products are foreseen to be implemented, including the above mentioned increase of the RCR mandate by EUR 2.5bn as well as EUR 1.0bn yet to be confirmed but likely with a larger scope, especially on growth stage and co-investment, but also on early stage, business angels and technology transfer in combination with InnovFin Equity, 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, PPCI, 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

³⁶ Collier 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 23rd edition (winter 2015-16) of the Global PE Barometer captured the views of 114 PE investors from round the world, surveyed in September-October 2015.

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.³⁷

4.6 Specific market segments

4.6.1 Lower mid-market and hybrid debt/equity finance

Following EIF's definition (see EIF, 2015a), the lower mid-market (LMM) covers fund strategies targeting equity and mezzanine investments at growth and buyout stages with a particular focus on SMEs and Mid-Caps. EIF provides its core LMM products (equity, hybrid debt-equity and private debt for SMEs and Mid-Caps) as alternative sources of long-term finance to established businesses and later stage technology companies. In the current market context, a full range of equity products combined or not with a debt component proved highly successful, particularly for shareholding reorganisation, organic and external growth, restructuring or expansion.

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

The lower mid-market is demonstrating good prospects, 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 and a real alternative for SMEs and Mid-Caps financing. (Source: EIF, 2015a.) This has also been confirmed by the recent developments of the Argos Mid Market Index, which measures the evolution of euro zone private Mid Market company valuations (see Epsilon Research, 2015). The index picked up in the third quarter of 2015 and is drawing close to its all-time high from 2006. However, the development is inter alia based on high liquidity in the markets and a relatively low number of "ready to invest" companies after the crisis. Hence, there is a risk of overheating (as we mentioned also in other places of this paper and in previous ESBFO issues). However, experienced managers are able to invest in less visible companies and provide added value in order to have them becoming more attractive and sustainable.

In 2014, the launch of the new Mezzanine Co-Investment Facility (MCIF) 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 hybrid 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 Mid-Caps, thereby enhancing their access to finance.

More recently, in the course of 2015, EIF has further developed its lower mid-market investment activities entering the private debt segment and investing, under the EIB Group Risk Enhancement

³⁷ More information on country-/region- and sector-specific initiatives is available here: http://www.eif.org/what_we_do/resources/index.htm.

Mandate (EREM) mandate, in Selective Loan Funds providing direct lending and debt solutions to European SMEs and Small Mid-Caps. Through this instrument, EIF is contributing to the development of this asset class in Europe, specifically aiming at addressing the financing gap still existing for smaller companies, despite substantial liquidity in the markets. For more information about EIF investments in Loan Funds, see the recent EIF Working Paper on institutional non-bank lending and the role of debt funds (see Kraemer-Eis, 2014).

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.

4.6.2 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 2015, the European TT segment continued its trend of increasing professionalisation, on the path of evolution towards a more mature setting.

EIF is also active in the field of TT in order to support the commercialisation of research know-how. In the recent past, 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. Another 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 and is expected to invest ca. EUR 125m in nine transactions in 2015 with a healthy pipeline for 2016 already emerging. Investments in new technology transfer markets, including Portugal, have successfully been committed and in 2014/15 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. TT transactions are also ongoing in Spain, Ireland and Italy.

Discussions with the European Commission to set up a Technology Transfer finance facility have continued through 2015. 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).

In 2016, EIF will continue to develop its technology transfer (TT) activity, linking businesses with research organisations, facilitating licensing to help the development of early stage technologies and collaborating with world-class research organisations and universities to commercialise discoveries and increase their impact on the market.

As a part of its TT activities, EIF supports business incubators. In the context of a cooperation with the University of Trier, EIF has also contributed to a recent research project on incubator business models in Europe (see Box 6).

Box 6: Incubator business models in Europe

Business incubation is a global and dynamic phenomenon that has developed into numerous different shapes over the past decades. It is deployed by a wide variety of stakeholders, reaching from business over academia to the public sector. Due to the prolific implementation of incubators in so many different fields, it is hard to determine how many business incubators actually exist and what their business models exactly look like.

Olschewski (2015) provides an overview of the business incubator landscape in form of a categorisation that aims to cover the different incubator business models in the EU. Following a qualitative research approach by analysing nine case studies, the researcher investigates the objectives, the funding structure and the measure of success of the different business models in order to verify the categorisation as well as to assess their exact business models and their sustainability.

Most of the business incubators follow a certain pattern according to the above-mentioned categories (see Table 3 for an overview). However, there are exceptions. Some of the incubator business models cannot be categorised easily as purely profit- or non-profit-oriented but rather feature a complex objective structure that is linked to the funding structure and the measure of success. Most of the analysed incubators are not able to operate on a self-sustainable basis – being mostly the public incubators but also some of the private incubators.

Table 3: Categorisation of incubator business models

	Public Incubators		Private Incubators	
Characterising Variables	Regional Development Incubators	University Incubators	Corporate Commercial Incubators	Independent Commercial Incubators
Objectives	Non-profit; main objectives are to foster innovation and the regional economic development, e.g. the creation of jobs	Non-profit; main objectives are to promote academic entrepreneurship and transfer research to industry	For-profit; main objectives are to create new independent business units and to stay close to innovations	For-profit; Main objective is to maximize the financial returns
Funding sources	Mostly public	Mostly public	Mostly private	Mostly private
Success measure	Mostly non-profit oriented	Mostly non-profit oriented	Mostly profit-oriented	Mostly profit-oriented
Incubation period	Long-term-orientation	Medium-/long-term orientation	Short-term orientation	Short-term-orientation
Origin of ideas	Mostly external	Internal and external	Internal and external	Mostly external
Services/ Features	Low involvement; mostly tangible services and intermediary function	Low involvement; office and laboratory space, intermediary function and internal scientific advices	High involvement; Access to company-related resources and networks, often seed investments for equity, business support, office spaces	High involvement; Intense mentoring programmes, seed funding for equity, institutionalized high quality networks

Source: Olschewski (2015)

5 SME guarantees and SME Securitisation in Europe

5.1 SME guarantees

5.1.1 Market failure and policy response

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).³⁸ 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).³⁹

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

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), i.e. in order to alleviate market failures in SME financing.

³⁸ 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.).

³⁹ Stiglitz and Weiss (1981) argued that under certain circumstances credit rationing can be rational for banks.

Moreover, loan guarantee programs expanded substantially in the years 2007-2011, as a government policy response to the financial crisis. Guarantee schemes are often viewed as having positive macroeconomic effects meaning that the costs for the tax payers due to default payments are outweighed by the positive stimulating effects (such as on employment and tax revenue) of guarantees for the economy. In addition, “new elements were added to some of these programmes, such as reduced red tape and more rapid provision (i.e. ‘express guarantees’ [in Belgium]), and new instruments were created outside traditional guarantee programmes” (OECD, 2014b). Therefore, loan guarantee programs continue to be “the most widely used instrument at governments’ disposal to ease SME access to finance” (OECD, 2015c; see also OECD, 2015e). Moreover, guarantees are “increasingly targeting young and innovative firms in an effort to boost employment and value added” (OECD, 2016).

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

5.1.2 Market size

Market information concerning CGS in Europe is gathered by AECM, the European Association of Guarantee Institutions.⁴⁰ These data covers SME guarantees, counter- and co-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.

Key figures, based on *outstanding guarantees* on SME loan portfolios as at 31.12.2014⁴¹, are presented in Table 4. In terms of total amounts of guarantee and counter-/co-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

⁴⁰ We thank our colleagues from AECM for their support. AECM has currently 42 members in 21 EU Member States plus Bosnia and Herzegovina, Russia, Serbia and Turkey. EU countries without an AECM member are Cyprus, Denmark, Finland, Ireland, Malta, Slovakia and Sweden, even if guarantee activities exist in some of these countries. 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.

⁴¹ For 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 one of AECM’s members from Slovenia and one from Belgium. These disclaimers apply as well for the diagrams and boxes presented throughout this chapter.

Portugal (81,621). The total number of SME beneficiaries in the portfolios of the AECM members amounted to almost EUR 2.6m.

Table 4: Outstanding guarantees and counter-guarantees⁴² on SME^{43,44} loan portfolios⁴⁵ and resulting average guarantee size in 2014⁴¹ by country

	Guarantee and counter-guarantee activity			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
B'nia-H'vina	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	18,139,70	742,744	24.4	17,281,48	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	33,399,70	1,057,470	31.6	20,078,00	941,075	21.3	13,321,70	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	65,684,23	2,467,294	26.6	14,769,36	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 31.⁴⁶ According to the OECD (2013), guarantees are particularly relevant “in those countries where a network of local or sectoral guarantee institutions is well established”. The guarantee activity in

⁴² In Romania and Slovenia, some AECM members provide counter-guarantees to other AECM members; in these cases, the summing-up of guarantee and counter-guarantee activities leads to a double-counting of the underlying guaranteed loans. However, for consistency of the data shown in the table, these were not cleaned accordingly.

⁴³ In the case of France, the counter-guarantee data consist exclusively of co-guarantees.

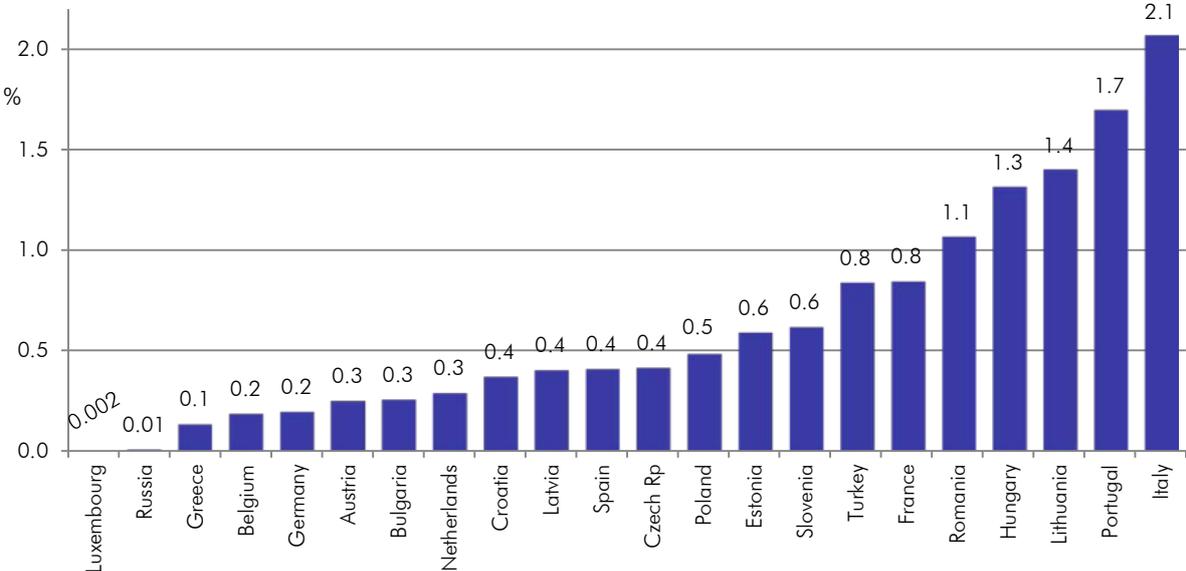
⁴⁴ Partly the data covers also non-SME related areas such as regional infrastructure and municipality financing. In the case of Austria, project-related guarantees, which can also cover non-SME financing, are included since 2014.

⁴⁵ In 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.

⁴⁶ Here and in the following, all figures include guarantee, counter- and co-guarantee activities.

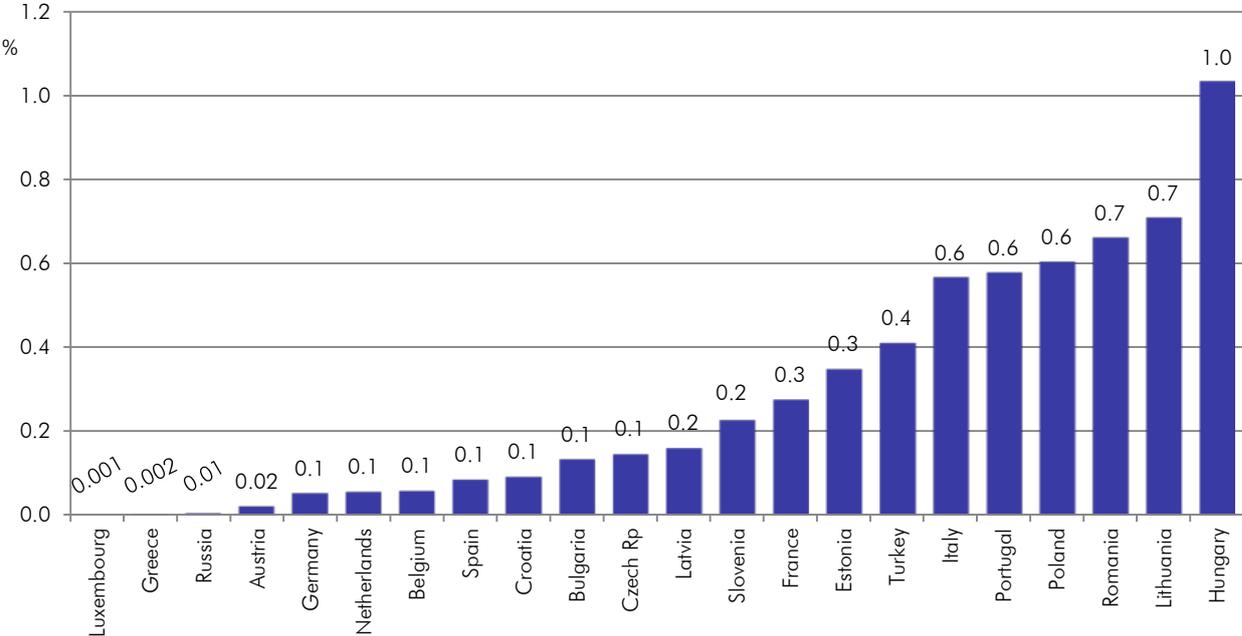
2014 was strongest, related to GDP, in Hungary, Lithuania, Romania, Poland, Portugal and Italy (see Figure 32).

Figure 31: Volumes of outstanding guarantees in portfolio scaled by GDP, 2014 data



Source: AECM (provisional figures)

Figure 32: Volumes of guarantees granted in 2014 scaled by GDP



Source: AECM (provisional figures)

5.1.3 Market activity in 2015⁴⁷

New guarantee issuance by AECM members has considerably increased in the first half of 2015. The amount of new guarantees granted increased by 6.1% compared to the previous half year to EUR 10.5bn, while the number of new guarantees⁴⁸ increased by 3.7% to 231k (see Table 5). Hence, the average size of new guarantees issued increased to EUR 45.4k, which was even larger than the average size of outstanding guarantees in portfolio.

Those countries with generally high guarantee activities also recorded substantial positive growth rates in the first half of 2015. Germany was the only exception (–12.6% in the total amount of new guarantees), which could be partially due to the relatively favourable financing conditions, and limited need for guarantees, following the large increases in guarantee demand observed during the crisis years of 2009-10 (VDB, 2012). The highest positive growth rate in the total amount of new guarantees was observed in the Czech Republic (+103% to EUR 157m) thanks to a new public guarantee programme, which is offered free of charge (AECM, 2015).

According to AECM (2015), several factors induced this development, such as an increase in the loan sizes that are underlying the guarantees, but also the cessation of a “small start-ups” support programme in France, which led to a higher average guarantee size. Contrary to the generally positive development, some AECM members recorded a decrease in their guarantee activities. The effect of the entry of one new AECM member into the AECM statistics in 2015/H1 is negligible, as this member’s activity figures accounted for only 0.05% of the total AECM new guarantee activity amounts.

Table 5: New guarantees granted per half year

	Amount [k EUR]	Number	Average guarantee size [k EUR]	Number of SME beneficiaries	Average guarantee per SME beneficiary [number]	Average guarantee per SME beneficiary [k EUR]
2014/HY1	9,991,088	230,855	43.3	201,355	1.15	49.6
2014/HY2	9,881,043	222,945	44.3	182,986	1.22	54.0
2015/HY1	10,487,663	231,103	45.4	198,062	1.17	53.0

Notes: Numbers of AECM members included: HY1/2015: 33, HY2/2014: 32, HY1/2014: 32. For one member, the half-yearly numbers of new SME beneficiaries in 2014 were estimated by AECM. Two associated AECM members do not have any guarantee activity at all.

Source: *Own calculations based AECM provisional figures*

⁴⁷ All information contained in this section is based on preliminary AECM data for those member organisations that reported their business activity figures to AECM for the first half of 2015.

⁴⁸ According to AECM (2015), interpretation is more straightforward for the number of guarantees than for the number of SME beneficiaries, due to technical items that have influence on the data brought forward by members presenting the population of beneficiaries such as changes in accounting methods, data management, and definition of beneficiaries.

5.1.4 EIF's role and recent developments

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

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 funds⁴⁹ 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 October 2015, 20 agreements have been signed in 13 different countries enabling SME financing up to EUR 5.3bn. 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 2007-2013.⁵⁰ Until June 2015, more than 373,000 SMEs were supported under CIP SMEG, and 72 agreements with 55 intermediaries were signed in 24 countries. The loan amount that CIP SMEG has so far generated for SMEs was in the order of EUR 19.9bn.

The InnovFin SME Guarantee Facility is part of “InnovFin – EU Finance for Innovators”, an initiative launched by the EC and the EIB Group in the framework of Horizon 2020. EIF, acting as the implementing body, covers a portion of the losses incurred by the financial intermediaries on loans, leases 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 October 2015, 25 agreements have been signed in 15 different countries enabling SME financing up to approximately EUR 3.2bn. 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 was an

⁴⁹ See Kraemer-Eis (2014) for more information on institutional non-bank lending and the role of Debt Funds.

⁵⁰ Source: EIF. For more information on the COSME LGF see http://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/index.htm. For more information on the CIP SMEG see http://www.eif.org/what_we_do/guarantees/cip_portfolio_guarantees/index.htm.

EIF/EIB/European Commission joint pilot guarantee scheme that aimed at improving access to debt finance for innovative SMEs and small mid-caps. RSI had been launched in 2011 and was speedily introduced to financial intermediaries with absorption and deployment to SMEs following swiftly. As of October 2015, 40 operations (including 4 increases) with 36 different intermediaries in 18 countries had been signed, totalling approximately EUR 1.6bn, which enables SME financing of up to EUR 3.2bn. So far EUR 1.8bn of financing has effectively been provided to 3,292 SMEs and small mid-caps in 3,701 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 JEREMIE⁵¹. 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 the end of September 2015, the impact, based on these products, is about to reach a total SME portfolio originated of almost EUR 2.5bn (including both, debt and equity products).

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. 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

⁵¹ The 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 TT funds. For more information see: http://www.eif.org/what_we_do/resources/jeremie/index.htm

this new EU initiative, contributing an amount of EUR 800m 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 3.2bn of new SME financing will be supported under this programme in Spain (see EIF, 2015b)⁵². Moreover, the *Cultural and Creative Sectors guarantee facility* (under the Creative Europe Programme) is under development for roll-out in the first quarter of 2016. With an initial budget of EUR 122m, this facility will focus on enhancing access to finance for SMEs in the cultural and creative sector through the provision of guarantees to financial intermediaries, together with expert advice, in order to increase their understanding of the cultural and creative sectors.

Many of EIF's guarantee products are also available for leasing providers as leasing is an important financing tool for SMEs. In our last ESBFO issue, we summarised findings from a recent Oxford Economics (2015) study, which was prepared for Leaseurope, the European Federation of Leasing Company Associations. Leaseurope intends to complement the report by national case studies on SME leasing. Moreover, Leaseurope and EIF recently compiled an overview of EIF's guarantee instruments in a new fact sheet for the European leasing industry, which is available here: [http://www.leaseurope.org/uploads/EIF_2015%20factsheet_WEB\(singlepage\).pdf](http://www.leaseurope.org/uploads/EIF_2015%20factsheet_WEB(singlepage).pdf).

⁵² More information on the SME Initiative in Spain can be found here http://www.eif.org/what_we_do/guarantees/sme_initiative/smei_spain/index.htm.

5.2 SME Securitisation⁵³

This chapter is based on a recent working paper, specifically dedicated to SMESec. See for more details, in particular regarding the current regulatory environment and actions of the EIB Group: Kraemer-Eis, Passaris, Tappi and Inglisa (2015).

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

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

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

5.2.1 SMESec market activity⁵⁴

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 33). 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;⁵⁵ then the overall market activity decreased to the 2003/2004 levels, in particular due to regulatory uncertainties⁵⁶ and tighter euro system collateral rules. To date, public issuance is still hindered in particular by the regulatory framework (and

⁵³ The term SME Securitisation (SMESec) comprises transactions backed by SME loans, leases, etc. It is important not only to look at banks/lending when analysing SMESec, but equally at leasing companies, which form part of the securitisation market. Given that bank financing is and will be less available for leasing companies post-crisis, it can be expected that SMESec will be particularly relevant in the leasing area. For more information on the importance of leasing for SMEs finance, see Kraemer-Eis and Lang (2012 and 2014).

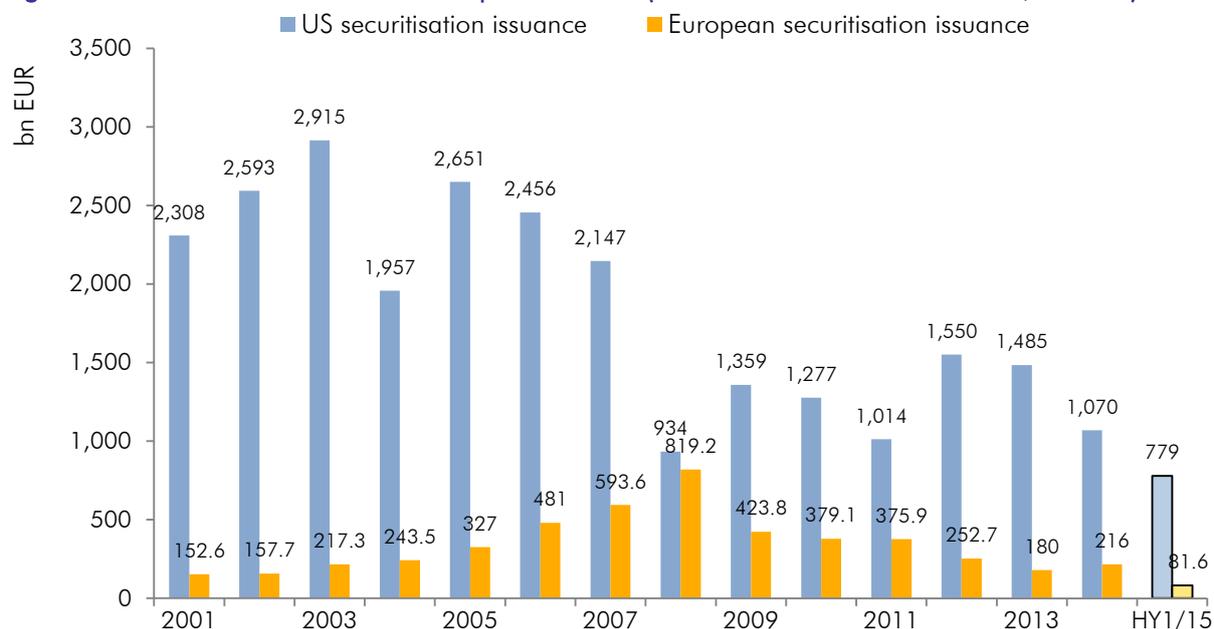
⁵⁴ If not flagged otherwise, the data source is AFME, the Association for Financial Markets in Europe (i.e. AFME, 2015).

⁵⁵ The ECB’s asset repurchase or “repo” facility allows (among other assets) Asset Backed Securities to be used as collateral for funding.

⁵⁶ See for details concerning the regulatory developments e.g. Wehinger and Nassr (2015) and Segoviano, Bradley, and Lindner (2015).

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)).

Figure 33: Securitisation issuance Europe versus US (annual issuance 2000 - 2015, bn EUR)



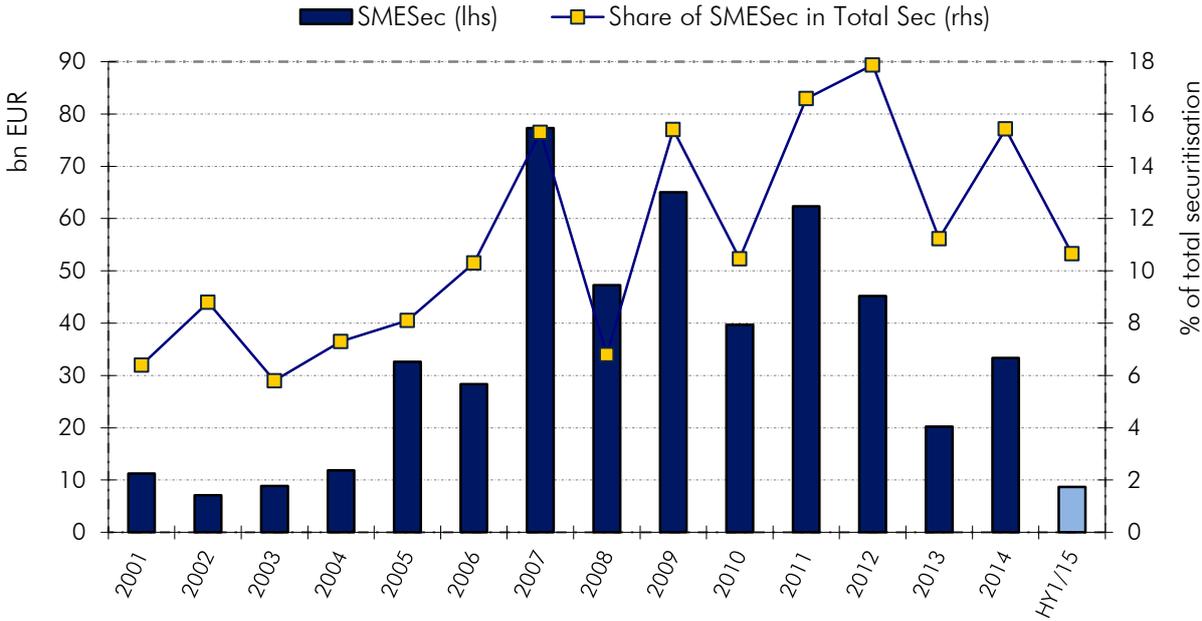
Source: Authors, based on data from AFME/SIFMA

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 2015, so far (HY1), UK (23%), Spain, the Netherlands (both slightly below 17%), and Italy (12%) were the most active countries. In line with the shrinking volumes, the number of active market participants is also declining: there are a reduced number of active securitisation professionals, i.e. at investors, issuers, rating agencies, agents and brokers (Bank of America/Merrill Lynch, 2015a).

Issuance

SMESec issuance is still suffering from the crisis, however the overall issued volume of SME deals in 2014 (EUR 33.3bn) was significantly higher than in 2013 (see Figure 34) – but the issuance in HY1/2015 (EUR 8.7bn) was significantly lower than in the same period the year before (EUR 19.3bn). The market share of SMESec in overall securitisation issuance rose (with some volatility) from 6% in 2001 to 18% (of total yearly issuance) in 2012, the highest value ever registered in Europe. This, however, came about due to the base effect, as the overall activity went down (while SMESec activity decreased slightly less). In 2014, the share of SMESec was 15% - and so far 10.7% in 2015 (HY1). During the crisis, also the large volumes of synthetic SMESec transactions, that were evidenced pre-2007 on SME portfolios dominated primarily by German SMEs on the back of KfW's PROMISE program, virtually disappeared (we go more into the details of synthetic securitisations later on). 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 34: SMESec issuance in Europe (volume and share of total securitisation, bn EUR and %)



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

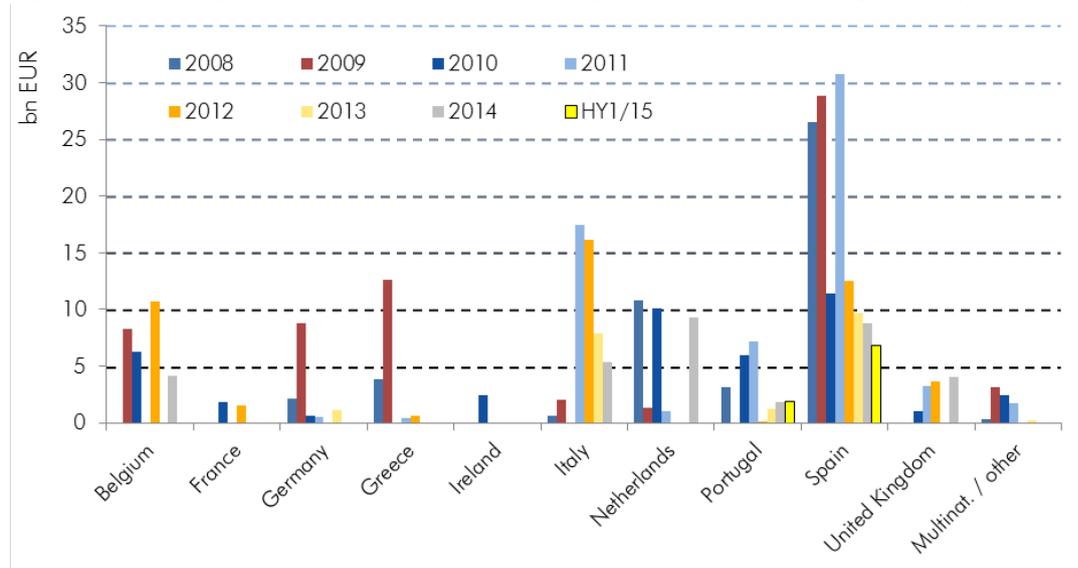
In terms of countries, the market activity is concentrated: The SME related issuance in 2014 occurred only in the Netherlands (EUR 9.3bn, 28% of SME issuance), Spain (EUR 8.8bn, 26%), Italy (EUR 5.3bn, 16%), Belgium (EUR 4.1bn, 12%), UK (EUR 4bn, 12%) and Portugal (EUR 1.8bn, 5%) – see as well Figure 35 for an overview of the SMESec issuance by country during the crisis. In HY1/2015, market activity happened only in Spain and Portugal.

However, it has to be noted that the AFME data, used above and in many of the following figures, classifies only *lending*-based transaction in the SME basket. Most leasing-based transactions, classified in AFME’s data under ABS Leases in the overall ABS basket, are de-facto SME transactions. Hence, the numbers shown here are an underestimation of the SMESec market size. A recent example is ALBA 7, an EUR 785m securitisation transaction of leases to Italian SMEs, originated by Alba Leasing. This SME transaction was successfully issued into the capital market in April 2015 (with the support of the EIB Group), but is - in terms of statistics - registered in the ABS basket. This example shows that the real volumes of SME transactions are higher and the country coverage is wider than revealed in the official data.

Typical originators are large banks or banking groups – some of them are active as originators in several countries (e.g. UniCredit, Raiffeisen, ING Group), but as well mid-sized banks. Moreover, in particular in the field of leasing, non-bank asset finance providers are active as originators; for instance, Alba Leasing in Italy and the small and medium size asset-finance providers in the UK which are the primary target recipients of the British Business Bank ENABLE program.⁵⁷

⁵⁷ See for more information e.g. <http://british-business-bank.co.uk/become-a-partner/wholesale-solutions/>

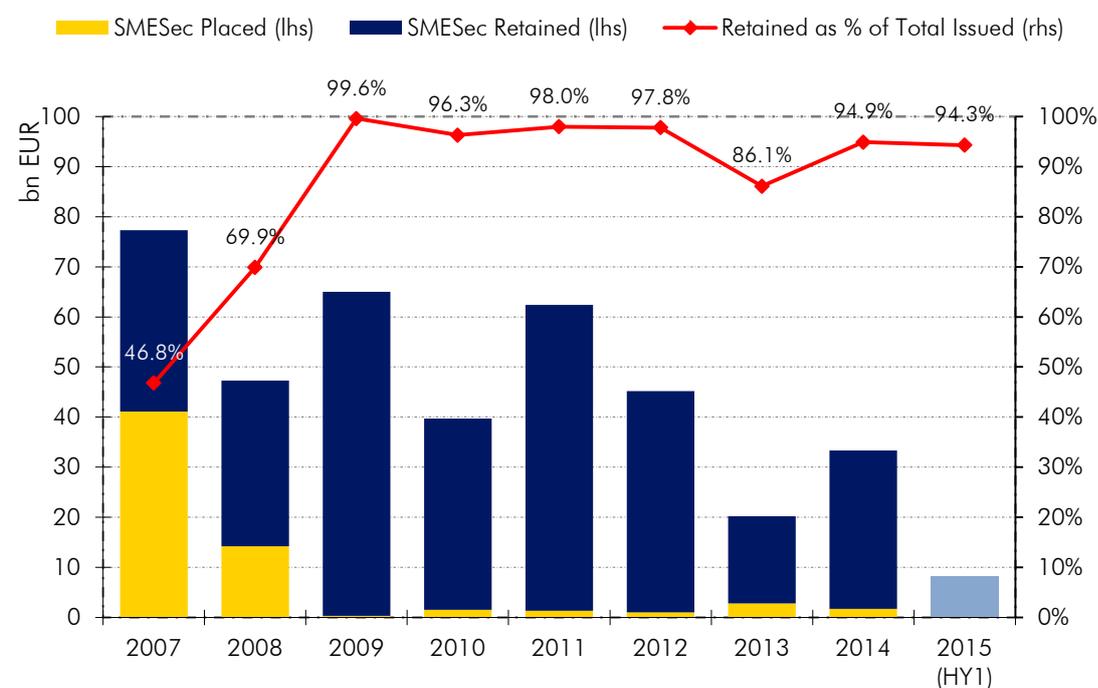
Figure 35: European SMESec issuance in Europe during the crisis (by country, in bn EUR)



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 36): 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.

Figure 36: European SMESec by retention (bn EUR and %)

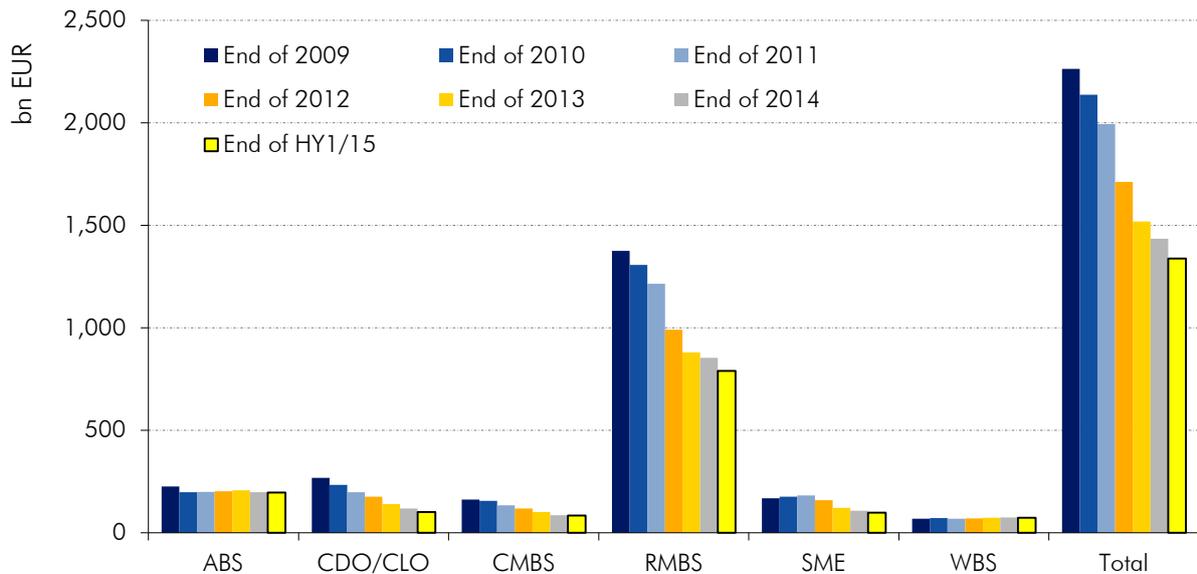


Source: Authors, based on data from AFME

Outstanding

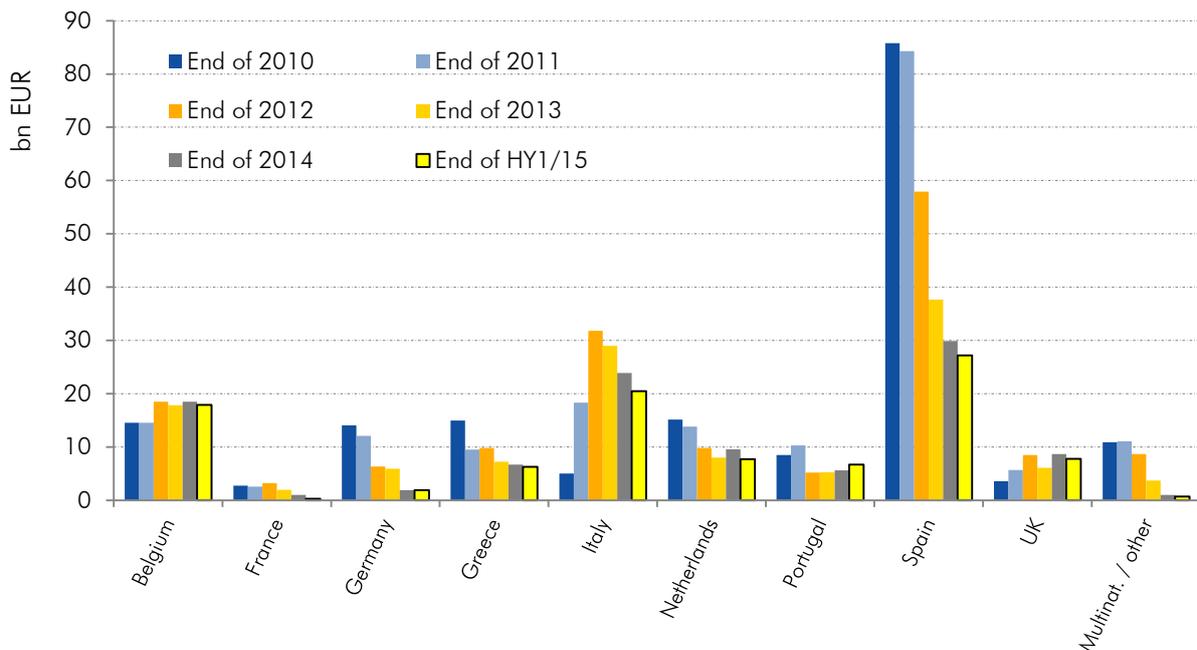
Due to low new activity levels, the volume of *total outstanding securitisation transactions* (see Figure 37) is on a downward trend (negative net supply). Compared to the end of 2014, until end of HY1/2015, the total outstanding decreased by another 6.4%. Since the end of 2009, the volume of total outstanding securitisation transactions decreased by 41%. During the same period, the volume of outstanding SMESec transactions decreased by a similar magnitude (by 42%), from EUR 168bn to EUR 97bn.

Figure 37: European outstanding securitisation transactions by collateral (bn EUR)



Source: Authors, based on data from AFME

Figure 38: European SMESec outstanding volume by country (bn EUR)



Source: Authors, based on data from AFME

If SMESec volumes per end of HY1/2015 are broken down by country (see Figure 38), the Spanish (28%) and Italian (21%) markets together count for almost half of the overall outstanding - despite decreasing volumes - followed by Belgium (18%), the Netherlands, and the UK (each almost 8%).

In the event that framework conditions for securitisation improve, there is also significant potential for SMESec transactions. Altomonte and Bussoli (2014) - for example - estimate a potential securitisation volume of EUR 325bn of SME ABS – spread mainly over the main markets Spain (19%), France, Germany (17% each), Italy (14%), Portugal (7%), Ireland (6%) and the rest of Europe (22%). Their estimate is predicated on the current outstanding loan volumes, adjusted by several “haircuts” based on different eligibility parameters.

SMESec performance trends

Despite the financial and sovereign crisis and the prolonged negative economic cycle, the European securitisation market in general has performed relatively well with comparatively low default rates.⁵⁸ The low losses are not only based on the typically high granularity, diversification and seasoning of these transactions, but also on the structural features (such as large credit enhancement) that helped counterbalance the negative effects of the deteriorating European economy (i.e. increased SME default rates).

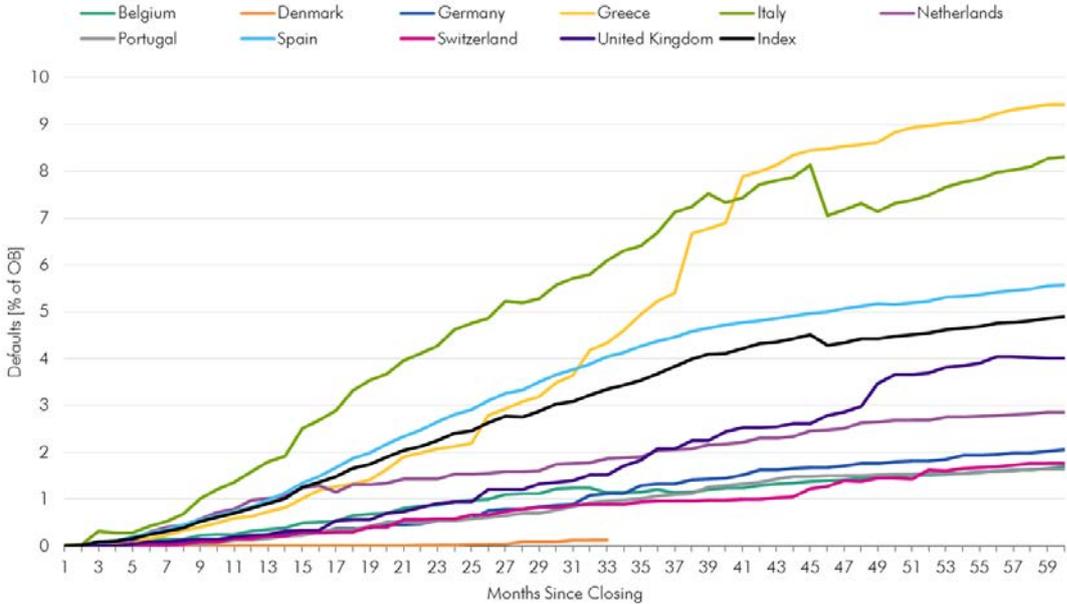
The track record of SMESec in Europe is relatively limited: the market started only towards the end of the 1990s – at the time, this segment was relatively unknown to investors and rating agencies (based on the novelty of the applied tools, but as well based on the heterogeneity of SMEs/SME loans), and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

On the one hand, before the crisis started, SMESec volumes were small compared to the overall securitisation market – and the market had not had much time to develop. On the other hand, the limited track record was one of the reasons for the relatively conservative SMESec structures which could explain the relatively good SMESec performance in Europe compared to other segments of the European securitisation market and to the US.⁵⁹ Figures 39 and 40 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).

⁵⁸ With some exceptions, i.e. the non-granular hybrid transactions (German Mezzanine CDOs). For more details see Kraemer-Eis, Passaris, and Tappi (2013).

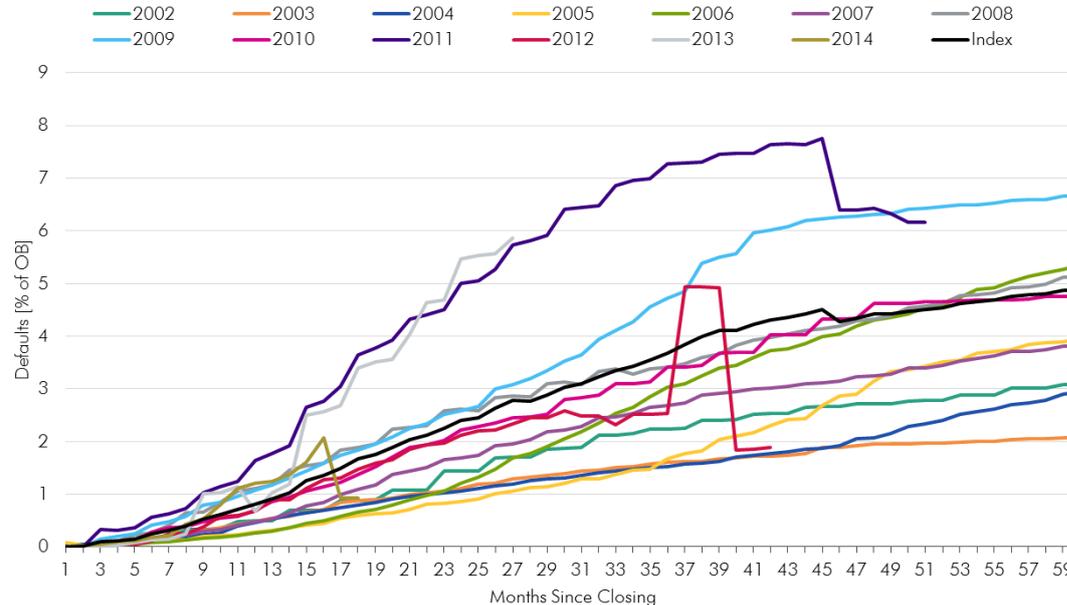
⁵⁹ According to Standard & Poor's (2014), only 1.58% of European Structured Finance notes (rated by Standard & Poor's) outstanding in mid-2007 had defaulted by mid-2014. The cumulative default rate for SMESec transactions was at 0.55% – for comparison: the cumulative default rate for US Structured Finance notes was at 19.3%, the one for CDO of ABS was at 41.08%. See also EBA (2014) for an analysis of historical credit performance of the securitisation market. It is sometimes stated that securitisation might lead to higher risk taking by banks (or lower lending standards). This is neither confirmed by performance data, nor by research. In a recent study, Kara, Marques-Ibanez, and Ongena (2015), analysing data from the euro-denominated syndicated loan market, found out, that in the run up to the financial crisis, banks, relying on securitisation, did not lower their lending standards more than other institutions.

Figure 39: EMEA ABS SME loan and lease cumulative credit events or defaults on original balance (seasoning by country)⁶⁰



Source: Moody's (2015)

Figure 40: EMEA ABS SME loan and lease cumulative credit events or defaults on original balance (seasoning by vintage)



Source: Moody's (2015)

⁶⁰ Terminated transactions are included in the index calculation, hence here “cumulative” curves can show as well a drop. Moody’s believes that this information must be included for an accurate representation of trends over time. Additionally, Moody’s notes show that vintage seasoning charts might move unexpectedly for the last few data points, because transactions start at different points in time within a vintage and, hence, some transactions may be more seasoned than others. The index includes only the transactions rated by Moody’s.

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

The rating transition data shows that the downgrade pressure for SME transactions persists across all tranche levels. The example below (Table 6) shows the rating migration of SME Collateralised Loan Obligation (CLO) transactions (rated by Fitch, migration since transaction closing). For example, of all the tranches initially rated AAA, 57% (by number⁶¹) have paid in full (pif), 11% are still AAA, 11% moved down to AA etc. Meanwhile, there has been very limited upgrading, but no tranche was upgraded to AAA.

Table 6: Fitch European SMEs Rating Transition Matrix (December 2015)⁶²

% of tranches		Current rating									
		PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf
Initial Ratings	AAAsf	57%	11%	11%	14%	4%	0%	1%	0%	0%	0%
	AAsf	34%	3%	41%	6%	3%	3%	9%	0%	0%	0%
	Asf	13%	0%	29%	32%	0%	13%	8%	3%	0%	3%
	BBBsf	6%	0%	3%	9%	13%	16%	13%	6%	28%	6%
	BBsf	0%	0%	0%	0%	0%	31%	25%	6%	25%	13%
	Bsf	0%	0%	0%	33%	0%	67%	0%	0%	0%	0%
	CCCsf	0%	0%	0%	0%	0%	0%	22%	0%	33%	44%
	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)

5.2.2 Final remarks

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

⁶¹ Relative to the number of tranches in a given initial rating category.

⁶² The addition sf indicates a rating for structured finance transactions.

Integrated EU capital markets (and their need for transparency and standardisation) and the relative complexity of securitisation techniques require considerable know-how and show the necessity for specialised institutions. As an established and respected player in the European market, EIF can play a role via market presence, reputation building, and signalling. Its securitisation activities, as well as initiatives and latest developments are explained in detail in Kraemer-Eis, Passaris, Tappi and Inglisa (2015). One example of these latest developments is described in Box 7.

Box 7: A potential securitisation platform in the context of the Investment Plan for Europe

In the context of EFSI⁶³, the EIB Group and various National Promotional Institutions (NPIs) are working on a concept to design a joint securitisation platform. The working group aims at defining a platform that will allow national and multilateral promotional institutions as well as potentially other public sources (as for example resources from the European Structural and Investment Funds, ESIF) to offer interested originators (in particular, banks and leasing companies) a common framework of parameters to support their securitisation transactions. There is also value in common definitions of the promotional institutions’ requirements, for example definitions of target group (SME definition), portfolio requirements, pricing conditions, timeframes and reporting requirements. However, whilst most benefit would come from a pan-European approach, the different mandates of NPIs may require a differentiated approach.

There are no reasons to limit the scope of the proposed instrument’s objective (funding, capital relief, reduction of portfolio concentration and deconsolidation) or structure (true sale vs. synthetic) as long as SME lending is stimulated and the transactions are compliant with NPIs’ mandates and internal guidelines on acceptable risk. NPIs, EIF/EIB and private investors can take on different roles in securitisation transactions corresponding to their individual mandates and risk appetite. A hypothetical example is shown in Table 7.

Table 7: Example for a potential tranching/risk sharing

	Potential Investor Group
Senior Tranche	private investors
	NPIs
	EIB EIF
Mezzanine Tranche	private investors
	NPIs
	EIF EFSI or other public funds
Equity Tranche	private investors
	other public funds (e.g. ESIF)

Source: EIF

⁶³ As part of the Investment Plan for Europe, the European Fund for Strategic Investments (EFSI) aims to unlock investment by addressing market gaps and mobilising private resources. The so called EFSI SME window is being implemented by the EIF through guarantee and equity agreements between the EIF and financial intermediaries signed in 2015-2018. The financial support must be additional to what would have been delivered under the existing and already foreseen programmes in the period 2015-2018. For more information please see the concluding remarks of this paper (chapter 7) as well as http://www.eif.org/what_we_do/efsi/index.htm.

Box 7 continued:

In general, participation of national and multilateral promotional banks should aim to strengthen and stabilise the investor base for SME securitisations in Europe. In recent years, most transactions have been structured for funding purposes with a most parts of it retained for ECB repo. In order to transfer risk efficiently and/or to achieve reasonable balance sheet management, a transfer of the whole portfolio or at least mezzanine and junior tranches to the market is necessary. This includes especially the equity tranche, since otherwise there would be no deconsolidation.

Private investors are willing in principle to invest in SME securitisations. However, small market volume often does not allow build-up market know-how in a cost-efficient way. Furthermore, spread levels required by investors are often unattractive for originators (both compared to funding alternatives as well as for capital release purposes). The number of investors willing to take mezzanine and equity risk is particularly restricted, with a large proportion coming from outside Europe. These investors are yield-driven and sometimes opportunistic, therefore not providing a stable investor base. In addition, the costs of capital release often prevent banks using securitisation for that purpose. Public intervention from NPIs and EIF/EIB is needed to revive and stabilise the market. However, most of these promotional institutions are currently either inactive in the securitisation markets or restricted with respect to the credit risk they are allowed to take. EFSI and other public funds' participation in mezzanine and especially equity tranches, can provide the catalytic effect for an increase in the current size of the market.

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

In November last year, the ECB started its Asset Backed Purchase Programme (ABSPP)⁶⁴. 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 31.10.2015, EUR 14.577bn have been bought by the ECB (mainly in the secondary market (71%)), compared to around EUR 131.144bn under the Covered Bond Purchase Programme (source: ECB⁶⁵). Even though ECB's activity in the primary market recently started to rise, the overall market impact of the ABSPP is so far limited. On 10.09.2015, the ECB clarified its intention to buy mezzanine tranches of European ABS with an eligible third party guarantee. However, the ECB's requirement of a *guarantee on demand* ("The guarantee shall be payable on first demand independently of the guaranteed marketable asset or credit claim") leads for guarantors to a gap between their payment obligation to ECB (on demand) and the receipt of payment from the

⁶⁴ See our previous ESBFO for a summary, see as well for more information Möglich, 2015 (in German), or Bank of America/Merrill Lynch, 2015b.

⁶⁵ <https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html>.

mezzanine ABS tranches (see as well Bank of America/Merrill Lynch, 2015c). This feature limits the number of potential guarantors significantly since a wrap of this sort would not be a market standard.

As described above, even 7 years after the start of the financial crisis, the European SMESec has still not recovered. Unbalanced regulation is still to be seen as the main impediment. We provide an overview over latest developments in Kraemer-Eis, Passaris, Tappi and Inglisa (2015) and do not go into details here. Most individual proposed regulations make sense on a stand-alone basis, but negative spill-overs from an non-holistic approach lead to unintended consequence that hinder a market development. Originators and investors need to have certainty and clarity. Short and medium term perspective, reasonably defined criteria for high quality securitisations HQS (incl. SMESec) - which should comprise of structures that are simple, transparent and efficient and which should receive preferential regulatory treatment - could be a way out of this dilemma.⁶⁶

The EIB Group, leveraging on the structured finance capabilities of EIF, has engaged in providing responses to several consultations aiming at testing market's sensibility in respect of high quality securitisation. The response to "Criteria for identifying simple, transparent and comparable securitisations" published by BCBS-IOSCO provides an exhaustive summary of our view on this topic⁶⁷. The fog around the future regulation design is lifting – which is good in order to reduce the respective uncertainty. We note that the approach likely to be steering the forthcoming regulation suggests a "light" set of high quality criteria, which in turn translates in a marginal (rather than substantial) reduction in the risk-weights. Concerning the forthcoming Capital Requirements Regulation, in our opinion, more could be achieved with a view to both increasing the breadth of the market for synthetic transactions, and to reduce the overall reliance on rating agencies, especially in respect with a view to establishing level playing field among different asset classes and funding instruments.⁶⁸

At the Ecofin Council meeting of the 08th December 2015, Ministers confirmed an agreement reached by the Coreper⁶⁹ on proposals aimed at facilitating the development of a securitisation market in Europe. A framework for securitisation is seen by the Council as the first major building block of the EU's plan, launched during 2015, to develop a fully functioning capital markets union by the end of 2019.⁷⁰ This confirms the recognised important role of securitisation and in particular SMESec. Moreover, in our opinion, it confirms as well EIF's efforts to revive the SMESec market. Overall, the EIF - and the EIB Group as a whole – has been supporting SMESec already since many years and continues to do so. Details regarding the interventions can be found in Kraemer-Eis, Passaris, Tappi, and Inglisa (2015).

⁶⁶ We use here HQS as term – in the current discussion, also other terminologies are used in the same context, e.g. STS (simple, transparent, and standardised) securitisation, used e.g. by the ECB, or STC (simple, transparent and comparable) securitisation, used by BCBS-IOSCO, or SST (simple, standard and transparent) securitisation, used by the European Banking Authority. September's proposed regulation published by the European Commission suggests that the STS acronym will prevail in European regulation.

⁶⁷ EIB Group's response is available at the consultation's web page:

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

⁶⁸ See Council of the EU (2015).

⁶⁹ Permanent Representatives Committee: <http://www.consilium.europa.eu/en/press/press-releases/2015/12/02-capital-markets-union-securitisation/>

⁷⁰ See: http://www.consilium.europa.eu/en/meetings/ecofin/2015/12/st15068_en15_pdf/

6 Microfinance market

6.1 What is Microfinance?

“Microcredit is generally recognised [...] as an effective financing channel for job creation and social inclusion, which can attenuate the adverse effects of the current financial crisis while contributing to entrepreneurship and economic growth in the EU” (European Commission, 2012b). In Europe, microfinance consists mainly of small loans (less than EUR 25,000) tailored to microenterprises (93% 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 8):

Box 8: What is “micro”?

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

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

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

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

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

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

EIF has 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.

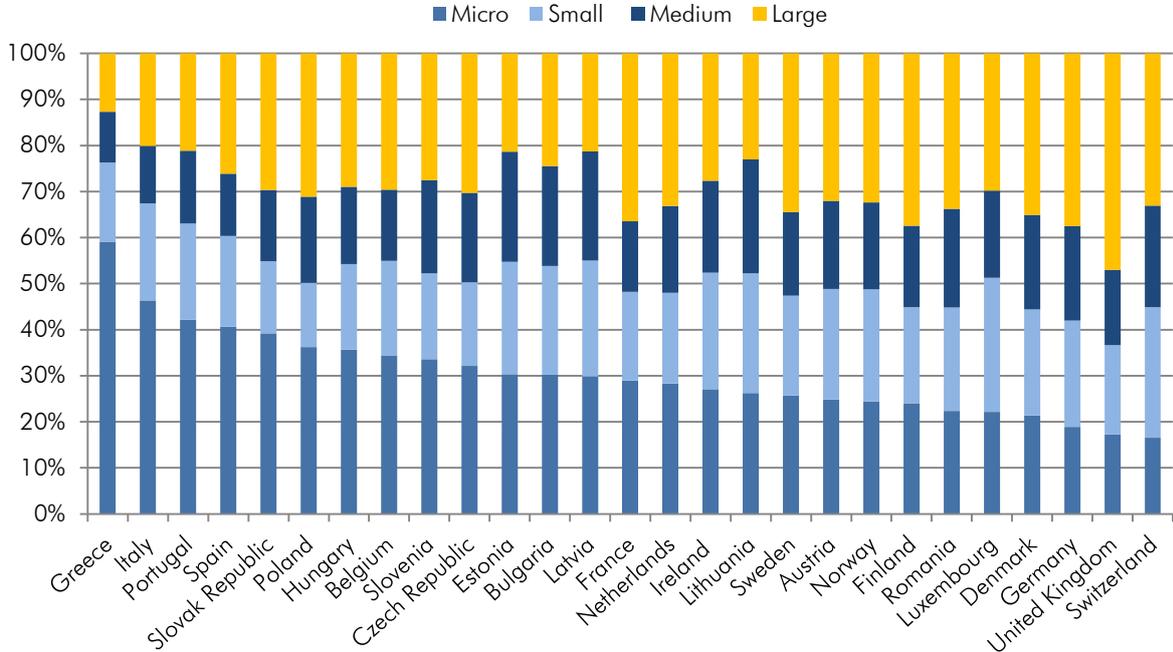
6.2 Overall situation and demand-side perspectives

The role of microfinance is seen differently across Europe. In Western Europe, microfinance serves the bottom of the pyramid, financially excluded population whose businesses do not seem commercially attractive for the mainstream financing providers but they are able to create certain social values. While in Eastern Europe microfinance targets potentially successful micro-enterprises that are financially excluded because of the underdeveloped credit market. Microfinance in Western Europe is mainly a social policy tool, while in Eastern Europe it is more of a business activity (Gloukoviezzoff, 2015). Because of the heterogeneity in the interpretation of microfinance across Europe, standardised, regularly available indicators to explain market developments for microfinance do not exist yet. 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

Microenterprises are important contributors to employment. Especially in the countries with high unemployment rates, micro-enterprises act as a driving force fostering job creation. In Spain, Portugal and Italy employment by microenterprises accounts for more than 40% of total employment and in Greece almost 60% (Figure 41).

Figure 41: Employment of microenterprises compared to other enterprise size classes, 2012

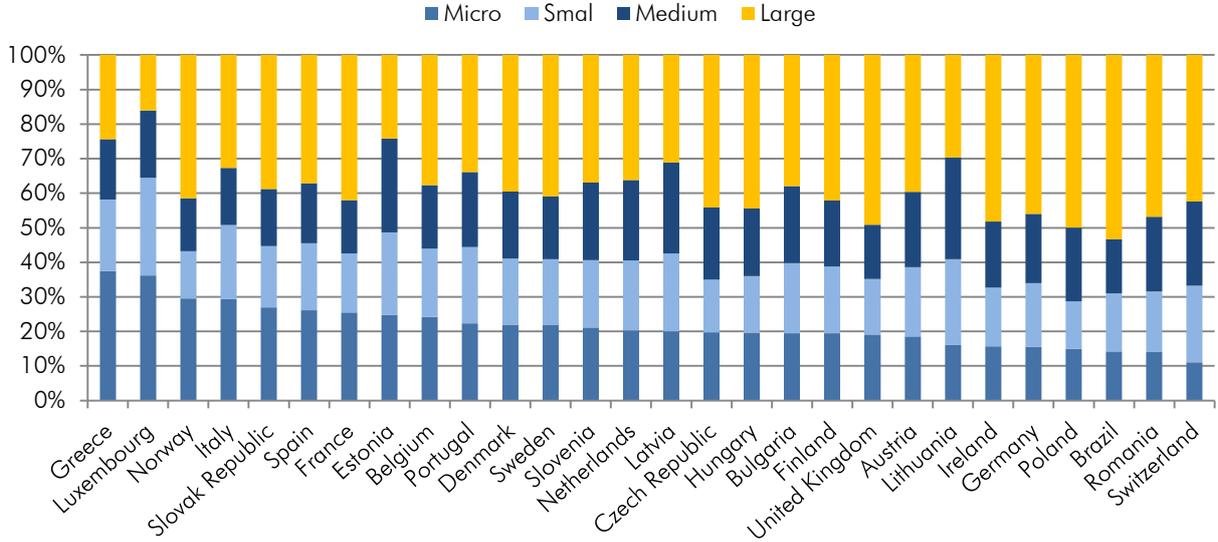


Source: OECD (2015b)

In terms of value added, Greek micro-enterprises also contributed the most among all other European countries. Overall, the share of value added created by microenterprises significantly

varies across the countries and very often it is higher than the share of value added created by larger SMEs (Figure 42).

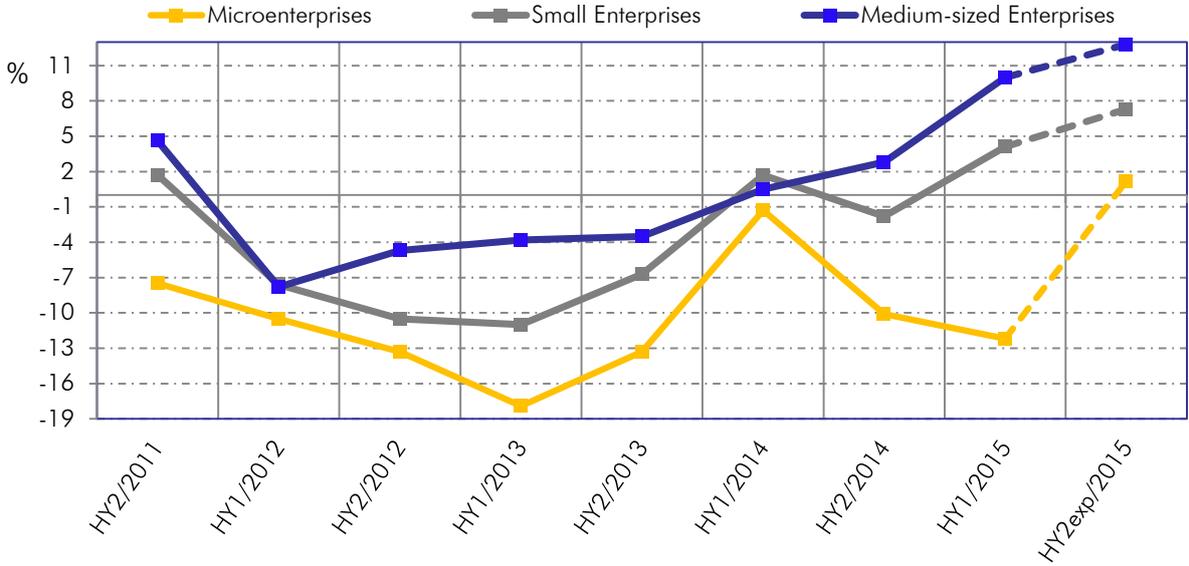
Figure 42: Value added by microenterprises compared to other enterprise size classes, 2012



Source: OECD (2015b)

For the second half of 2015, microenterprises, on balance, are expecting positive changes (1.2%) in their overall situation. This also holds true for employment and orders, while turnover and investments are expected to worsen in the second half of 2015. Despite some positive developments, microenterprises are expecting more difficulties than other SMEs.

Figure 43: Overall situation of European microenterprises compared to other size classes

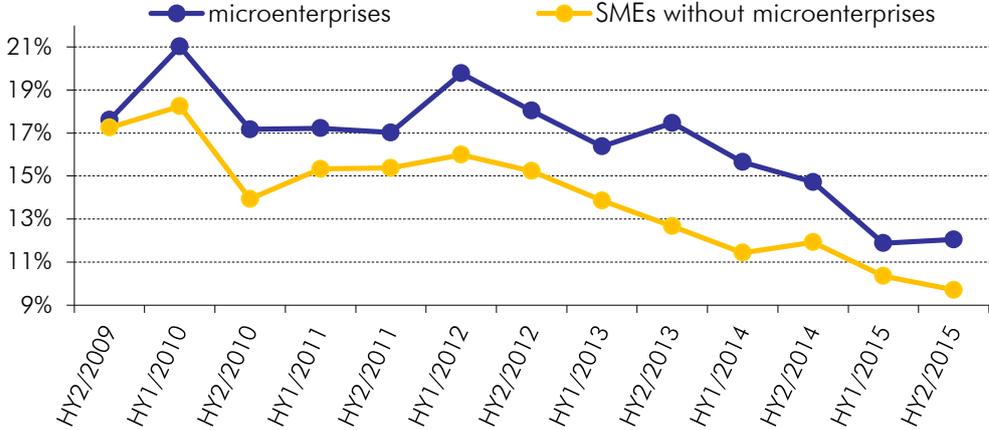


Source: UEAPME Study Unit (2015)

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 important problem increased and remained bigger among microenterprises than the share among other

SMEs (Figure 44). “Finding customers” remained the most frequently mentioned concern. The ECB (2015a) also reported a slight rise in bank loan rejection rates for microenterprises. The rejection rate is still the highest for microenterprises (13%), compared to 8% for small firms and 4% for medium-sized firms.

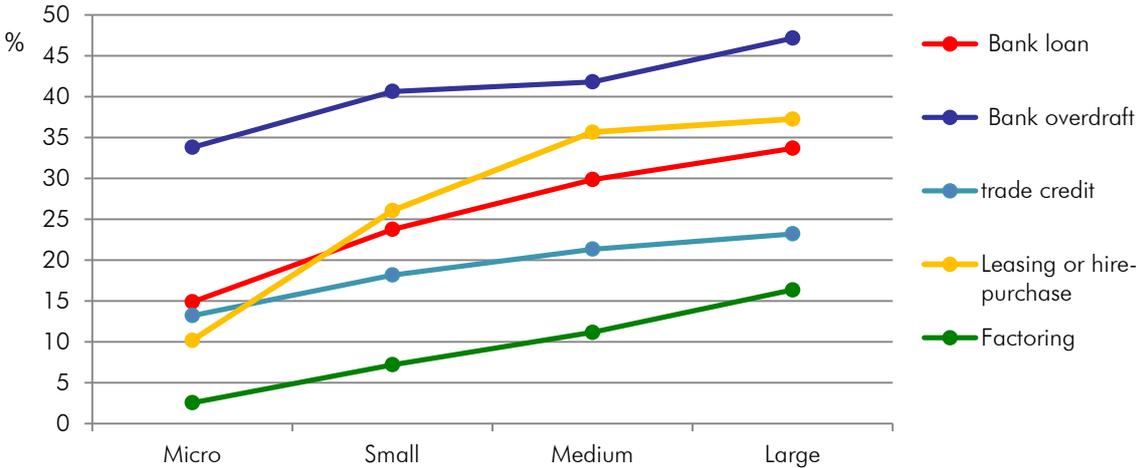
Figure 44: Share of enterprises reporting access to finance as their most important problem



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 45 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.

Figure 45: Different financing sources used by enterprises (by enterprise size class), 2015

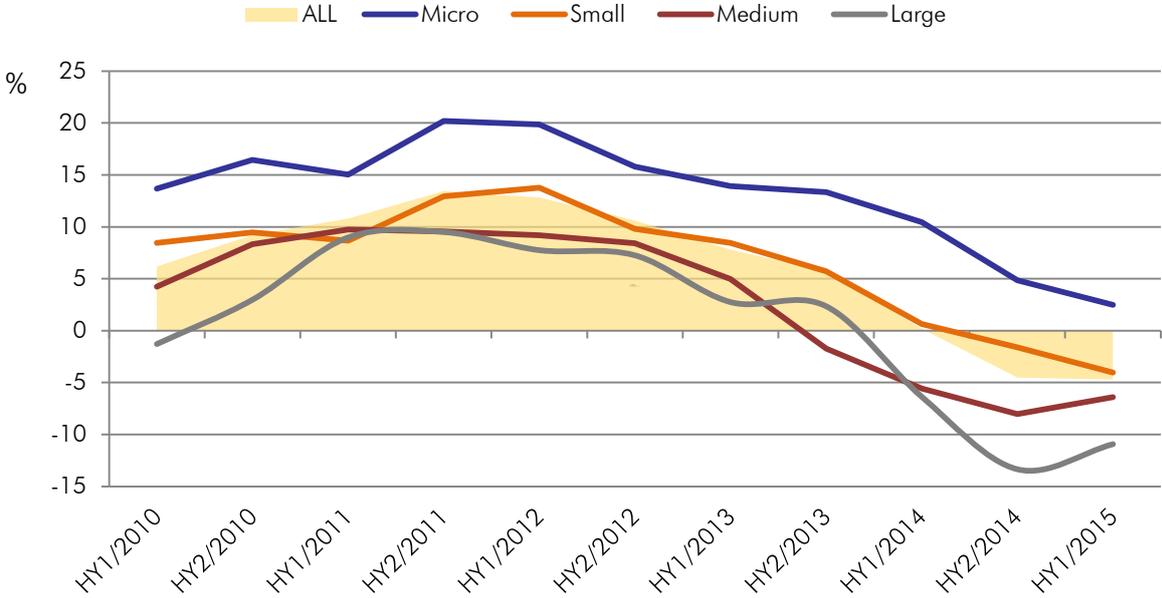


Source: Authors, based on ECB (2015a) data

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), (see chapter 3.2.1 for more on loan size and borrowing cost).

Further above (see chapter 3.2.3), we showed the perceived financing gaps, based on data from the ECB’s SAFE survey (ECB, 2015a). According to the same source, microenterprises still perceive an increasing gap in the external financing (2.5% down from +5% in the previous survey period), (see Figure 46).

Figure 46: Perceived change in the external financing gap (by firm size)



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

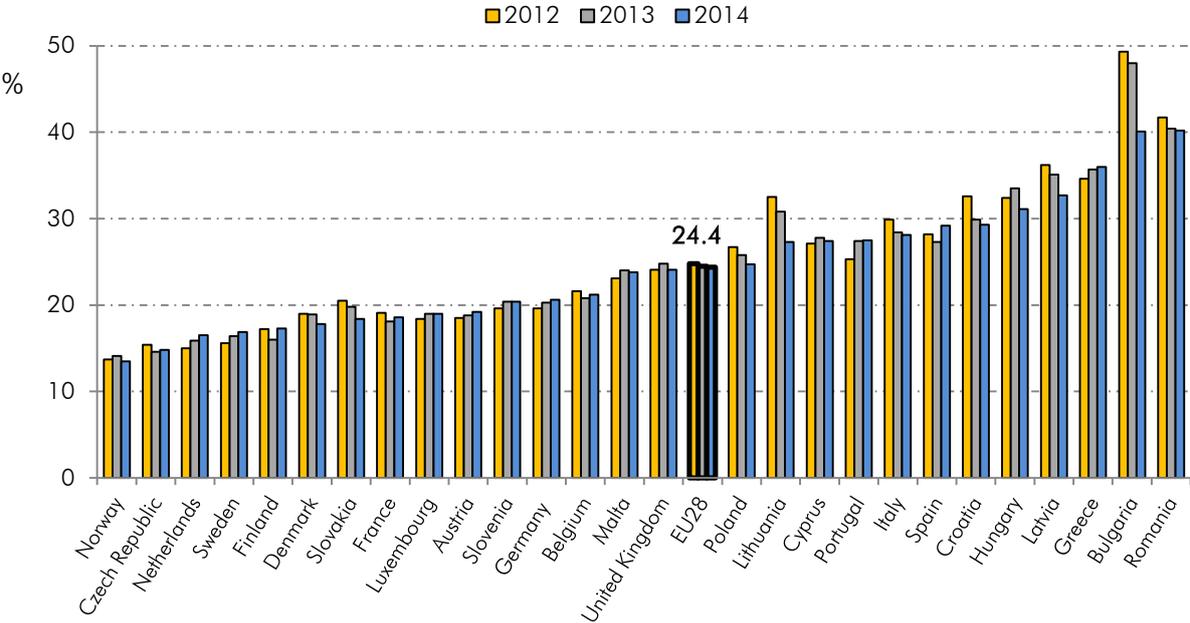
6.2.2 Necessity-driven business creation

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 47 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 2014 to 2013 and 2012, the situation became worse in many countries. Within the EU, the highest risks of poverty or social exclusion are recorded in Romania, Bulgaria Greece and Latvia. The countries on the right-hand side of the diagram includesome 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. 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

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=t2020_50

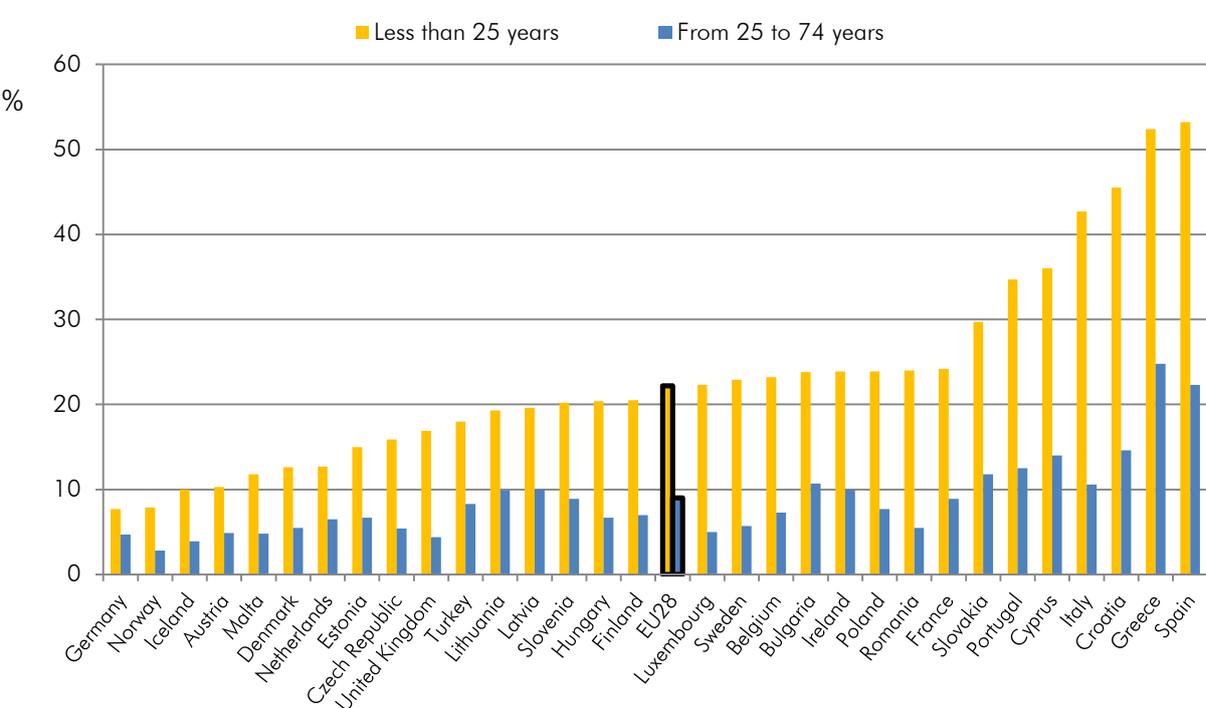
also play an important role. The majority of entrepreneurs start businesses to improve their economic situation (OECD, 2014a).⁷³

Figure 47: People at risk of poverty or social exclusion (percentage of total population)



Source: Authors, based on data from Eurostat

Figure 48: Unemployment rate by age groups, 2014



Source: Authors, based on data from Eurostat

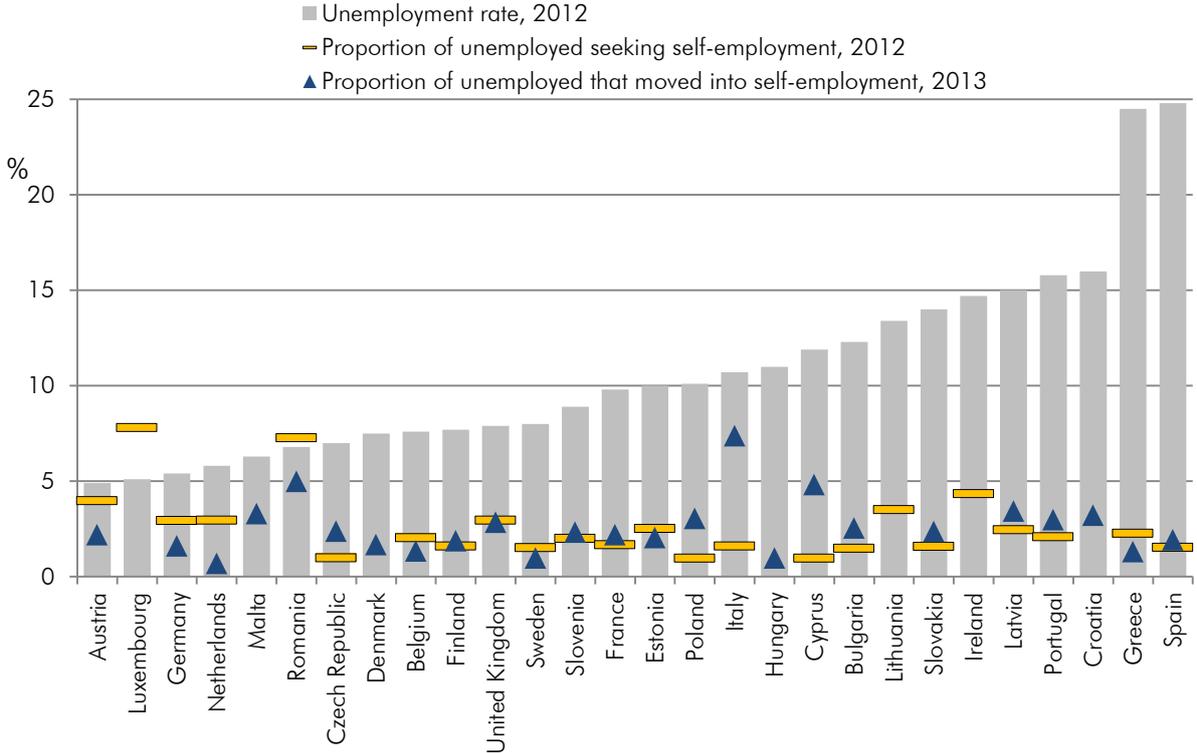
⁷³ According to the Eurobarometer Survey on Entrepreneurship (European Commission, 2012a), in most countries of the EU, the majority of self-employed people found dissatisfaction with their previous work very important in their decision to start a business.

Furthermore, unemployment is one of the main challenges in Europe (see Figure 48) – in particular youth unemployment; it increases the risk to be socially excluded and decreases not only current but also lifetime earnings. Self-employment - potentially supported by microfinance – could be a way out of unemployment (OECD/European Commission 2014).

Of the unemployed people in the EU in 2012, more than 685,000 (2.7%), successfully entered self-employment in 2013. Figure 49 reveals that in some countries there were more people entering self-employment in 2013 than there were people looking for self-employment in 2012. This indicates that some unemployed people were not planning but they were driven to start a business out of necessity. Regarding youth population, overall self-employment rates are increasing; however in some countries self-employment rates remain close to zero (OECD, 2015b, 2015d).

One of the significant barriers to starting a business for people at risk of poverty or for unemployed people is financial exclusion. “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).

Figure 49: Self-employment by the unemployed, 2013



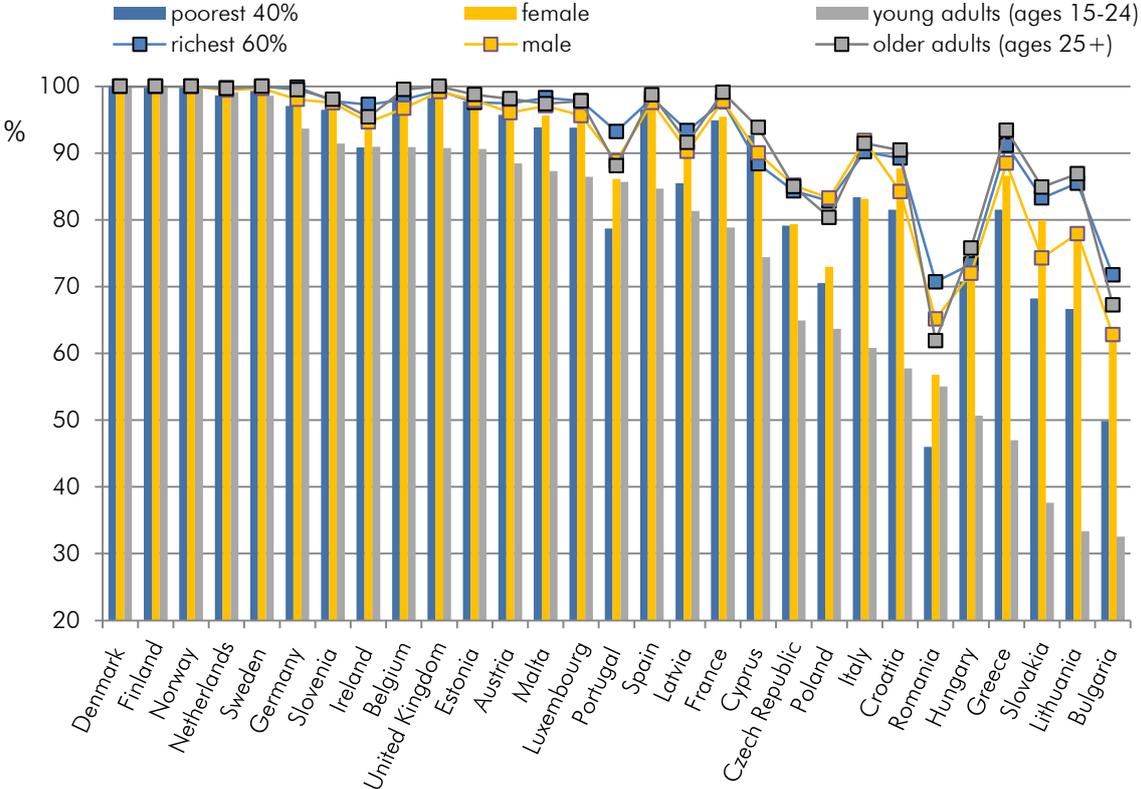
Note: Data for Ireland, Lithuania, Luxembourg, Hungary, Denmark, Croatia and Malta is partially missing.

Source: OECD (2015d), Eurostat

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 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, regardless of the social group they belong to, 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 (22%). In most of the countries, women reported lower account-holding rate than 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 percent in Lithuania, followed by Slovakia (47%) and Greece (46%), (see Figure 50).

Figure 50: The percentage of respondents who report having an account at a bank or another type of financial institution



Source: Global Findex Database

Financial exclusion is not the only barrier for unemployed people to seek for self-employment. Another reason why they do not start a business is lack of entrepreneurial skills. In most EU countries, the majority of people do not feel that they have enough knowledge and skills to start a business (OECD, 2015d).

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

6.3 Supply side

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

The latest EMN survey⁷⁵ 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).

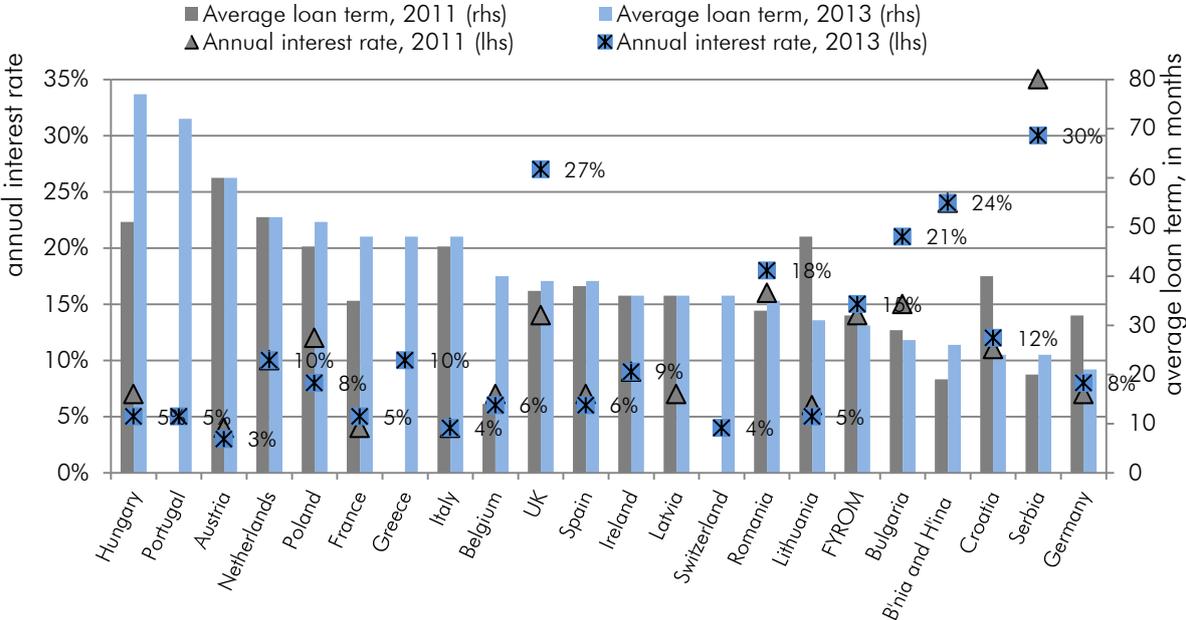
In addition to the national heterogeneity in institutional environments and microfinance providers, the characteristics of microloans are also quite diverse across countries. According to EMN (2014), the average interest rate among the surveyed microfinance providers was 10% in 2013 (11% in 2011), but ranging from 5% in France, Italy, Austria and Switzerland, to 27% in the UK, and even higher in non-EU Balkan states (Figure 51).

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).

⁷⁵ The 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.

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 consistent with a socially oriented investment strategy. In fact, the micro-loan business model, if operated on sustainable terms in the long run, inherently requires relatively high interest rates on the microloans (Bruhn-Leon, Eriksson and Kraemer-Eis, 2012).

Figure 51: Microcredit conditions in Europe



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

6.4 Microfinance prospects

Difficulties in access to finance remains particularly pronounced for microenterprises and other target groups of microfinance. The overall situation in microcredit provision in Europe is still complex.

Microenterprises are facing a tightening credit supply by mainstream banks with a high risk aversion and increasing need to de-leverage their balance sheets. In this 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.

Access to finance is very important not only for existing microenterprises, but also for those who are eager to create a business in order to escape poverty or unemployment and contribute to job

creation. Supporting a financially excluded segment of the population that can potentially produce a substantial amount of business creators is especially important in countries with high unemployment figures. In addition to the financial support, unemployed people are often in need of acquiring the necessary skills for success through coaching and mentoring. Microfinance can be an important tool 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. Aside from these financial products and services, many European MFIs provide non-financial services as well.

With regard to future trends, MFIs are expecting less public support in the coming years, due to public budget restrictions. The MFIs have prepared to develop more efficient and lean processes, 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.

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 five years of Progress Microfinance, as their main focus is micro-lending, unlike banks. Moreover, many non-bank MFIs have made use of the flexibility under Progress Microfinance to provide funding and risk coverage denominated in local currency. Progress Microfinance will cover 23 countries as of end-2015 with no additional countries to be added before the end of the investment period in early April of 2016. It is estimated that Progress Microfinance had as of end-September 2015 mobilised more than EUR 350m of new financing across some 40,000 eligible micro-borrowers. The long-term target under the facility of providing EUR 500m of new microcredits to minimum 46,000 micro-borrowers seems still to be within reach.

In mid-2015 the Progress Microfinance successor program, the program for Employment and Social Innovation (EaSI) was 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 microenterprises and social enterprises (see Box 5 for a

general description of the financing of 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.

The initial demand for the EaSI guarantee instrument has been very high and as of end-2015 it is estimated that the signed guarantee agreements, covering 8 EU countries, over time will mobilise almost EUR 350m of new financing to eligible micro-borrowers and social enterprises.

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 earlier ESBFOs, 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 support of Debt Funds or initiatives in the field of social entrepreneurship.

In the areas of *credit guarantees* and *securitisations*, EIF cooperates with a wide range of financial intermediaries. They include: banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks, and other financial institutions that provide financing or financing guarantees to SMEs. Given that SMEs have no direct access to the capital markets, banks are typically the most important source of external SME finance. Hence, funding limitations of banks have direct impact on SME lending capacity. For loans to SMEs, a standardised, highly transparent and quality-controlled securitisation market could transform these illiquid loans into an asset class with adequate market liquidity. This has also been confirmed - as described above - by the recent Ecofin Council meeting of the 08. December 2015.

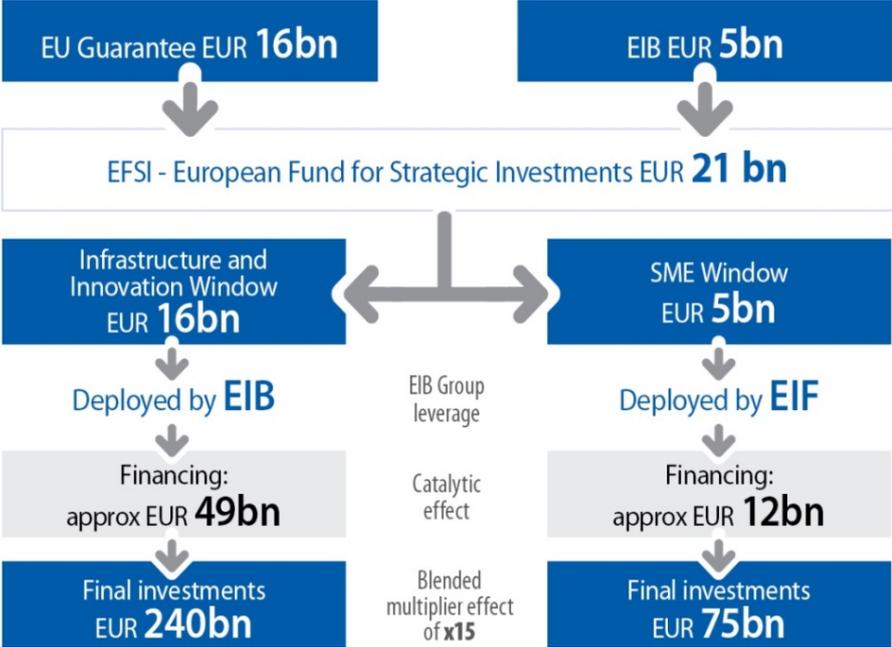
Finally, *microfinance* is an important contribution to overcoming the effects of the crisis, and in particular to supporting inclusive growth. EIF provides funding, guarantees and technical assistance to a broad range of financial intermediaries, from small non-bank financial institutions to well-

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.

Significant additional support for European enterprises is available under the new “Investment Plan for Europe”⁷⁶. The global economic and financial crisis has hampered investment in infrastructure, innovation and the private sector. As part of this investment plan, the European Fund for Strategic Investments (EFSI) aims to unlock investment by addressing market gaps and mobilising private resources. By taking on some of the risk, the EIB Group can help increase the appetite to invest. The EIB Group provides loans and other financial products that are partly covered by an EU budget. As there is abundant liquidity in the market, sound projects and risk-absorbing financial products will be able to attract more funding, especially from private investors.

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 52). The EFSI SME window is being implemented by the EIF through guarantee and equity agreements between the EIF and financial intermediaries signed in 2015-2018. The financial support must be additional to what would have been delivered under the existing and already foreseen programmes in the period 2015-2018.

Figure 52: EFSI structure



Source: EIB Group

⁷⁶ See for more information: <http://www.eib.org/about/invest-eu/index.htm> and Council of the EU (2015a).

The resources under EFSI enable EIF to deploy its existing support for SMEs at a higher and faster rate than initially planned to satisfy strong demand of support to SME access to finance. Over time additional instruments are foreseen to be implemented under EFSI – including the above-mentioned important platforms in cooperation with National Promotional Institutions (NPIs) in the fields of equity and securitisation. Initial EFSI resources under the SME Window are being used to accelerate and enhance the deployment of existing EU flagship programmes which EIF manages – i.e. COSME, InnovFin – and to significantly increase the Risk Capital Resources (RCR) mandate for equity investments, which EIB has entrusted to EIF. Thanks to EFSI, also the RCR equity mandate which EIF manages on behalf of EIB has been increased by EUR 2.5bn.

A front loading of the InnovFin SME and COSME SME guarantee programmes was approved in April 2015 by the EIF Board, including a EUR 0.5bn warehousing capacity by EIF. Several transactions were already in preparation, of which the first one under EFSI was signed 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.⁷⁷

The implementation of the SME window is well on track. As per mid-November 2015, overall 62 SME operations have already been signed under EFSI, covering 12 countries so far (Belgium, Bulgaria, Czech Republic, France, Germany, Italy, Luxembourg, Netherlands, Poland, Portugal, Slovenia and UK). It is expected that these transactions trigger investments of around EUR 20bn and that more than 70,000 SMEs and small midcaps benefit. Further signatures should follow soon, as reflected by EIF's substantial deal pipeline.

⁷⁷ For more information see: http://www.eif.org/what_we_do/efsi/index.htm.

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

- **Attachment Point:** The attachment point is the level of subordination that a particular tranche has beneath it. The attachment point is a proxy of percentage of the transaction that will absorb losses before the senior tranche is adversely affected.
- **Credit Default Swap:** An agreement used in synthetic securitisations where the originator (protection buyer) sells the credit risk of an underlying portfolio to a counterparty (protection seller) without transferring the ownership of the assets.
- **Credit Enhancement:** Refers to one or more measures taken in a securitisation structure to enhance the security, the credit quality or the rating of the securitised instrument, e.g. by providing a third party guarantee (such as the EIF guarantee). The credit enhancement could be provided in the form of:
 - (i) Structural credit enhancement (tranching of the transaction in senior, mezzanine and junior tranches);
 - (ii) Originator credit enhancement (cash collateral, profit retention, interest sub-participation);
 - (iii) Third party credit enhancement (e.g. EIF or monoline insurers).
- **Credit Linked Notes (CLN):** A security issued by an SPV (or directly from the balance-sheet of the originator) credit-linked to the default risk of an underlying portfolio of assets. Usually used in synthetic securitisations for the mezzanine tranches of a transaction.
- **Collateralised loan obligations (CLOs)** are a form of securitisation where payments from multiple middle sized and large business loans are pooled together and passed on to different classes of owners in various tranches.
- **First Loss Piece (FLP):** Part of a securitisation transaction which is usually kept by the originator (as an “equity piece”) and which covers the risk of first loss in the portfolio. Its size is a function of the historical losses, so as to protect the investors against the economic risk (estimated loss) of the transaction.
- **Issuer:** Refers to the SPV which issues the securities to the investors.
- **Kirb:** means the sum of the expected loss and regulatory capital that a financial intermediary assigns to an exposure (a portfolio) by using an Internal Rating Based (IRB) approach.
- **Mezzanine Risk:** Risk or tranche which is subordinated to senior risk, but ranks senior to the FLP.
- **Originator:** The entity assigning receivables in a securitisation transaction (funded transaction) or seeking credit risk protection on the assets (unfunded transaction).
- **Primary market:** The market in which securities are issued.
- **Secondary market:** The market where issued securities are traded.
- **Senior:** The class of securities with the highest claim against the underlying assets in a securitisation transaction. Often they are secured or collateralised, or have a prior claim against the assets. In true sale structures they rank senior in the cash flow allocation of the issuer’s available funds.
- **Servicer:** Refers to the entity that continues to collect the receivables, enforcement of receivables, etc. Generally, the originator is also the servicer.
- **Special Purpose Vehicle (SPV):** Issuing entity holding the legal rights over the assets transferred by the originator. An SPV has generally a limited purpose and/or life.
- **Subordinated:** The classes of securities with lower priority or claim against the underlying assets in a securitisation transaction. Typically, these are unsecured obligations. They are also called Junior (or Mezzanine) notes and bonds.
- **Synthetic securitisation:** A transaction where the assets are not sold to an SPV but remain on balance sheet; and where only the credit risk of the assets is transferred to the market through credit default swaps or credit linked notes.
- **Tranche:** A piece, a portion or slice within a structured transaction.
- **Portfolio Tranching Cover:** The technique by which an Originator can buy protection on a portfolio. Such protection is only activated when the losses exceed a given threshold (Attachment Point).
- **True sale:** It refers to the separation of the portfolio risk from the risk of the originator, i.e. there is a non-recourse assignment of assets from the originator to the issuer (special purpose vehicle). To be contrasted with synthetic securitisations where only the underlying credit risk is transferred.
- **Whole Business Securitisation (WBS):** Securitisation of the general operating cash flow arising from a certain line or area of the business of the originator over the long term.

Annex 3: List of acronyms

- ABCP: Asset Backed Commercial Paper
- 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
- BCBS-IOSCO: Basel Committee on Banking Supervision-Board of the International Organisation of Securities Commissions
- BCG: Boston Consulting Group
- BIS: Bank for International Settlements
- BLS: Bank Lending Survey
- bn: billion
- BoE: Bank of England
- bp: basis point(s)
- CDFIs: Community Development Financial Institutions
- CDO: Collateralised Debt Obligation
- CDP: Cassa Depositi e Prestiti, Italy
- CDS: Credit Default Swap
- CESEE (countries): (countries in) Central, Eastern and South-Eastern Europe
- CGAP: Consultative Group to Assist the Poor
- CGS: Credit Guarantee Scheme
- CIP: Competitiveness and Innovation Framework Programme
- CLN: Credit Linked Note
- CLO: Collateralised Loan Obligation
- CMU: Capital Markets Union
- COM: European Commission (also: EC)
- COSME: Programme for the Competitiveness of enterprises and SMEs (COSME) 2014-2020
- CRD: Capital Requirements Directive
- CRR: Capital Requirements Regulation
- CVC: Corporate Venture Capital
- EAF: European Angels Fund
- EBA: European Banking Authority
- EBAN: European Business Angels Network
- EBF: European Banking Federation
- EC: European Commission (also: COM)
- ECB: European Central Bank
- EFG: Equity Facility for Growth
- EFSI: European Fund for Strategic Investments
- EFTA: European Free Trade Association
- EIB: European Investment Bank
- EIF: European Investment Fund
- EIOPA: European Insurance and Occupational Pension Authority
- EL: expected loss
- EMEA: Europe, Middle East, and Africa
- EMN: European Microfinance Network
- ERB: External Ratings Based
- EREM: EIB Group Risk Enhancement Mandate

- ERP: European Recovery Program
- ESBFO: European Small Business Finance Outlook
- ESIF: European Structural and Investment Fund
- 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
- FLP: First Loss Piece
- FLPG: First Loss Portfolio Guarantee
- FRSP: Funded Risk Sharing Product
- FTPYME: Fondos de Titulización de activos para Pequeñas Y Medianas Empresas (Asset Securitisation Funds for SMEs)
- FYROM: Former Yugoslav Republic of Macedonia
- GDP: Gross Domestic Product
- GP: General Partner
- HICP: Harmonised index of consumer prices
- HQS: High Quality Securitisation
- HY: Half Year
- ICT: Information and communications technologies
- IMF: International Monetary Fund
- InnovFin:
- IPO: Initial Public Offering
- IRB: Internal Ratings Based
- IRR: Internal Rate of Return
- IT: Information Technology
- JEREMIE: Joint European Resources for Micro to Medium Enterprises
- k: thousand
- KfW: Kreditanstalt für Wiederaufbau, Germany
- Kirb: IRB capital requirements for the underlying pool of securitised assets
- LBO: Leveraged buy out
- LGD: loss given default
- LGF: Loan Guarantee Facility
- LP: Limited Partner
- m: million
- MAP: Multi Annual Programme for Enterprise and Entrepreneurship
- MCIF: Mezzanine Co-Investment Facility
- MFI (in the context of ECB): Monetary Financial Institutions
- MFI (in the context of microfinance): Microfinance Institution
- NBFIs: Non-bank Financial Institutions
- NFC: Non-financial corporation
- NGO: Non-Governmental Organisation
- NPB: National Promotional Bank
- NPI: National Promotional Institution
- NPL: Non-performing loan
- OECD: Organisation for Economic Co-Operation and Development
- PCS: Prime Collateralised Securities
- PD: probability of default
- PE: Private Equity
- PFB: Public Funding Body

- pif: paid in full
- PRSL: Portfolio Risk Sharing Loan
- PVCI: Portugal Venture Capital Initiative
- Q: Quarter
- RCR: Risk Capital Resources
- RMA: Research and Market Analysis
- RMBS: Residential mortgage backed securities
- RSI: Risk-Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps
- SA: Standardised Approach
- SAFE: Survey on the Access to Finance of Enterprises
- sf: Structured Finance
- SFA: Supervisory Formula Approach
- SIA: Social Impact Accelerator
- SME: Small and medium sized enterprise
- SMEG: SME Guarantee Facility
- SMESec: SME Securitisation (comprising transactions based on SME loans, leases etc.)
- SPGM: Sociedade Portuguesa Garantia Mutua, Portugal
- SPV: Special Purpose Vehicle
- SSM: Single Supervisory Mechanism
- SST: simple, standard and transparent
- STC: simple, transparent and comparable
- STS: simple, transparent and standardised
- TMT: Technology, Media, Telecom
- TT: Technology transfer
- UEAPME: European Association of Craft, Small and Medium-sized Enterprises
- UK: United Kingdom
- US: United States
- VC: Venture Capital
- WAL: weighted average life
- WBS: Whole Business Securitisation

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

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