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European Small Business Finance Outlook

December 2013

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Working Paper 2013/20
EIF Research & Market Analysis



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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 2013.

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

Market Environment:

- Europe's sluggish and uneven economic performance has continued since the publication of the last ESBFO. Among the top issues of the SME environment are still the concerns surrounding the large funding needs of sovereigns and capital requirements of banks.
- Despite this negative environment, the business expectations of European SMEs have slightly improved and there is hope that 2013 could be a turning point for the better.
- The ECB Bank Lending Survey shows that, on balance, the reporting euro-area banks have further tightened their credit standards for non-financial corporations, but the additional net tightening was this time less pronounced for SMEs than for larger enterprises.
- According to the European Commission's and ECB's latest "survey on the access to finance of SMEs in the euro area", access to finance remained the second most pressing problem for the euro area SMEs. Moreover, this problem still appears to be a more severe concern for SMEs than for large firms.
- The still relatively difficult access to finance conditions for SMEs in those countries which are suffering the most from the sovereign debt crisis is particularly worrying, as SMEs account for relatively large shares of gross value added in these countries.

Private equity:

- Following the deep crash of the European private equity (PE) investment in 2008/2009, this market has partially rebounded over 2010 - 2011. However, the recovery suffered a setback in 2012, which seems to have continued into 2013. EVCA preliminary figures show that all PE market segments so far (Q1 to Q3 in 2013) appear to have recorded another relatively poor year in terms of investment activity. In the venture capital (VC) part of the market, all VC stages have shown weak investment activity. The disappointing developments in PE and VC investments were at least partially driven by the difficult general economic environment.
- Some of the gap left by the fall in venture capital (VC) investment has been filled in by business angel activity; their proximity to the market has been beneficial during this difficult period.

¹ This paper benefited from comments by many EIF colleagues for which we are very grateful. All errors are of the authors.

² We are using the term "equity finance" to combine linguistically 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.

- According to EVCA preliminary figures, total PE fundraising appears to have substantially improved in the first three quarters of 2013. However, venture fundraising appears to have experienced another weak year. Divestment activity seems to have improved somewhat for all PE, while divestments in VC appear to have fallen considerably.
- Investors' currently cautious sentiment towards VC is shown in the shift in the investor base, which has been going on during the past years. According to EVCA figures, government agencies – which continue to support the market counter-cyclically – accounted for almost 40% of total VC fundraising in 2012, and they appear to have been the largest investor group again in 2013, according to preliminary information from EVCA.
- VC performance, although still disappointing, has slightly improved. Moreover, EIF is observing an increasing number of auspicious early-stage companies. They show a promising pattern of growth and good potential to positively impact the funds' future performance.

SME Guarantees / Securitisation:

- Credit guarantees are widely used across economies as important tools to ease financial constraints for SMEs, and in order to alleviate market failures in SME financing.
- According to AECM preliminary data of outstanding guarantees, a decrease in values and a parallel increase in the number of guarantees was observed in 2012. Hence, the guarantee size has on average declined, a trend which seems to have continued in the first half-year of 2013. These developments could be explained by an increase of guarantees with smaller amounts, as well as of short term guarantees (i.e. working capital loan guarantees and bridge financing guarantees).
- In these times of a severe financial and economic crisis, public support coming from the European level could at least improve the situation on the supply side. Several new initiatives are in preparation for the multi-annual framework 2014 to 2020.
- In the SME securitisation market, originators continue mainly to retain newly-issued deals in order to create liquidity buffers and to use the assets as collateral with central banks.
- Despite the financial and sovereign crisis, the European securitization market has in general performed relatively well so far; also the SME segment shows low default rates.
- With regard to future /potential regulatory treatments of SMESec, a holistic view should be taken and the impact of the “regulatory wave” duly analysed. The regulatory framework should reflect the actual risks of SMESec.

Microfinance:

- The microfinance market in Europe is immature and fragmented, but shows trends towards efficiency, professionalization, and self-sustainability. The market needs access to stable funding, even more so as microfinance makes an important contribution to help overcome the effects of the crisis, and in particular to support inclusive growth.
- The impact of the on-going crisis on the availability of microfinance is still a central issue of the sector. In times of crisis, as at present, microfinance clients, typically find capital even harder to obtain, regardless of whether they are an enterprise or self-employed. Additional challenges are also faced by such vulnerable groups as ethnic minorities or female entrepreneurs.



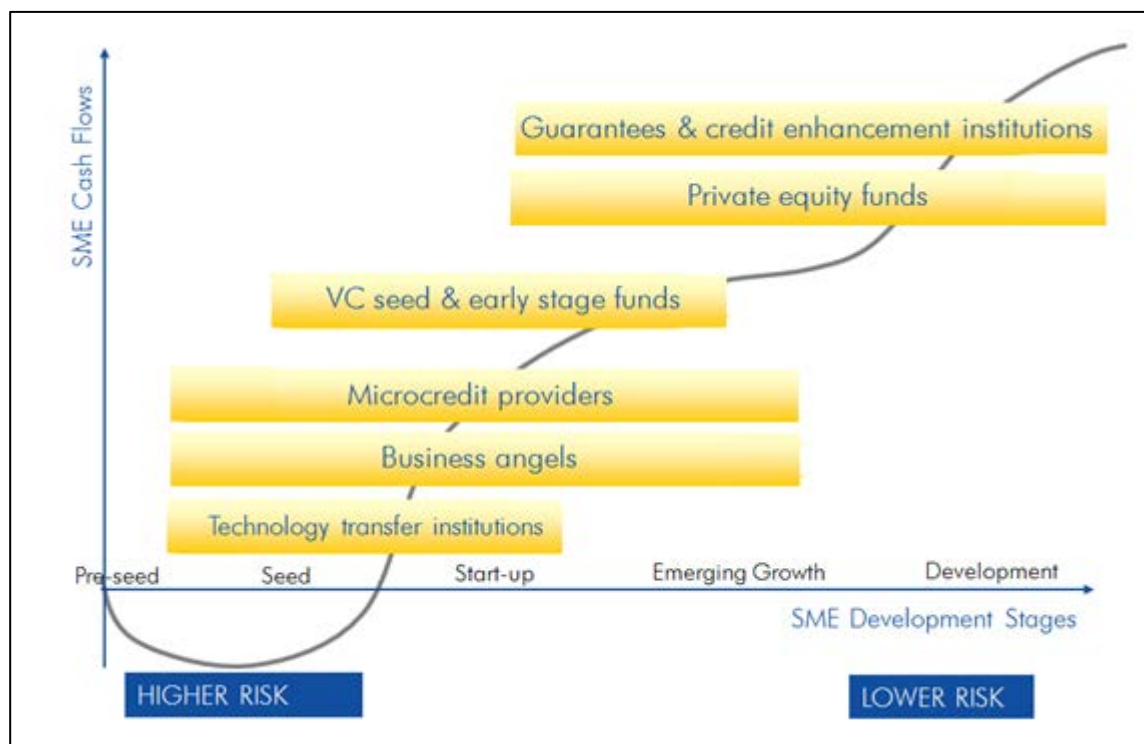
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1 Introduction

The European Investment Fund (EIF) is the European Investment Bank (EIB) Group's specialist provider of risk financing for entrepreneurship and innovation across Europe, delivering a full spectrum of financing solutions through financial intermediaries (i.e. equity instruments, guarantee and credit enhancement instruments, as well as microfinance). The following figure 1 shows the range of EIF's activities:

Figure 1: EIF tool kit for SMEs



Source: EIF

The EIF focuses on the whole range of micro to medium-sized enterprises, starting from the pre-seed, seed-, and start-up-phase (technology transfer, business angel financing, microfinance, early stage VC) to the growth and development segment (formal VC funds, mezzanine funds, portfolio guarantees/credit enhancement).

Against this background, the European Small Business Finance Outlook (ESBFO) provides an overview of the main markets relevant to EIF (equity³, guarantees/securitisation, microfinance). The present edition is an update of the ESBFO June 2013.

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

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

2 Economic environment and insolvencies

Since the publication of the previous ESBFO in June 2013, the global economic outlook has slightly weakened. The International Monetary Fund (IMF) has recently forecast a slowdown of global growth from 3.2% in 2012 to 2.9% in 2013. Global growth is expected to increase again to 3.6% in 2014. However, compared to IMF's previous projections (April 2013), these forecasts have been decreased by 0.4 percentage point for both 2013 and 2014 (IMF, 2013).

The European Commission has also updated its projections for the European Union (EU), expecting no (0.0%) growth for 2013, followed by positive growth in 2014 (+1.4%) and in 2015 (+1.9%), (see table 1). For 2013, 2014 and 2015, the labour market conditions are again expected to register a double-digit unemployment rate in the EU. However, private and public consumption are both expected moderately to expand. As over the last two years, net exports have remained the most powerful growth driver in 2013. For 2014, domestic demand is expected to take over as the main contributor to growth (European Commission, 2013d).

Table 1: Main features of the European Commission autumn 2013 forecast for the EU

(Real annual percentage change, unless otherwise stated)				Autumn 2013 forecast		
	2010	2011	2012	2013	2014	2015
GDP	2.0	1.7	-0.4	0.0	1.4	1.9
Private consumption	1.1	0.3	-0.8	-0.1	0.9	1.5
Public consumption	0.6	-0.2	-0.1	0.1	0.3	0.7
Total investment	-0.2	1.6	-3.0	-2.9	2.5	4.0
Employment	-0.5	0.2	-0.3	-0.4	0.3	0.7
Unemployment rate (a)	9.7	9.7	10.5	11.1	11.0	10.7
Inflation (b)	2.1	3.1	2.6	1.7	1.6	1.6
Government balance (% GDP)	-6.5	-4.4	-3.9	-3.5	-2.7	-2.6
Government debt (% GDP)	80.2	83.1	86.6	89.8	90.2	90.1
Adjusted current-account balance (% GDP)	-0.5	-0.3	0.5	1.3	1.4	1.4
Contribution to change in GDP						
Private and Public Consumption	0.7	0.2	-0.4	-0.1	0.6	1.1
Investment and Inventories	-0.8	0.6	-1.1	-0.6	0.5	0.7
Net exports	0.5	0.9	1.1	0.6	0.3	0.2

(a) Percentage of the labour force.

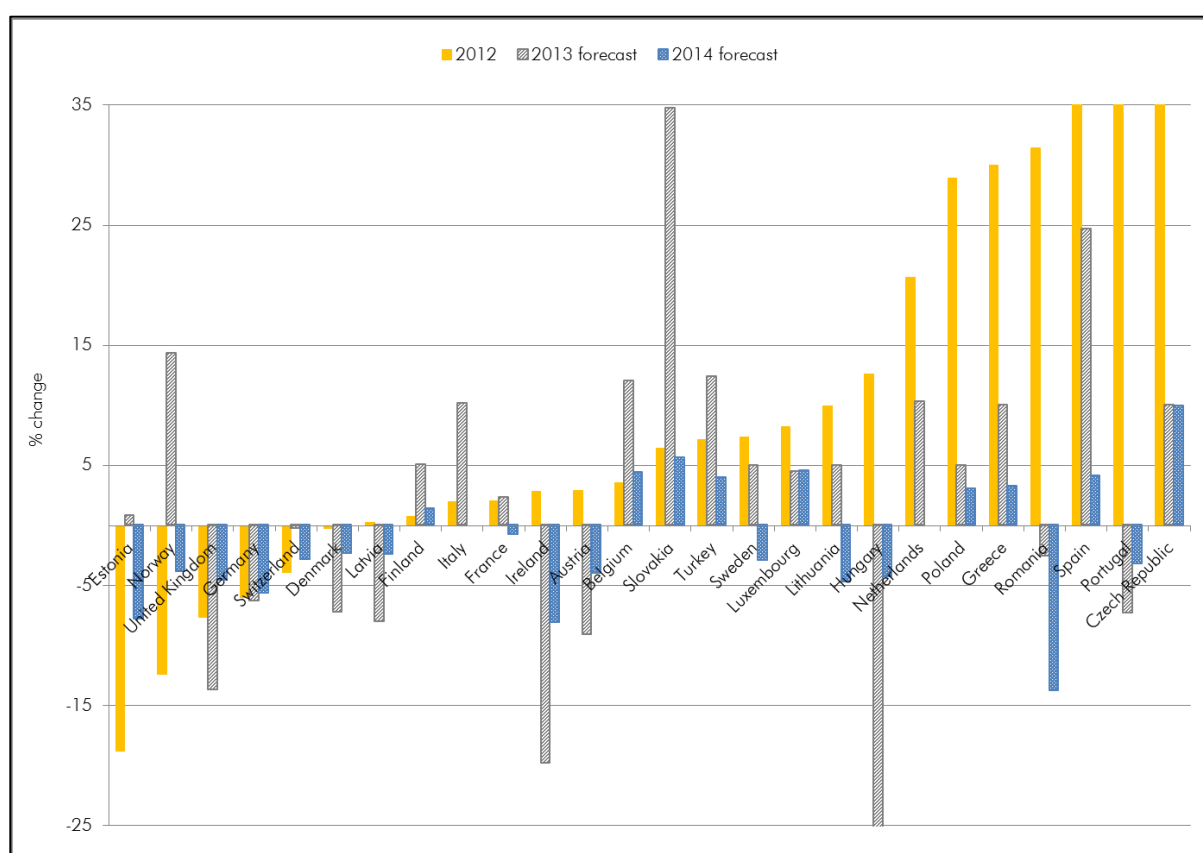
(b) Harmonised index of consumer prices (HICP), annual percentage change.

Source: European Commission (2013d)

The aforementioned economic developments have an impact on insolvencies. Recently, Euler Hermes (2013) has updated the predicted increase in global business insolvencies in 2013 to a slightly more pessimistic level. For 2013, the Euler Hermes Global Insolvency Index⁴, which analyses changes in business insolvencies across the world, forecasts an increase (+2%) for the first year, after two consecutive years of improvement (i.e. the reduction in insolvencies of -5% in 2011 and -1% in 2012).

Concerning the euro area, the Insolvency Index registered an increase in bankruptcies by +12% in 2013, while the projection for 2014 has been recently updated by Euler Hermes to a more optimistic level of +1% (compared to +7% projected in March 2013). At the same time, the regional disparities have remained prevalent, as indicated in figure 2.

Figure 2: Rate of change in insolvency, 2012-2014



Source: Based on Euler Hermes (2013)

In 2012, the insolvency indexes increased at a record rate of +41% in Portugal, +37% in Spain, and +30% in Greece, while double-digit increases were also recorded in the Czech Republic (+46%), Romania (+31%) and Poland (+29%). On the other hand, the most significant falls in the European insolvency indexes were recorded in Estonia (-18.8%), Norway (-12%), the UK (-8%) and Germany (-6%).

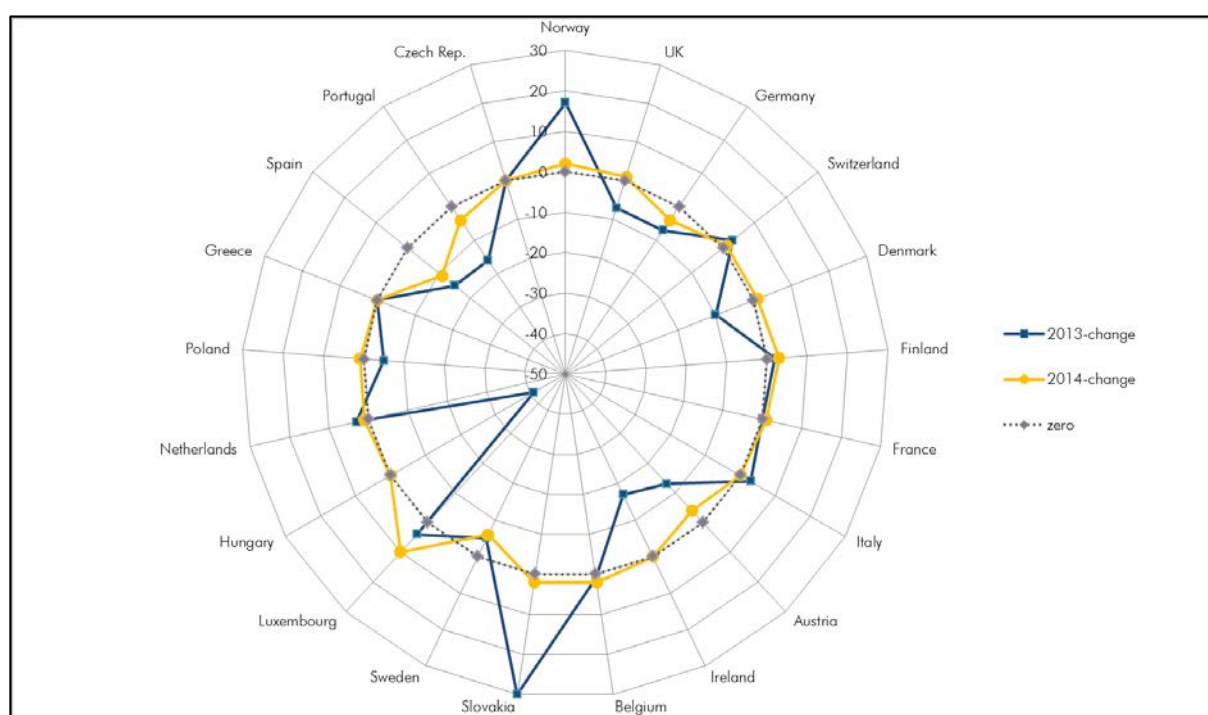
⁴ For each country, an insolvency index is calculated with a basis of 2000=100. The Global Insolvency Index (GII) is the weighted sum of the national indices. Each country is weighted according to its share of the total GDP (at current exchange rates) of the countries included in the study, which account for more than 85% of world GDP at current exchange rates for 2011 (Euler Hermes, 2013).

For 2013, the final insolvency figures in some countries are expected to worsen, e.g. in Slovakia (35%) and in Spain (+25%); on the other hand, improvements are expected in Hungary (-37%), Ireland (-20) and Portugal (-7%) (Euler Hermes, 2013).

Interestingly, for some countries, the updated forecast for the Insolvency Index for 2013 and 2014 significantly varies from the projections made 6 months earlier and reported in previous versions of our ESBFO. The negative deviations from the 2013 forecast, reported in the previous Euler Hermes Insolvency Indexes, reflect the improving economic environment (see figure 3).

In Hungary, for example, the projected change in insolvencies for the second half of 2013 is (-37%), which was much better than the projection reported in the previous Insolvency Index (+4%) (a negative rate of change is indicated by a blue spot inside the zero line), while the projection for 2014 has broadly remained unchanged from the previous one made six months earlier (also cf. footnote 3).

Figure 3: Insolvency Index – gap between current and previous projections per country⁵



Source: EIF, based on data from Euler Hermes Global Insolvency Index 2013 and 2014

⁵ The gap is calculated as follows: for 2013 and 2014, the gap is the difference between the current projection of the Insolvency Index per country and the previous projection (reported 6 months earlier in ESBFO 1/2013). The spots of the graph that are out of the black circle – zero line (positive) represent a deterioration of the forecast in percentage points (more insolvencies). The negative points (inside the black circle) show an improved situation in terms of business insolvencies.

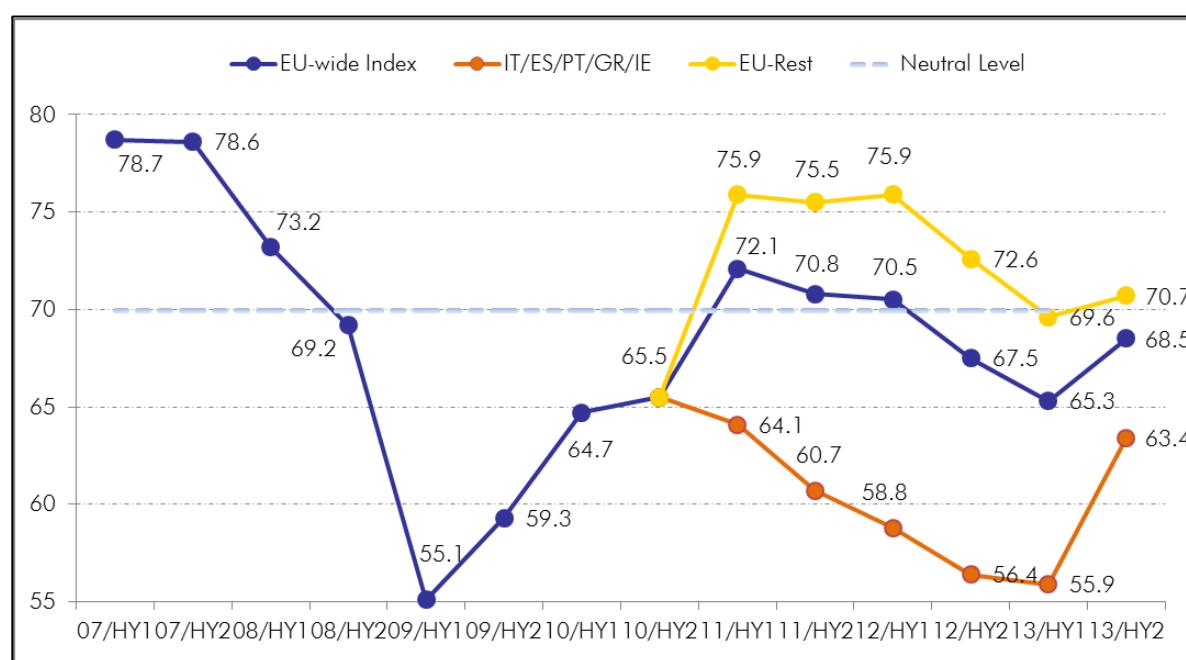
3 Small business environment

3.1 SME business climate

According to the UEAPME SME Business Climate Index, the overall business environment of European SMEs, which kept deteriorating for four consecutive semesters, has increased now by more than three percentage points. The index (68.5%) for the second half-year of 2013 is still standing below its neutral level of 70%, but it has already departed from the previous one of 65.3%, which represented the very bottom trough of the entire recession so far (see figure 4).

The trend for the EU is rising, which could indicate that European SMEs are on their way out of the current recession. A remarkable progress can be noticed especially in the countries mostly affected by the sovereign debt crisis, namely Portugal, Ireland, Italy, Greece and Spain. The SME Business Climate Index for these countries increased by 7.5 percentage points in the second half-year of 2013, which is higher than the increase in “the rest of the EU” (1.1 percentage points). As a result, the imbalance between the two diverse country groups has diminished again, with the current gap equal to 7.3 percentage points (UEAPME Study Unit, 2013).

Figure 4: SME Business Climate Index⁶

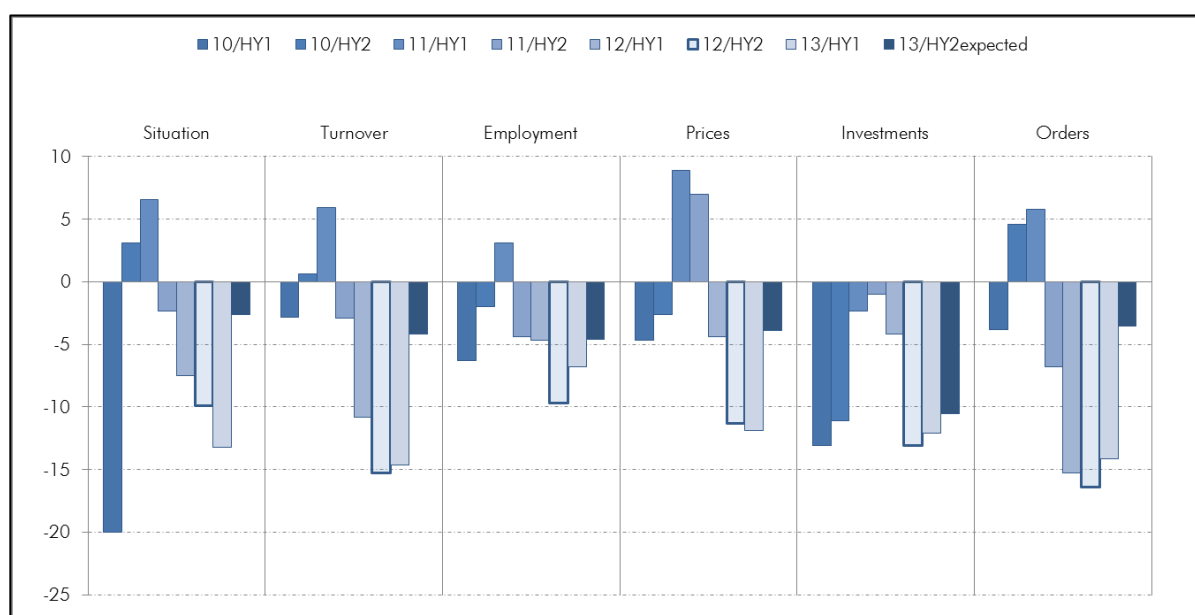


Source: Based on UEAPME Study Unit (2013)

⁶ The UEAPME SME Business Climate Index is calculated as the average of the current situation and the expectations for the next period, resulting from the sum of positive and neutral (meaning: no change) answers pertaining to the overall situation for the business. For example, for “semester A” with 25% positive, neutral 55%, and 20% negative answers, the Index would be $(25 + 55) = 80$, and for “semester B” with 40% positive, 30% neutral, and 30% negative answers, it would fall to $(40 + 30) = 70$. However, the respective balances of positive minus negative answers would show an opposite result, growing from “semester A” $(25 - 20) = 5\%$ to “semester B” $(40 - 30) = 10\%$. Therefore, these balances should also be examined, and are reported in UEAPME’s EU Craft and SME Barometer.

Figure 5 shows the balance of “positive minus negative” answers reported by European SMEs, with reference to situation, turnover, employment, prices, investments and orders on a semi-annual base, starting from the first half-year 2010, with the last column being expectations for the second half-year 2013. Specifically, for the second half of 2013, turnover and orders were on balance expected to fall by 4.2% and 3.5%, respectively. Despite the fact that both numbers are still negative, they indicate significantly smaller decreases than the numbers in the previous semester (turnover (-14.6) and orders (-14.1)). Expectations for investments, on balance, are still negative (-10.5%), which shows that SMEs in Europe are waiting for a better situation before making investments and creating new jobs. Lastly, SMEs, in line with the previous survey rounds, continue to expect lower prices (UEAPME Study Unit, 2013).

Figure 5: Main Results of the EU Craft and SME Barometer HY1/2013⁷



Source: Based on UEAPME Study Unit (2013)

The balance between the expectations and the final results for the first half of 2013 is depicted in figure 6. The most remarkable difference was observed for prices for which the balance of expectations (-3.8%) contrasts significantly with the balance of the actual reported results (-11.9%). It seems that SMEs were showing patience and accepted lower prices to keep the turnover and the employment levels stable until a real recovery (UEAPME Study Unit, 2013).

These improvements in sentiments are confirmed by the recent results of the European Commission’s economic sentiment indicator (ESI) for the EU and the euro area, as well as by the Business Climate Indicator (BCI) for the euro area. The indicators have steadily followed upward trends since May 2013 (European Commission, 2013e and 2013f). The improvement in the ESI

⁷ The EU Craft and SME Barometer builds on surveys that are conducted by UEAPME member organisations. The 2013/H2 results are based on about 30,000 answers collected between May and September 2013. The balanced figures mentioned in the text show the difference between positive and negative answers, with national results weighted by employment figures. The surveyed categories include overall situation, turnover, employment, prices, investment, and orders. For details see UEAPME Study Unit (2013).

was more pronounced in the EU than in the euro area. For the EU, the ESI has already exceeded its long-term average.

Figure 6: Expectations of SMEs and real outcome for HY1/2013



Source: Based on UEAPME Study Unit (2013)

The results of the recent Eurochambres (2013) Economic Survey⁸ point to a similar direction. According to this study, business confidence has increased in 2013, following two years of decline. Moreover, businesses were on balance expecting a further improvement for 2014. Furthermore, all indicators showed an improvement in forecasts, suggesting signs of economic recovery in most of the participating countries. The optimism shown by the businesses seems to be driven by structural reforms deployed in response to the financial and Eurozone crises. Despite the general positive expectations for 2014, great disparities in business confidence by country persist. Lithuania is the most optimistic of all. The highest increase in business confidence for 2014 was observed in Portugal as a result of their economic reforms. Improvements are also visible in Greece and Spain. In Cyprus, which experienced the onset of the crisis later compared to others, businesses showed the highest levels of pessimism.

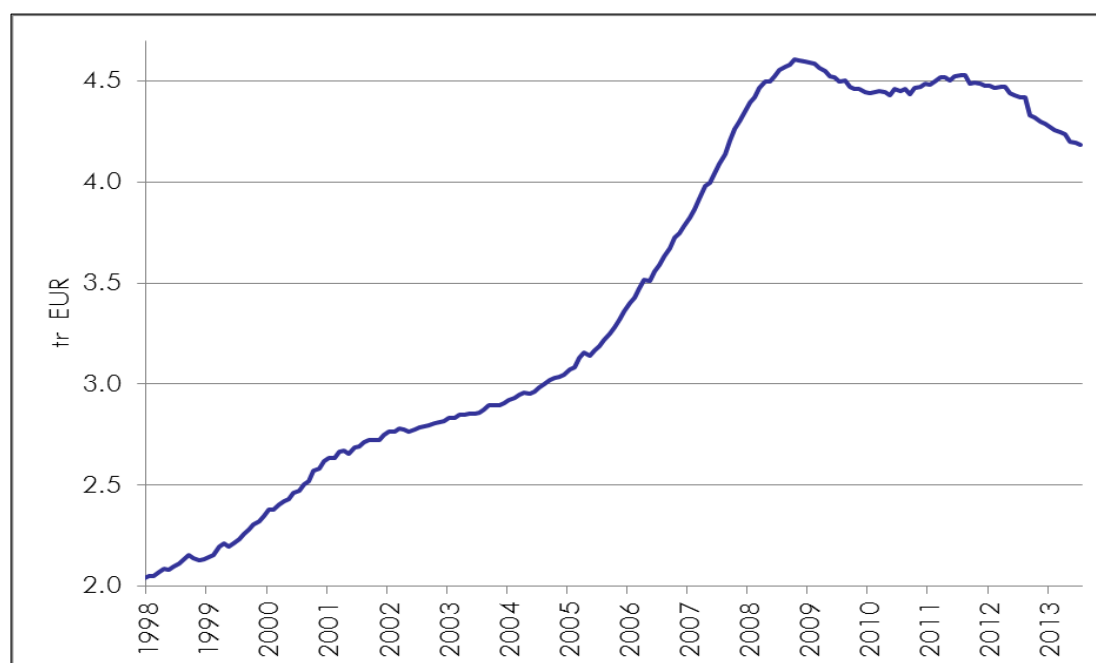
The latest EC annual report on European SMEs (European Commission, 2013h) gives hope that 2013 is likely to be a turning point for EU SMEs, with the expectation of slightly increasing aggregate employment (+0.3% compared to 2011) and value-added (+1% compared to 2011). Moreover, preliminary forecasts expect an acceleration in these promising phenomena in 2014.

⁸ The Eurochambres Economic Survey is a European qualitative survey of business expectations for the year ahead. Conducted annually by the Chambers of Commerce and Industry, and coordinated by Eurochambres, the survey records the expectations of approximately 59,000 businesses in EU Member States and EU Candidate Countries on six economic indicators: business confidence, total turnover, domestic sales, export sales, employment & investment. The Eurochambres Economic Survey has been conducted since 1993. For details on the methodology see Eurochambres (2013).

3.2 Bank lending activity

According to ECB data, the trend in lending to non-financial corporations (NFCs) in Europe has been declining since 2009 and still has to bottom out (see figure 7). Compared to the peak of EUR 4.6tr reached at the beginning of 2009, the volume of outstanding loans has decreased by more than 9% to EUR 4.2tr in the Euro area in October 2013.⁹

Figure 7: Outstanding Loans to Non-Financial Corporations in the Euro Area



Source: Based on ECB data

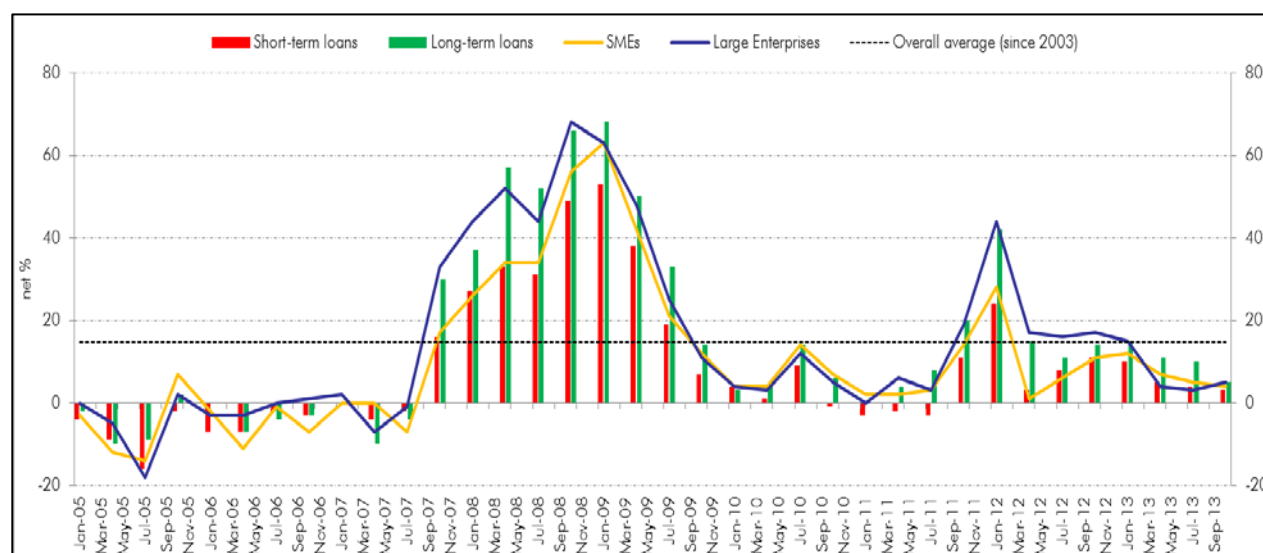
Given the strong prior increase in loan accumulation, the deleveraging of NFCs was a necessary process to some extent, leading away from potentially unsustainable levels. However, the recent downsizing in loan volumes fosters the risk of exaggerating to the downside.

⁹ SME loan data do not exist on European level,. Only recently, did the European Commission initiate a project to improve the evaluation, collection and monitoring of SME lending data. With respect to financing cost for SMEs, Hueriga et al. (2012) suggest that interest rates charged on small loans to NFCs (up to and including EUR 0.25m) could be used as a proxy. Even if new business volumes are also reported for small loans, the time series contains data going back only to June 2010. A longer history (back to 2003) exists for the size-class differentiation between loans to NFCs up to, and including, EUR 1m, and loans over EUR 1m. Looking at moving averages of the preceding 12 months, loans \leq EUR 1m grew relatively steadily and reached their peak in April 2008 at EUR 86bn, which was 25% larger than by end-2003. Loans $>$ EUR 1m grew for one year longer and peaked in April 2009 at EUR 276bn, which was 81% larger than by end-2003. Following their respective peaks, loans of both size-classes decreased continuously until June 2013, by 36% for loans \leq EUR 1m and by 42% for loans $>$ EUR 1m. While loans \leq EUR 1m are today 20% below their 2003 levels, loans $>$ EUR 1m are still 6% above the corresponding level. This particularly reflects the strong differences between the pre-crisis growths of both loan-size classes. However, it is questionable if the growth in loans to NFCs of \leq EUR 1m can be taken as a proxy for the development of SME loans. For example, since 2011, loans to NFCs \leq EUR 0.25m have decreased by 13%, while loans to NFCs \leq EUR 1m (as well as loans to NFCs $>$ EUR 1m) have (both) decreased by only 10%.

The current status of bank lending has also been analysed in the ECB's latest Bank Lending Survey (BLS, see ECB, 2013c)¹⁰: the net tightening of credit standards in the third quarter of 2013 stands below its historical averages. On balance, the reporting euro area banks have further tightened their credit standards to non-financial corporations (NFCs). However, the survey reports a slight decrease in the *additional* net tightening¹¹; a net 5% of banks reported a tightening in Q3/2013 (compared to 7% in the previous quarter).

As shown in figure 8, the overall net tightening of credit standards was less pronounced for SMEs than for large firms. The net tightening of standards for SME loans decreased from 5% in Q2/2013 to 4%, while the net tightening of standards for large enterprises increased from 3% in Q2/2013 to 5%. These developments in the net tightening of credit standards for loans can be explained as further narrowing of margins on average loans and a smaller widening of margins on riskier loans (ECB, 2013c). The BLS examines the net tightening of credit standards also with respect to the loan maturity and it declined for both, loans with longer maturities as well as for short-term loans.

Figure 8: Changes in credit standards applied to the approval of loans or credit lines to enterprises (SMEs versus large enterprises)



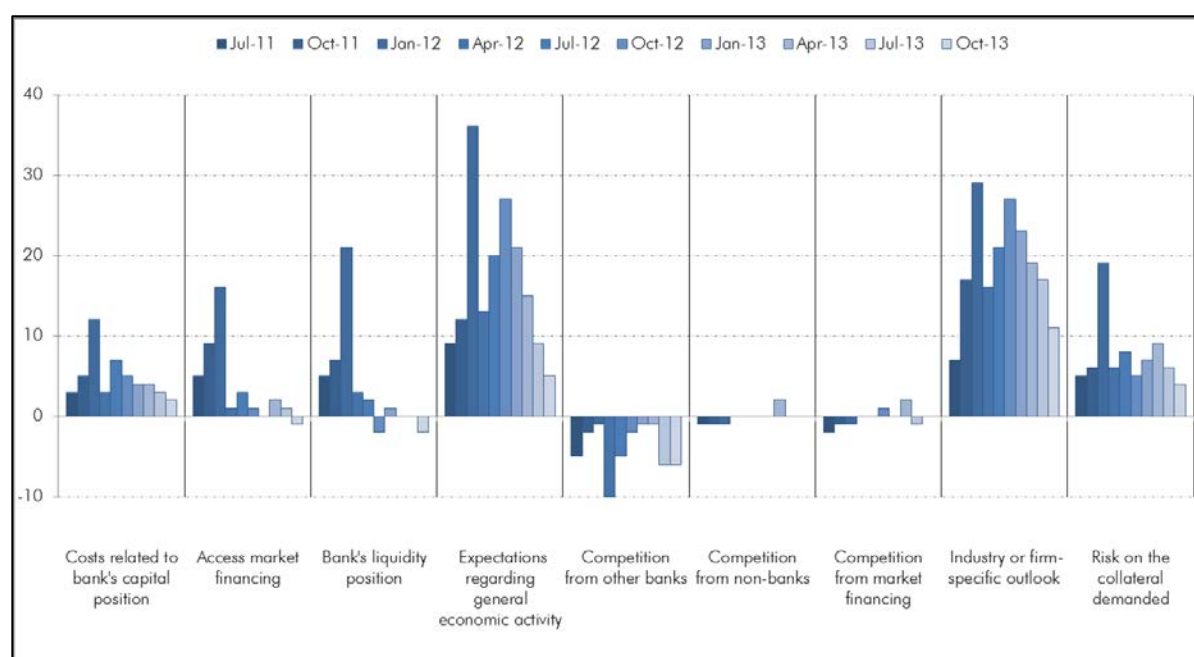
Source: Based on data from ECB (2013c)

In Q3/2013, in net terms and as far as SMEs are concerned, the factors that mostly contributed to tighter credit standards were the expectations concerning the industry (or firm) specific outlook and the expectation regarding the general economic outlook. However, both factors contributed less to tighter credit standards than in the previous quarter. In contrast, factors related to banks' cost of funds and balance sheet constraints contributed on average to a net easing of credit standards for loans to SMEs (ECB, 2013c), (see figure 9).

¹⁰This survey was conducted on 135 euro area banks and reports changes during the third quarter of 2013 (Q3/2013) and expectations of changes in the fourth quarter of 2013 (Q4/2013).

¹¹Text and diagram refer to *net* percentages of banks contributing to tightening standards (the difference between the sum of the percentages of banks responding "tightened considerably" and "tightened somewhat", and the sum of the percentages of banks responding "eased somewhat" and "eased considerably").

Figure 9: Factors contributing to tightening credit standards for SMEs¹²



Source: Based on data from ECB (2013c)

According to the reporting banks, the decline of net demand for loans to NFCs was slightly less pronounced in Q3/2013 (-12% compared to -18% in Q2/2013), mainly driven by a still substantial negative impact of fixed investment on the financing needs of firms. Concerning the projections for Q4/2013, banks mainly expect a net easing in credit standards (for large firms and SMEs). Moreover, they expect an increase in demand (for all categories of loans).

3.3 ECB interest rate statistics

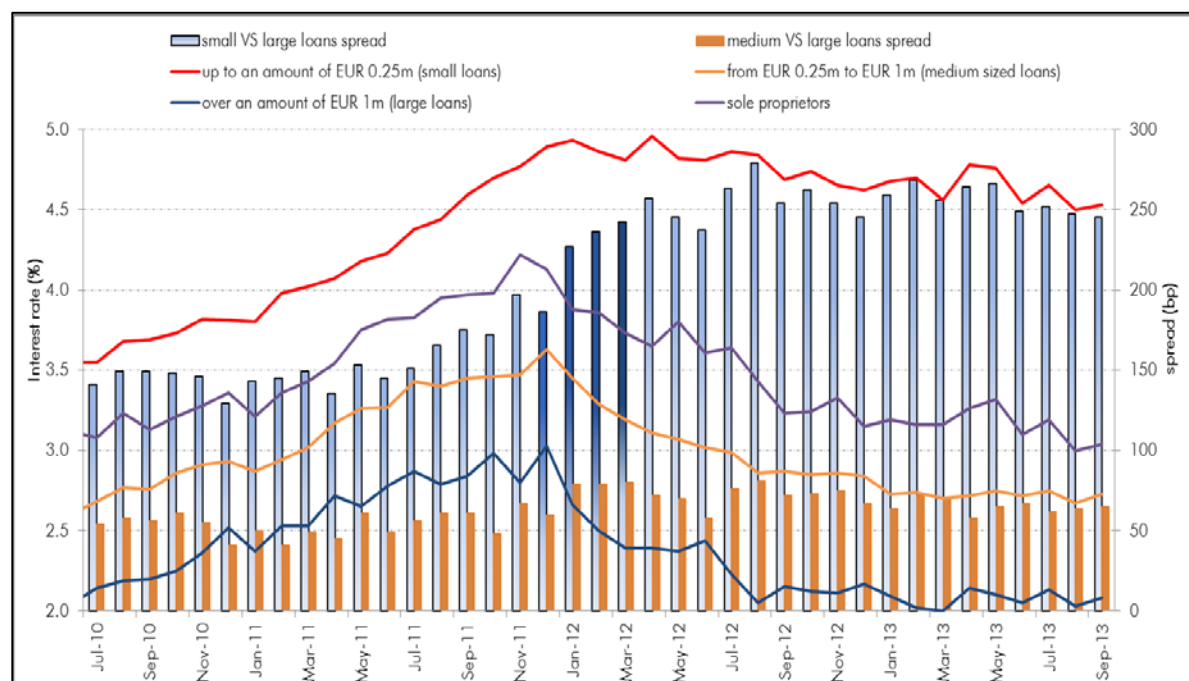
The interest rate statistics for monetary financial institutions, published by the ECB, provide information about the interest rates and volumes for different size classes of new euro-denominated loans. Since June 2011, the former category of loans (of up to EUR 1) to the euro area, extended to non-financial corporations, is divided into two sub-categories. One category includes loans up to and including EUR 0.25m, and the other loans over EUR 0.25m and up to EUR 1m. Based on the assumption that the average size of new loans for SMEs is smaller than the typical loan size for large enterprises (Hueriga et al., 2012), this categorisation affords a closer look at the financing cost of SMEs.

Loans of amounts over EUR 0.25m up to EUR 1m (medium-size loans) had a rather stable spread over loans of more than EUR 1m (large loans), averaging 62 basis points (bp) for the period June 2010 to September 2013 (see figure 10). In contrast, the interest rate spread between loans of up to EUR 0.25m (small loans) and large loans was higher, but relatively stable at an average level of 145bp from the start of the time series in June 2010 until July 2011. In the following months,

¹²The net percentages for responses to questions related to the factors are defined as the difference between the percentage of banks reporting that the given factor contributed to a tightening and the percentage reporting that it contributed to an easing.

this spread had showed an increasing trend until August 2012 when it reached a record high of 279bp. Since then, the spread has been rather stable, averaging 255bp.

Figure 10: Evolution of monetary financial institutions interest rates on new loans to non-financial corporations¹³



Sources: Based on Huerga et al. (2012), ECB (2013a), ECB SDW, and own calculations

Using small loans as a proxy for the financing cost of SMEs, shows that financing conditions remain persistently tighter for SMEs than for large firms (ECB, 2013f). The difference between the interest rates for small and larger firms is a consequence of a supposed divergence in firm-specific risks, in particular in the countries most affected by the deepened sovereign debt crisis. Partially, it can also be explained by the fact that smaller enterprises are more dependent on their domestic banking sectors, where they face more adverse conditions compared with larger enterprises that are more flexible to benefit from global financial markets (ECB, 2013g).

However, with regard to the interest rates charged on the SMEs, significant inter-country differences remain. According to Fitch (2013c), the SME loan margins above Euribor are now at their highest levels over the last decade for Italy and Spain, with loan interest rates for Spanish SMEs at around 5%, 1.5% above the rates in the UK or in Germany.

¹³New loans to non-financial corporations, with floating rate and up to three-month initial rate fixation by loan size, and new loans to sole proprietors (percentages per annum excluding charges; period averages). The series about new loans to "sole proprietors" have an initial rate fixation period of up to one year, and not up to three-months, as the rest of the series used in the graph, because data for lower rates of fixations are not collected.

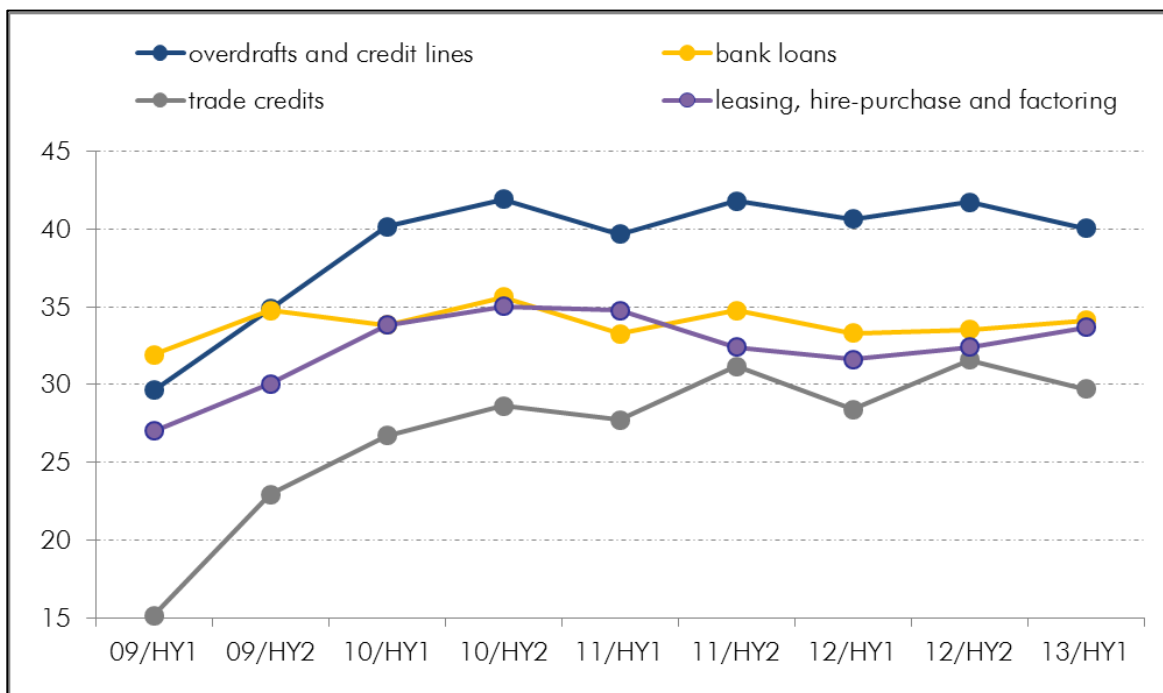
3.4 SMEs' Access to finance

According to the European Commission's and the ECB's latest Survey on the Access to Finance of SMEs (SAFE), covering April to September 2013 (European Commission, 2013g and ECB, 2013b)¹⁴, access to finance remained the second most pressing problem for euro area SMEs. Moreover, it still appears to be a more severe concern for SMEs than for large firms. Compared to the previous survey wave, the percentage of companies that mention access to finance as their most pressing problem has remained broadly unchanged. 'Finding customers' stayed the most frequently mentioned concern. Unsurprisingly, the divergence across the countries was large. "On the high side, 32% of the SMEs in Greece, 23% in Spain, 20% in Ireland, Italy and the Netherlands mentioned 'Access to finance' as the most pressing problem, compared to around 8% of the SMEs in Germany and Austria on the low side" (ECB, 2013b).

Compared to the previous ECB survey (covering the period October 2012 to March 2013), there has been a slight increase in the percentage of SMEs which used the most popular sources of debt financing, i.e. bank loans and trade credits, leasing, hire-purchase or factoring. Traditional bank financing (overdrafts, credit lines, bank loans), however, remained the most important external funding source (see figure 11).

Figure 11: Sources of external financing of euro area SMEs

(over the preceding six months; percentage of respondent SMEs that used the different financing sources)

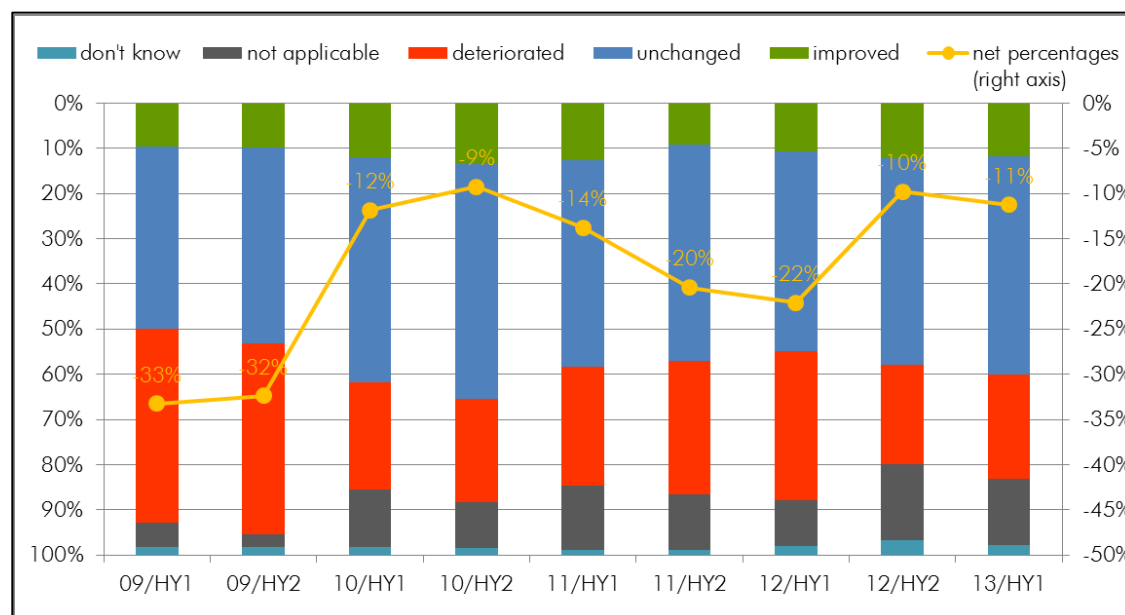


Source: Based on ECB (2013b), Statistical Data Warehouse

¹⁴The European Commission and the European Central Bank decided in 2008 to collaborate on a survey on the access to finance of SMEs in the European Union, and they established The Survey on the Access to Finance of Small and Medium-sized Enterprises (SAFE). SAFE ECB waves are run every 6 months, covering the Euro area countries. The SAFE Commission waves are published every 2 years, covering all EU countries and other countries participating in the Entrepreneurship and Innovation Programme of the CIP.

During the reference period, the net percentage¹⁵ of SMEs reporting a higher need for bank loans remained unchanged in comparison to the previous survey (5%). At the same time, the net percentage of SMEs that perceived a deteriorated availability of bank loans increased slightly (see figure 12). “This mainly resulted from the strong deterioration signalled by Italian SMEs, which was almost compensated for by SMEs in Germany that reported, on balance, an improvement in the availability of bank loans and by SMEs in Ireland and Spain that indicated, on balance, a smaller net deterioration in the availability of bank loans” (ECB, 2013b).

Figure 12: Change in the availability of bank loans for euro area SMEs
(over the preceding 6 months; % of respondents)



Source: Based on ECB (2013b), Statistical Data Warehouse

According to the responses of surveyed SMEs, the main factor which negatively impacted the availability of external financing was the general economic outlook. However, on balance, a less negative impact was observed compared to the previous period and SMEs signalled some signs of a reduced deterioration in banks' willingness to lend.

The net percentage of SMEs reporting an increase in interest rates, has now increased to a level of 19% (from 17%). The net share of SMEs which observed increases in costs of financing other than interest rates (43% from 46%) and in collateral requirements (31% from 35%), has decreased, albeit at high levels. “At the same time, country developments were heterogeneous. Mainly SMEs in Spain and Italy contributed, on balance, to the reported increase in bank lending rates, whereas SMEs in Germany and France indicated on balance a decline. This underlines the considerable on-going fragmentation of SMEs' lending conditions across euro area countries” (ECB, 2013b).

When looking at actual applications for external financing, 25% of SMEs applied for a bank loan between April and September 2013. The main reason for SMEs not to apply for a bank loan was

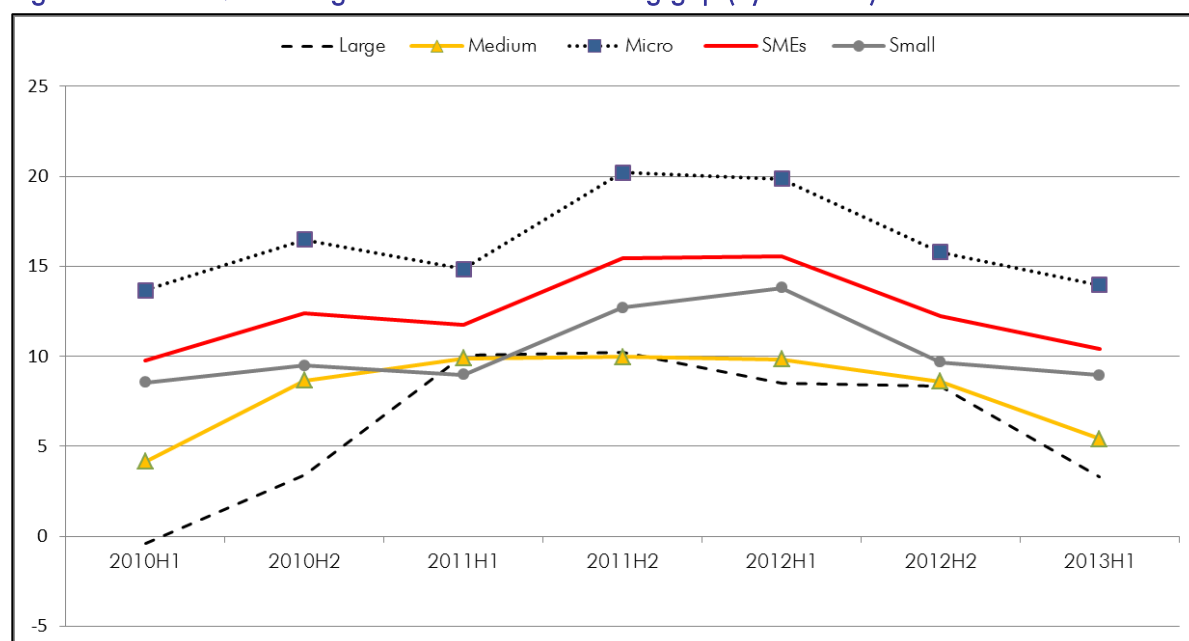
¹⁵“Net percentage” means the difference between the percentage of firms reporting an increase (or an improvement) for a given factor and that reporting a decrease (or deterioration).

the availability of sufficient internal funds. The success rates of actual loan applications by SMEs remained broadly unchanged compared to the previous survey. 65% of the euro area SMEs reported that they had received the full requested amount. Nevertheless, SMEs continued to report a higher rejection rate than large firms.

Looking ahead, on balance, the euro area SMEs expect no deterioration in access to bank loans and bank overdrafts during October 2013 to March 2014. In addition, SMEs expect a slight increase in internal funds. Despite some improvements in net expectations, SMEs in Greece and France are still showing the most pessimistic outlook for their future access to bank loans, while SMEs in Spain begin expecting improved access and higher internal funds. In addition, SMEs in Germany expect improved access to bank loans.

There are also disparities in the perception of financing gaps across different enterprise size-classes. The results shown in figure 13 below have been calculated on the SAFE data and a new composite indicator on perceived changes in the needs and availability of external financing of firms¹⁶.

Figure 13: Perceived change in the external financing gap (by firm size)



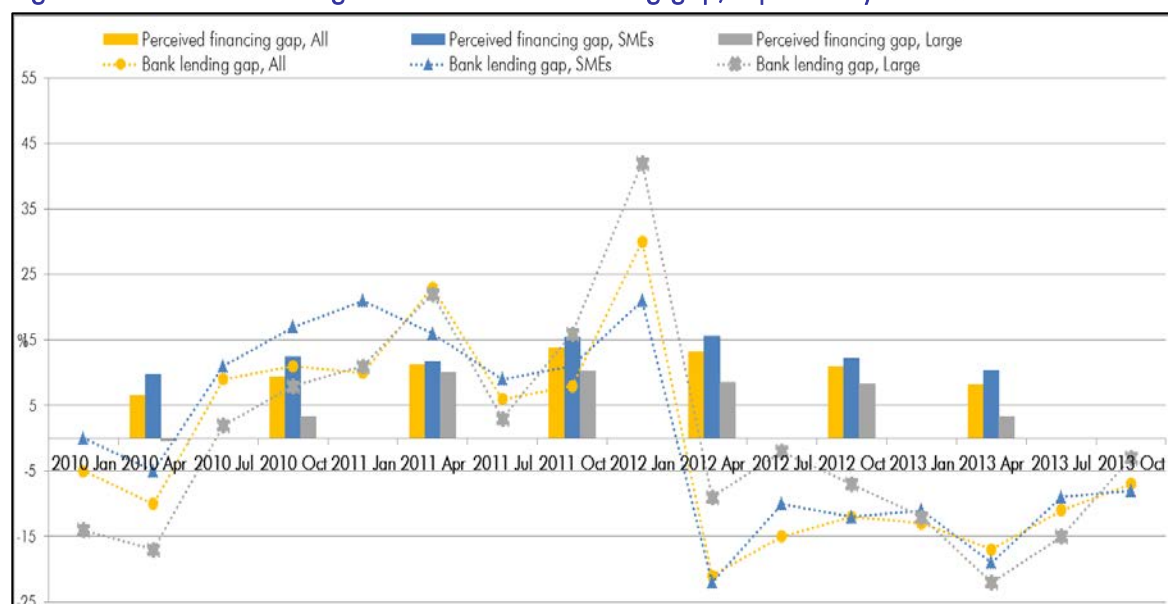
Source: Based on ECB (2013b), Statistical Data Warehouse

These perceived gaps in external financing instruments are calculated based on the SAFE, i.e. from data gathered by a demand-side survey. The ECB's Bank Lending Survey (BLS) data allows comparison to the gap from the supply side, albeit only for bank loans. The BLS bank lending gap is defined as the difference between the net percentage of banks reporting an increase in the

¹⁶For 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.

demand for bank loans and the net percentage of banks reporting an easing in credit standards. From July 2010 until January 2012, the perceived gaps in bank loans reported by the firms were in line with the gaps reported by the banks in the BLS (see figure 14).

Figure 14: Perceived change in the external financing gap, reported by borrowers and lenders¹⁷



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: SAFE, BLS and own calculations

In contrast, during other time periods, the BLS gaps were significantly different compared to the SAFE external finance gaps (referring to bank lending). For example, in April, 2012, the net percentage of firms, perceiving an increased gap, was 19%, while the net percentage of banks reporting an increased gap was –21%. Such a difference in the gaps of the two respondent groups was partially triggered by the differences in perception of the availability of bank loans. The net availability of bank loans deteriorated, as reported by the enterprises (18%), while only 7% of the banks, on balance, reported tightening of credit conditions.

We discussed further above that the access to finance still shows large differences by country. The relatively difficult access to finance conditions for SMEs in those countries which are suffering the most from the sovereign debt crisis is particularly worrying. SMEs account for relatively large shares of gross value added in these countries, as was pointed out in a recent Morgan Stanley Research (2013) paper. The study concludes that it is in particular the “highly SME-dependent economies that face the greatest challenges – or an SME squeeze”.

¹⁷On this figure the distinction between large enterprises and SMEs is based on annual sales as defined by the BLS.

To promote better understanding of the factors behind reduced financing, the IIF and Bain & Company held more than 140 interviews with a broad range of stakeholders in six euro area countries, and with officials in key European institutions. The interviews made clear that progress is needed both to improve the availability of information and the financial health of SMEs, and also to broaden the base of financial institutions that are able to identify and fund promising SME activities (IIF, 2013).¹⁸ The OECD's scoreboard on financing SMEs and entrepreneurship (see box 1) is an important step towards developing a comprehensive framework to monitor trends in access to finance by SMEs and entrepreneurs at the country level.

Box 1: Financing SMEs and Entrepreneurs: An OECD Scoreboard

The OECD is preparing the Third Edition of its *Financing SMEs and Entrepreneurs: An OECD Scoreboard* (OECD, forthcoming 2014)¹⁹. The analysis covers 31 OECD and non-OECD countries and examines 13 core indicators of debt, equity and general market conditions, complemented by a review of government policy measures.

The report confirms our view that, based on 2012 data, SMEs' access to debt and equity finance and the conditions at which they were granted – varied significantly across countries. SME lending conditions deteriorated in most countries, particularly as a result of higher interest rates and greater demand for collateral by banks.

The stock of outstanding SME loans decreased in many countries, i.e. in the countries experiencing severe economic difficulties, but also in countries that had experienced positive economic growth, such as the United Kingdom and the United States. On the other hand, SME lending continued to expand in emerging economies, though at a lower rate than in the recent past. In the majority of participating countries, the interest rate spread between small and large enterprises increased – indicating that banks often view lending to SMEs as higher-risk, with stricter lending conditions applied to SMEs than to large firms.

From the banks' perspective, available data indicates increasing levels of non-performing loans (NPL) – although it has to be borne in mind that the NPL definition varies across countries – with related impacts on banks' capital buffers and risk appetite. SMEs' access to finance might suffer from the increasing risk aversion showed by banks, particularly in light of a large share of SME NPLs compared to those for large firms.

On the whole, the analysis shows that access to finance for SMEs remained difficult over 2011-12, but with a trend towards stabilization. The availability of alternative sources of financing (such as Venture Capital) was itself limited and volatile and as such not able to fill the financing gap. Looking ahead, financing conditions are expected to remain challenging for SMEs in most participating countries, although a slight recovery appears to be on track.

The European Commission (EC) recently reviewed and revised the methodology to calculate the SME Access to Finance (SMAF) index to track conditions for SMEs access to financial resources. The SMAF index provides an indication of the changing conditions of SMEs access to finance over

¹⁸The report recommends the establishment of a coordinated European process focused on national task forces to develop tailored, technical, and non-political action plans to address each of these impediments in each national market (IIF, 2013).

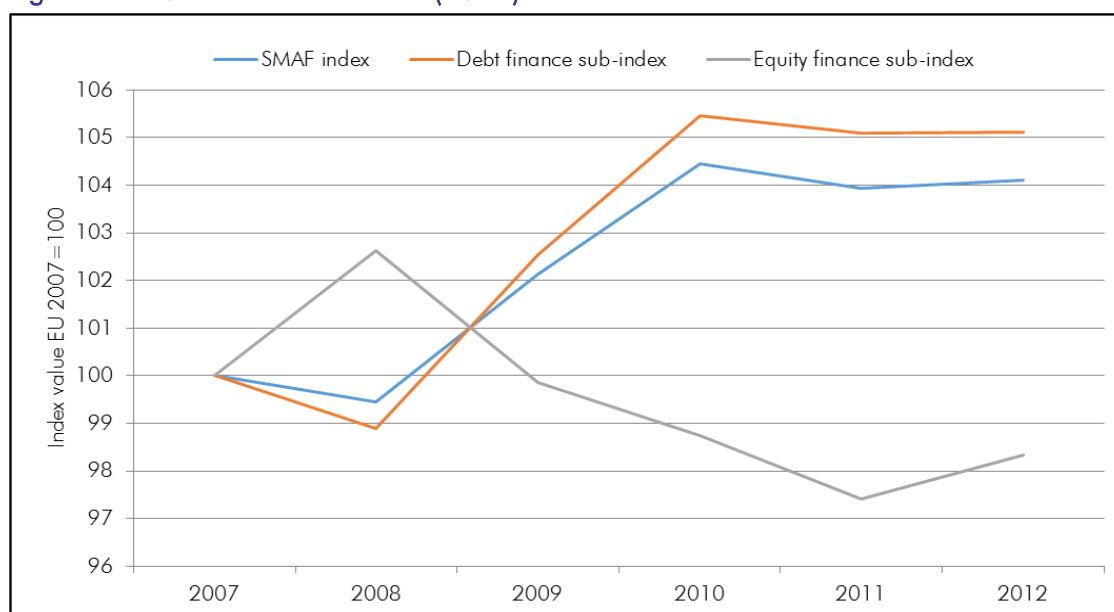
¹⁹EIF closely cooperates with the OECD on this project and other projects related to SME finance.

time for the EU and its Member States. The SMAF index is a weighted mean of two sub-indices: The access to debt finance index (85%) and the access to equity finance index (15%)²⁰. High values in the overall Index and its sub-indices indicate better performance of the access to finance indicators relative to the EU level in 2007.

The SMAF index is a tool to compare the conditions for access to finance between the Member States. In 2012, Germany, France and Austria scored the highest values in the index (approximately 120 for all), whereas, Greece, Portugal and Bulgaria scored the lowest values in terms of access to finance for SMEs (index values of 78, 85 and 92, respectively).

The aggregated SMAF index for the EU countries (see figure 15) has increased since 2008 - however, it has to be borne in mind that such an aggregated view hides significant inter-country differences. The key factor for this improvement was the debt finance sub-index, which itself had increased due to the fall in interest rates for loans and overdrafts since 2009 for many EU countries. The factor that slowed the SMAF index growth was the performance of the equity finance sub-index (we will discuss this market segment in detail in the following chapter).

Figure 15: SME Access to Finance (SMAF) Index and its sub-indices for the EU



Source: European Commission (2013i)

In general, the constraint bank lending environment in many countries leads on the one hand to increasing importance of alternative financing solutions²¹ to complement the banking system and to diversify the sources of funding, and on the other hand to more need for support of guarantee and securitisation approaches, in order to incentivise bank lending. Some of these markets will be analysed in chapters 4 and 5.

²⁰These sub-indices are calculated using data from the following sources: European Central Bank (ECB) for debt; European Venture Capital and Private Equity Association (EVCA) and European Business Angel Network (EBAN) for equity; and the EC and ECB's Survey on the Access to Finance of SMEs.

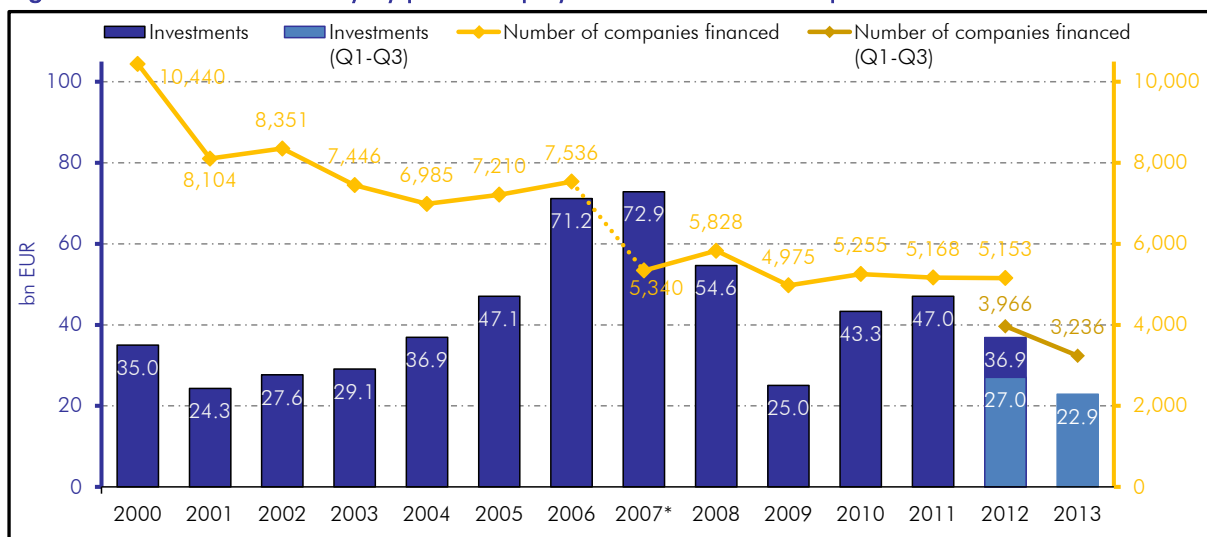
²¹An interesting overview of alternative financing solutions for SMEs and mid-market companies can also be found in TheCityUK (2013).

4 European private equity market

4.1 Investment activity

Following the deep crash of European private equity (PE) investment in 2008/2009, it had partially rebounded in the years 2010 and 2011. However, the recovery suffered a setback in 2012, which seems to have continued in 2013. According to EVCA²² figures, total PE investment amounts slumped by 22% in 2012, compared to the year before, to a level of EUR 36.9bn.²³ In the first three quarters of 2013, this was followed by another decrease by 15%, compared to the same period one year before (see figure 16). Nevertheless, total PE investment is still well above the 2009 crisis low²⁴. The number of companies which benefited from PE investment fell to less than 4,000 in the first three quarters of 2013. However, conclusions from quarterly EVCA data should be drawn much more carefully than when interpreting annual data. A significant number of funds report business figures to EVCA 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.

Figure 16: Investment activity by private equity firms located in Europe²⁵



Source: Based on data from EVCA

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

²²We would like to thank our colleagues from the EVCA research team for their support.

²³The EVCA figures mentioned in this chapter show investment activity by PE firms located in Europe ("industry approach" or "office approach").

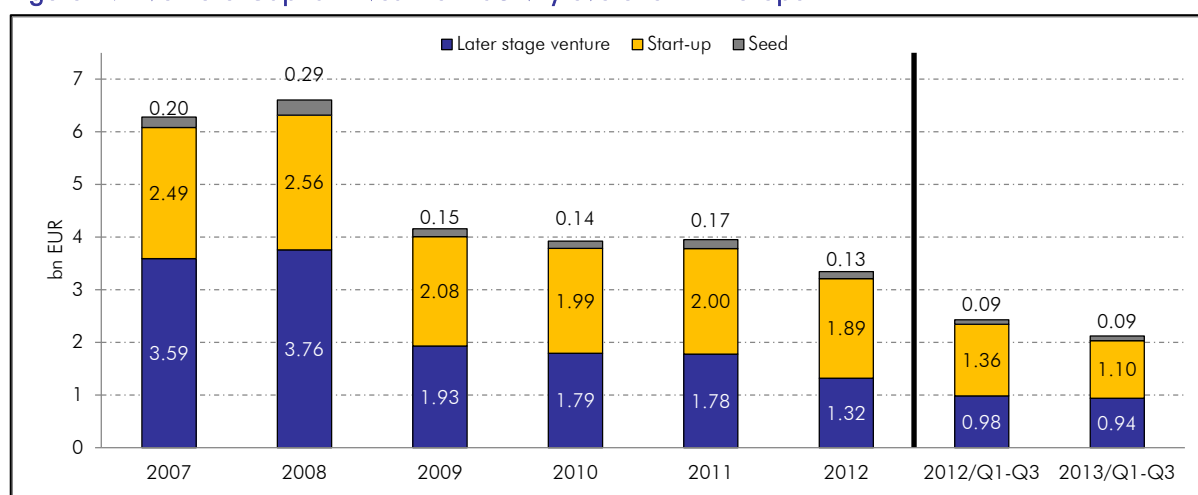
²⁴In 2009, total PE investment amounted to EUR 25.0bn. In the first three quarters of 2009, total PE investment amounted to EUR 15.9bn.

²⁵All investment figures are equity value, i.e. excluding leverage.

In terms of amounts invested, all private equity market segments so far (Q1 to Q3/2013) appear to have recorded another relatively poor year (please note that the market segment Business Angels is not included in PE or VC statistics. As business angel financing is important for the financing of SMEs and innovation, we present more information in box 2). In the buyout sector, which forms the largest part of the market, investment activity decreased by 10% to EUR 18.2bn.

The downturn was even more pronounced in the growth capital market segment (-43%). Venture capital investment dropped by 13% to EUR 2.1bn. According to the EVCA preliminary quarterly figures, all VC stages have shown weak investment activity in the first three quarters of 2013 (see figure 17), however, venture investments in the start-up segment performed the worst so far (-19% to EUR 1.1bn). Moreover, according to Preqin (2013a), the average value of angel/seed deals has fallen in Europe during 2012 and 2013. These developments are at least partially driven by the severe general economic crisis to which private equity – and in particular the buyout sector being the biggest segment of the market – has been exposed to a relatively large extent.

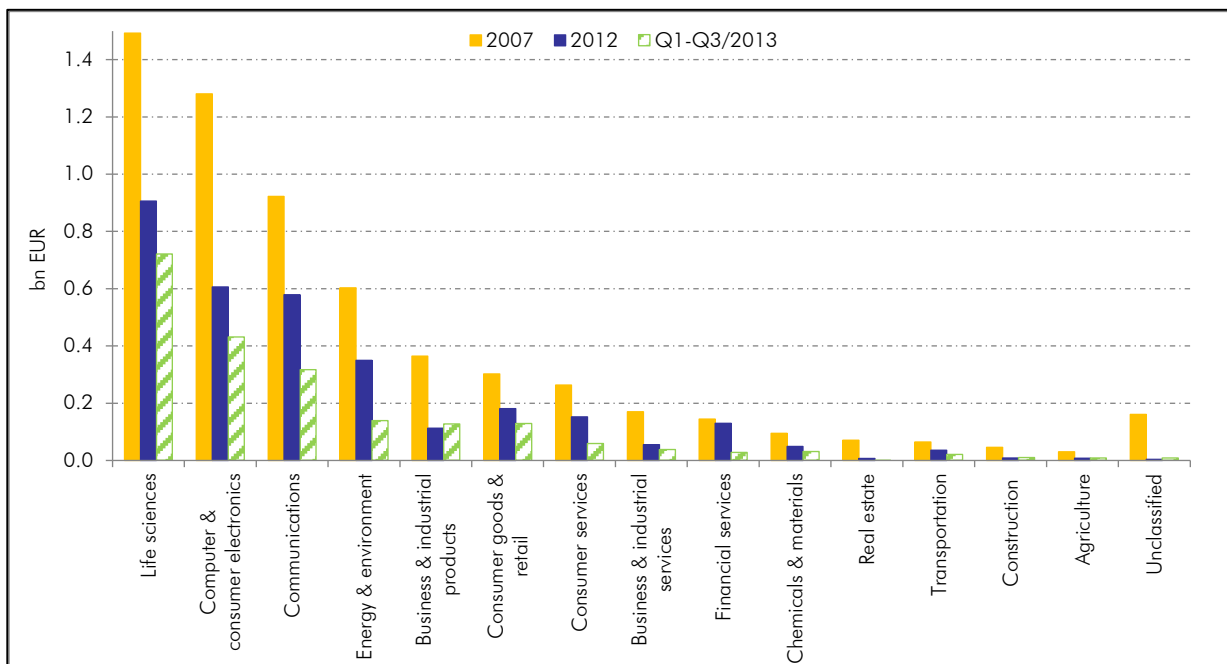
Figure 17: Venture Capital investment activity evolution in Europe



Source: Based on data from EVCA

Recent developments in venture investment by sector are shown in figure 18. The relative importance of sectors shows certain stability over time: life sciences, computer/consumer electronics, and communications remain the most relevant industries for venture investment. The share of life science in total VC investment activity has even increased from 25% in 2007 to 28% in 2012, and to 35% in the first three quarters of 2013.

Figure 18: Venture investment in Europe by sector, Q1-Q3/2013 vs. 2012 and 2007²⁶



Source: Based on data from EVCA

Box 2: Business Angel activity

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

Business Angels differ from VC funds, which primarily invest third parties' funds (e.g. Institutional Investors'). Angel-financed companies are typically in earlier stages of their development, compared to the VC-backed ones. Moreover, Business Angel investments are usually short-term, with a median holding period of approximately six years. The past three years have seen an increase in Business Angel investments in early-stage high-growth companies, as VC funds have migrated to less risky later-stage investments. Business Angels offer a number of advantages compared to VC funds:

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

There are difficulties in measuring the size of the business angel community, the main ones being identification and definition. Business Angels typically prefer to stay anonymous, and the details on their investments are rarely disclosed. Further, nothing can prevent an individual from identifying oneself as a 'virgin' angel, although he/she may have never actually invested. Others may have occasionally acted as angels, but are no longer looking for investment opportunities.

²⁶Figures based on market approach (i.e. by country of portfolio company), due to data availability.

²⁷For a general description of Business Angel financing we refer Kraemer-Eis and Schillo (2011) and to OECD (2011).

Box 2 continued:

Moreover, the so called “invisible market” makes a precise estimation of the angel market difficult. There are studies that the invisible part of the market is up to seven times greater than the visible part (CSES, 2012), while others estimate even a multiplier of nine to ten (EBAN, 2013). 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. EBAN²⁸, for example, reported for 2012 a further increasing number of Business Angel networks in Europe (from 410 in 2011 to 460 in 2012), with estimated investments by the approximately 26k BAN members of EUR 509m in more than 2,900 companies. Most of the BA activity is concentrated on the UK, Spain, France, Finland, Germany and Sweden, with Finland, Ireland and Turkey being the fastest growing markets. The average investment per company is estimated to be EUR 175k in 2012, and as such 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, with individual angel investments varying significantly.

As explained, the invisible part of the market is dominant – therefore, data availability for general statements is limited. However, it can be assumed that during the crisis Business Angels behavior did not move in the same direction like bank lending or venture capital supply. Mason and Harrison (2013), e.g., show for the UK that angel investment activity has held up since the onset of the crisis and they emphasize the economic significance of this market segment. Moreover, they underline the need for on-going government support.

4.2 Fundraising activity

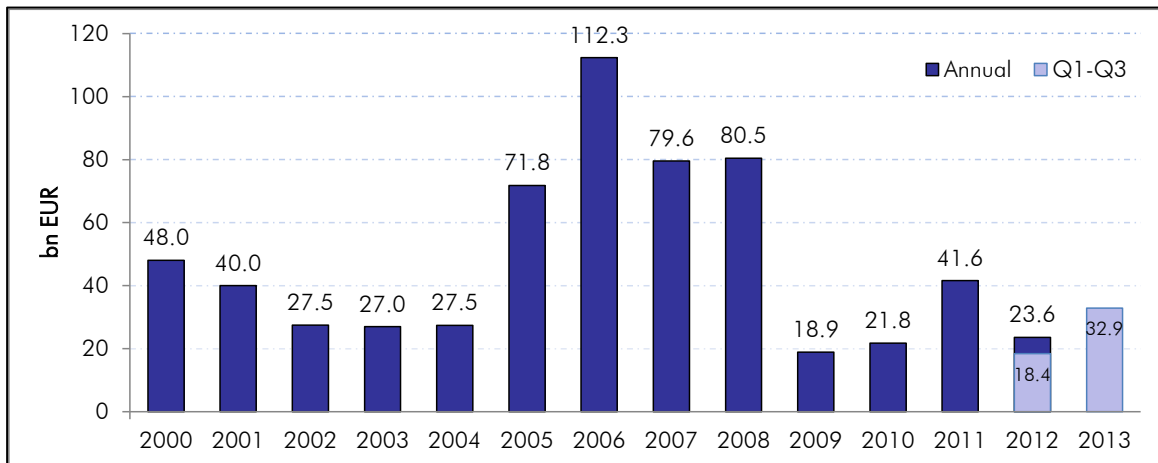
Total PE fundraising appears to have substantially improved. For the first three quarters of 2013, EVCA preliminary quarterly figures report a 79% increase (compared to the same period one year before) in funds raised by private equity firms located in Europe to EUR 32.9bn (see figure 19).²⁹ This is very positive news, in particular when taking into account the fall-back that PE fundraising had experienced in 2012.

The recent improvements in PE fundraising were mainly driven by the buyout sector (+111% to EUR 27.9bn), which by far forms the largest part of the market. In addition, fundraising increased considerably in the generalist (+260% to EUR 2.4bn) and growth capital (+79% to EUR 0.6bn) segments of the market, while EVCA preliminary figures so far show a weak year for the mezzanine segment (–70% to EUR 0.3bn).

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

²⁹Figures show fundraising activity (incremental amounts raised during the year) by private equity firms located in Europe (“industry approach” or “office approach”).

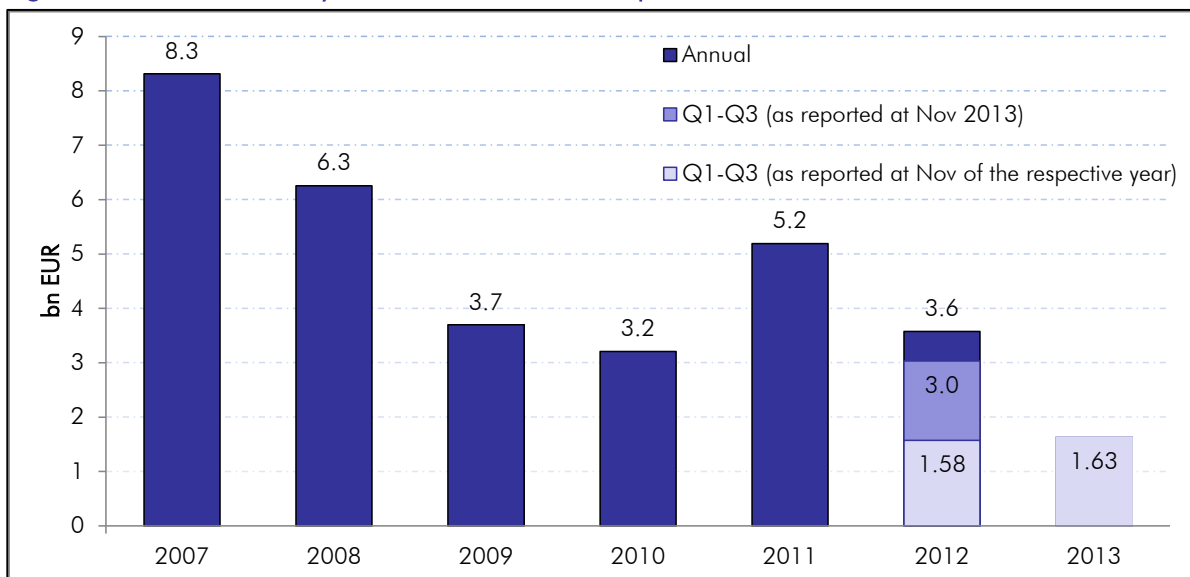
Figure 19: Funds raised by private equity firms located in Europe



Source: Based on data from EVCA

At first glance, European Venture Capital fundraising appears to have experienced another weak year. EVCA preliminary quarterly figures report a decrease of European VC fundraising by 46% in the first three quarters of 2013 (compared to the same period one year before) to EUR 1.6bn (see figure 20), with a particularly negative contribution coming from the early stage segment (–58% to EUR 0.7bn). However, again, bearing in mind that annual EVCA data can differ significantly from the data of the first three quarters of a year, it needs to be seen if the annual figures confirm this downward trend. At the same point in time one year before, EVCA preliminary figures had even reported a slightly lower level of VC fundraising (for Q1-Q3/2012). The preliminary figures were later revised upward to EUR 3.0bn. Hence, 2013 might finally show better results than EVCA preliminary figures have suggested so far (e.g. 60% of EIF’s commitments in 2013 are expected to be made in Q4/2013, vs. 40% in Q4/2012). However, in 2013, VC fundraising will potentially not exceed the levels of the crisis years 2009, 2010 and 2012. This would confirm that “Europe’s venture capitalists face a funding shortage” (EVCA, 2013b).

Figure 20: Funds raised by VC firms located in Europe



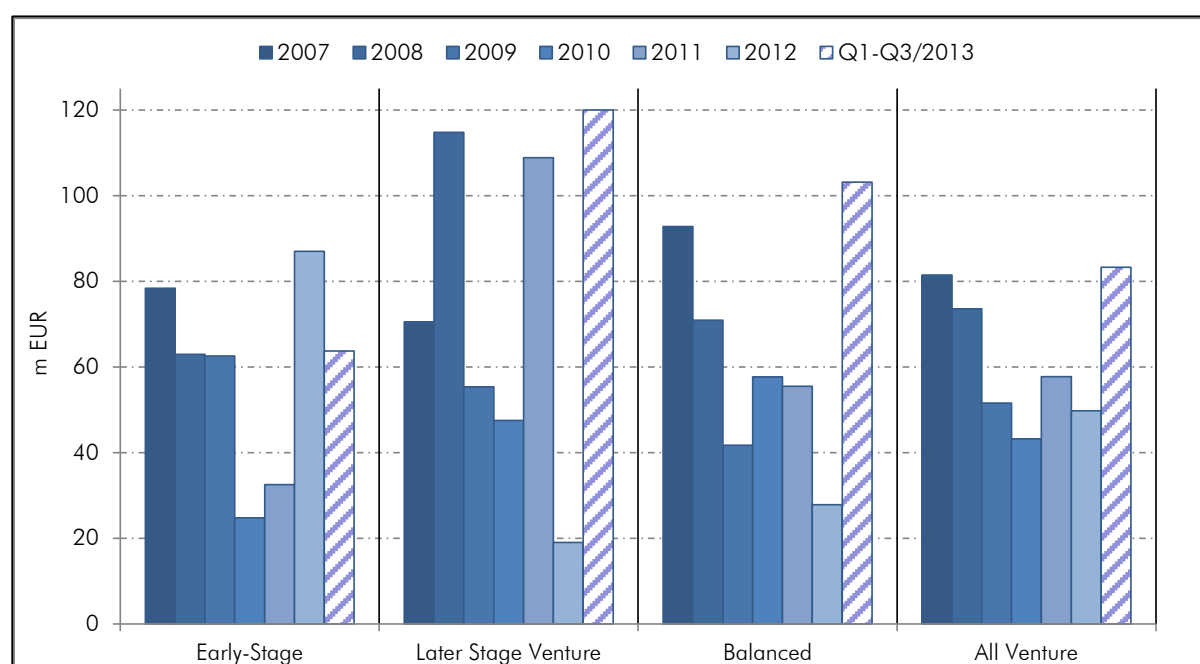
Source: Based on data from EVCA

Note on Q1-Q3/2012: EUR 1.58bn forms part of EUR 3.0bn. The figures should not be summed up.

Some positive signs come from the latest available developments in fund sizes. EVCA figures indicate that the average VC fund size has increased to EUR 83m (see figure 21), based on the number of 19 final fund closings during the first three quarters of 2013. Given the evidence in previous studies, which indicated that small fund size was one of the reasons for poor European VC performance (Kelly, 2011), the current finding might indicate positive news. However, these preliminary figures 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 small number of final fund closings that had been reported to EVCA so far. In particular, for later stage venture, EVCA figures show only one final closing.

Figure 21: Average VC fund size

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

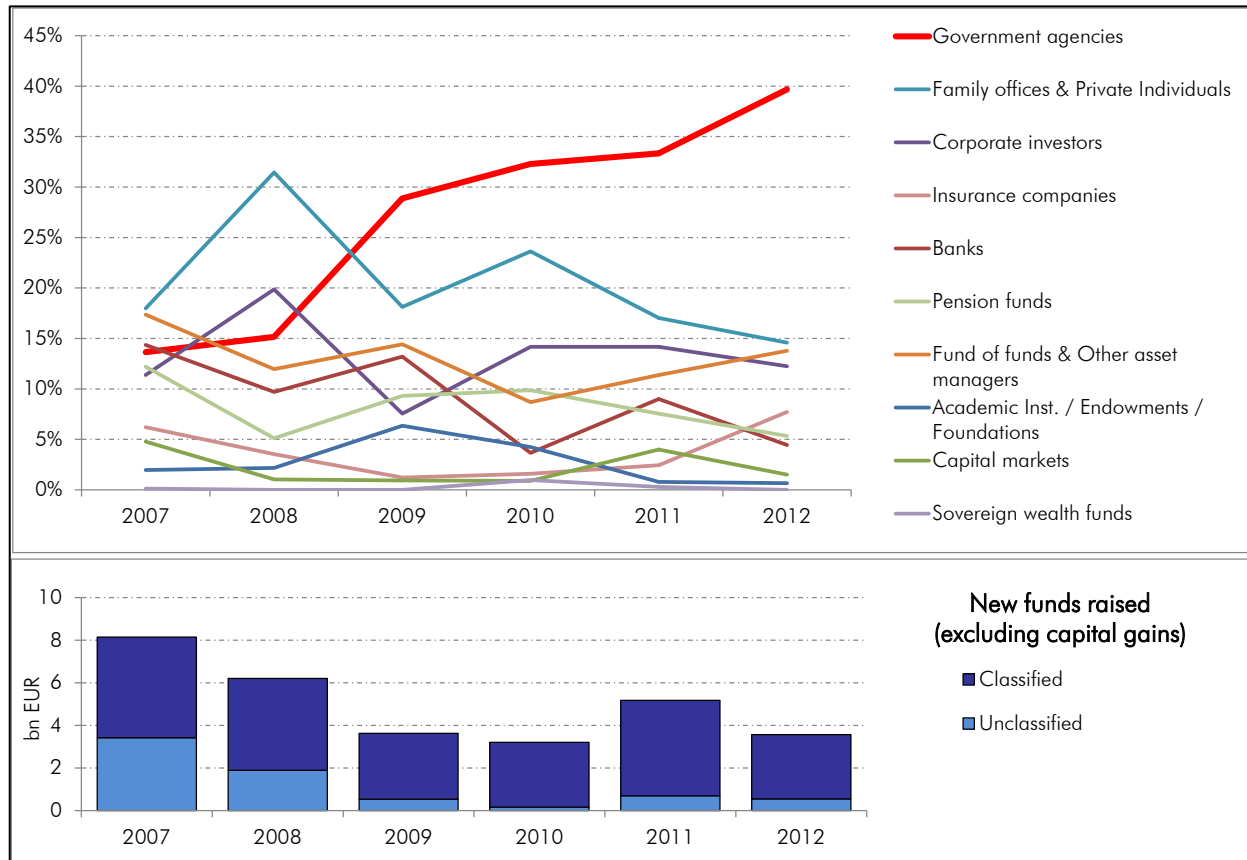


Source: Based on data from EVCA

A sign of the currently cautious sentiment for venture capital from investors is the shift in the investor base which has been going on during the past years (see figure 22). According to EVCA figures, government agencies had accounted for almost 40% of total investors into venture capital funds in 2012.

According to preliminary information from EVCA, the “ranking” of the most important investor groups has not much changed during 2013. Government agencies appear to have been the largest investor group again, followed by family offices/private individuals and corporate investors. 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 current times of a severe economic and financial crisis.

Figure 22: Investor base: Share of government agencies in VC fundraising



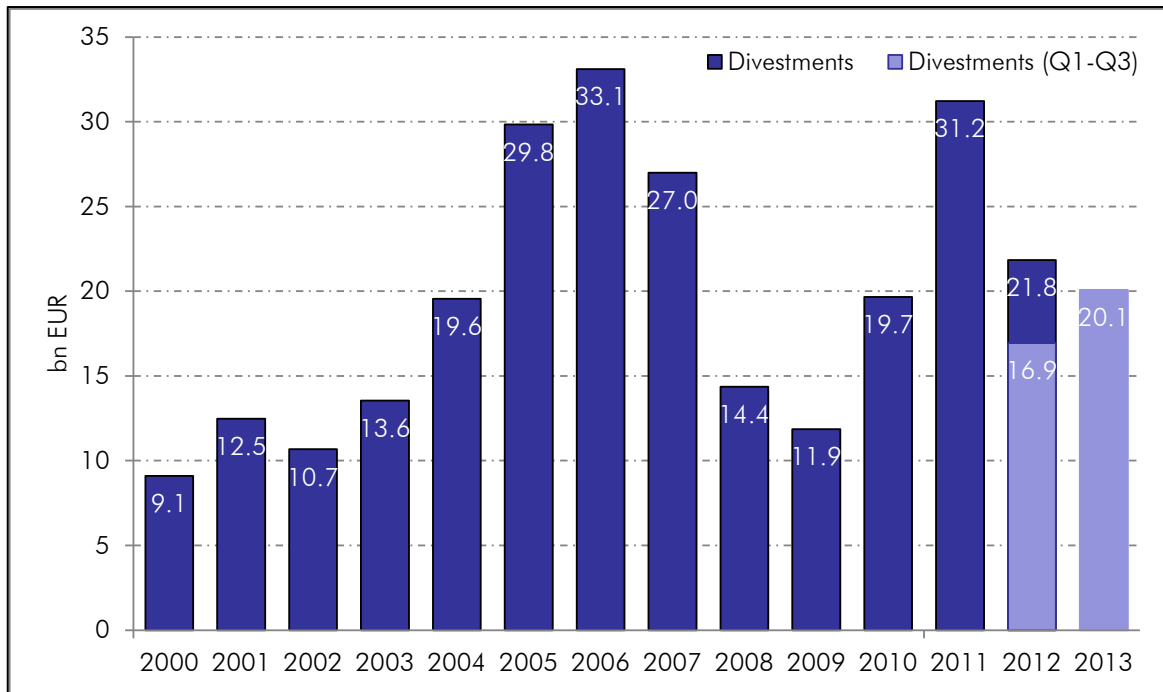
Source: Based on data from EVCA

4.3 Divestment activity

PE divestment activity appears to have improved somewhat. According to EVCA preliminary quarterly figures, total divestments by PE firms located in Europe amounted to EUR 20.1bn in the first three quarters of 2013, which was 19% above the value reached during the same period one year before (see figure 23). That rise was mainly due to increased activity in the buyout (+23%) and growth (+19%) segments³⁰ of the market. In contrast, divestment activity in the VC segment decreased by 31%. Total PE divestment amounts strongly exceeded the levels of the crisis years 2008 and 2009. However, venture exits are still below those levels that were reached during the worst years of the crisis – but, as stated above, it needs to be seen if the annual figures confirm this preliminary picture.

³⁰Due to data availability, divestment activity for the sub-segments of the PE market (buyout, growth, and VC) is reported on the basis of statistics that follow the market approach (i.e. by country of the portfolio company), but not the industry approach (or office approach, i.e. by country of the PE firm).

Figure 23: Divestments by private equity firms located in Europe

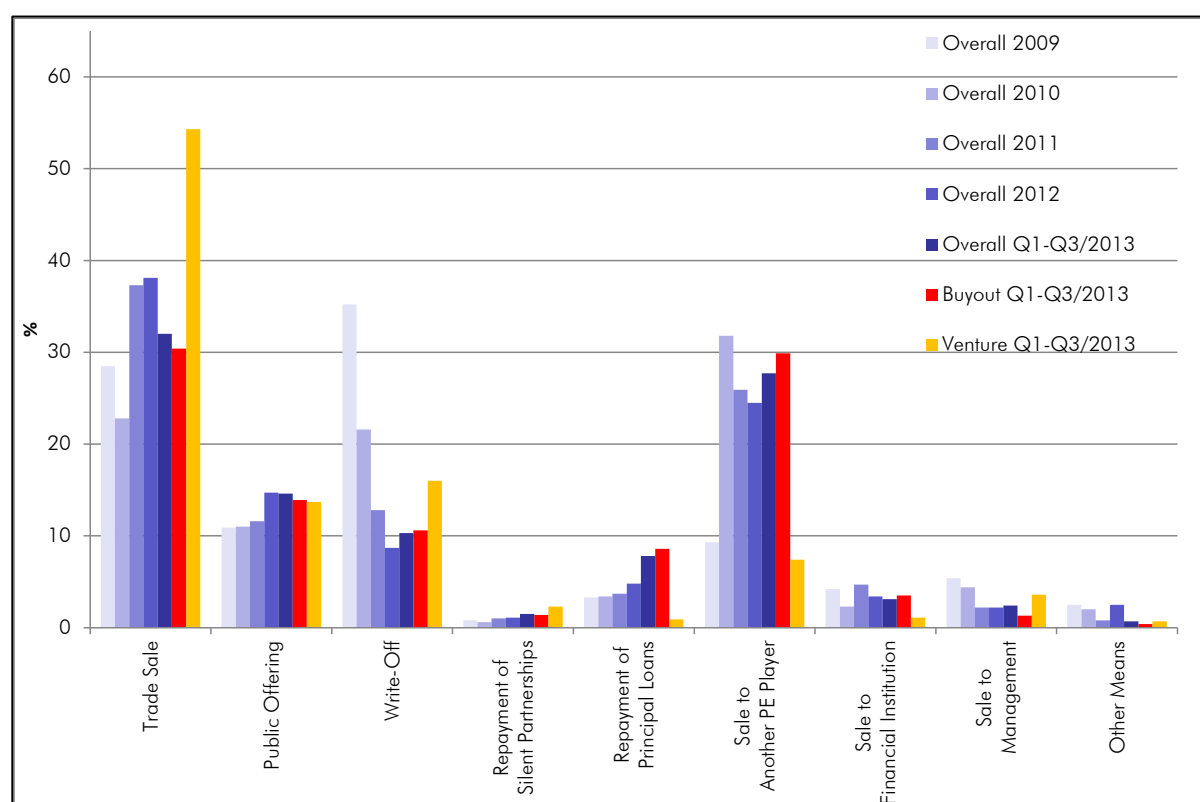


Source: Based on data from EVCA

Following a continuous decrease since 2010, the relative importance of write-offs as a form of divestment has slightly grown again in the first three quarters of 2013 (see figure 24). However, trade sales are still the most popular form of divestment. Together with sales to another private equity house, they account for approximately 60% of the total exit value. While write-offs made up only 11% of all buyout stage divestment amounts, they accounted for 16% in the venture part of the market. This means, however, already good news for venture capital, as last year's write-offs in the venture segment of the market had recorded their largest share (24.4%) in divestment amounts since the beginning of EVCA's VC records in 2007.

Another sign of a potentially slow movement towards "normalisation" in the VC exit market could be taken from the increase in the relative importance of public offerings in the first three quarters of 2013. This followed, however, the significant decrease of 2012, when public offerings had reached the lowest numbers since the start of EVCA's VC records. Moreover, the recent increase is only due to higher sales of quoted equity, while initial public offerings (IPOs) are still at depressing levels. Over the past years, the probability of an exit via IPO (initial public offering) decreased, while the time to successful exit increased. This has been confirmed by a recent study by Axelson and Martinovic (2013), but it can also be corroborated by the performance of EIF's equity portfolio. However, in the very recent past, EIF has observed several successful exits which could signal general improvements in the exit market conditions.

Figure 24: Divestment routes (shares)³¹



Source: Based on data from EVCA

4.4 Performance trends

An analysis of the European private equity performance was provided in the previous ESBFO. As these data are available only on an annual basis, the analysis in this chapter is based on the figures available up to 2012. As the EVCA (2013a) Pan-European Private Equity Performance Benchmarks Study for 2012 was only released after the publication of our previous ESBFO, given that and Thomson Reuters provided updated³² of data in the intervening period, it is worth looking at the revised performance data here.

According to the EVCA and Thomson Reuters data, European venture capital performance has slightly improved. The Internal Rate of Return (IRR), computed by Thomson Reuters, with a 3 year-rolling-horizon increased for the third year in a row, and amounted to 3.0%³³ in 2012. This is good news, in particular when taking into account the long period of negative returns during the years 2008 to 2010. However, when looking at longer-term performance figures, the picture is

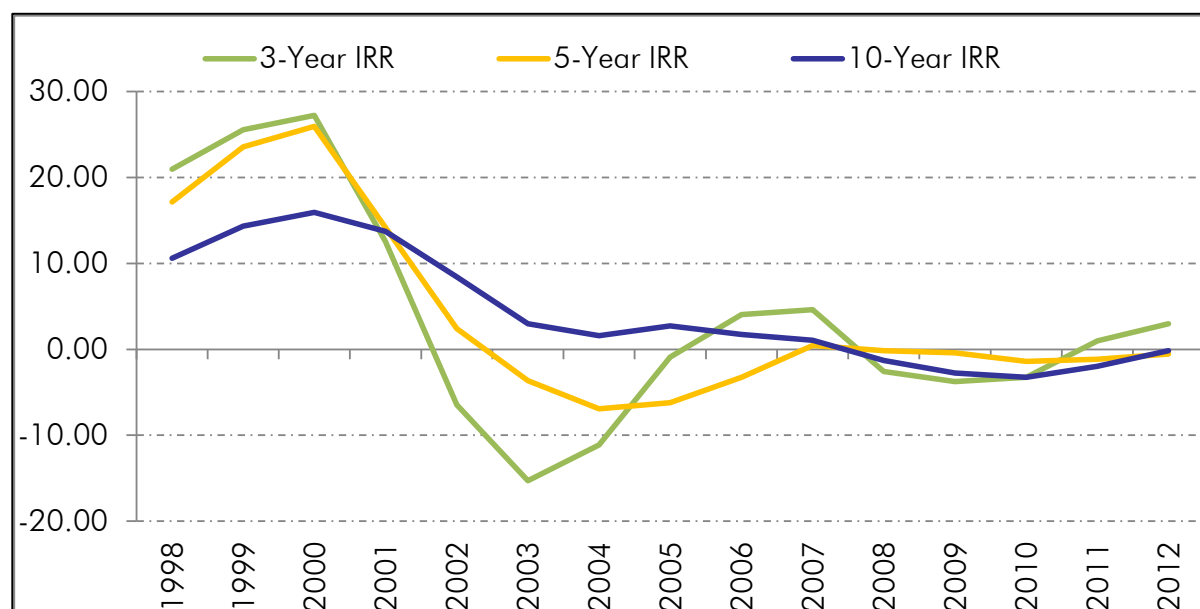
³¹ Shares based on amounts at cost divested. Market approach, due to data availability. "Overall" figures are *not* the weighted average of the "buyout" and "venture" figures, as "overall" figures additionally include the growth, rescue/turnaround and replacement capital market segments.

³² According to information provided to EIF by EVCA and Thomson Reuters, the EMEA, including European, fund performance data for 2012 is updated through 30 June 2013.

³³ This means an upward revision by 1 percentage point, compared to the figures that we based our analysis upon in our June ESBFO. (For the 5- and 10-year rolling horizon IRRs, the upward revision amounted to 0.6 and 0.4 percentage points, respectively.) The revisions for earlier years were of smaller amounts.

less bright (see figure 25). The IRRs with the rolling horizon of 5 years (-0.6%) and 10 years (-0.1%) are reported to be still in the negative area. Nevertheless, in 2011 and 2012, European VC performance improved for all the three aforementioned rolling horizon periods, i.e. 3, 5, and 10 years.

Figure 25: Rolling Horizon IRR European Venture Capital (in %)



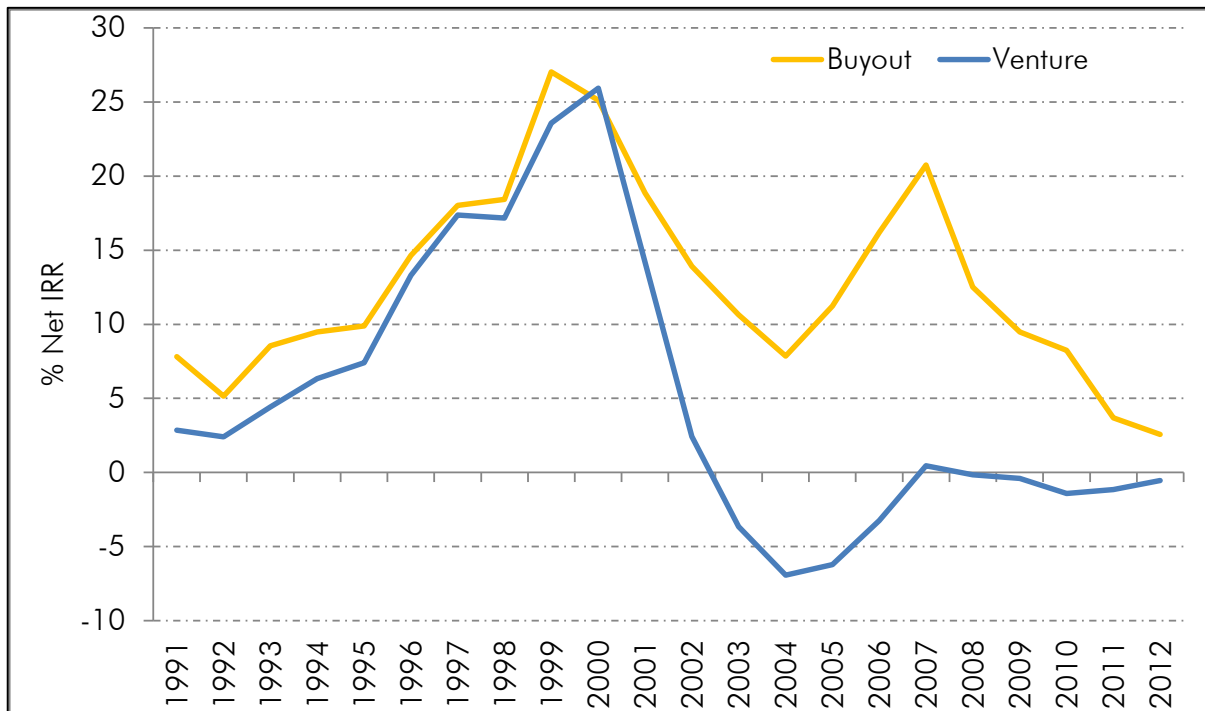
Source: Based on data from EVCA and Thomson Reuters

VC performance in Europe, however, is still below the level of returns reported for the private equity industry as a whole, which also includes the buyout and the mezzanine segments of the market. For the 5-year-rolling-horizon IRR, figure 26 shows that the relatively good performance of the buyout sector compared to venture capital in Europe holds also true when looking at the past, in particular at the last decade. However, the IRR figures for the buyout and the venture sectors are converging.

When looking only at the top-quarter, the total venture performance was at 18.5% (pooled IRR), thereby emphasizing the importance of careful selection by investors. These figures are indeed in the range of top-quarter buyout (21.0%) and mezzanine funds (18.7%), according to the EVCA (2013a) performance study.

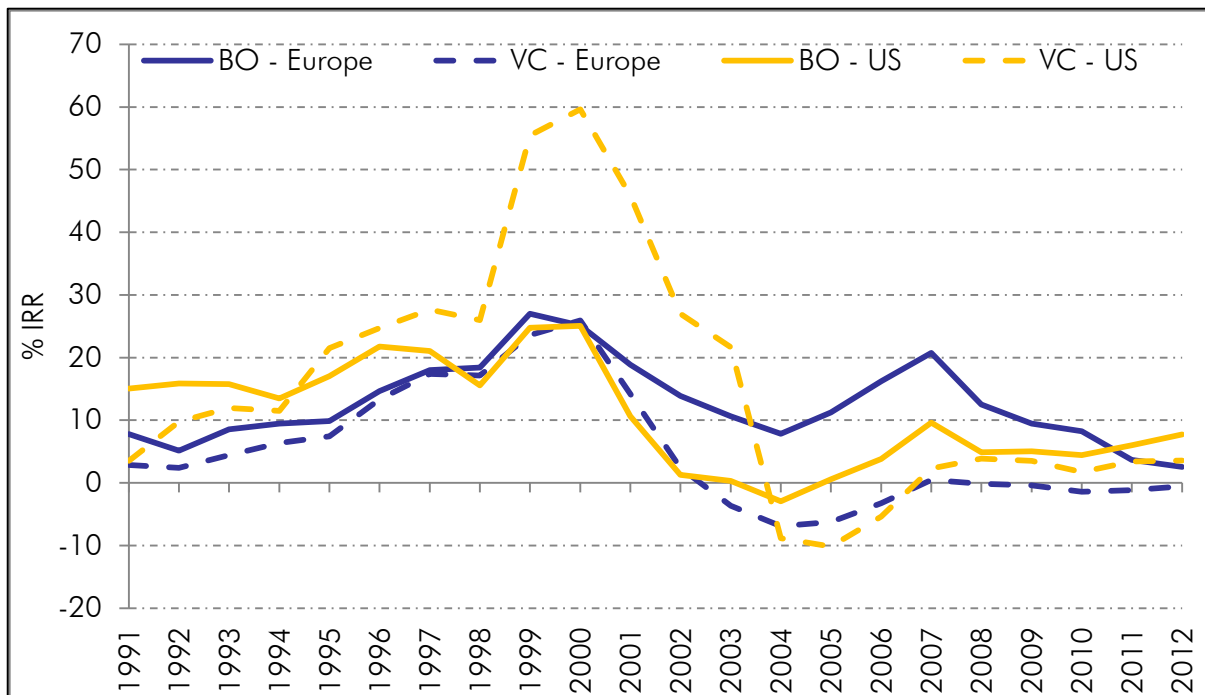
From a geographical point of view, the European picture looks relatively brighter for the buyout sector than for the venture capital part of it. Figure 27 shows that buyout performance (measured as a rolling five-year-horizon IRR) in Europe was better than in the US between 1998 and 2010. However, the US buyout sector had been picking up over the last two years and, consequently, outperformed the European buyout market. The European *venture* sector performed worse than its American benchmark in almost all years. Only during 2004 and 2006, when US VC performance entered negative territory, did its European counterpart perform slightly better.

Figure 26: Five-year horizon rolling net IRRs for European venture and buyout funds



Source: Based on data from EVCA and Thomson Reuters

Figure 27: Five-year horizon rolling IRRs for Europe and the US



Source: Based on data from EVCA and Thomson Reuters

4.5 Prospects

The current economic situation and various regulatory changes continue to make the private equity environment very challenging. According to a recent global Preqin (2013b) survey among PE fund investors, regulation, portfolio performance and the economic environment were the biggest challenges that investors were currently facing.

According to a recent global survey among PE fund investors, 19% of them viewed the regulatory changes and proposals as beneficial to the PE industry, 41% were of the opposite opinion, and 40% were still unsure (Preqin, 2013b). The large share of uncertain respondents shows that “the industry has yet to see the full impact of the regulations”. The ambiguous character of the regulatory measures is also shown through a statement put out by a German-based insurance company: “Solvency II has been bad for the industry but it is needed for stability” (Preqin, 2013b).

In addition, the current market environment is still hampering the fundraising perspectives. Therefore, fund managers’ track records are becoming increasingly important. According to Preqin (2013c), “many LPs are choosing to invest in funds raised by more established managers”. In addition, many VCs have at least partially turned to investments in companies with substantial revenues, i.e. to the growth equity market segment.

The structural challenges in the European VC market, the difficult fundraising environment, and the risk-averse market sentiment, all create problems with access to funding in general, and for new funds in particular. According to a recent Coller Capital (2013) study, more than half of the global LPs believe that there are insufficient sources, other than VC, available to finance innovation and growth in Europe. All this supports a view that public backing is especially needed for this market segment in order to strengthen, inter alia, the early stage part of the market. The latest findings on policy measures taken by governments to support seed and early-stage financing are outlined in box 3.

Box 3: Public policy interventions for seed and early stage finance³⁴

Start-up and innovation-oriented firms are contributing to economic growth and job creation. However, access to finance for these firms is particularly difficult due to the high risks associated with their lack of track record and collateral. Banks find it difficult to provide loans to young firms due to, inter alia, asymmetric information that results in market failures. Especially after the financial crisis, banks have been less willing than otherwise to provide credits to young firms. Moreover, venture capital firms became more risk averse and started to focus more on less risky investments.

Young firms need public support to transition from the early stage to later stages of their development, as their risks decline and their access to finance becomes easier. Therefore, policy interventions have increased in the past five years in many OECD countries in order to address the financing gaps and existing market failures.

³⁴This text box is based on Wilson, K. and F. Silva (2013).

Box 3 continued:

An OECD questionnaire that was sent to experts in 32 OECD countries indicates that supply actions taken by those countries were (i) grants, loans, guarantees, (ii) tax incentives and (iii) equity instruments.

The questionnaire showed that the majority of OECD countries have intervened by providing direct funding through grants or loans. Additionally, governments sometimes acted as guarantors through loan guarantees programmes.

Another way in which governments have intervened was by increasing tax incentive programmes in some OECD countries. These programmes include tax credits on investment, and reduced capital gains taxes, for investors in start-ups.

With respect to equity instruments, the questionnaire has also indicated an increase in co-investments funds and fund-of-funds. The interventions through equity instruments are justified not only for addressing market failures and financing gaps, but can also be seen as a way of facilitating the creation of private seed and early stage markets by providing critical mass. Moreover, the decision to intervene may also be incentivized by considerations that go beyond pure financial returns, such as social returns or strategic national interests.

In this context, EIF – as a reference catalytic investor in European venture and growth capital funds – has increased its counter-cyclical role in providing financing solutions to boost entrepreneurship and innovation. In the coming years, EIF will continue to cornerstone across the spectrum from technology transfer to venture capital to the lower mid-market and mezzanine financing (see box 4 for more information concerning “mezzanine”). This also includes the launch and extension of new and pilot initiatives. They include the European Angels Fund (EAF)³⁵ or partnerships with corporate investors, structured as a Corporate Innovation Platform (CorIP)³⁶, to establish collaboration between fund managers, strategic investors and portfolio companies. Moreover, a pilot initiative – the Social Impact Accelerator (SIA) – has been started to satisfy the growing need of equity finance for support to social enterprises. This segment of the business world is becoming increasingly instrumental in promoting social inclusion, providing alternative sources of employment to marginalised social groups, and contributing to growth.

EIF's activities are funded, inter alia, by EU initiatives. The EU level support for equity instruments for the programming period 2014 to 2020, given in the past through the CIP programme, will be continued and enhanced in the form of the COSME programme. Additional funds will be provided under “Horizon 2020”, which combines research and innovation funding provided by EU programmes. Moreover, private equity instruments can be supported under the JEREMIE initiative to promote regional business development.

³⁵EAF is a co-investment fund to provide equity to Business Angels. It was launched in March 2012 in Germany, and has been extended to Spain and Austria in 2013. Further roll-out to other countries is foreseen. More information on the EAF is available here: http://www.eif.org/what_we_do/equity/eaf/index.htm. In the field of Business Angels and in addition to EAF, complementary approaches, also in cooperation with BA networks, are under discussion.

³⁶More information on the Corporate Innovation Platform (CorIP) is available here: http://www.eif.org/what_we_do/equity/corip/index.htm.

Box 4: Mezzanine finance market

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

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

During 2013, the mezzanine mandate granted by EIB has been doubled (EUR 2bn), converted into evergreen, and merged within the other EIB mandates. As of 30/09/2013, EUR 890m were committed to twenty-five hybrid debt/equity funds. EIF’s investments have already catalysed over EUR 3bn of commitments, and in most cases EIF’s investment was key to the successful launch and closing of mezzanine funds. Importantly, EIF has supported market players in many EU Member States and Candidate Countries.

Under the same umbrella, EIF established the “Mezzanine Dachfonds für Deutschland” (MDD) in 2012, a mezzanine fund-of funds program for Germany. MDD is a EUR 100m fund-of-funds funded by the BMWi (German Federal Ministry of Economics and Technology), LfA Förderbank (the development bank of Bavaria), and NRW.BANK (the development bank of North Rhine-Westphalia). For each MDD investment in a hybrid debt/equity fund active in Germany under MDD, EIF is co-investing an amount that is at least equivalent to MDD’s.

With regard to *performance*, the medium term perspective remains uncertain, as the difficult general economic and financial environment continues to impact the performance of private equity in all of its segments. However, a crisis is also a source of opportunities in PE, as valuations are decreasing and acquisitions can be completed at more favourable prices. Furthermore, the outcome of the on-going fund selection process in the market might not only be negative (in terms of fewer investors), but might also result in a more efficient investor base. Indeed, the lack of experience in the young European VC industry, relative to its US counterpart, has been a key source of its relatively weak performance envelope. Europe has developed its venture sector later than the US, and Europe has less repeat (or “serial”) entrepreneurs. These differences have already started to become smaller, and this process can be expected to continue. Interestingly, US investors are an important part of some recent success stories in fundraising. According to Go4Venture Advisers (2013e), “it’s rather ironic that US LPs seem to have more belief in European venture than European LPs themselves. In many ways this is a vote of confidence in a pan-European approach to venture investing.”

Moreover, recent EIF market insight shows an increasing number of companies (names like Shazam, Supercell, and Wonga) in the early-stage segment that show a promising pattern of growth. It is, of course, important to grow these companies, and also identify and help to build their next generation. In addition, the VC ecosystem is developing, including the emergence of more and more successful incubators and accelerators. Should these trends continue, the potential returns of early-stage companies would have significantly positive impacts on the future performance of the financing funds. In consequence, the medium-term perspective of the European Venture Capital market would be more positive than the backward looking statistics reveal.³⁷

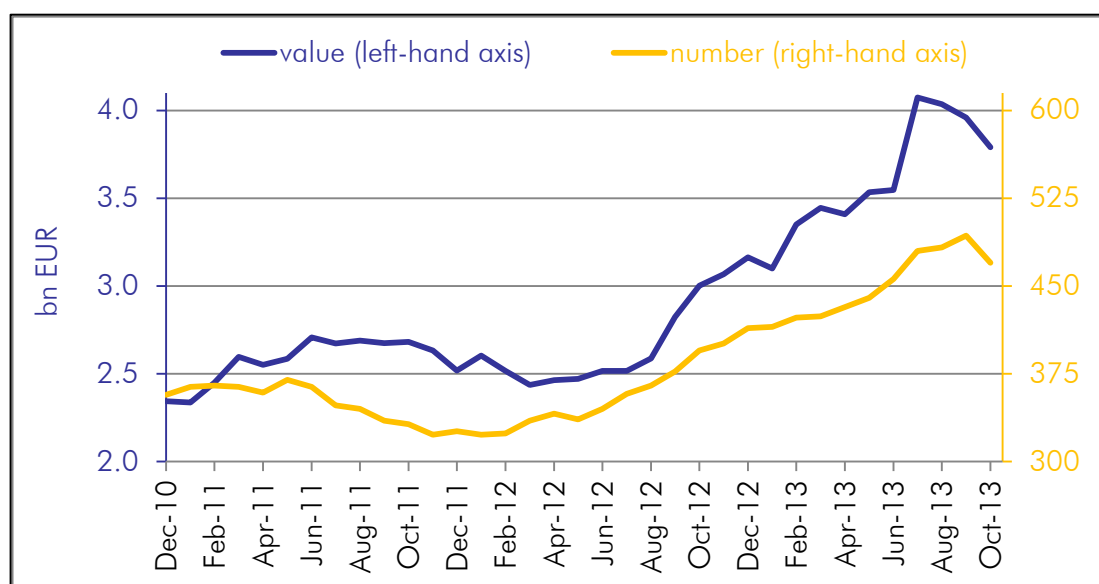
Some positive news have also come from Go4Venture Advisers’ early indicator, the European Tech Headline Investment Transactions Index³⁸. It recorded, on average, strong increases from summer 2012 to July 2013 (see figure 28). According to Go4Venture Advisers (2013a), “renewed interest in European venture is partly driven by the search for growth in the context of a moribund macro environment [and] low interest rates”. In addition, as another positive signal, EIF observed several cases of oversubscribed funds this year.

However, a general trend in the European Growth and VC markets since the summer of 2013, shows a repeated slowing rate of growth (Go4Venture Advisers, 2013d), which is also reflected in a drop in the Tech Headline Investment Transactions. Hence, it needs to be seen if the green shots, observed in the recent past, can really develop into a longer term positive trend. As shown above, EIF is actively working to let the green shots flourish.

³⁷For example, EIF sees as well several double-digit interim IRRs in its VC portfolio for some vintages.

³⁸Go4Venture Advisers’ European Tech Headline Investment Transactions Index “is a derivative index” which is “compiled [...] based on the deals reported in major trade publications and news feeds [...] as an early indicator of evolutions in the private investments market for European TMT companies. [...] TMT is defined to include Technology, including IT and Life Sciences (except drug discovery); Media, including Internet & Digital Media; Telecom Services (alternative operators only)”. For this and more information on definition and methodology see Go4Venture Advisers’ (2013b) and Go4Venture Advisers’ (2013c).

Figure 28: European Tech Headline Investment Transactions (12-month rolling horizon)



Source: EIF calculations based on Go4Venture Advisers data.

5 SME guarantees and SME Securitisation in Europe

5.1 SME guarantees

Information asymmetries can be reduced via three ways: a strong relationship between lender and borrower, through due diligence/lenders' examination (screening), and by a firm's ability to signal its credit worthiness (incl. an institutional assessment or rating by an independent agency and the provision of collateral or a guarantee). However, this means that new or young firms, with a lack of collateral and, by definition, without a track record, are the ones with the greatest degree of difficulty in accessing debt capital. These financing obstacles can also negatively affect productivity in the economy. Against the background of the on-going economic crisis, with the sources of financing possibly becoming scarce, this problem is even more relevant today (ECB, 2013c).

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. The reasons for a market failure relate to insufficient supply of capital (debt or equity), and inadequacies on the demand side. This market failure is mainly based on asymmetric information (in the case of debt: information gap between lender and borrower), combined with uncertainty, which causes agency problems that affect debt providers' behaviour (see Akerlof, 1970 and Arrow, 1985).³⁹

Guarantee mechanisms 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, 2013b), and in order to alleviate market failures in SME financing.

Data on the provision of guarantees to the benefit of SMEs in Europe is scarce. Some market information is gathered by AECM, the European Association of Mutual Guarantee Societies.⁴⁰ These data covers SME guarantees provided by AECM members. In the following we provide information about the countries with at least one AECM member in order to start to show the state and development of this important market segment. However, for the first half-year of 2013 (in the following: HY1/2013) data is currently available for a subset of AECM members only. Therefore, we also have a look at the years 2011 and 2012 again in order to show a more complete picture (data for 2012 and 2013 are preliminary.)

³⁹Agency theory/the principal-agent approach is often applied in economics literature for the analysis of relationships between lenders and borrowers (e.g. contract design, selection processes, credit constraints, etc.).

⁴⁰We would like to thank our colleagues from AECM for their support. AECM has currently 39 members in 20 EU Member States, Montenegro, Russia, and Turkey. EU countries without an AECM member are Cyprus, Denmark, Finland, Ireland, Malta, Slovakia, Sweden and the UK, even if guarantee activities exist. In the AECM member countries, the AECM members cover all or almost all SME guarantee activity. Some AECM members are national associations or networks and thus have their own member organisations. AECM has purely private, mutual, public, and public-private mixed members. Source: AECM.

Market size (based on annual data for 2011 and 2012)

In terms of total volume of *outstanding guarantees*, the core countries are Italy, France, Germany, and Spain (see table 2), while Italy has the highest total *number* of outstanding guarantees (866,237 in 2011)⁴¹, followed by: France (449,450 in 2012), Turkey (264,118 in 2012), Poland (150,314 in 2012), Spain (80,077 in 2012) and Portugal (71,968 in 2012). Within the EU, the average size per outstanding guarantee is the largest in Latvia (EUR 227k in 2012), followed by: the Czech Republic (EUR 157k), Slovenia (133k), Germany (120k), and the Netherlands (107k). In contrast, France (34k) and Italy (41k in 2011), the two leading countries in terms of total number and value of guarantees, have relatively small average guarantee sizes in portfolio.

Table 2: Total volume (k EUR) of outstanding guarantees on SME loan portfolios by country^{41,42}

Country	2012 (provisional)
Austria	396,264
Belgium	747,291
Bulgaria	57,417
Czech Rp	855,853
Estonia	111,637
France	16,011,762
Germany	5,836,312
Greece	585,298
Hungary	1,419,256
Italy	35,682,369
Latvia	88,652
Lithuania	173,456
Luxembourg	1,563
Netherlands	2,449,310
Poland	389,815
Portugal	2,968,495
Romania	1,757,905
Russia	268,257
Spain	5,527,645
Slovenia	194,605
Turkey	3,578,607
TOTAL	79,101,770

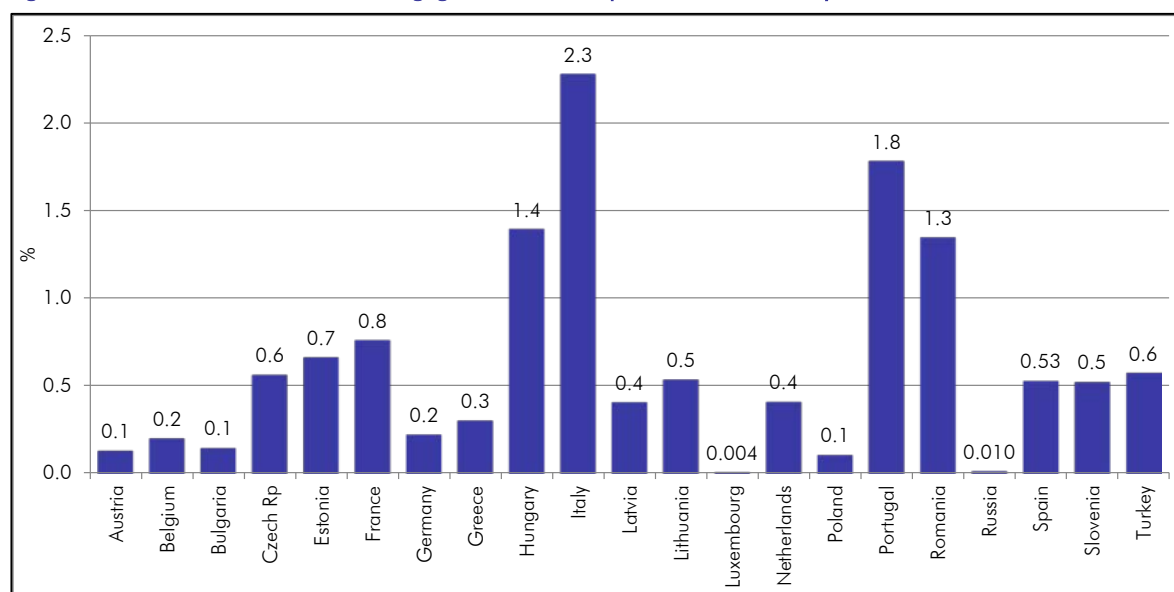
Source: AECM

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 (2.3%), Portugal (1.8%), Hungary (1.4%), and Romania (1.3%), as shown in figure 29. According to the OECD (2013b), guarantees are particularly relevant “in those countries where a network of local or sectoral guarantee institutions is well established”.

⁴¹For data availability reasons, AECM statistics include Italian members’ business figures with a time lag of one year. This is also true for the diagrams and tables presented throughout this chapter.

⁴²Since the previous issue of the ESBFO, which already contained an overview of AECM data for 2012, the AECM figures were slightly upwards revised. Nevertheless, these figures are still of preliminary nature.

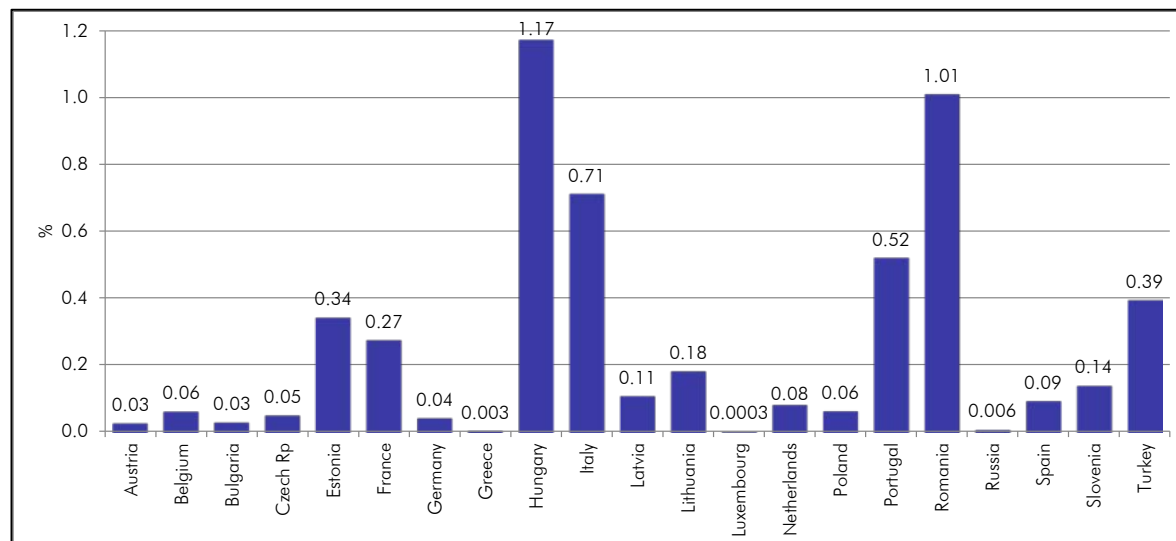
Figure 29: Volumes of outstanding guarantees in portfolio scaled by GDP, 2012 data



Source: AECM (provisional figures).

The country rankings, shown above, are broadly in line with the guarantee activity in 2011 and 2012, which was strongest (related to GDP) in Hungary, Romania, and Italy (see figure 30 for 2012 data).

Figure 30: Volumes of guarantees granted in 2012 scaled by GDP



Source: AECM (provisional figures).

Recent activity (based on data for 2011, 2012 and HY1/2013)

Guarantees outstanding

Changes in the volumes of guarantees outstanding

In 2012, according to the preliminary AECM data, the total volume of outstanding guarantees in portfolio, had amounted to EUR 78.6bn, after adjustments in order to allow for comparisons with the previous year.⁴³ For those AECM members that consistently reported data for 2011 and 2012, the volume of outstanding guarantee business had decreased by 4% in 2012, compared to 2011.⁴⁴

In HY1/2013, according to the preliminary AECM data based on a subset of AECM members, the total volume of outstanding guarantees in portfolio remained rather stable: For this subset of countries, the total volume of outstanding guarantees in portfolio decreased only slightly by 0.4% from EUR 34.85bn as at 31/12/2012 to EUR 34.71bn as at 30/06/2013.⁴⁵ The largest decreases were recorded in Bulgaria (–32%) and the Czech Republic (–18%). So far the only country for which increases were reported in the course of HY1/2013 is France (+4%).⁴⁶

Changes in the numbers of guarantees outstanding

In 2012, the total number of outstanding guarantees in portfolio of AECM members were at a record level of 2.1m in 2012. For those AECM members that consistently reported data for 2011 and 2012, the number of outstanding guarantees increased by 10.0% compared to the year before.

For the subsample of the AECM members that provided information for HY1/2013, the number of outstanding guarantees in portfolio increased by 1.7% (from 719k as at 31/12/2012 to 732k as at 30/06/2013). The largest increases were recorded in France (+6%) and the Czech Republic (+6%),⁴⁷ while Bulgaria (–21%) and Romania (–18%) reported the most substantial declines. At

⁴³In order to allow for comparisons with the previous year, the 2012 figures presented here were adjusted by AECM for counter-guarantee activities of those members that reported such activities for the first time in 2012. Without these adjustments, the total volume of outstanding guarantees amounted to EUR 79.1bn in 2012, and the volume of new guarantees granted in 2012 was at a level of EUR 26.2bn.

⁴⁴In order to report reasonable growth rates, two forms of adjustment of AECM statistics were conducted.

- We deducted the business figures of Italian AECM members, as these are included in AECM statistics with a time-lag of one year.
- In addition, we deducted the data for countries from which AECM members did not report business figures for one of the two years 2011 and 2012.

⁴⁵Counter-guarantee activity was excluded for the comparison 2013/HY1 vs. 2012.

⁴⁶For Italy the reported increase amounted to +11%. However, this figure is only based on the data of one AECM member, which is active in the agricultural sector only, whose reported volume of outstanding guarantees in portfolio amounted to the negligibly tiny fraction of 0.3% of the total volume of outstanding guarantees in portfolio as reported for 2012 in Italy.

⁴⁷For Italy the reported increase amounted to +31%. However, this figure is only based on the data of one AECM member, which is active in the agricultural sector only, and whose reported number of outstanding guarantees in portfolio amounted to the negligibly tiny fraction of 0.06% of the total number of outstanding guarantees in portfolio as reported for 2012 in Italy.

the same time, the total number of SME beneficiaries in portfolio increased by 5.4% to 668k SMEs for the subsample of the AECM members that provided information for HY1/2013.

New guarantees provided

Volume of new guarantees provided

The volume of *new guarantees granted per year* was reported to be at the level of EUR 26.2bn in 2012 (EUR 23.1bn of guarantee activity plus EUR 3.2bn of counter-guarantee activity). For those AECM members that consistently reported data for 2011 and 2012, the volume of new guarantees decreased by 6.0%. For the subsample of the AECM members that provided consistent information for HY1/2013 and for 2012, the volume of new guarantees (excluding counter-guarantees) granted has fallen by 3.8% in HY1/2013, compared to the average new guarantee volume per half-year in 2012.

As for the developments in new guarantee business *by country* (for those countries for which 2011 and 2012 data is available), the strongest value increases of new guarantees granted per year were recorded for the Czech Republic (+19.3%) and Portugal (+19.0%), followed by: Romania (+13.2%), Estonia (+10.6%), Hungary (+7.7%), Austria (+5.2%), and Turkey (+3.6%). The strongest decreases were observed in Greece (-84.1%), Luxembourg (-82.7%), and Bulgaria (-70.4%). Moreover, several countries with large guarantee activities (in absolute terms) recorded substantial slumps in new business in 2012, e.g. France (-7.2%), Spain (-24.6%), Germany (-5.1%), and the Netherlands (-46.6%). In some countries (e.g. Bulgaria and Greece), cuts in the budgets allocated to these purely public guarantee schemes led to strong decreases in guarantee activity, in addition to setbacks in demand. For Luxembourg, small absolute changes already imply strong relative variations, due to the low size of the scheme.

For the subsample of the AECM members that provided consistent information for HY1/2013 and for 2012, the largest decreases were recorded in Bulgaria (-96%), Luxembourg (-65%), the Netherlands (-28%) and Spain (-24%). Only three EU countries reported increases in new guarantee business in HY1/2013, compared to the average volume per half-year achieved in 2012, namely the Czech Republic (+59%), Estonia (+10%) and France (+6%).⁴⁸

Number of new guarantees provided

In 2012, 636,000 *new guarantees* were issued (+3.5% compared to the previous year, for those AECM members that consistently reported data for 2011 and 2012). At the time, this seemed to reflect some bottoming out of the negative trend after strong falls in the number of new guarantees in 2010 and 2011. Indeed, this trend appears to have continued in HY1/2013, when the number of new guarantees granted increased by 11% compared to the average number of new guarantees granted per half-year in 2012 – with a proviso that this increase is based only on

⁴⁸For Italy the reported increase amounted to +8%. However, this figure is only based on the data of one AECM member, which is active in the agricultural sector only, and whose reported value of new guarantees provided amounted to the negligibly tiny fraction of 0.5% of the total value of new guarantees provided as reported for 2012 in Italy.

a subsample of AECM members that provided consistent information for HY1/2013 and for 2012.

In HY1/2013, the largest increases in the number of new guarantees, compared to the average number per half-year achieved in 2012, were reported for the Czech Republic (+87%), Romania (+47%), Estonia (+42%), France (+15%).⁴⁹ The most considerable decreases were so far recorded in Bulgaria (−96%), Luxembourg (−43%), Lithuania (−24%), the Netherlands (−20%), Spain (−18% and Slovenia (−18%).

The total number of new SME⁵⁰ beneficiaries in portfolio (excluding counter-guarantees) stood at 78.6k in HY1/2013, for the subsample of the AECM members that provided this information.

Ratio of new business to outstanding business

The ratio of new business to outstanding business decreased significantly from 2010 to 2012. For the number of guarantees, the share fell from 37.8% in 2010 to 32.5% in 2011 and then to 28.8% in 2012. For the volume of guarantees, the share decreased from 40.0% in 2010 to 36.7% in 2011 and to 33.2% in 2012.

Average guarantee size

The observed decrease in values, with a parallel increase in the number of guarantees, is reflected in the development of the average guarantee sizes, for which the AECM statistics show an increase from EUR 34.1k in 2008 to EUR 40.2k in 2011, while the value dropped back again in 2012 (to EUR 37.9k), i.e. towards the average size reached in prior years. In HY1/2013, the average guarantee size has further decreased, based on preliminary AECM statistics for the subsample of members that had provided data.⁵¹

According to AECM, the recent developments could be explained by an increase of guarantees with smaller amounts, as well as of short-term guarantees (i.e. working capital loan guarantees and bridge-financing guarantees, which have in general smaller amounts). Short-term guarantees generally (for the AECM members) cover less than 12 months.

Drivers of recent developments in guarantee business

The developments in SMEs guarantee transactions are, on the one hand, caused by special items in particular countries, while on the other, they seem to mirror the specific macro and microeconomic situation in the different economies. Those countries that suffer relatively strongly

⁴⁹For Italy the reported increase amounted to +46%. However, this figure is again based on the data of one AECM member that represents only a tiny fraction of the total Italian guarantee activities.

⁵⁰Including guarantees for agricultural businesses.

⁵¹For the subsample that had provided data for 2013/H1 and for 2012, the average size of outstanding guarantees has fallen by 2.1% from EUR 48.4k in 2012 to EUR 47.4k in 2013/H1.

from the current sovereign debt crisis and experience weak economic growth – or even a fall in economic activity – also show poor developments in guarantee transactions. This seems to be driven by both demand and supply side factors. In times of the weak economic output growth, SMEs business, investments, the related need for finance, and, hence, their implied demand for guarantees – are all low. At the same time, tightening restrictions on public budgets and high financial risk perceptions (ECB, 2013d) are weighing quite heavily on guarantee supply. Consequently, public support from the European level could improve the situation, if only on the supply side. In some countries, e.g. Germany, the weak development of guarantee activity can also be explained by relatively favourable financing conditions, and so lesser need for guarantees, following the strong increases in guarantee demand were observed during the crisis years of 2009-10 (VDB, 2012).

EIF activity and recent developments

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

As part of its mandate activity, EIF manages the SME Guarantee Facility (SMEG) under the Competitiveness and Innovation Framework Programme (CIP) on behalf of the European Commission (EC). Under this facility, losses are covered using specifically allocated EC budgetary resources. Moreover, EIF continues to deploy its financial products in order to catalyse EU structural funds. This is done with a view to enabling SME financing in countries less supported by “traditional” EIF products, namely risk-sharing loans and portfolio guarantee instruments under JEREMIE⁵². Under the JEREMIE First Loss Portfolio Guarantee (FLPG), EIF covers part of the credit risk relating to a new portfolio of loans and/or leases granted by a financial intermediary to SMEs. Moreover, EIF further implemented a risk sharing loan product, the Funded Risk Sharing Product (FRSP), whereby EIF provides funding to banks for the financing of new portfolios of SME loans (such loans to be co-financed by the financial institutions), and shares part of the credit risk related to the portfolios.

In addition, in 2011 EIF launched the Risk-Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps (RSI) Facility. The RSI is an EIF/EIB/European Commission joint pilot guarantee scheme that aims at improving access to debt finance for innovative SMEs

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

and small mid-caps (enterprises with fewer than 500 employees) in support of research, development and innovation projects. RSI complements the scope of the existing Risk Sharing Finance Facility (RSFF), which is managed by the EIB and mainly addresses large corporates and mid-caps. Under RSI, EIF issues guarantees and counter-guarantees to selected financial intermediaries in order to allow them to provide loans, financial leases and loan guarantees. Serving as a basis for the EU 2014-2020 programming period, RSI complements the existing EU SME support schemes.

With regard to the EU programmes, and looking towards the new programming period, the EU guarantee instruments are going to be continued and enhanced. They will be deployed through the Loan Guarantee Facility (under the COSME Programme), the RSI II Facility (under the Horizon 2020 Programme), the Cultural and Creative Sectors Facility (under the Creative Europe Programme), and via continued support through the instruments available under European Structural and Investment Funds. It is the objective to achieve simplified implementation modalities, together with increased coherence and consistency of the instruments. These EU level instruments are not to be seen as special measures to fight the crisis, however, but as the instruments with which to mitigate the structural weaknesses in SME lending.

Another instrument to alleviate the impact of the crisis on SME lending is being prepared: 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, the EIB Group (EIB and EIF) and the Member States to achieve significant and rapid impact. The initiative is explained in more detail in chapter 5.2, as the options refer to the guarantee and securitisation solutions.

5.2 SME Securitisation (SMESec)⁵³

A well-functioning securitisation market could be a way to easing supply problems by helping banks diversify their funding and achieve capital relief. The OECD stated in 2011 (Blommestein et al., 2011) that “it seems likely that in the long run, structured-finance securitisation will once again become an important channel for debt markets; in the shorter term, securitisation may even rebound to support the global economic recovery, provided certain important pre-conditions are in place”. However, as already outlined in our previous ESBFOs, this development has not yet taken place. SME securitisation placed with investors currently represents only a very small portion (approximately 1%) of the total placed Asset Backed Securities (ABS) issuance. The bulk of SME ABS is retained for ECB refinancing purposes, and there is currently no real primary market.

Now, however, the important role of securitisation in financing, and in particular SMESec⁵⁴, is publicly voiced more and more often again. In our recent working paper on SMESec (Kraemer-Eis, Passaris, and Tappi, 2013), we refer to the various statements by ECB, EC, IMF, AFME, UEAPME, and the European Council. As a recent additional example, Yves Mersch, Member of

⁵³This chapter is based on our latest paper about SMESec, see: Kraemer-Eis, Passaris, and Tappi (2013), but considers updated information: http://www.eif.org/news_centre/publications/eif_wp_2013_19.pdf

⁵⁴The term SME Securitisation (SMESec) comprises transactions based on SME loans, leases, etc. The reader can find a securitisation glossary in the Annex.

the Executive Board of the ECB said “as disintermediation is not an option for most euro area SMEs, a promising middle way is to increase possibilities for the securitisation of SME loans. This could build a bridge between SMEs and non-bank sources of finance. (...) If we are to reap the potential gains of securitisation for SMEs, we need to revive this market. This implies removing some key impediments to its functioning” (Mersch, 2013).

5.2.1 Market activity⁵⁵

The European securitisation market had grown steadily from the beginning of the previous decade until the outbreak of the crisis. During the crisis, issuance remained at high levels, but these high volumes were almost exclusively driven by the eligibility of ABS as collateral for ECB liquidity operations. After having peaked in three successive years over 2008-2010, the overall market activity decreased to the levels just before the crisis due to regulatory uncertainties and tighter Euro system collateral rules.⁵⁶ Rating downgrades, based on negative credit trends and revised rating agency criteria (without grandfathering), contributed to the negative market sentiment. However, despite the crisis, the European securitisation market in general performed relatively well with comparably low default rates.

Nevertheless, SMESec is still suffering from the economic and financial crisis. The near-collapse of the European structured-finance market, in tandem with the other markets around the globe more generally, has profoundly affected the status and outlook of SMESec. Unfortunately, the situation has only slightly improved over the recent past. It is still the case that originators mainly retained newly issued deals in order to create liquidity buffers, and to use the assets as collateral with central banks for re-financing purposes. At this point in time, we can still not talk about a functioning primary market.⁵⁷

In consequence, overall securitisation activity was high during the crisis (but this mainly reflects retained transactions), with a peak in 2008 (EUR 711bn), and since then a continuous decrease. The *issuance* in Europe went down significantly (-33%), from EUR 372bn in 2011 to EUR 251bn in 2012 (for comparison: a level like in 2004). Q1 (with EUR 32.7bn) and Q3 (with EUR 35.4bn) of 2013 were in terms of overall issuance among the weakest since 2002.

The most active markets in terms of issuance were the Netherlands (market share in Q1-Q3/2013: 29%), Italy (19%), UK (14%) and Germany (14%). The overall reduction in collateral production is dominated by a reduced issuance of the UK Prime Residential Mortgage Backed Securities (RMBS). The main reason for this development in the UK is the availability of the “Funding for Lending Scheme”, FLS (since August 2012) that provides potential UK RMBS originators with cheaper refinancing via the Bank of England. FLS aims at reducing the costs of banks’ funding in exchange for commitments to lend more (to mortgagors and companies). The FLS had been originally foreseen to cease operations in January 2014, but the Bank of England

⁵⁵If not flagged otherwise, the data source is AFME, the Association for Financial Markets in Europe.

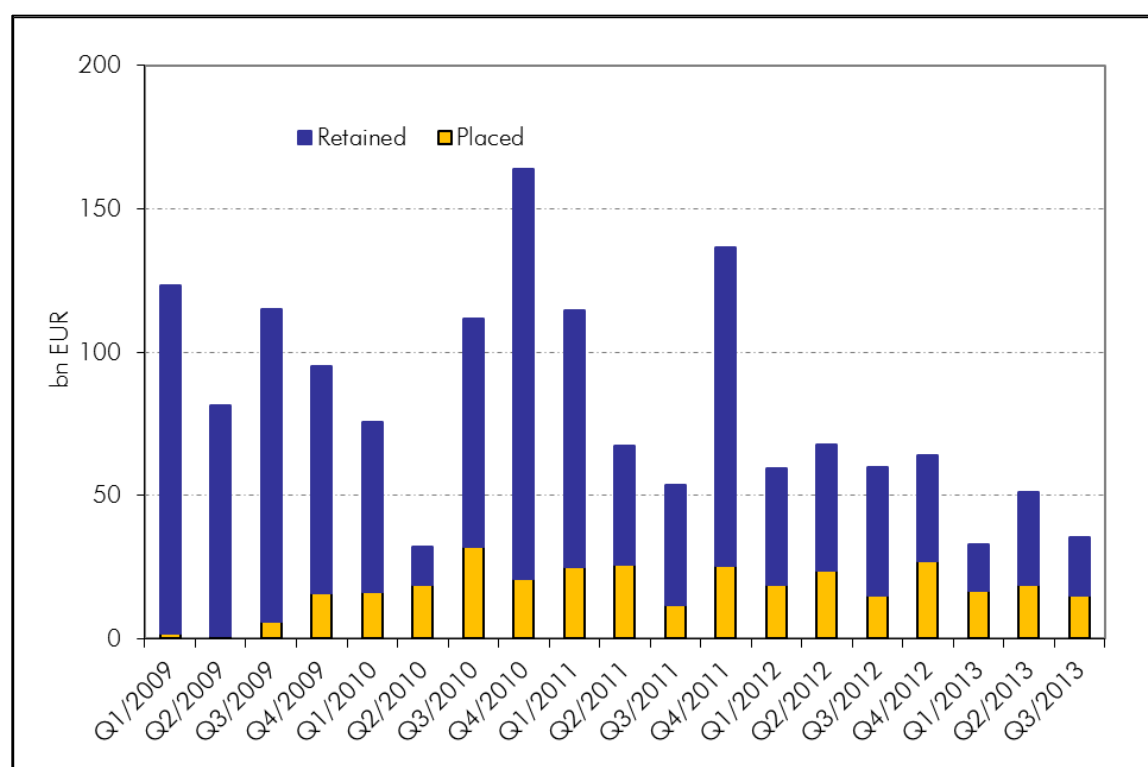
⁵⁶The ECB’s asset repurchase or “repo” facility allows (among other assets) Asset Backed Securities to be used as collateral for funding.

⁵⁷For information, in July 2013, the ECB relaxed its collateral eligibility rules to reduce haircuts applicable to ABS in order to catalyse recent initiatives by European institutions to improve funding conditions for SMEs.

and HM Treasury announced its one-year extension on 24 April 2013. The scheme will continue until January 2015, with incentives to boost lending in favor of SMEs. Moreover, the Bank of England and HM Treasury announced changes to the terms of the FLS extension on 28 November 2013. The changes focus the FLS on business lending by removing the direct incentives to expand household lending in 2014. The FLS extension will thus provide continued substantial support for lending to businesses in 2014, with a strong focus on lending to SMEs (Bank of England, 2013). These adjustments will most likely (again) lead to an increasing role of UK RMBS in funding UK mortgage lending (see also UniCredit, 2013).

For the full year 2012, the retention (see figure 31) hovered around 66% (2011: 76%), and in the first three quarters of 2013 went down to 57%. At first sight, the reduced retention rates look encouraging, but this is only true in relative terms, as the overall amounts issued went down (see also figure 32), and the amounts placed with investors went down by 12% (Q1-Q3, 2012: EUR 57.7bn; Q1-Q3, 2013: EUR 50.7bn).

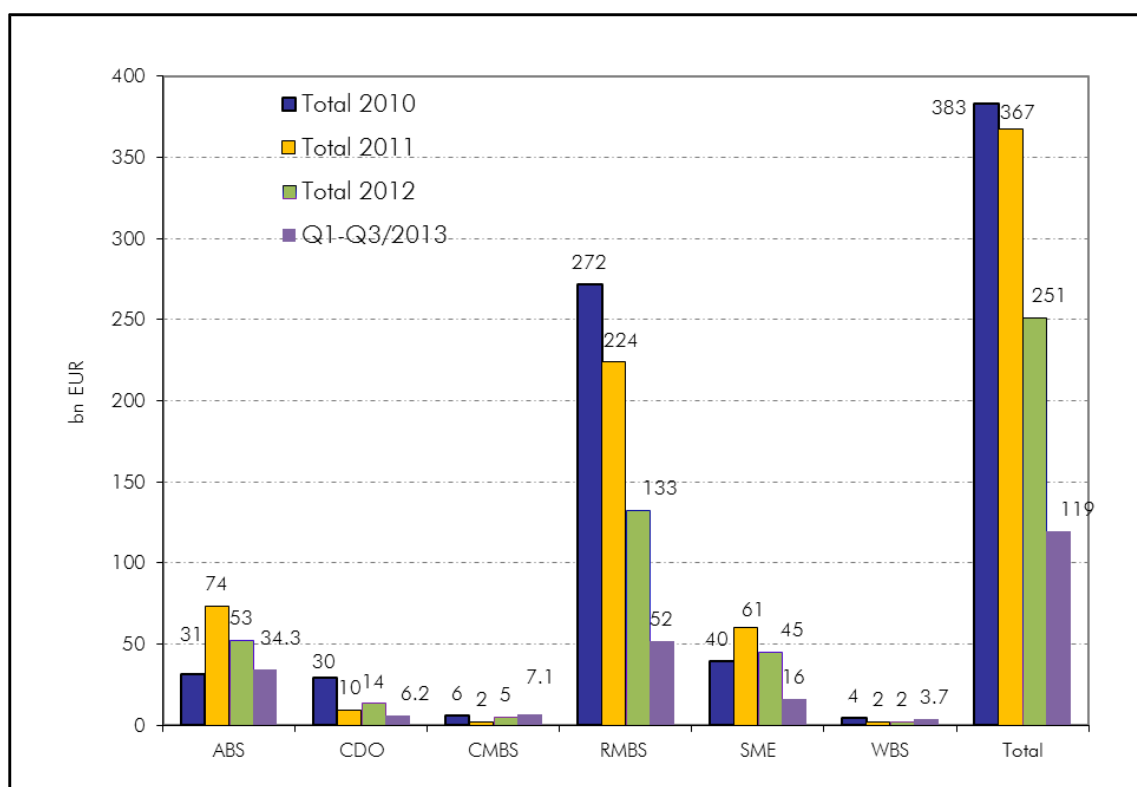
Figure 31: European total securitisation issuance by retention (bn EUR)



Source: Based on data from AFME

Given the dominance of the securitisation of RMBS, SMESec remained a relatively limited but important segment of the European structured finance market (see figure 32 and 33). The market share of SMESec rose (with some volatility) from 6% in 2001 to 18% (of total yearly issuance) in 2012, the highest value ever registered in Europe. This, however, came about due to the base effect, as the overall activity went down. Over the first three quarters of 2013, the share of SMESec was 13% (see figure 33). The SME related issuance in Q1-Q3/2013 occurred mainly in Italy (49%), followed by Spain (37%), Portugal (7%), and Germany (6%).

Figure 32: European securitisation issuance by collateral (bn EUR)⁵⁸

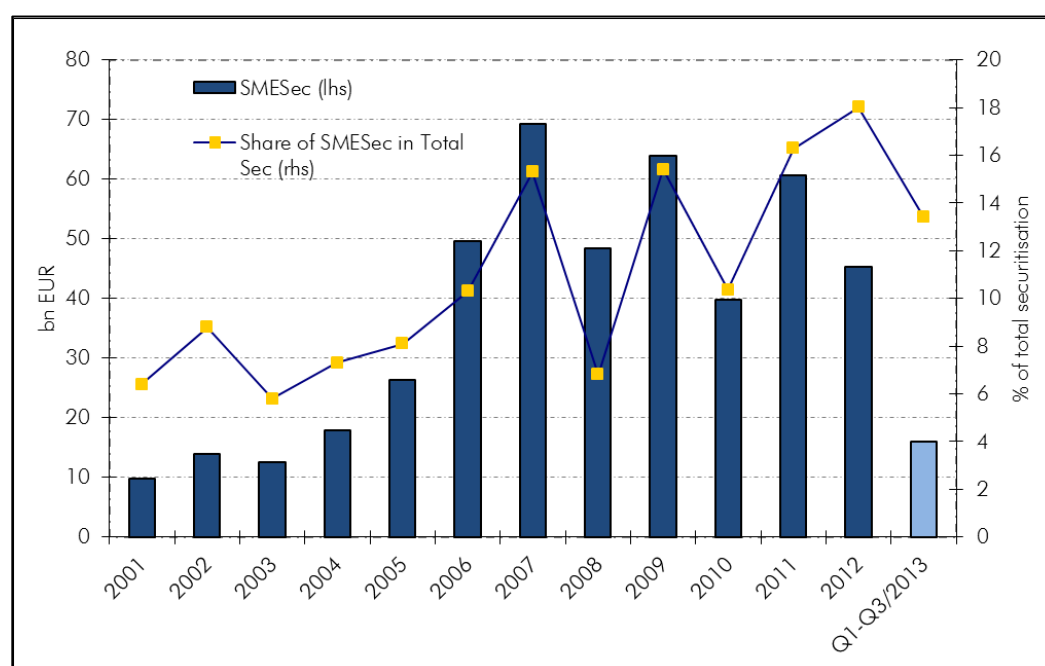


Source: Based on data from AFME

Due to the weak Q3 (only EUR 2.4bn), the issued volume of SME deals during the first three quarters of 2013 was significantly lower compared to the same period a year before (EUR 16bn compared to EUR 30.7bn in Q1-Q3/2012). Moreover, as already mentioned, it is important to note that only a very small fraction of the issuance has been placed with investors: The nature of the SMESec market changed from a developing market (pre-crisis, with almost all transactions placed on the primary market) to a purely ECB repo-driven market during the crisis (with almost no placement on the primary market).

⁵⁸AFME definitions: European ABS issuance includes auto, credit card, leases, loans, receivables and other. European CDO issuance numbers only include issuance denominated in a European currency regardless of the country of collateral. A substantial percentage of CDOs are backed by multi-jurisdictional collateral. Historical CDO issuance totals have been revised due to periodic updates of the sector. WBS: whole business securitisation – a securitisation in which the cash-flows derive from the whole operating revenues generated by an entire business or segmented part of a larger business.

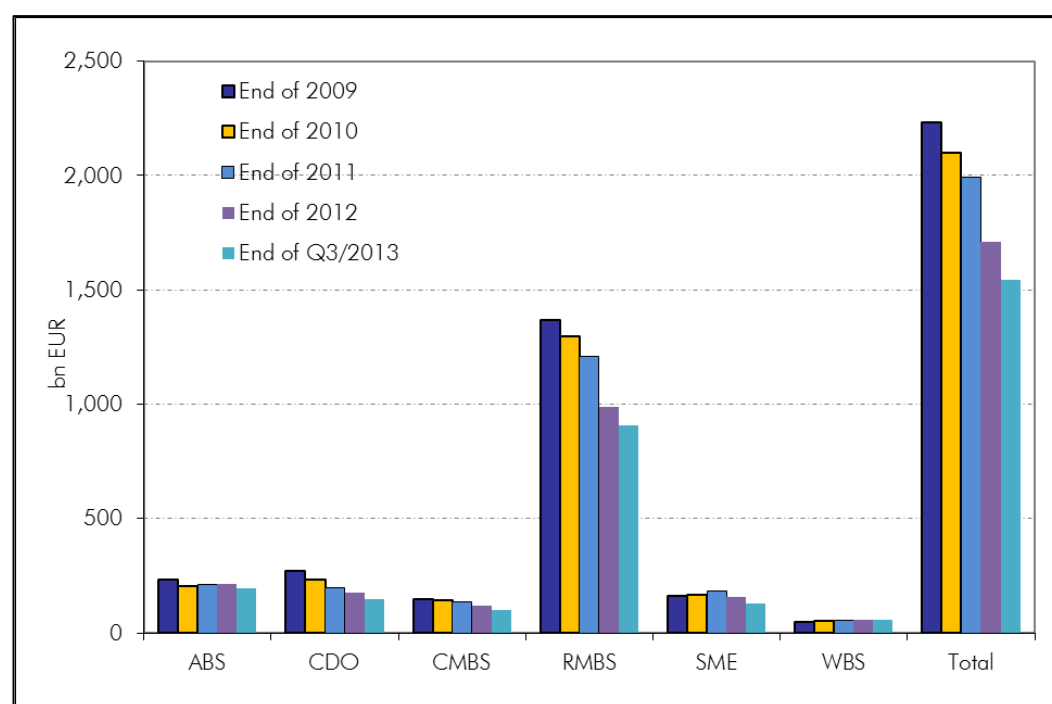
Figure 33: SMESec transaction volumes in Europe and share of SMESec in total securitisation



Source: Own calculation, based on data from AFME and KfW

With regard to the *outstanding securitisation transactions*, compared to the end of 2012, the total outstanding decreased by almost 10% from EUR 1,992bn to EUR 1,545bn (end of Q3/2013, see figure 34). The regional distribution of the outstanding remained almost unchanged with respect to the past: in terms of volumes, UK ranks first (28.7% of the EUR 1.545bn), followed by the Netherlands (18.2%), Italy (11.9%) and Spain (11.5%).

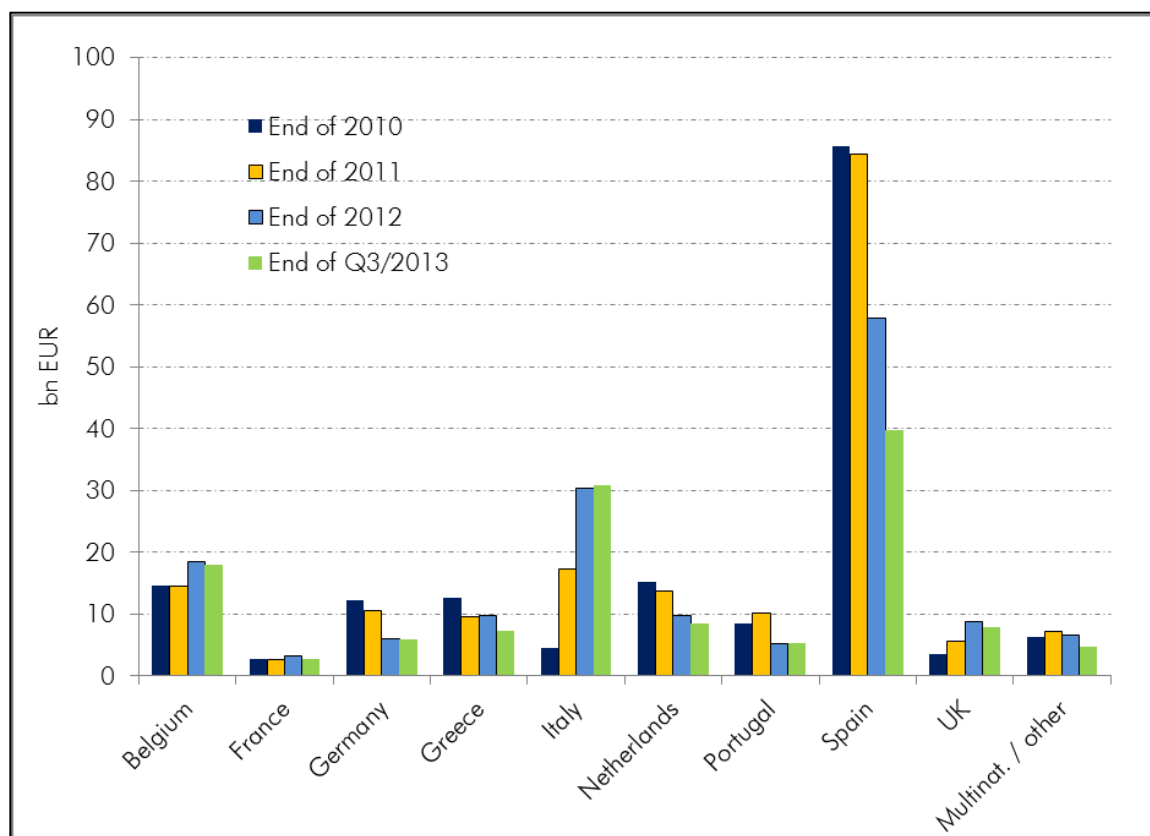
Figure 34: European outstanding securitisation transactions (by collateral, bn EUR)



Source: Based on data from AFME

For SMESec, since the end of 2011, the outstanding volumes have decreased by about almost 28% (from EUR 181bn to 158bn (end of 2012), to EUR 131bn (end of Q3/2013)). If the EUR 131bn of outstanding SMESec are broken down by country (end of Q3/2013), the significance of the Spanish market is still visible, although the outstanding volumes decreased significantly over the past years (see figure 35).

Figure 35: European SMESec outstanding volume by country (bn EUR)



Source: Based on data from AFME

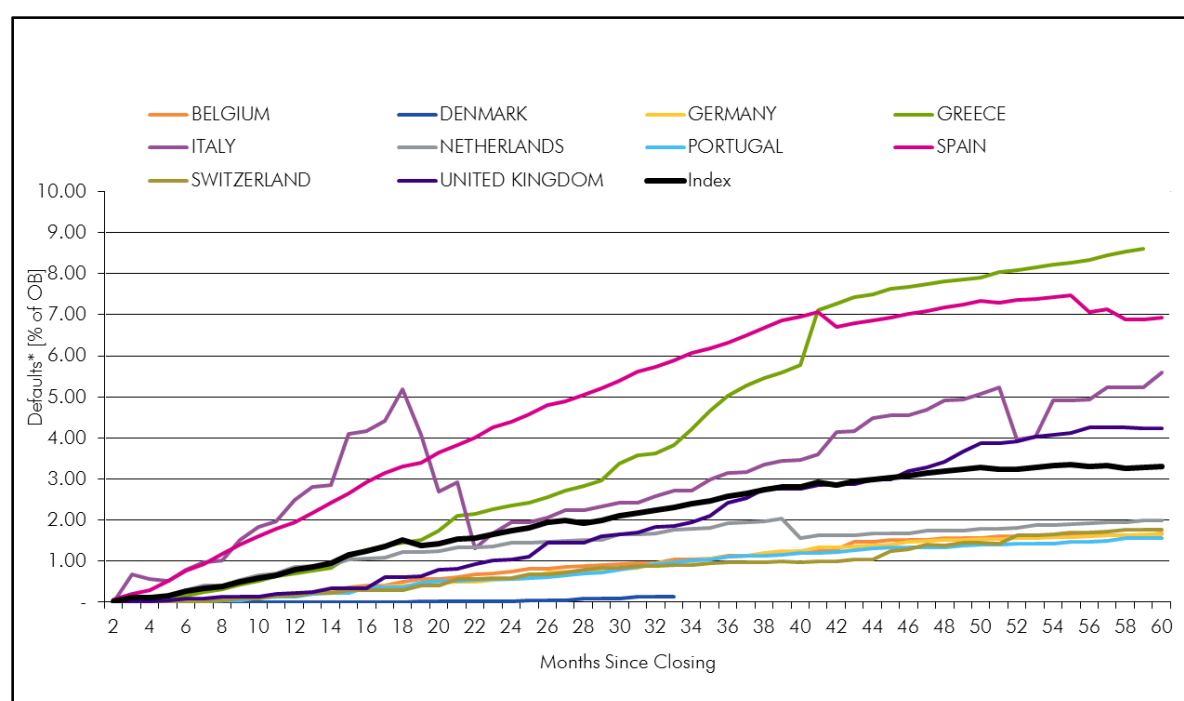
5.2.2 SMESec performance trends

Despite the financial and sovereign crisis, the European securitisation market in general has performed so far relatively well in terms of losses. The low losses are not only based on the typically high granularity/diversification of these transactions, but also on the structural features that helped to counterbalance the negative effects of the deteriorating European economy (i.e. increased SME default rates). The track record of SMESec in Europe is relatively short: the market started only towards the end of the 1990s – at the time, this segment was unknown to investors and rating agencies, and the technique of securitisation was also new to most of the originators. The related uncertainty was one of the reasons for mainly conservative structures in the general SMESec segment.

The tightening of credit conditions for SMEs has been mentioned earlier. Although this development has a direct negative impact on the SMEs, it has an indirect positive effect for new loan vintages, and hence for the quality of newly securitised portfolios, as banks have become

more risk-averse. However, the sovereign crisis and weak macroeconomic fundamentals in many European countries had also negative effects on SME transactions, and it is expected that the credit quality of the existing portfolios in stressed markets will further deteriorate, as credit performance of SME portfolios is typically dependent on GDP growth trends. Moreover, many counterparties in SME-related transactions will continue to suffer from the on-going stress in the European banking system.⁵⁹ In fact, the latest data show that the performance of SME ABS has deteriorated. For example, in the SMESec transactions rated by Moody's (in the EMEA⁶⁰ region), the 90-360 day delinquency rate rose from 2.13% in December 2011 to 4.91% in December 2012. This predominantly reflected the weakness in markets such as Portugal, Spain, and Italy (and based on a small number of badly performing transactions), but it decreased again to 3.07% in May 2013 (Moody's, 2013a). Although delinquencies are improving, the cumulative defaults deteriorated, with Italy, Spain, and Greece being the weakest markets (see figure 36).

Figure 36: EMEA SME ABS cumulative 90+ delinquency or defaults on original balance (seasoning by country)



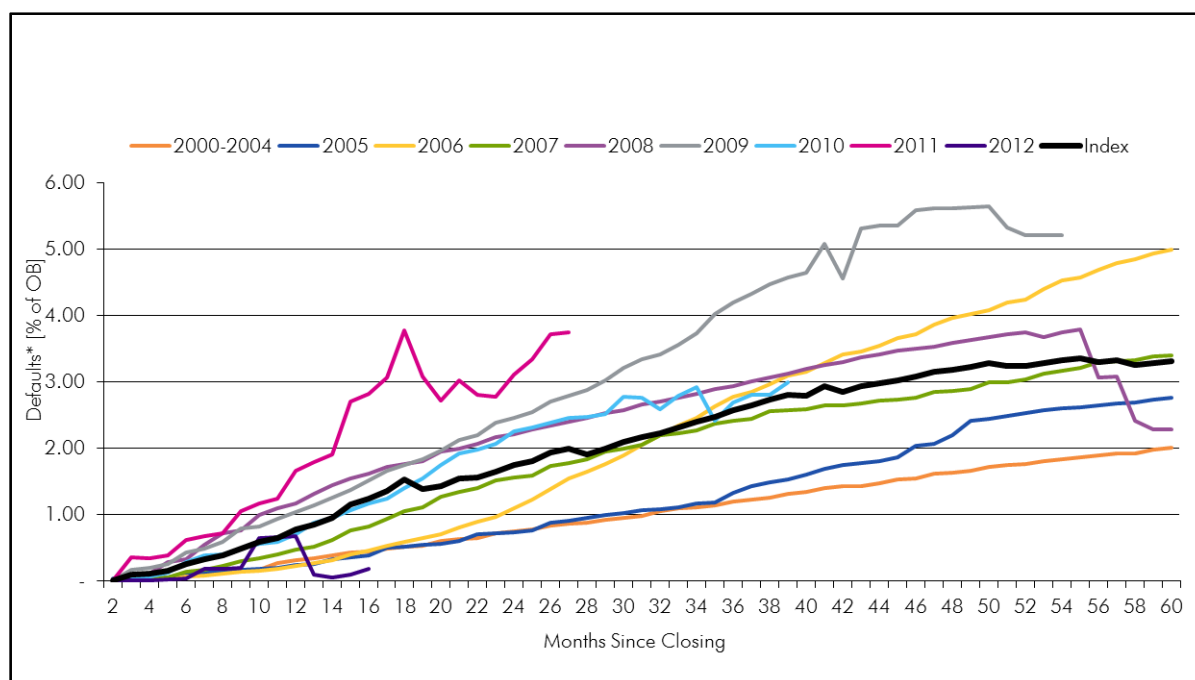
Source: Moody's (2013a)

Figure 37 depicts cumulative credit events (or defaults) on original balance by vintage for the EMEA region (transactions analysed by Moody's). It shows a relatively constant development over time for most vintage years.

⁵⁹We discussed the impacts of the sovereign crisis on securitisation transactions in more detail in our ESBFO in December 2012: http://www.eif.org/news_centre/publications/eif_wp_2011_12.pdf.

⁶⁰The "EMEA region" includes Europe, Middle East, and Africa; with regard to Structured Finance most of the transactions in this region are in Europe.

Figure 37: EMEA SME ABS cumulative 90+ delinquency or defaults on original balance (seasoning by vintage)⁶¹



Source: Moody's (2013a)

Due to various reasons, and as explained in more detail in earlier EIF working papers, the SMESec market has also been hit by a wave of downgrades due to weaker performance, as well as the rating methodology changes. Typically, AAA tranches show strong rating stability, but today also AAA and AA tranches migrate downward. This is mostly driven by downgrades of the respective country/sovereign ratings, and the limitation by the country ceilings (Fitch, 2013a), or they may be driven by downgrades of (not replaced) counterparties (whose rating is also affected by the respective sovereign ratings).⁶²

The rating transition data show that the downgrade pressure for SME transactions persists across all tranche levels. The example below (table 3) shows the rating migration of SME Collateralized Loan Obligation (CLO) transactions (rated by Fitch, migration since transaction closing). For example, of all the tranches that have initially been rated AAA, 30% (by number) have paid in full (pif), only 12% are still AAA, 23% moved down to AA etc. Meanwhile, there has been very limited upgrading, but no tranche was upgraded to AAA.

⁶¹Terminated transactions are included in the index calculation. Moody's believes that this information must be included for an accurate representation of trends over time. Additionally, Moody's notes show that vintage seasoning charts might move unexpectedly for the last few data points, because transactions start at different points in time within a vintage and, hence, some transactions may be more seasoned than others. The index includes only the transaction rated by Moody's.

⁶²For example: According to Fitch, currently Italian SME CLO would have a stable rating outlook, if only transaction-specific points were considered, because Fitch expects deleveraging to offset further performance deterioration. However, the outlook is stable/negative due to the negative outlook of the sovereign (Fitch, 2013d).

Table 3: Fitch European SMEs Rating Transition Matrix (November 2013) ⁶³

% of tranches		Current rating									
Initial Ratings		PIF	AAAsf	AAAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf
	AAAsf	30%	12%	23%	21%	10%	3%	0%	1%	0%	0%
	AAAsf	13%	0%	34%	13%	9%	9%	16%	3%	3%	0%
	Asf	4%	0%	15%	40%	13%	9%	13%	4%	0%	2%
	BBBsf	4%	0%	0%	4%	7%	22%	15%	28%	15%	4%
	BBsf	4%	0%	0%	0%	9%	22%	22%	13%	26%	4%
	Bsf	0%	0%	0%	0%	25%	50%	25%	0%	0%	0%
	CCCsf	0%	0%	0%	0%	0%	0%	0%	18%	27%	55%
	CCsf	0%	0%	0%	0%	0%	0%	0%	0%	40%	60%
	Csf	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

Source: Fitch (2013b)

5.2.3 SMESec prospects

Overly simplified discussions sometimes brand securitisation as being “toxic”. Yet, neither is the instrument “toxic”, nor is its underlying asset (SME loans!) the “toxic waste”. Securitisation is just a tool, and, if properly applied, it could be a replicable technique to enhance access to finance for SMEs (see box 5).

Box 5: How to avoid the bad experiences from the past

In the years running up to the crisis, the first signs in Europe had already suggested a drift away from the key principles and the main success factors for SMESec – i.e. granular portfolios (highly diversified in terms of obligor concentration, sector diversification and regional distribution), and transparent structures. Examples for this drift-away are the hybrid transactions (i.e. the so-called German Mezzanine CDOs) with non-granular portfolios, larger (mid-cap) borrowers and non-aligned incentive structures. The generally poor performance of these transactions provides lessons for the future of SMESec.

SME loans are, in principle, less homogenous than residential mortgages (with regard to size, legal forms, collateral etc.), and the underwriting criteria are less standardised. On the other hand, SME loans are typically thoroughly analysed by credit experts and systems (e.g. most banks apply detailed (quantitative) internal rating methodologies on top of the more qualitative assessments). Moreover, banks normally have a relationship approach to their customers and tend to know them very well. They are thus being able to manage the risk over the long term in contrast to the more automated lending decisions seen in the mortgage and credit card markets. This distinguishes SMESec from those other securitised asset classes.

⁶³The addition sf indicates a rating for structured finance transactions.

Box 5 continued:

As a result, and as “lessons learnt”, some key features of successful SMESecs can be summarised:

- Granular, diversified portfolios (i.e. with regard to single obligor exposure, sectors, regional distribution);
- Transparent and standardised structures (and no multiple securitisations like CDO of CDOs/CDO of ABS);
- Proper and transparent incentive structures in order to avoid moral hazard; originators have to have sufficient “skin in the game”;
- Loans originated in line with relationship banking and in line with adequate credit/credit risk standards; no “originate-to-distribute” practices⁶⁴;
- Investors/guarantors should perform their own analysis/due diligence and should not be only “external rating driven”.

Considering these criteria: properly applied, SMESec

- can enhance access to finance for SMEs;
- is a replicable tool for SME support;
- is an efficient way of using public resources that provides a multiplier effect.

As mentioned above, the important role of securitisation in financing, in particular SMESec – and the need to revive the market - is frequently voiced in public again. The European Council, at its meeting on the 27/28th June 2013, discussed ways to boost investment and improve access to credit (European Council, 2013a). It called for the mobilisation of European resources, including that of the EIB Group, and launched a new “Investment Plan” to support SMEs and provide a boost the financing of the economy at large. In particular, the European Council agreed – inter alia – to the expansion of the joint risk-sharing financial instruments managed by the European Commission and the EIB Group to leverage investments in SMEs in the private sector and on the capital markets. An important element of this expansion is the *EU SME Initiative* (already briefly mentioned above).

This call to expand the aforementioned joint risk-sharing financial instruments was reiterated at the European Council meeting of the 24/25th October (European Council, 2013b). The new instruments should achieve high leverage effects, with the overall objective of expanding the volume of new loans to SMEs across the EU. Moreover, the Council has asked immediately to start the work on developing other tools for deployment in future, especially for securitisation, and has encouraged the Member States to participate with the greatest possible contributions. The new instruments should become operational in January 2014 to accompany the ongoing recovery, to combat unemployment, and also to reduce the fragmentation in the initial years of the new financial framework (European Council, 2013b).

⁶⁴Securitisation should not lead overly to soften credit standards. According to Carbo-Valverde et al. (2011), the Spanish “housing bubble was partly funded via spectacular developments in the securitisation market, which led to looser credit standards and subsequent problems with financial stability”.

There are many initiatives to revive the SMESec market in Europe. However, the recovery of the European Structured Finance market will not only depend on the development of market fundamentals and the enhancement of investors' confidence, but also strongly on the direct and indirect impact from regulatory priorities. Hence, future/potential regulatory treatments of SMESec have to be duly analysed. For both investors and originators, a stable and reliable regulatory framework is key. Moreover, a holistic view should be taken in order not to stall the revival of the market, but to frame its development in an economically reasonable way. Importantly, the regulatory framework should reflect the actual risks of SMESec. While the majority of individual regulations that have been proposed are sensible when viewed in isolation, some of them might appear questionable when the overall picture of the regulatory wave is taken into account (Frohn, 2013).⁶⁵

The details of the new initiatives are described in a recent working paper (Kraemer-Eis, Passaris, and Tappi, 2013), with their highlights including:

- the initiatives to improve transparency, i.e. the
 - DataWarehouse / Loan Level Initiative, and
 - Prime Collateral Securities (PCS) Initiative.⁶⁶
- SMESec support with EIF intervention, i.e.
 - Strengthened "normal" EIB Group activities;
 - Support of SME covered bonds;
 - EC/EIF activities: the CIP Securitisation Window, in the next programming period to be followed by support under the COSME programme;
 - EC / EIB Group activities, i.e. the already above mentioned EU SME Initiative (see box 6 below).

Box 6: The EU SME Initiative

The EU SME Initiative is a joint initiative between the European Commission and the EIB Group. It aims at stimulating SME lending (loans/leases) through financial institutions. The SME initiative would combine budgetary contributions from Structural Funds (ESIF) and other EU programmes (COSME/Horizon 2020) with EIB Group's own resources. It also aims at stimulating private sector capital market investments in SMEs and reducing market fragmentation across Europe. It is important to note here that the SME Initiative is only at an early stage of its development, and has not yet been approved. It would only become available to those countries which contribute to it some of their ESIFs.

⁶⁵For more details on the regulatory changes please see Kraemer-Eis, Passaris, and Tappi (2013)

⁶⁶As far as SMESec is concerned, the EIB Group has been actively involved in these two initiatives from their inception.

Box 6 continued:

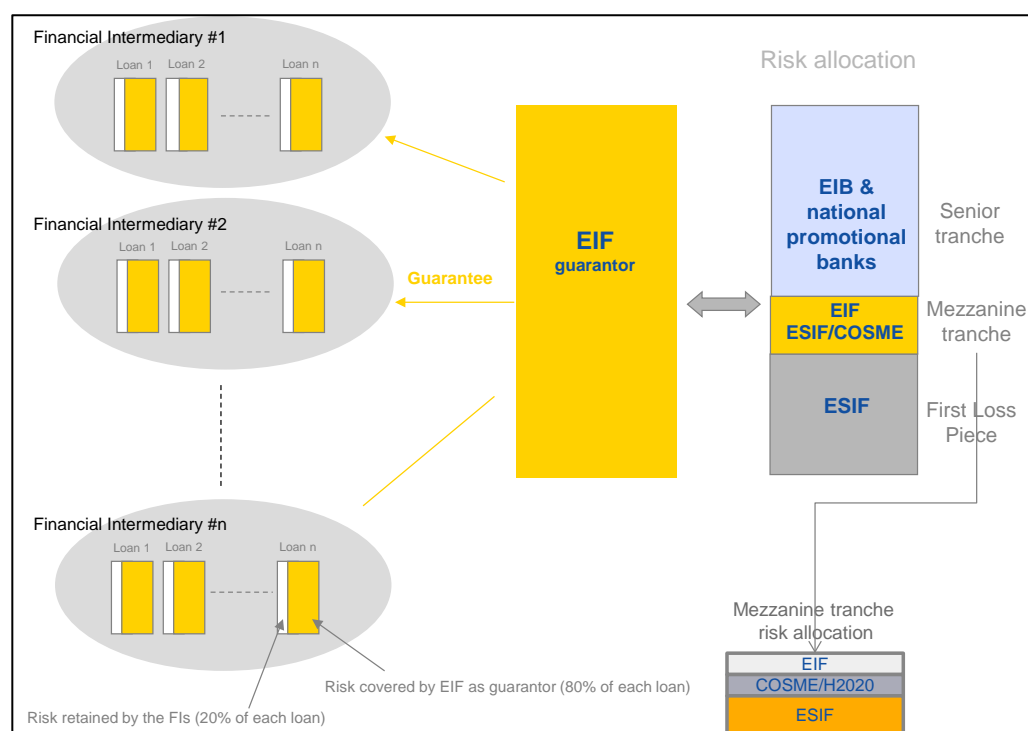
Two joint instruments are envisaged:

- a “guarantee facility” for new SME loans/leases (Option 1); and
- a “joint securitisation instrument” (Option 2) for the securitisation of existing and new SME loans/leases.

Option 1 – Guarantee Facility (see also figure 38)

Under this instrument, financial institutions would receive partial guarantees (up to 80%) from EIF (AAA and 0% risk-weighted) for their new SME loans. Financial institutions may also receive funding from the EIB under a separate agreement alongside the EIF guarantee. The risk taken by EIF under the guarantees would be shared, on a portfolio basis, between the EU funds, which would cover the first losses, and the EIB Group. National promotional banks might also participate alongside the EIB Group.

Figure 38: Schematic representation of Option 1



Source: EIF

The terms and conditions of the loans included in the guaranteed portfolio would reflect the attractive rates at which the guarantee would be provided to the financial intermediaries. The SME loan agreements would also highlight the EU support (and other related features, such as audit rights, etc.) for the portfolios to be built up (under both Options).

Box 6 continued:

The instrument would be compatible with the legal framework governing the COSME and Horizon 2020 programmes of the European Commission. COSME aims at supporting SMEs, while Horizon 2020 aims at supporting innovative enterprises (SMEs and Small MidCaps). Depending on which EU programme is used to support a transaction, eligible Final Beneficiaries would have to comply with the eligibility criteria set out under the applicable EU programme, as follows:

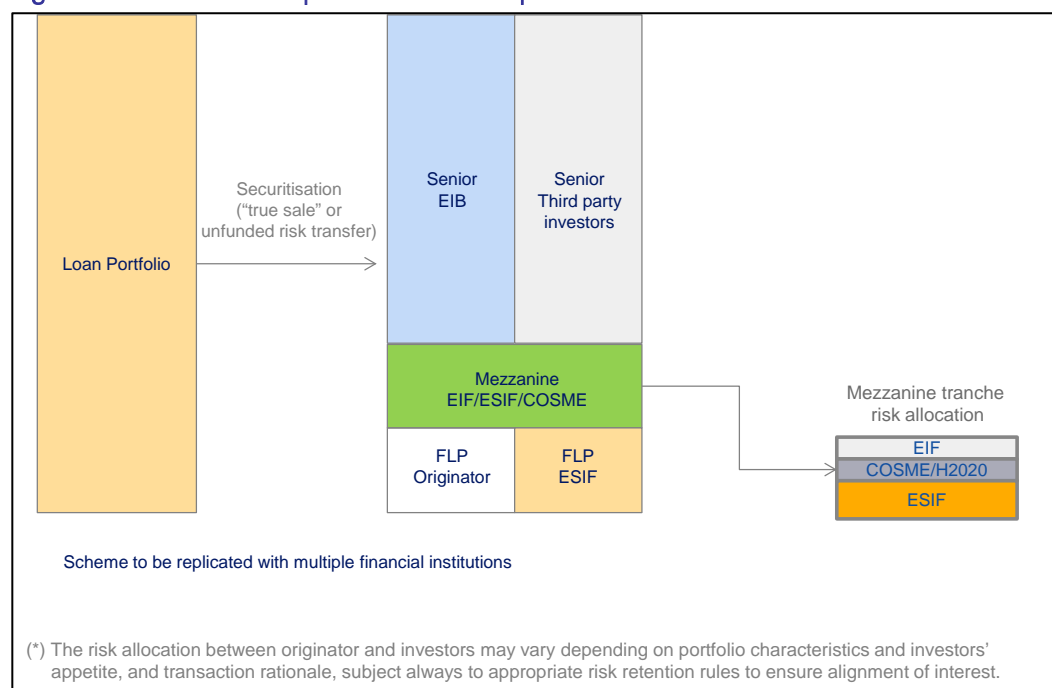
- COSME: viable SMEs facing difficulties in accessing finance, either due to their perceived high risk or their lack of sufficient available collateral;
- Horizon 2020: all types of SMEs with an innovation potential.

Option 2 – Joint Securitisation Instrument (see also figure 39)

Option 2 provides for securitisation transactions backed by SME loans, either through the sale of the portfolio to a dedicated vehicle (“True Sale”), or through synthetic risk transfer. EU funds would cover the first losses. The EIB Group, alongside national promotional banks and other private investors, would subscribe or guarantee the notes issued or the tranches of a synthetic transaction.

Originators would retain an interest in the junior tranche in order to ensure both the necessary alignment of interest and a focus on performing loans to viable companies. Subject to regulatory requirements relating to capital relief purposes, the originator’s “skin in the game” is confirmed in the chart below by the assumed retention of 50% of the First Loss Piece.

Figure 39: Schematic representation of Option 2



Source: EIF

Box 6 continued:

In contrast to Option 1, where only new loans could be guaranteed, under Option 2 the existing loans could also be securitised (yet with new loans possibly included through replenishment). In exchange, financial institutions would be obliged to originate an adequate volume of new SME loans (Additional Portfolio).

The terms and conditions of the loans included in the Additional Portfolio would reflect the attractive rates at which funding/capital relief was provided to the financial intermediaries through the securitisation. The SME loan agreements would also highlight the EU (indirect) support (and other related features such as audit rights, etc.) for the portfolios to be built up (under both Options).

The instrument should be compatible with the legal framework governing the COSME and Horizon 2020 programmes of the European Commission. The COSME aims at supporting SMEs, while the Horizon 2020 aims at supporting innovative enterprises (SMEs and Small Mid-Caps).

Depending on which EU programme was used to support a transaction, eligible Final Beneficiaries (i.e. SMEs benefitting from the new loans included in the Additional Portfolio) would have to comply with the eligibility criteria set out under the applicable EU programme, as follows:

- COSME: all types of SMEs;
- Horizon 2020: all types of SMEs with an innovation potential.

Currently, a market testing for the EU SME Initiative is ongoing, moreover, an ex-ante assessment (as required under the Common Provisions Regulation) is in the process of being finalised.

If public support could contribute to the re-emergence of the primary European SME securitisation market, it could be an important element to enhance access to finance for SMEs in Europe.⁶⁷ In this context, not only the volumes for the intervention matter, but also the positive signalling effect, triggered by the public involvement and support, would be important. However, this effect would only be beneficial to SMEs, if the freed-up capital / fresh liquidity were going to be used by the banks to finance the real economy (i.e. for new SME lending), and not for e.g. regulatory arbitrage.

It is appropriate to summarise this SMESec chapter with the ECB (ECB, 2013e) comment from its September Monthly Bulletin: “(...) several EU institutions have been exploring joint policy initiatives to promote lending to SMEs that would be based on reactivating the ABS market for such loans.

⁶⁷It is important not only to look at banks when analysing SMESec, but equally to leasing companies and trade receivables financing, which both form part of the SME securitisation market. It could be expected that leasing companies in particular are going to play a larger role in the market for SME finance, as banks partially retreat. Given that bank financing is, and will be, less available to leasing companies post-crisis, it could be expected that SME securitisation would be particularly relevant in the leasing area. For more information on the importance of leasing for SME finance, see Kraemer-Eis and Lang (2012).

The institutions could leverage their respective expertise (for example by providing guarantees to ABS transactions or ring-fencing public funds for specific purposes) to play a catalytic role in this regard. Such initiatives may be helpful for reducing spreads in certain jurisdictions, for facilitating new issuance and the transfer of risks from bank balance sheets, and finally for stimulating lending to firms and households, where this has become severely impaired. In addition, it is important to make further efforts in developing simple and standardised ABS products, which can benefit investors and provide regulators with comfort from a prudential perspective. However, all these initiatives are not a silver bullet for restoring loan growth and reactivating the ABS market, and their success will also depend on wider economic developments and the return to health of the EU banking sector.

The European ABS market has the potential to play a long-lasting and important role in European funding markets and real economy financing. Nevertheless, the turbulence in recent years has led to a number of regulatory initiatives that will play a key role in the viability of the market. These warrant careful consideration in order to ensure that important distinctions across jurisdictions and relative to other assets are sufficiently taken into account. Investor uncertainty and the challenging economic circumstances in many countries continue to present additional challenges. In this context, initiatives to improve transparency and standardisation, with the aim of enabling investors to better assess risk, and to support the real economy are crucial to attract market participants and reactivate the European ABS market.”

6 Microfinance

6.1 Microfinance business environment

"Microcredit is generally recognised [...] as an effective financing channel for job creation and social inclusion, which can attenuate the adverse effects of the current financial crisis while contributing to entrepreneurship and economic growth in the EU." This statement, given in a recent European Commission (2012) report, emphasises the social and economic objectives associated with microfinance, and makes it clear why it is such an important aspect of EU social and business policy objectives.

The initiative "European platform against poverty and social exclusion" makes one part of the Europe 2020 strategy⁶⁸. It lays out the EC plans to reach the EU target of reducing poverty and social exclusion by at least 20 million people by 2020. Although combating poverty and social exclusion is mainly the responsibility of national governments, the EU can play a coordinating role, if only by making the necessary funding available. One key action of this plan is the "better use of EU funds to support social inclusion and combat discrimination", including improvements in the use of microcredits (e.g. via the JASMINE initiative and PROGRESS financial instruments).⁶⁹

In order to assess the likelihood of achieving the Europe 2020 poverty/social inclusion target, Eurostat has provided the indicator called "people at risk of poverty or social exclusion".⁷⁰ Figure 40 depicts the headline indicator, corresponding to the sum of persons who are at risk of poverty or severely materially deprived or living in households with very low work intensity (i.e. a combination of the three sub-indicators).⁷¹ Central-Eastern Europe shows the largest incidence of poverty or social exclusion. When comparing 2012 to 2011 and 2010, the situation became worse in most of the countries. Within the EU, the highest risks of poverty or social exclusion are recorded for Bulgaria, Latvia and Romania. The countries on the right-hand side of the diagram include some of the relatively new entrants to EU and those countries that have suffered the most

⁶⁸The Europe 2020 strategy is the growth strategy of the European Union for the current decade. For details please see the Europe 2020 website http://ec.europa.eu/europe2020/index_en.htm.

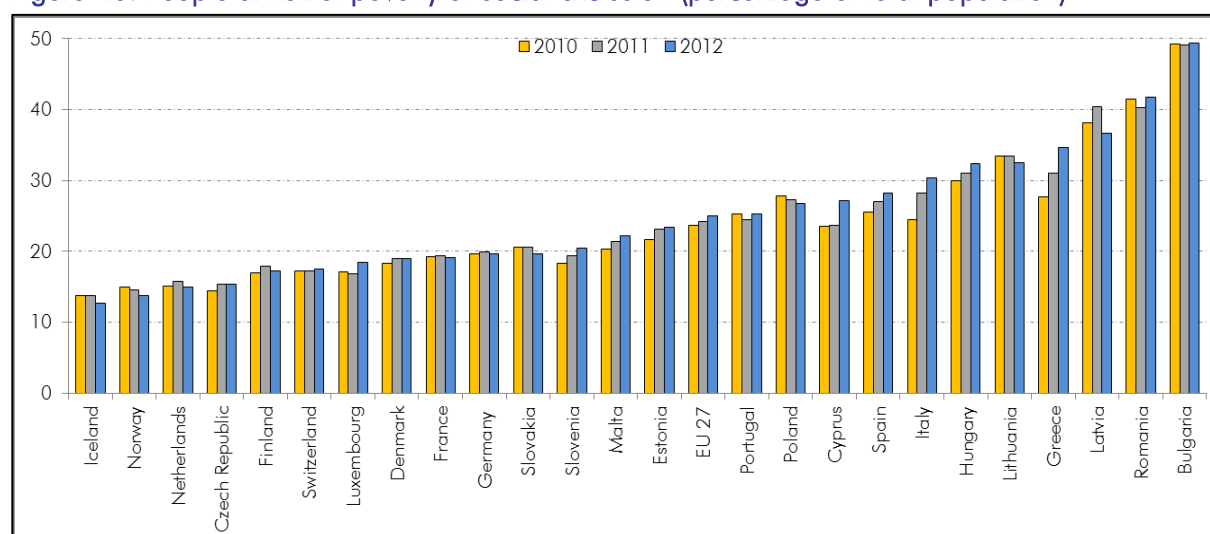
⁶⁹For more information on Europe 2020's social inclusion/poverty initiatives and actions please see <http://ec.europa.eu/social/main.jsp?catId=961&langId=en> and <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2010:1564:FIN:EN:PDF>, p. 8. For information on JASMINE, the European PROGRESS Microfinance Facility, and EIF microfinance activities please see: http://www.eif.org/what_we_do/microfinance/index.htm.

⁷⁰The indicator is a union of the three sub-indicators "People living in households with very low work intensity", "People at-risk-of-poverty after social transfers", "Severely materially deprived people" See the Eurostat internet site on the Europe 2020 indicators at: http://epp.eurostat.ec.europa.eu/portal/page/portal/europe_2020_indicators/headline_indicators

⁷¹Persons are only counted once, even if they are present in several sub-indicators. At risk-of-poverty are persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers). Material deprivation covers indicators relating to economic strain and durables. Severely materially-deprived persons have living conditions severely constrained by a lack of resources. People living in households with very low work intensity are those aged 0-59, living in households where the adults (aged 18-59) worked less than 20% of their total work potential during the past year. For more information please see: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=t20_20_50

from the impact of the current sovereign-debt crisis, i.e. Greece, Italy, Spain, Portugal, and Cyprus.

Figure 40: People at risk of poverty or social exclusion (percentage of total population)



Source: Based on data from Eurostat

As regards some Central-Eastern EU Member States, their relatively poor performance in social welfare indicators, combined with relatively low bank penetration rates, is one reason for the existence of a significant market for microfinance (i.e. commercial microfinance) in their respective economies.

6.2 Microfinance market

Microfinance in Europe consists mainly of micro-loans (less than EUR 25,000) tailored to micro-enterprises (92% of all European businesses). It also includes people who would like to become self-employed but are facing difficulties in accessing the traditional banking services (see box 7 below for definitions). Throughout the EU, 99% of all start-ups are micro or small enterprises, and one third of those were launched by unemployed people.

As outlined in the previous editions of this paper series⁷² the European microfinance market is still young and heterogeneous due to the diversity of legal frameworks, institutional environments and microfinance providers in European countries. In addition to commercial banks that target microenterprises as part of their general SME-lending activity, the spectrum of European microcredit developers includes many profit-oriented and non-profit associations. They range from microfinance associations to credit unions, cooperatives, Community Development Financial Institutions (CDFIs), non-bank financial institutions, government bodies, religious institutions, and Non-Governmental Organizations (NGOs) or Foundations.

⁷²E.g. the last issues of the ESBFO, or our papers specifically referring to microfinance; see http://www.eif.org/news_centre/research/index.htm

Box 7: What is “micro”?

Microfinance is 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).

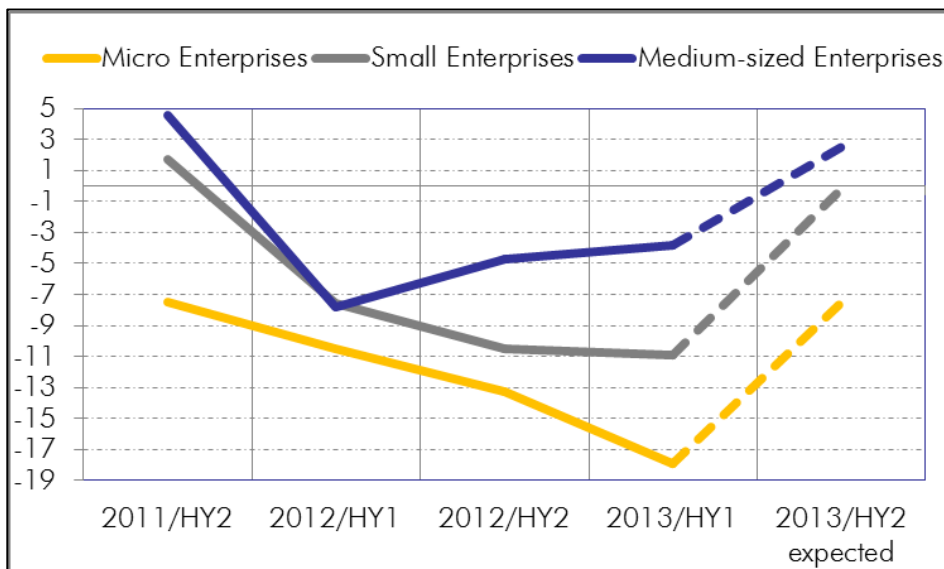
Microcredit is defined by the European Commission as a loan or lease under EUR 25,000 to support the development of self-employment and micro-enterprises. It has a double impact: (1) an economic impact, as it allows the creation of income generating activities, and (2) a social impact, as it contributes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

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.

When looking at the business climate of micro-enterprises, the EU Craft and SME barometer shows that, on balance, micro-enterprises estimated their overall situation less favourably than other SMEs in the first half of 2013 (see figure 41). However, micro-enterprises, on balance, expected some improvement in their business situation in the second half of 2013 ((-7.5%) compared to (-17.9)% in the first half of 2013). Similar results were reported for the survey questions on turnover, employment, and orders in the first half of 2013. According to the overall picture, micro-enterprises will continue facing more difficulties than other SMEs.

Figure 41: Overall situation of European micro-firms compared to other enterprise size classes

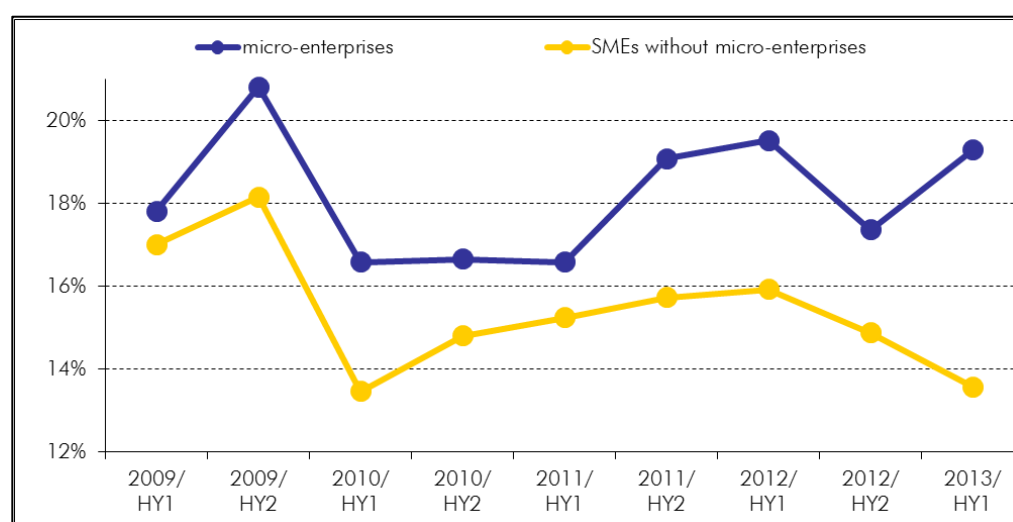


Source: Based on UEAPME Study Unit (2013)

According to the data from the latest ECB survey on the access to finance of SMEs in the euro area (ECB, 2013b), the share of enterprises which see access to finance as their most pressing problem is larger among micro-enterprises than among other SMEs. Micro-enterprises reported “access to finance” as the second of their most pressing problems (while it is in the fourth place of the “most pressing problems” for small enterprises, and sixth for the medium and large ones).

Compared to the previous survey wave, the percentage of companies listing access to finance as their most pressing problem has decreased (see figure 42) for all enterprise size classes, except for micro-enterprises, while “finding customers” stayed the most frequently mentioned concern. The ECB (2013b) has also reported a drop in bank loan rejection rates for micro and medium-sized enterprises, and a rise for small-sized ones. However, the rejection rate is still the highest for micro firms (17%), compared to 12% for small firms and 6% for medium-sized firms.

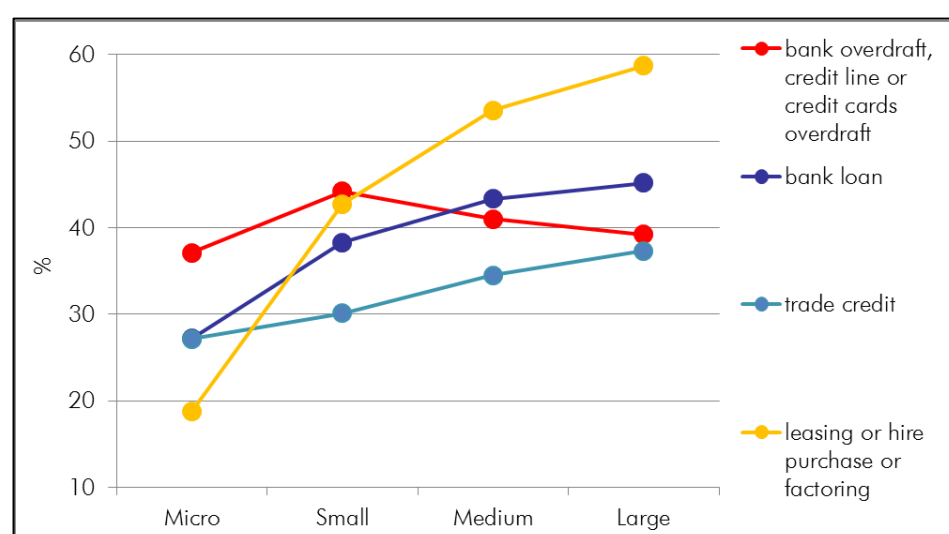
Figure 42: Share of enterprises reporting access to finance as their most pressing problem



Source: Based on ECB (2013b) Statistical Data Warehouse

Difficult access to finance, in particular to bank loans, might be one key reason why micro-enterprises in Europe use bank loans and other external financing sources considerably less than other SME size classes. Figure 43 shows that, with the exception of “bank overdraft, credit line or credit cards overdraft”, the usage of different financing sources on average typically increases with the size of the SME.

Figure 43: Enterprises having used different financing sources (by enterprise size class) over the preceding 6 months (April to September 2013); percentage of respondents



Source: Based on ECB (2013b) data

As outlined in the previous editions of this paper series⁷³, the conditions for microloans are much diversified across countries in Europe. The differences in average interest rates are typically related to various factors, such as differences in the legal framework, MFI business models, pricing policies, refinancing conditions, and the level of subsidies. The main elements of the pricing are explained in box 8.

Box 8: Loan pricing by European microfinance institutions⁷⁴

Microloan pricing is typically made up of three elements: (1) funding cost margin, (2) credit margin, and (3) operating cost margin:

Depending upon where a microfinance institution operates and type of lender (bank, non-bank MFI, promotional agency, etc.) the *funding cost margin* varies significantly across the universe of European microcredit providers. Whereas it could be 1 – 2% per annum for many banks in Western Europe, it is likely to be 4 – 10% for many non-bank MFIs in Central-Eastern Europe. In case of new types of micro lenders (e-tailer micro lenders, crowd funding vehicles, etc.), there is in principle no wholesale funding available, and VC-backed funding could cost as much as 15 – 20% per annum.

The *credit margin* is mainly a function of the inherent credit risk in the targeted micro-borrower segment (e.g. start-ups are riskier than well-seasoned micro-enterprises) and the practise of the lender in terms of security (e.g. unsecured loans or those benefitting from soft collateral are riskier than loans backed by hard collateral). In general, the credit quality of micro-borrowers tends to be “single B”-equivalent or worse (1-year probability of default of approx. 7%) and their performance is highly volatile.

The recovery rates for unsecured microloans are 10% - 20% at best, and the fact that loan amounts are small often makes recovery actions uneconomical. Having these factors in mind, one could assume that the credit margin in many cases spans the range of 2 – 4 % per annum.

The *operating cost margin* in microlending is generally very high. This is also the factor that most differs between banks and non-bank MFIs. Since most banks benefit from significant scale advantages in their credit origination, the operating cost margins could be as low as 1 – 2 % per annum. Also, even if costs were to be “under-allocated” to the micro credit activity, it would hardly have any visible impact on the overall cost structure of a bank, since the micro credit activity typically makes up a very small portion of the overall lending book. On the contrary, many non-bank MFIs almost exclusively provide micro-credits, and benefit from very limited scale advantages (given small overall loan book sizes in the range of EUR 2m – EUR 50m). As a result, operating cost margins for non-bank MFIs could be as high as 10 – 15% per annum or even higher, especially for MFIs that are in a ramp-up mode. Also, compared to a bank, there are no opportunities for cross-subsidisation across small and large loans, since all loans tend to be small. Small loan amounts will inevitably result in higher operating costs per loan, since there are certain tasks to be carried out / analysis to be made, regardless of the loan size. This is a further reason for the high operating costs of many non-bank MFIs.

Adding these 3 elements together, one could expect micro loan pricing in Europe to be as low as 4 – 8% p.a. on the low end, and reach 16% - 29% p.a. on the high end.

⁷³E.g. previous editions of the ESBFO, or our papers specifically referring to microfinance; see http://www.eif.org/news_centre/research/index.htm

⁷⁴Based on internal assessment performed by EIF’s microfinance team.

EIF performed a mid-2013 survey among 35 microfinance institutions across the EU28.⁷⁵ Each institution was asked to provide indications of their typical loan pricing for micro-lending in local currency, fee charges, pricing trend, loan maturities, collateral requirements, etc. Overall, the response rate was satisfactory with 29 microfinance institutions in 21 countries.

The average micro loan across the surveyed respondents was reported to have had an interest rate in the range of 8% - 10.7%, the fees in the range of 0.9% - 2.5%, and the maturities in the range of 3.2 – 5.2 years. There are significant differences in the average micro loan pricing between banks, promotional institutions and non-bank MFIs. This applies in particular to the lower range of interest rates and fees, which are 10% p.a. and 2% (flat) respectively for non-Bank MFIs vs. a range of 6 – 7% p.a., and close to 0% for banks and promotional institutions. Average loan maturities offered by banks tend to be significantly longer than for non-bank MFIs, in the range of 3.7 – 6.2 years for banks, and 2.8 – 4.4 years for MFIs, respectively.

Most surveyed microfinance institutions price their loans within a relatively narrow band. The highest microloan interest rates are charged by a non-bank MFI based in the UK, 19% - 21% p.a. (but this should also be seen in the specific UK context of payday lenders and similar organisations which legally charge annual interest rates equivalent to annual rates in the range of 1,500% - 2,000% for providing loans with very short maturities, often 1 – 4 weeks only).

In terms of pricing trends, 69% of the surveyed microfinance institutions regard the trend as stable, 24% expect a downward pressure, and only 7% see micro loan prices increase. In terms of typical collateral policy, 39% have a mixed policy, 25% require “soft” collateral (e.g. personal or third party guarantees), 21% provide loans on an unsecured basis, and only 14% require any type of hard collateral (in this case to be seen as collateral with a predictable recovery value).

The question of setting interest rates and fees at a “fair” level in the microfinance sector has been long-debated. Level setting is a trade-off between client protection and sustainability of microfinance institutions: the established practice shows a large diversity across EU28. EIF closely follows the interest rate-setting by microfinance institutions over time, not only looking at actual levels of interest rates but also considering the impact the interest rates have on net profits of microfinance institutions. Some leading voices in the microfinance community – i.e. in the western part of the EU - are advocating for setting rates near or at the sustainable price to allow larger financial inclusion, which ultimately is the bottom line of microfinance.

⁷⁵Internal assessment performed by EIF’s microfinance team.

6.3 Microfinance prospects

The impact of the on-going crisis on the availability of microfinance is a central issue to this sector. In times of crisis, microfinance clients – be it as an enterprise or a self-employed person – find that capital is even harder to obtain. Additional challenges are also faced by vulnerable groups, such as ethnic minorities or female entrepreneurs. However, when commercial banks reduce their lending to the “typical” microfinance clients, this process provides an opportunity for non-bank MFIs to strengthen their position in the market.

On the demand side, the increased levels of unemployment in many European countries, especially in those most affected by the sovereign debt crises, contribute to the rise in demand for microfinance. This can be viewed both from the perspective of social-inclusion lending and from enterprise lending.

As often mentioned before: there is no common microfinance business model in Europe. The microfinance market is immature and fragmented. There is a trend, however, towards efficiency, professionalization, and self-sustainability. Yet, without access to stable funding, the prospects of the sector for growth and self-sufficiency are limited, indeed.

The rationale for public support in the microfinance area was discussed in a previous working paper⁷⁶, which also explained the approach chosen for the Progress Microfinance mandate to provide support on European level. In the current market environment, this support is even more important. 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. In 2013, Progress has been deployed as planned, and it is expected to be fully committed by 2016. In terms of numbers of new microfinance transactions, 2013 has been a record year for the Progress mandate, with well above 20 transactions recorded by the end of December. Particular efforts have been put in place to identify guarantee transactions with a youth employment theme. Demand for Progress funded products continue to be particularly strong among non-bank MFIs, both in terms of EUR funding and funding in local currency. Progress Microfinance now covers 19 countries, with the largest projected microcredit volumes in the Netherlands, France and Romania.

EIF intends to sustain its support of microcredit, social investments, and participations in the increasing number of social finance institutions which are being established in the Member States.

⁷⁶See i.e. Bruhn-Leon, Eriksson and Kraemer-Eis (2012).

7 Concluding remarks

Europe's sluggish and uneven economic performance continues apace, and a number of downside risks remain. Among the top issues are still the concerns surrounding the large funding needs of sovereigns and capital requirements of banks. Fiscal consolidation in many advanced economies is important to ensure future growth, yet it is also a burden for economic growth prospects in the short term. Moreover, and as shown above, the overall business environment of European SMEs is still in weak shape, and the imbalances between the EU Member States are still significant. The multifaceted analyses of the crisis impact EU SMEs offered in the literature, typically confirm that many economies have severely restricted access to finance for SMEs. Annex 1 offers a brief summary of a recent literature review. While SMEs continue to face problems with access to finance, there are also significant differences from country to country in such fields as, for example, debt financing.

Against this broad backdrop, it is evident that public support continues to play a crucial, catalytic role in enhancing access to finance for SMEs. The catalytic effects of public support, in large part provided to SMEs by EIF, speak for themselves. Indeed, the existing support measures have facilitated SME survival, development and success in many countries of the European Union, and – equally importantly – new public support initiatives are being prepared. The guiding principles for public support, as understood and implemented by the European Investment Fund, are summarised in box 9 below.

Box 9: Basic principles for the design of public support

Efficient markets do not require public intervention. However, as outlined above, there are market imperfections affecting SME finance that are serious enough to warrant the intrusion. This intervention to mitigate the “bottlenecks” must be conditional upon ensuring “additionality,” i.e. not crowding out private activities, but rather serving as a catalyst for the entry of private capital in order to create self-sustainable markets in the long run. Public support must improve the conditions for entrepreneurship and the overall business climate for SMEs without distorting efficient market forces; this public support must be provided on the general understanding that:

1. Public money is not enough: Public money alone cannot finance SMEs and cannot be THE solution to the current crisis – instead, it is but one element of the possible solution. Public money is often best-used as seed money to motivate private investors. For the same reason, there should also be a move away from grants to revolving financial instruments. Used in an intelligent way via financial intermediaries, financial instruments, such as loans, guarantees or equity, have multiplier effects and encourage more private funding. In many instances, these instruments have greater amplifying effects in the market, and provide a more efficient deployment of public money than outright grants would do.
2. Investment decisions should be made by market-oriented professionals: The past experience of many markets suggests that public money should be channelled through experienced, market-oriented professionals who make investment decisions on a business basis, independently of political decisions.

Box 9 continued:

3. Risks must be shared. Public support cannot remove the risk associated with commercial activity at company level, nor should it attempt to do so. Public financing could best be used to make investments more attractive to private investors, but not to bear entire risk.
4. One size does not fit all. It is impossible to design catch-all policy instruments, and so there should be a toolbox of targeted instruments. To be of optimal value to the financial markets, this toolbox must be continuously reviewed. Market conditions must be duly analysed, new instruments tested, and constant adjustments made to meet the evolving needs of the markets.
5. Given SMEs' importance in the EU economy, and their dependence on bank, the measures supporting SME finance must be part of all initiatives to revive growth and jobs. One difficulty here is that the countries hardest hit by the crisis have only limited scope for support due to their budget constraints. Hence, it is doubly important for EU public support to have the capacity to provide much needed assistance to them.

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. EIF has worked very hard to develop new and pioneering financing instruments to reach those parts of the market that are currently not accessible through existing public support. This work provides for leveraging EIF's market interventions 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 reference 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 cornerstone across the spectrum of Technology Transfer through Venture Capital to the Lower Mid-Market and mezzanine financing. This also includes the launch and extension of new/pilot initiatives, such as the European Angels Fund and partnerships with corporate investors.

In the areas of *credit guarantees* and *securitisations*, EIF cooperates with a wide range of financial intermediaries, such as banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks, or other financial institutions providing financing to SMEs, or guarantees for SME financing. Credit guarantees are used widely across economies as important tools to ease financial constraints for SMEs, and in order to alleviate market failures in SME financing (OECD, 2013b). EIF has seen strong demand for its portfolio guarantee solutions. Given that SMEs have no direct access to the capital markets, banks are the most important source of external SME finance. Hence, funding limitations of banks have direct impact on SME lending capacity. That is why securitisation, or similar techniques, such as e.g. SME-covered bonds, are important to access the capital markets and allow mitigating the inherent illiquidity of SME portfolios. There are several initiatives to revive the SME securitisation market. Its re-emergence would be an important factor in enhancing access to finance for SMEs in Europe.⁷⁷ However, there is currently significant

⁷⁷It is important not only to look at banks when analysing SMESec, but equally at leasing companies and trade receivables financing, which form part of the SME securitisation market. In particular, we expect the leasing companies to play a larger role in the SME finance market, as banks will partially retreat from it. Given that bank financing is and will be less available for leasing companies post-crisis, we expect that SME securitisation 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).

uncertainty concerning the future regulatory treatments of securitisations. In our view, a holistic view has to be taken, and the impact of the “regulatory wave” duly analysed not to stall the market revival, but to frame its development in an economically reasonable way.

Finally, *microfinance* is an important contribution to overcoming the effects of the crisis, and in particular to support 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 participations in the increasing number of social finance institutions being established in the Member States.

ANNEX

Annex 1: SMEs and the credit crunch – messages from a literature review

The impact of the crisis on SME's access to finance is often discussed in literature. In this context, the OECD (2013b) undertakes research that includes a literature review of the topics related to SMEs and the credit crunch. This review, based on the most recent empirical studies, explores the effect of the crisis on the supply of credit and on the real economy. The main findings can be summarized as follows:

- The euro area sovereign debt crisis had a major impact on financing conditions; the crisis had detrimental consequences for borrowers and lenders.
- There is broad empirical evidence for negative credit crunch effects, but they vary across companies and economies.
- Supply constraints have slowed the euro-area bank lending during the crisis, and loan supply shocks affect economic activity, particularly during slowdowns.
- SMEs tend to be more vulnerable to credit constraints than larger companies are.
- Strong policy support has attenuated, or abated, the risks of a severe credit crunch.
- The need for banks recapitalization has reduced lending and further aggravated the crisis (but safer banks make for better lending).
- SMEs benefit from intense bank-firm relationships, and smaller banks play a positive role (i.e. as non-myopic lenders).
- Healthier companies face fewer financing constraints.
- Cross-border banking can attenuate local credit squeezes, but also transmit crises.
- Credit-less recoveries are possible and common after banking crises, but they are relatively weak.

The research outlined above confirms the general and often-stated assumptions. They are based on the evidence which suggests that significant segments of the various economies studied have severely restricted access to finance for SMEs during the crisis, with the attendant bank deleveraging and the lack of alternative financing channels.

Annex 2: Private Equity Glossary

(selection, from EVCA)

- **Buyout:** A buyout is a transaction financed by a mix of debt and equity, in which a business, a business unit or a company is acquired with the help of a financial investor from the current shareholders (the vendor).
- **Buyout fund:** Funds whose strategy is to acquire other businesses; this may also include mezzanine debt funds which provide (generally subordinated) debt to facilitate financing buyouts, frequently alongside a right to some of the equity upside.
- **Capital weighted average IRR:** The average IRR weighted by fund size.
- **Carried interest:** A share of the profit accruing to an investment fund management company or individual members of the fund management team, as a compensation for the own capital invested and their risk taken. Carried interest (typically up to 20% of the profits of the fund) becomes payable once the limited partners have achieved repayment of their original investment in the fund plus a defined hurdle rate.
- **Closing:** A closing is reached when a certain amount of money has been committed to a private equity fund. Several intermediary closings can occur before the final closing of a fund is reached.
- **Commitment:** A limited partner's obligation to provide a certain amount of capital to a private equity fund when the general partner asks for capital.
- **Deal flow:** The number of investment opportunities available to a private equity house.
- **Disbursement:** The flow of investment funds from private equity funds into portfolio companies.
- **Distribution:** The amount disbursed to the limited partners in a private equity fund.
- **Divestment:** See exit.
- **Drawdown:** When investors commit themselves to back a private equity fund, all the funding may not be needed at once. Some is used as drawn down later. The amount that is drawn down is defined as contributed capital.
- **Early stage:** Seed and start-up stages of a business.
- **Early stage fund:** Venture capital funds focused on investing in companies in the early part of their lives.
- **Exit:** Liquidation of holdings by a private equity fund. Among the various methods of exiting an investment are: trade sale; sale by public offering (including IPO); write-offs; repayment of preference shares/loans; sale to another venture capitalist; sale to a financial institution.
- **Expansion capital:** Also called development capital. Financing provided for the growth and expansion of a company, which may or may not break even or trade profitably. Capital may be used to: finance increased production capacity; market or product development; provide additional working capital.
- **Follow-on investment:** An additional investment in a portfolio company which has already received funding from a private equity firm.
- **Fund:** A private equity investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies (investee companies). These are generally private companies whose shares are not quoted on any stock exchange. The fund can take the form either of a company or of an unincorporated arrangement such as a limited partnership. See limited partnership.
- **Fund of Funds:** A fund that takes equity positions in other funds. A fund of fund that primarily invests in new funds is a Primary or Primaries fund of funds. One that focuses on investing in existing funds is referred to as a Secondary fund of funds.
- **Fund size:** the total amount of capital committed by the limited and general partners of a fund.
- **Fundraising:** The process in which venture capitalists themselves raise money to create an investment fund. These funds are raised from private, corporate or institutional investors, who make commitments to the fund which will be invested by the general partner.

- **General Partner:** A partner in a private equity management company who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.
- **General Partner's commitment:** Fund managers typically invest their personal capital right alongside their investors capital, which often works to instil a higher level of confidence in the fund. The limited partners look for a meaningful general partner investment of 1% to 3% of the fund.
- **Generalist fund:** Funds with either a stated focus of investing in all stages of private equity investment, or funds with a broad area of investment activity.
- **Holding period:** The length of time an investment remains in a portfolio. Can also mean the length of time an investment must be held in order to qualify for Capital Gains Tax benefits.
- **Horizon IRR:** The Horizon IRR allows for an indication of performance trends in the industry. It uses the fund's net asset value at the beginning of the period as an initial cash outflow and the Residual Value at the end of the period as the terminal cash flow. The IRR is calculated using those values plus any cash actually received into or paid by the fund from or to investors in the defined time period (i.e. horizon).
- **Hurdle rate:** A return ceiling that a private equity fund management company needs to return to the fund's investors in addition to the repayment of their initial commitment, before fund managers become entitled to carried interest payments from the fund.
- **Inception:** The starting point at which IRR calculations for a fund are calculated; the vintage year or date of first capital drawdown.
- **Institutional investor:** An organization such as a bank, investment company, mutual fund, insurance company, pension fund or endowment fund, which professionally invest, substantial assets in international capital markets.
- **Internal rate of return (IRR):** The IRR is the interim net return earned by investors (Limited Partners), from the fund from inception to a stated date. The IRR is calculated as an annualised effective compounded rate of return using monthly cash flows to and from investors, together with the Residual Value as a terminal cash flow to investors. The IRR is therefore net, i.e. after deduction of all fees and carried interest. In cases of captive or semi-captive investment vehicles without fees or carried interest, the IRR is adjusted to create a synthetic net return using assumed fees and carried interest. For the avoidance of doubts: IRR means the financial IRR and not the economic IRR, i.e. it does not account for any externalities.
- **IPO (Initial public offering):** The sale or distribution of a company's shares to the public for the first time. An IPO of the investee company's shares is one the ways in which a private equity fund can exit from an investment.
- **Later stage:** Expansion, replacement capital and buyout stages of investment.
- **Leverage buyout (LBO):** A buyout in which the New Company's capital structure incorporates a particularly high level of debt, much of which is normally secured against the company's assets.
- **Limited Partnership:** The legal structure used by most venture and private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the management firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). The general partner receives a management fee and a percentage of the profits. The limited partners receive income, capital gains, and tax benefits. The general partner (management firm) manages the partnership using policy laid down in a Partnership Agreement. The agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.
- **Management fees:** Fee received by a private equity fund management company from its limited partners, to cover the fund's overhead costs, allowing for the proper management of the company. This annual management charge is equal to a certain percentage of the investors' commitments to the fund.
- **Mezzanine finance:** Loan finance that is halfway between equity and secured debt, either unsecured or with junior access to security. Typically, some of the return on the instrument is deferred in the form of rolled-up payment-in-kind (PIK) interest and/or an equity kicker. A mezzanine fund is a fund focusing on mezzanine financing.

- **Multiples or relative valuation:** This estimates the value of an asset by looking at the pricing of “comparable” assets relative to a variable such as earnings, cash flows, book value or sales.
- **Pooled IRR:** The IRR obtained by taking cash flows from inception together with the Residual Value for each fund and aggregating them into a pool as if they were a single fund. This is superior to either the average, which can be skewed by large returns on relatively small investments, or the capital weighted IRR which weights each IRR by capital committed. This latter measure would be accurate only if all investments were made at once at the beginning of the funds life.
- **Portfolio company:** The company or entity into which a private equity fund invests directly.
- **Pre seed stage:** The investment stage before a company is at the seed level. Pre-seed investments are mainly linked to universities and to the financing of research projects, with the aim of building a commercial company around it later on.
- **Private Equity:** Private equity provides equity capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies (also called venture capital), to expand working capital, to make acquisitions, or to strengthen a company’s balance sheet. It can also resolve ownership and management issues. A succession in family-owned companies, or the buyout and buyin of a business by experienced managers may be achieved by using private equity funding.
- **Private Equity Fund:** A private equity investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies. These are generally private companies whose shares are not quoted on a stock exchange. The fund can take the form of either a company or an unincorporated arrangement such as a Limited Partnership.
- **Quartile:** The IRR which lies a quarter from the bottom (lower quartile point) or top (upper quartile point) of the table ranking the individual fund IRRs.
- **Rounds:** Stages of financing of a company. A first round of financing is the initial raising of outside capital. Successive rounds may attract different types of investors as companies mature.
- **Secondary investment:** An investment where a fund buys either, a portfolio of direct investments of an existing private equity fund or limited partner’s positions in these funds.
- **Seed stage:** Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.
- **Start-up:** Companies that are in the process of being set up or may have been in business for a short time, but have not sold their product commercially.
- **Target company:** The company that the offeror is considering investing in. In the context of a public-to-private deal this company will be the listed company that an offeror is considering investing in with the objective of bringing the company back into private ownership.
- **Top Quarter:** Comprises funds with an IRR equal to or above the upper quartile point.
- **Track record:** A private equity management house’s experience, history and past performance.
- **Venture Capital:** Professional equity co-invested with the entrepreneur to fund an early-stage (seed and start-up) or expansion venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment. Venture capital is a subset of private equity.
- **Venture Capitalist:** The manager of private equity fund who has responsibility for the management of the fund’s investment in a particular portfolio company. In the hands-on approach (the general model for private equity investment), the venture capitalist brings in not only moneys as equity capital (i.e. without security/charge on assets), but also extremely valuable domain knowledge, business contacts, brand-equity, strategic advice, etc.
- **Vintage year:** The year of fund formation and first drawdown of capital.
- **Volatility:** The volatility of a stock describes the extent of its variance over time.
- **Write-off:** The write-down of a portfolio company’s value to zero. The value of the investment is eliminated and the return to investors is zero or negative.

Annex 3: Securitisation Glossary

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

Annex 4: List of acronyms

- ABS: Asset Backed Securities
- AECM: European Association of Mutual Guarantee Societies
- AFME: Association for financial markets in Europe
- AIFM: Alternative Investment Fund Manager
- AIFMD: Alternative Investment Fund Managers Directive
- BA: Business Angels
- BAN: Business Angels Network
- BCI: Business Climate Indicator
- BLS: Bank Lending Survey
- BMWi: Bundesministerium für Wirtschaft und Technologie
- bp: basis point(s)
- BVCA: British Private Equity & Venture Capital Association
- CDFIs: Community Development Financial Institutions
- CDO: Collateralized Debt Obligation
- CGAP: Consultative Group to Assist the Poor
- CIP: Competitiveness and Innovation Framework Programme
- CIS: Commonwealth of Independent States (former Soviet Union)
- CLN: Credit Linked Note
- CLO: Collateralized Loan Obligation
- COM: European Commission (also: EC)
- CorIP: Corporate Innovation Platform
- COSME: Programme for the Competitiveness of enterprises and SMEs (COSME) 2014-2020
- EAF: European Angels Fund
- EBA: European Banking Authority
- EBAN: European Business Angels Network
- EC: European Commission (also: COM)
- ECB: European Central Bank
- EIB: European Investment Bank
- EIF: European Investment Fund
- EMEA: Europe, Middle East, and Africa
- ESBFO: European Small Business Finance Outlook
- ESI: Economic Sentiment Indicator
- ESIF: EU Structural and Investment Fund
- EU: European Union
- EU15: the 15 countries which formed the EU until April 30, 2004
- EU28: the 28 EU Member States
- EVCA: European Private Equity & Venture Capital Association
- FLPG: First Loss Portfolio Guarantee
- FLS: Funding for Lending Scheme
- FRSP: Funded Risk Sharing Product
- FYROM: Former Yugoslav Republic of Macedonia
- GDP: Gross Domestic Product
- GII: Global Insolvency Index
- HLG: High Level Group
- HM / HMT: HM Treasury is the UK government's economic and finance ministry
- HY: Half Year
- IMF : International Monetary Fund
- IPO: Initial Public Offering
- IRR: Internal Rate of Return

- JASMINE: Joint Action to Support Microfinance Institutions in Europe
- JEREMIE: Joint European Resources for Micro to Medium Enterprises
- LBO: Leveraged buy out
- LFA: Förderbank Bayern
- LP: Limited Partner
- MDD: Mezzanine Dachfonds für Deutschland
- MFG: Mezzanine Facility for Growth
- MFI (in the context of ECB): Monetary Financial Institutions
- MFI (in the context of microfinance): Microfinance Institution
- MS: Member State
- NFC: Non-financial corporation
- NGO: Non-Governmental Organisation
- NPL: Non-performing loans
- NRW: The development bank of North Rhine-Westphalia.
- OB: Original Balance
- OECD: Organisation for Economic Co-Operation and Development
- p.a.: per annum
- PCS: Prime Collateral Securities
- pif: paid in full
- PE: Private Equity
- R&D: Research and Development
- RMA: Research and Market Analysis
- RMBS: Residential mortgage backed securities
- RSFF: Risk Sharing Finance Facility
- RSI: Risk-Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps
- SAFE: Survey on the Access to Finance of SMEs in the euro area
- SIA: Social Impact Accelerator
- SDW: Statistical Data Warehouse
- sf: Structured Finance
- SMAF : SME Access to Finance
- SME: Small and medium sized enterprise
- SMEG: SME Guarantee Facility
- SMESec: SME Securitisation (comprising transactions based on SME loans, leases etc.)
- SPV: Special Purpose Vehicle
- TMT: Technology, including IT and Life Sciences (except drug discovery); Media, including Internet & Digital Media; Telecom Services
- UEAPME: European Association of Craft, Small and Medium-sized Enterprises
- UK: United Kingdom
- US: United States (of America)
- VC: Venture Capital
- VDB: Verband Deutscher Bürgschaftsbanken e.V.
- WBS: Whole Business Securitisation

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The European Investment Fund (EIF) is the European body specialised in small and medium sized enterprise (SME) risk financing. The EIF is part of the European Investment Bank group and has a unique combination of public and private shareholders. It is owned by the EIB (62.1%), the European Union - through the European Commission (30%) and a number (25 from 16 countries) of public and private financial institutions (7.9%).

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