



Brussels, 5.12.2013
SWD(2013) 517 final

PART 1/2

COMMISSION STAFF WORKING DOCUMENT

Ex-ante assessment of the EU SME Initiative

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LIST OF ACRONYMS

■ ABS	Asset Backed Securities
■ AECM	European Association of Mutual Guarantee Societies
■ CDO	Collateralized Debt Obligation
■ CEB	Council of Europe development bank
■ CESEE	Central, Eastern and South-Eastern Europe
■ CH	Cédula hipotecaria
■ CIP	Competitiveness and Innovation Framework Programme
■ CLO	Collateralized Loan Obligation
■ CRD	Capital Requirements Directive
■ EAD	Exposure at Default
■ EAFRD	European Agricultural Fund for Rural Development
■ EBA	European Banking Authority
■ EC	European Commission
■ ECB	European Central Bank
■ EIB	European Investment Bank
■ EIF	European Investment Fund
■ EIOPA	European Insurance and Occupational Pensions Authority
■ EMEA	Europe, Middle East and Africa
■ ERDF	European Regional Development Fund
■ ESI	European Structural and Investment
■ ESIF	European Structural and Investment Funds
■ ESMA	European Securities and Markets Authority
■ EU	European Union
■ FCT	Fonds Commun de Titrisation
■ FEI	Financial Engineering Instrument
■ FI	Financial Instrument

■ FLP	First Loss Piece
■ FP7	7th Framework Programme for Research, technological development and demonstration
■ GDP	Gross domestic product
■ HG SME	High-Growth SME
■ HLG	High Level Expert Group
■ ICO	Instituto de Crédito Oficial
■ IMF	International Monetary Fund
■ LGD	Loss Given Default
■ LTRO	Long-Term Refinancing Operation
■ MFF	Multiannual Financial Framework
■ MFI	Monetary Financial Institution
■ MS	Member State
■ NPB	National Promotion Bank
■ NPL	Non-Performing Loan
■ OECD	Organisation for Economic Co-operation and Development
■ OMT	Outright Monetary Transaction
■ OP	Operational Programme
■ PD	Probability of Default
■ RSI	Risk Sharing Instrument
■ SAFE	Survey on the Access to Finance of SME's in the Euro area
■ SF	Structural Fund
■ SFH	Société de Financement de l'Habitat
■ SMAF	SMEs' access to finance
■ SMEG	SME Guarantee
■ SMESec	SME Loan Securitisation
■ SPV	Special Purpose Vehicle
■ SRM	Single Resolution Mechanism
■ SSM	Single Supervisory Mechanism

- **UEAPME** European Association of Craft, Small and Medium-sized Enterprises
- **WEF** World Economic Forum

EXECUTIVE SUMMARY

This Staff Working Document has been prepared by the Commission services with input from the EIB and the EIF, and constitutes an ex-ante assessment of the SME Initiative. The SME Initiative has been presented in June 2013 in the Commission's and EIB's joint report to the European Council, to complement and utilise synergies between existing SME support programmes at national and EU level. More specifically, a joint-instrument, blending EU funds available under COSME and Horizon 2020 and ESIF resources in cooperation with EIB/EIF was proposed in view of generating additional lending to SMEs. The Initiative has been endorsed by the European Council both in its June and October meetings and has received a positive opinion by ECOFIN and the EFC.

The drafting of the study has been carried out under stringent data and time constraints in order to meet the requirements of the draft Common Provision Regulations, art. 33bis, in relation to ESIF contributions by Member States. For COSME and Horizon 2020 ex-ante assessments have already been carried out.

The document is structured as follows:

Chapter 1 analyses EU SMEs' difficulties in accessing external finance and estimates the amount of loans that "financially viable" firms would need but cannot obtain from the banking system (the "financing gap"). During the financial crisis, while the reduction in the volume of lending and the worsening of lending conditions has affected all non-financial corporations, it has particularly hit EU SMEs. This credit growth weakening may in itself justify policy measures, aimed at speeding up and strengthening the recovery. However, in order to design specific policy measures, focusing on the causes of credit growth weakening, it was deemed necessary to investigate more in depth the nature of SMEs' difficulties with access credit; this is done not so much by looking at demand and supply side behaviour, but by exploring financial market failures in providing credit to financially viable borrowers. We adopt a statistical methodology – appropriate for the data at our disposal – to gauge the SME "financing gap" at both the EU level, and at Member State level. At the EU28 level, we estimate the proportion of "financially viable" SMEs¹ that faced problems in accessing bank financing between 2009 and 2012 in the interval of 0.7%-4.1% of all SMEs to be at approximately 154,000-855,000 SMEs. This figure includes all financially viable SMEs that: i) have been refused a bank loan; ii) have turned down a bank loan, presumably due to the credit conditions; iii) have been discouraged from even applying for a bank loan. By multiplying the average SME loan size by the aforementioned number of financially viable SMEs with problems in accessing loan financing, an EU-wide gap can be quantified within the range of €20 bn to €112 bn, representing the average for the period 2009-2012. In 2012, based on the latest available figures, the EU wide gap decreased to a total of EUR 105 bn, representing EUR 95 bn for non-agricultural SMEs and EUR 10 bn for agricultural SMEs.

¹ We proxy the proportion of financially viable SMEs with the proportion of SMEs that have experienced a turnover growth higher than 20% in the previous 3 years (lower bound), or higher than 0% in the previous 6 months (upper bound).

This Ex-Ante Assessment builds on the methodology used in previous field studies (most notably *Economisti Associati, 2011*) and expands it by taking into account Member States heterogeneity at the level of SME access to loan financing.

1. The starting point is the **percentage of financially viable SMEs that are unsuccessful in obtaining loan finance**. This is computed using the following formula:

$$\text{Unsuccessful SMEs} = [\text{SMEs that applied} \times (\text{SMEs rejected} + \text{SMEs refused})] + \text{SMEs discouraged}$$

Where:

- I. **SMEs that applied**: share of financially viable SMEs that applied for a bank loan;
- II. **SMEs rejected**: share of financially viable SMEs that applied for a bank loan and whose demand was rejected by the bank;
- III. **SMEs refused**: share of financially viable SMEs that applied for a bank loan and refused the proposed bank loan because of high interest rates;
- IV. **SMEs discouraged**: share of financially viable SMEs that did not apply for a loan for fear of rejection;

Country-level information on *Unsuccessful SMEs* is provided in Annex 6 to Chapter 1.

2. Using the estimated *Unsuccessful SMEs*, the **SME loan financing gap (LFG)** is calculated as follows:

$$\text{LFG} = \text{Nr SMEs} \times \text{Financially Viable SMEs} \times \text{Unsuccessful SMEs} \times \text{Average SME loan size}$$

Where:

- I. **Nr SMEs**: number of SMEs;
- II. **Financially Viable SMEs**: share of SMEs exhibiting positive turnover growth;³
- III. **Unsuccessful SMEs**: share of financially viable SMEs unsuccessful in obtaining loan financing (see above);
- IV. **Average SME loan size**: average size of loans granted to SMEs.

Country-level information on the *SME loan financing gap* is provided in Annex 6 to Chapter 1, under the indication for the "Estimated interval for SME Loan Financing Gap" with a lower and an upper bound. Overall, the upper bound at the EU28 level is estimated at EUR 105bn.

These are the reference figures for the SME loan financing gap used in Table 1, columns 2-4 below. At the Member State level, significant differences in SME access to finance

² This box briefly introduces the methodology adopted in the estimation of the loan financing gap. The reader is referred to Section 4.1.2 and Annexes 3 to 7 to Chapter 1 for a comprehensive description of the study performed and the data sources involved.

³ For a detailed description of the measurement of financially viable SMEs, the reader is referred to Section 4.1.2 and Annex 4 to Chapter 1.

emerge: while some Member States seem to experience almost no problem in financing their financially viable SMEs, other countries appear to record a substantial SME financing gap. An assessment of the projected evolution of the main factors affecting the SME financing gap in the upcoming years (the EU economic outlook, the evolution of the financial conditions of banks, the developments of credit guarantee schemes, the developments of the SME securitisation market, the introduction of measures against late payments, the development of alternatives for bank finance, the launch of the banking union) points to a likely reduction of the financing gap, although to an extent that is not bound to greatly affect our current quantitative assessment.⁴

Having established the existence of a financing gap at all levels – albeit with differences across geographical areas – **Chapter 2** examines the rationale for policy interventions, in particular through the SME Initiative. The need for policy intervention is established, both to enhance SMEs' credit availability (through the revival of the SME securitisation market and the SME uncapped guarantee market), and in the field of entrepreneurship and innovation to counter information asymmetries, transaction costs and lack of sufficient policy coordination and to foster spill-over effects. Secondly, **the case is made for public intervention at the EU level, rather than at other levels, due to the EU-wide lack of access to finance.** Furthermore, an EU-level intervention may also trigger off positive externalities throughout the area; i.e. i) the scale of the EU-wide policy measure may enhance its efficiency (*critical mass*), ii) an EU-wide initiative can contribute to repairing the monetary policy transmission channels, iii) the EU banking system as a whole can benefit from the "bank multiplier" effect of additional SME loans. Successively, the SME Initiative is described: the two proposed products (uncapped portfolio guarantee and portfolio securitisation) are analysed in detail, including the necessary critical mass for the 3 options (EUR 3 bn for Option 1, generating an aggregate SME loan amount of up to EUR 15 bn; 4-5 bn for Option 2, generating an aggregate SME loan amount of EUR 28-35 bn; and 4-5 bn for Option 3, generating an aggregate SME loan amount of EUR 36-45 bn). The proposed SME initiative does not require new legal bases, but uses the legal framework that already exists, namely the COSME and Horizon 2020 legal acts, together with the Financial Regulation and the Common Provisions Regulation (CPR). Thus, the implementation of both the uncapped guarantee and the securitisation instruments will follow clearly defined rules and principles on addressing market failures, non-distortion of competition, additionality, selection of financial intermediaries, as well as on reporting, monitoring, intervention modalities. This framework is set to ensure, *inter alia*, avoidance of moral hazard through alignment of the financial intermediaries' interest with EU objectives, and pursuit of best practices through the financial expertise of the EIB Group as the implementing body. Alignment of interest with the intermediaries will be ensured through risk sharing (in the case of uncapped guarantees) and retention of portfolio First Loss Piece by the originator (in the case of securitisation). Finally, the value added of the Initiative is assessed in the light of the rationale for EU intervention established beforehand. The Ex-ante assessment concludes that **the value added of the SME Initiative** is its potential to:

⁴ Our assessment of the gap is very conservative and actually likely to be underestimated, due to the exclusion from our estimate of "financially viable" SME loan requests which have been *partially* turned down.

- address financial market **fragmentation**, as securitisation can play an important role in the funding strategy as well as for capital relief, contributing to level off SME financial conditions across countries;
- exhibit **demonstration, signalling, and catalytic effects**, including **multiplier effects and economies of scale** by pooling resources in a complementary way from the EU (COSME, Horizon 2020, and ESIF), the EIB, the EIF, and possibly also those of the national promotional/development/public banks and private investors, thus scaling up the available resources and ensuring a more critical impact in the market, for the benefit of SMEs;
- contribute to **capacity building**, that draws on the experience of the EU institutions – the European Commission, the EIB and also the EIF – in designing and implementing SME financing schemes. Moreover, as an established and respected player in the European market, EIF can play a key role via market presence, reputation building, and signalling.
- enhance **EU policy objectives and consistency** - the SME initiative has the potential to significantly contribute to enhancing access to finance of SMEs and would thus contribute as such to the achievement of the EU 2020 objectives, as well as to addressing market fragmentation.

Chapter 3 of the report is devoted to the analysis of the *consistency* of the SME Initiative with other existing and envisaged SME policies, and of the *proportionality* of the proposed intervention with respect to the problem to be addressed, namely the EU SME financing gap. As for consistency, the initiatives considered include: centrally managed EU instruments, ESI Funds (including existing initiatives), national initiatives (including a description of specific national measures in a number of countries), EIB intermediated lending and other sources of financing. In general, the SME initiative does not aim at replacing other instruments that provide debt finance to SMEs, but complements them and ensures critical mass. The proportionality analysis is twofold. First, it takes stock of market testing performed by the High-Level Working Group of the Economic and Financial Committee and by the EIB. It indicates that market participants in the HLG and stakeholders consulted by the experts express a strong interest in a European financing initiative as it has the potential of overcoming the limitations linked to national programmes, such as different (and unequal) structures, policies and availability (i.e. some jurisdictions do not have a framework) for SME finance across Member States. In particular, from the viewpoint of originators, large/better rated institutions could be interested in a scheme that would allow them to optimise their regulatory capital consumption. Securitisation could attract interest from both small and large institutions. However, for originators "overly strict criteria will have an impact on the portfolio size and hence the effectiveness of generating big volumes." Among potential investors (generally banks and money managers) some are focusing on senior exposure, with a disbursement capacity of 20-30 EUR bn, while more risk-prone investors would more likely focus on mezzanine tranches. This market testing is complemented by another market testing based on a sample of originators and arrangers, performed by the EIB/EIF. Based on the responses received, there was broad agreement between both originators and arrangers that economic and regulatory capital constraints, credit risk considerations and SME demand were among the main challenges hampering more lending towards SMEs. The respondents also suggested that cheaper and easier

access to capital and more demand by SMEs would allow them to increase their lending volumes to SMEs.

The second part of the proportionality analysis shows that, given the widespread nature and the size of the market failure that SMEs face when seeking access to finance, there will be ample scope for other national and/or regional initiatives and financial instruments to further address the market failure. Indeed, the fraction of the SME financing gap that might be covered by the loans generated through the SME Initiative is on average at least around 10%, although with large variations across countries. More specifically, the expected impact of the SME Initiative on the evolution of the SME loan financing gap – estimated in Chapter 1 (see Box 1 above) – will depend on two factors: i) the projected growth of the gap over the MFF period based on the historical growth during 2009-2012; and ii) the dynamic impact of the lending under the SME Initiative, which may generate potential for further investments and growth, thus prompting some further demand for finance. (see section 4.3.8 for further details).

The following Table 1 summarises, for each Member State, the expected SME gap coverage over the next MFF period, under different overall contribution scenarios (3bn, 5bn, or 8.5bn total ERDF+EAFRD contributions, assuming full Member State participation).

Columns 10-12 provide an estimate of the projected coverage of the gap through the SME Initiative, for the three scenarios (EUR 8.5bn, EUR 5bn or 3bn of ESIF contributions), taking into account an average leverage assumption (for options 1 and 2) of 1:6.3. In case the coverage rate is below 100% for a Member State participating in the SME Initiative, the Member State may allocate further resources up to the Maximum Contribution indicated in column 6, provided that the aggregate ESIF contribution does not exceed EUR 8.5bn.

TABLE 1 - LOAN FINANCING GAP COVERAGE CAPACITY OF THE SME INITIATIVE. ALL ABSOLUTE AMOUNTS IN € MILLION (UNLESS OTHERWISE STATED)

Country	Upper Bound of Latest Measured Gap (2011-2012)			Allocated ERDF+EAFRD Amounts (% of EU28 total)	Maximum Contribution ⁵	Necessary Contributions			Projected Gap Coverage		
	Non-Agricultural SMEs	Agricultural SMEs	Total SMEs ⁶			8.5 € Bln Scenario	5 € Bln Scenario	3 € Bln Scenario	8.5 € Bln Scenario	5 € Bln Scenario	3 € Bln Scenario
TOTAL GAP	95 EUR Bln	10 EUR Bln	105 EUR Bln	ASSUMED LEVERAGE: 6.33 ⁷							
AT	0.44%	0.80%	0.47%	1.56%	147	144	79	47	98%	54%	32%
BE	2.15%	0.18%	1.97%	0.52%	94	48	27	16	8%	4%	3%
BG	0.73%	1.41%	0.79%	2.08%	273	192	106	62	71%	39%	23%
HR	0.46%	1.17%	0.53%	2.32%	181	181	118	70	100%	65%	38%
CY	0.06%	0.08%	0.06%	0.10%	18	9	5	3	42%	23%	14%
CZ	0.93%	0.14%	0.86%	4.86%	296	296	248	146	100%	84%	49%
DK	0.90%	0.22%	0.84%	0.27%	49	25	14	8	9%	5%	3%
EE	0.14%	0.27%	0.16%	0.94%	53	53	48	28	100%	90%	53%
FI	0.38%	0.39%	0.38%	1.10%	118	102	56	33	86%	48%	28%
FR	5.50%	2.67%	5.25%	6.44%	1,156	596	328	193	36%	20%	12%
DE	6.18%	3.47%	5.94%	6.82%	1,225	632	348	205	34%	19%	11%
EL	4.50%	9.21%	4.92%	4.45%	799	412	227	133	27%	15%	9%
HU	0.64%	0.92%	0.67%	5.25%	229	229	229	157	100%	100%	69%
IE	1.63%	2.61%	1.72%	0.92%	165	85	47	28	16%	9%	5%
IT	22.17%	17.99%	21.80%	11.62%	2,088	1,077	593	349	16%	9%	5%
LV	0.18%	0.32%	0.20%	1.17%	67	67	60	35	100%	89%	52%
LT	1.10%	5.96%	1.53%	1.78%	320	165	91	53	31%	17%	10%

⁵ Computed as the maximum amount of resources that can be allocated by each Member State, without breaching the CPR 7% limit of ERDF and EAFRD.

⁶ Calculated as the weighted average of the two previous columns.

⁷ Refer to Section 4.3.8.3 and footnote 131 for a complete discussion on the assumed leverage.

Country	Upper Bound of Latest Measured Gap (2011-2012)			Allocated ERDF+EAFRD Amounts (% of EU28 total)	Maximum Contribution ⁵	Necessary Contributions			Projected Gap Coverage		
	Non-Agricultural SMEs	Agricultural SMEs	Total SMEs ⁶			8.5 € Bln Scenario	5 € Bln Scenario	3 € Bln Scenario	8.5 € Bln Scenario	5 € Bln Scenario	3 € Bln Scenario
LU	0.66%	0.01%	0.60%	0.04%	8	4	2	1	2%	1%	1%
MT*	0.07%	0.04%	0.06%	0.17%	22	15	9	5	71%	39%	23%
NL	3.56%	0.66%	3.30%	0.38%	69	36	20	12	3%	2%	1%
PL	2.99%	21.82%	4.67%	17.78%	1,602	1,602	907	533	100%	57%	33%
PT	2.10%	3.45%	2.22%	5.30%	694	491	271	159	71%	39%	23%
RO	1.50%	18.30%	2.99%	6.55%	1,027	606	334	196	59%	33%	19%
SK	0.30%	0.20%	0.29%	3.25%	101	101	101	97	100%	100%	97%
SI	0.91%	0.60%	0.88%	0.81%	145	75	41	24	25%	14%	8%
ES	28.22%	5.05%	26.17%	9.71%	1,744	899	495	291	11%	6%	4%
SE	2.19%	0.47%	2.03%	0.94%	170	88	48	28	13%	7%	4%
UK	9.39%	1.57%	8.70%	2.89%	519	268	147	87	9%	5%	3%
EU28	100.00%	100.00%	100.00%	100.00%	13,378	8,500	5,000	3,000	27%	15%	9%

* The sample size for viable SMEs was too small to be representative, so a broader SME sample was analysed

I. INTRODUCTION

This Staff Working Document has been prepared by the Commission services with input from the EIB and the EIF, and provides the ex-ante assessment of the SME Initiative presented by the Commission and the EIB,⁸ endorsed by the European Council,⁹ as required by the draft Common Provision Regulations, art. 33bis.¹⁰

The ex-ante assessment of the SME Initiative aims to underpin the rationale of the Initiative and to contribute constructively to its further design in view of a timely implementation as requested by the June European Council.

A weak and fragmented EU banking sector, the SMEs high reliance on banks for their funding and the importance of SMEs for economic growth makes the case for public intervention aiming at improving funding for SMEs. The EU provides financing to SMEs through a number of different channels, including both grants and financial instruments such as loans, guarantees, securitisation and equity/venture capital products.

EU policy instruments in the **current** 2007-2013 Multiannual Financial Framework (MFF) involve both Structural Funds programmes (EUR 50 billion of grants and financial instruments to SMEs¹¹) and financial instruments implemented under direct management. The latter, used to guarantee partner banks' SME loan portfolios and to provide venture capital, generate some EUR 6 billion in total equity and loans to SMEs annually. It is expected that these instruments will mobilise new finance of EUR 32.5 billion and support about 368.000 SMEs including micro-enterprises over the period 2007-2013, with a budget contribution of EUR 1.5 billion. Additional equity investments totalling some EUR 500 million in 2007-2013 are supported from central EU budget funds

In addition, the European Investment Bank (EIB) and the European Investment Fund (EIF) are already significantly assisting SMEs' access to finance by using own resources, in addition to EU budget funds. The EIF is providing credit enhancements for SME loan portfolios through guarantee activities while the EIB is providing "global loans" for SMEs. Overall, in the years 2011 and 2012, the EIF has been providing over EUR 1 billion per annum in equity investments in venture funds which then support SMEs and also more than EUR 1.1 billion (or even EUR 1.4 billion in 2011) in guarantees to banks lending to SMEs. The EIB signed more than EUR 10 billion of loans to SMEs in 2012. Several Member States operate similar SME schemes through national promotional banks.

For the next MFF, 2014-2020, support to SMEs will be a key priority for the European Structural and Investment Funds (ESIF) and EU level financial instruments also aim to increase the support to SMEs under the COSME and the Horizon 2020 programmes. These programmes should support EUR 33 billion of financing to SMEs. In addition, the EIB plans to provide approximately EUR 18 billion annually in direct and indirect financial support to

⁸ European Commission and European Investment Bank (2013).

⁹ European Council (2013).

¹⁰ For COSME and Horizon2020 ex-ante assessments have already been carried out.

¹¹ In 2007-2013, EAFRD contributed to financial instruments budgetary resources of EUR 355 million.

SMEs in the EU, in the form of loans to partner financial institutions for on-lending to SMEs. Also the EIF is set to continue and possibly increase its support. However, while there are different resources available to enhance access to finance by SMEs, much greater leverage effects and economies of scale can be achieved by combining these various resources, notably from centrally managed EU programmes, ESIF, the EIB and EIF and possibly those of national institutions and private investors. This is why, for the 2014-2020 MFF, a proposal has been made for a new SME Initiative, based on financial instruments of COSME and Horizon 2020 jointly funded by the EU central budget and voluntary ESIF allocations, allowing Managing Authorities to contribute ERDF and EAFRD resources to COSME and Horizon 2020.

II. BACKGROUND

2.1 EU financial instruments under the MFF 2014-2020

In the Communication "A budget for Europe 2020", the Commission highlighted the intention to extend the use of innovative financial instruments for increasing the impact of the EU budget. Financial instruments, such as guarantees, equity or quasi-equity investments, or other risk-sharing instruments, are used to address market failures or sub-optimal investment situations. Their use at EU level has to respect the principle of additionality, meaning that they shall not replace existing funding and distort competition in the internal market. They also have to create a leverage effect, i.e. the contribution from the EU budget shall mobilise investments exceeding the size of the Union contribution.

2.2 Proposal of the SME Initiative

In June 2013, the European Commission and EIB Group submitted to the European Council an initiative to complement and utilise synergies between existing SME support programmes at national and EU level.¹² More specifically, In particular, a joint-instrument, (the "SME Initiative) blending EU funds available under COSME and Horizon 2020 and ESIF resources in cooperation with EIB/EIF was proposed in view of generating additional lending to SMEs. The proposed SME Initiative builds on the Basic Acts of COSME and Horizon 2020 and makes use of the concept of Joint Instruments developed in the Common Provisions Regulation and referred to in the COSME and Horizon 2020 Basic Acts to complement the actions taken at national level in support of SMEs.

To foster investment and improve access to credit, the June European Council called for the mobilisation of European resources including those of the EIB and launched a new "Investment Plan" to support SMEs and boost the financing of the economy, endorsing the expansion of joint risk-sharing instruments between the European Commission and the EIB Group. To leverage the private sector and incentivise capital market investments in SMEs it was agreed that "The Council, in consultation with the Commission and the EIB, will specify without delay the parameters for the design of such instruments co-financed by the Structural Funds, aiming at high leverage effects. The necessary preparations should be made to allow these instruments to begin operating in January 2014".¹³

UEAPME,¹⁴ as representative of SMEs, reacted to this conclusion: As a summary of UEAPME's position a reference can be made to one of UEAPME's Press Releases, dated 11.07.2013 "(...), UEAPME will promote to all regions to use the new possibilities of all ESI

¹² See European Commission and European Investment Bank (2013).

¹³ See European Council (2013).

¹⁴ UEAPME is the employers' organisation representing the interests of European crafts, trades and SMEs at EU level. UEAPME is a recognised European Social Partner. As the European SME umbrella organisation, UEAPME incorporates around 80 member organisations from 34 countries consisting of national cross-sectorial SME federations, European branch federations and other associate members, which support the SME family. UEAPME represents more than 12 million enterprises, which employ around 55 million people across Europe. See <http://www.ueapme.com/>

Funds to support financial instruments for SMEs, especially loan guarantees and the securitisation of SME loan portfolios of banks to improve their capacity to lend additional money to SMEs. In this context, UEAPME President Almgren supported at the meeting of the European Council the new initiative of the European Commission and the European Investment Bank to blend money from the Regional Development Fund with money from the Commission Programmes COSME and Horizon 2020 to create an impactful instrument for the securitisation of SME loan portfolios.

Against the backdrop of (a) difficult financing conditions for SMEs, with particular difficulties for innovative ones, (b) an overreliance of European enterprises on bank finance compared to capital market-based finance and, (c) the fragmentation of Euro area financial markets, the Commission/EIB report to the June European Council presented three options to expand joint risk-sharing instruments between the European Commission, Member States and the EIB and EIF to leverage private sector capital market investments in SMEs and reduce market fragmentation (the SME Initiative).

At the request of the Economic and Financial Committee (EFC), a High Level Expert Group (HLG) has prepared an opinion¹⁵ on the proposed initiative and provided an assessment of the potential market interest. The report endorsed clearly: (a) the value added attached by the private and institutional investors to a European initiative supported politically by Finance Ministers, central bank Governors and Heads of State and Government, (b) the specific added value of the involvement of the EIF and EIB in the structuring of each transaction providing a standard approach and facilitating the investors analysis of each transaction, (c) the potential of such a European initiative for developing European capital market financing and supporting a diversification of corporate financing from banks to capital markets, and (d) its potential in contributing to overcoming fragmentation of the Euro area financial markets and thus contributing to repairing the impaired monetary policy transmission channel.

An important feature of the SME Initiative, also highlighted by the work of the HLG, is that from the point of view of originating banks, investors and SMEs, the three proposed options presented by the Commission and the EIB boil down in substance to two alternative ways of operating, namely (a) guarantees and (b) securitisation structures. From the point of view of the market, options 2 and 3 are identical. Option 3 simply increases the risk bearing capacity of the EIF, allowing it to take more risky mezzanine *tranches* (i.e. achieve a lower attachment¹⁶ point) and therefore allows the Initiative to reach out to a larger number and a wider group of SMEs. The level of complexity vis-a-vis the market is the same as in option 2 and investors will still look at and get exposure to individual transactions. However the level of complexity for EIB is much higher for Option 3.

Also at the request of the EFC an EIB/EIF report on the SME Initiative was prepared in parallel to the work of the HLG. This report showed that (a) the EIB/EIF supports the opportunity of such an SME Initiative, (b) all options are workable and complementary to each other, and (c) by and large the expected leverage ratios included in the Commission proposal are achievable. The EIB/EIF assessment points also to the important challenges that need to be addressed in order to ensure a smooth implementation: (a) a timely

¹⁵ See High Level Working Group to the EFC (2013a, 2013b).

¹⁶ Minimum level of losses in a portfolio to which a *tranche* is exposed.

adjustment of the Common Provision Regulation to allow for a smooth and simple use of structural funds, and (b) involvement of national regulatory and supervisory authorities.

The October European Council endorsed the SME initiative and invited Member States to make good use of the opportunities provided. It reiterated its call to expand joint risk-sharing financial instruments between the Commission and the European Investment Bank (EIB) to leverage private sector and capital market investments in SMEs, with the aim of expanding the volume of new loans to SMEs across the EU. Work should be finalised to amend the Common Provisions Regulation to enable the use of guarantees. The new instruments should achieve high leverage effects and be attractive for private sector and capital markets investment. The EIB should start implementing them while work should start immediately on further developing tools for the future, especially on securitisation. While contributions to the SME initiative should remain voluntary, the European Council called for the greatest possible participation by Member States. Participating Member States will inform the Commission and the EIB about their contributions by the end of the year. The new instruments should begin operating in January 2014 to accompany recovery, fight unemployment and reduce fragmentation in the initial years of the financial framework.

2.2.1 EIB/EIF involvement in the SME Initiative

EIB/EIF's role is crucial in the sourcing and structuring of the operations supported by the SME Initiative, ensuring a consistent approach and proper risk assessment and management. Assuming a maximum of 8.5 bn of ESI funds and a 50/50 split between COSME and Horizon 2020 allocations (EUR 180m each) to the mezzanine risk coverage, the EIB/EIF total involvement in the initiative, in terms of guarantee exposure and funding, over the 6 to 7 years (2014–2020), would be capped in the range of maximum EUR 36-49 billion, depending on the chosen option, the products and on the overall riskiness of the portfolios. The exact volume will depend on the ESI Funds made available by Member States and the maximum leverage the Bank can commit to. These amounts are calculated in order to ensure maintenance of a credit profile compatible with other parallel activities performed by the Group. Of this volume, around EUR 7-9 billion would be provided by the EIF in the form of guarantees and credit enhancement, enabled by a combination of a future EIF capital increase and a new EIB mandate. Whilst the intention is to catalyse funding from third-party investors, the EIB Group's involvement would not exceed these ranges. In case of fewer-than-expected third-party investors, there would be a reduction of the allocated ESIF resources (rather than a reduction in leverage), with the balance being returned to the respective Member States.

2.2.2 ESIF contributions

Member States' contribution to the proposed initiative would be voluntary and should be made from a single dedicated programme, with a view to ensuring that the body implementing the new financial instrument would negotiate and sign one single funding agreement with each participating Member State and not with individual regions.

In order to ensure that resources allocated to instruments under Article 33bis achieve an effective and efficient critical mass of new SME debt finance, they should be used in the entire territory of the Member State concerned without regard to the categories of region

therein. Negotiation of the funding agreement between the Member State and the EIB may nevertheless allow for a pro-rata return to a region or group of regions within the same Member State, as part of a single dedicated national programme per financial contribution by ERDF and EAFRD.

The dedicated national programme should cover a dedicated investment priority under thematic objective (3), with common indicators to align with the objectives of Horizon 2020 and COSME programmes which will co-finance the initiative. The co-financing rate for ESI Funds can be set at up to 100% (national co-financing will be optional).

In accordance with CPR article 33bis, contributions should be justified on the basis of *"one ex ante assessment at Union level carried out by the EIB and the Commission. On the basis of available data sources on bank debt finance and SMEs, the ex-ante assessment will cover, inter alia, an analysis of the SME financing needs at Union level, SME financing conditions and needs as well as an indication of the SME financing gap in each Member State, profile of the economic and financial situation of the SME sector at Member State level, minimum critical mass of aggregate contributions, a range of estimated total loan volume generated by such contributions and the value added."* The purpose of the present Staff Working Document is to provide this ex-ante assessment.

Member States wishing to participate in the Initiative should set this out in the Partnership Agreement before the end of 2013. Without prejudice of the final decision to be taken by the authorities of a Member State, namely as a result of the findings of the ex-ante assessment and of other elements which influence the decision process regarding the allocations by programme of ERDF and EAFRD resources, Member States are invited to confirm by 15 December:

1. whether they intend to contribute ERDF and/or EAFRD resources to the new financial instruments to be set under the SME initiative;
2. if affirmative, the indicative amount of such possible contribution by fund and
3. the split of such contributions between the two options offered by the provisions of the Regulation, namely (a) uncapped guarantees providing capital relief and (b) securitisation of existing debt finance and new loans to SMEs.

The dedicated national programme should be adopted in January 2014, to allow funds to be committed in January 2014. A prior commitment of a minimum number of participating Member States and a minimum volume of resources shall be necessary to guarantee a critical mass of funding for the instrument to go ahead and deliver the expected results.

Participating Member States should in parallel negotiate and, after adoption of the respective dedicated programme, sign the funding agreement with the EIB/EIF.

III. OBJECTIVES OF THE ASSIGNMENT

The objective of this ex-ante assessment is to analyse the market demand and the need for EU intervention in more detail, also in view of facilitating the participation of Member States in the SME Initiative.

It should be noted that the ex-ante assessment builds on and further complements the ex-ante assessments carried out for COSME and Horizon 2020,¹⁷ using the methodology set out in the ex-ante assessment for COSME, but also provides an analysis of SME financing needs at the level of each Member State. Indeed, in accordance with CPR, article 33bis, with the limits imposed by available data sources on bank debt finance and SMEs, the ex-ante assessment *"covers, inter alia, an analysis of the SME financing needs at Union level, SME financing conditions and needs as well as an indication of the SME financing gap in each Member State, profile of the economic and financial situation of the SME sector at Member State level, minimum critical mass of aggregate contributions, a range of estimated total loan volume generated by such contributions and the value added."*¹⁸

The ex-ante assessment has to be carried out in a relatively short period of time to allow Member States to take a decision on whether to participate in the Initiative by the end of 2013, as requested by the October European Council.

¹⁷ Economisti Associati (2011) and European Commission (forthcoming).

¹⁸ See Common Provision Regulations article 33 bis as agreed at the October 2013 trilogue meetings.

"...key to sustainable growth is that the necessary structural change and new economic activity must be financed. Many SMEs in southern Europe in particular still struggle to access finance."

Vice-President Olli Rehn

IV.REPORT

4.1 Chapter 1: Analysis of the market gap in accessing bank financing by SMEs

4.1.1 SMEs' difficulties in accessing finance¹⁹

4.1.1.1 Access to finance for SMEs

SMEs²⁰ constitute the backbone of the European productive fabric: they represent 99.8% of EU companies, almost 60% of GDP (total value added) and near 70% of the total workforce. According to OECD, SMEs and entrepreneurs are crucial for tracing new paths to more sustainable and inclusive growth, thanks to their role in developing and diffusing innovation. However, they can only fulfil this potential if they obtain the finance necessary to start and grow their businesses (OECD, 2013b). Yet they are also particularly vulnerable, especially on the financing side. According to the ECB's (2013b) latest Survey on the Access to Finance of SMEs in the Euro area (SAFE), **access to finance remained the second most pressing problem for euro area SMEs**. Moreover, it appears to be still a more severe concern for SMEs than for large firms. One reason for this structural weakness is that SMEs are more dependent on bank financing, such as loans and credit lines, than large firms (ECB, 2013c, and Cœuré, 2012), since their access to alternative forms of financing (e.g. bond or equity) is limited (see for example Chava and Purnanandam, 2011, and Mosk and Ongena, forthcoming). These problems are exacerbated by financial market fragmentation in the EU, both across Member States and between firm classes. Hence, SMEs are more strongly affected than other firms by changes in bank lending conditions, for example due to deleveraging.

¹⁹ Sections 4.1.1 and 4.1.2 are to a large extent based on Kraemer-Eis, Lang, and Gvetadze (2013a), Kraemer-Eis, Lang, and Gvetadze (2013b), and Kraemer-Eis, Passaris, and Tappi (2013).

²⁰ The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million.(European Commission Recommendation of May 6, 2003 (2003/361/EC).

4.1.1.2 Effects of the crisis on SMEs

In the years prior to the financial crisis, “there was little evidence that euro area SMEs were constrained over and above levels expected in the context of a sound financial system” (Cœuré, 2012). However, at the same time, there was also “a strong increase in credit growth in the euro area following a persistent easing of bank lending standards. [...] One of the adverse consequences of this credit expansion was that the euro area corporate sector had accumulated, on the eve of the global financial crisis, considerably higher leverage than during the early 2000s [...]”. This effect was largely driven by micro and small firms, for which financial leverage increased from 0.14 in 2004 to 0.19 in 2007” (Cœuré, 2012). However, since then, financial conditions have deteriorated strongly and lending volumes have come down.

The financial crisis has put additional burden on SMEs’ access to funds. Even if the difficult economic situation reduced corporate demand for loans, balance sheet concerns²¹ and risk considerations of banks imply a) higher costs of SME loans and b) difficulties to securitise these loans, leading to a **more restrictive lending behaviour on the supply side**. Also the OECD confirms the difficult SME financing conditions in their annual Scoreboard (see Box 3).

Moreover, during the crisis, European banks have started the deleveraging process due to expected new capital regulations and additional funding constraints (see Box 4.1.1)

Box 4.1.1 - BANKS’ DELEVERAGING – A RECENT ANALYSIS OF THE SITUATION IN EUROPE

This box is based on Mosk and Ongena (forthcoming Nov. 2013). The paper investigates the deleveraging process of the European banking sector since the onset of the financial crisis in 2007 and its impact on corporate investment.

*It shows that, while many European governments recapitalised the banks in their countries and provided guarantees, banks are still highly levered in some countries, face funding constraints and are still highly dependent on ECB funding and face increasingly non-performing loans. According to the analysis, **the deleveraging process resulted so far in a reduction in the provision of credit**, although the correlation between bank leveraging and lending activity was found stronger in Southern than in Eastern Europe.*

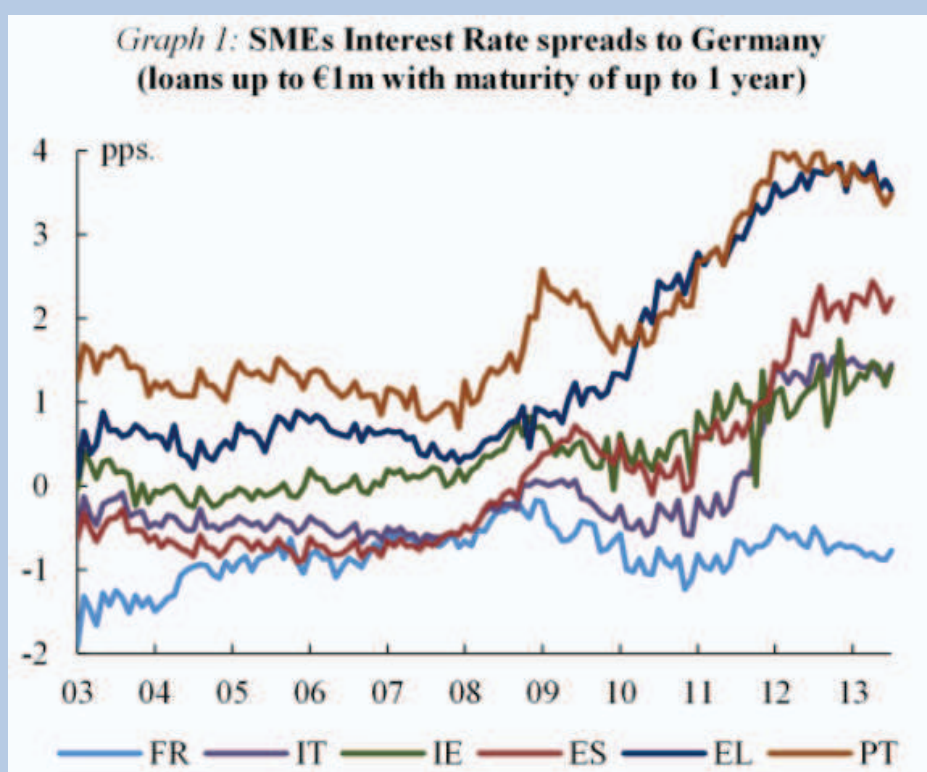
*The on-going crisis remains a risk for all European countries, and it could directly or indirectly result in **rapid contraction in bank lending** because of acute funding and capital shortages. Moreover, the paper finds that the investment of small, non-listed firms is strongly correlated with banking sector leverage.*

These problems are more pronounced in those countries that are most affected by the financial and sovereign-debt crisis (Box 4.1.2).

²¹ During the financial crisis, banks’ balance sheets turned out to include unsustainable amounts of bad assets. The following necessary adjustment process has involved “the recognition of legacy losses, the disposal of impaired assets, and the build-up of robust capital buffers supported by a reliable earnings capacity.” This need to repair balance sheets has weighed on banks’ ability to lend and has led to a “disruption to financial intermediation”. And still, “[u]ncertainty about asset quality remains a greater concern in Europe” than in the US (see BIS, 2013).

Box 4.1.2: FINANCIAL FRAGMENTATION AND SMEs' FINANCING CONDITIONS²²

[...] Small and medium-sized enterprises (SMEs) are usually more exposed to economic downturns and asymmetric shocks as they are typically more specialized, sectorally and geographically. In addition, SME funding is particularly dependent on bank lending: unlike large corporations, they have hardly access to any alternative sources of financing.²³ Given that SMEs are essential for economic growth and job creation, financial fragmentation could impede the economic recovery in the vulnerable Member States and amplify cyclical divergences within the euro area. The latest survey on the access to finance of SMEs in the euro area (SAFE)²⁴ shows that vulnerable countries (Spain, Greece, Ireland, Italy, Portugal) reported the largest share of SMEs indicating that access to finance is their greatest concern at the current juncture. Firms in these countries also mention more frequently that interest rate expenses are increasing, in line with ECB data which illustrate that particularly firms in the southern euro area face higher borrowing rates on loans below a volume of 1m EUR, a proxy usually used for loans to SMEs (see Graph 1). The survey also shows that SMEs are confronted with higher rejection rates compared with larger corporations, a feature magnified in vulnerable Member States.



While banks generally charge higher rates for loans to SMEs than for loans to larger corporations, this interest-spread has increased in the euro area, notably in vulnerable Member States (see Graph 2).²⁵

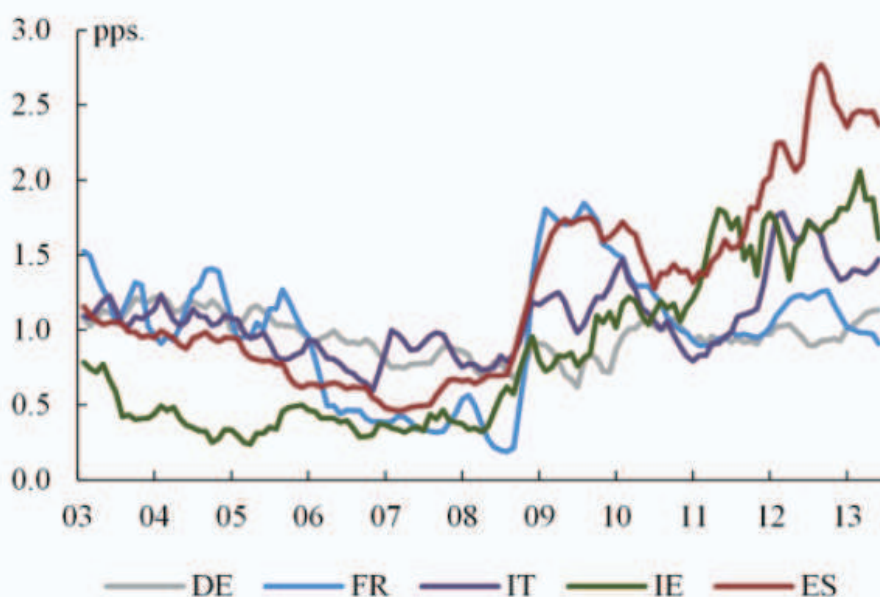
²² Drawn from European Commission (2013e), Box 1.2: Financial fragmentation and SMEs' financing conditions.

²³ Smaller firms are over-proportionally subject to financial constraints, see for example Iyer et al. (2013).

²⁴ See ECB (2013e), The perceived external financing gap indicator for small and Medium-sized enterprises in the euro area, pp. 19-24. See also Canton and van der Zwan (2013). In the Commission's annual investment survey at the end of 2012 manufacturing firms from vulnerable Member States reported that financing conditions were less favourable compared to those in core countries. The size breakdown, however, did not suggest that SMEs were systematically more affected than large corporations.

²⁵ According to qualitative information, there was a pronounced increase in the rate of loans to riskier SMEs, which suggests that the average rates recorded in statistics may give a too benign picture of the credit costs many SMEs are facing, see Institute of International Finance (IIF)/Bain & Company (2013).

*Graph 2: Interest Rate Spread
between Smaller and Larger Loans to NFCs
(loans up to €1m vs above €1m, 3m moving average)*



Bank lending volumes have significantly declined in the euro area periphery, but there is no clear indication that lending volumes for SMEs have fallen more rapidly than those for larger enterprises. However, this comparison may be misleading because larger enterprises crucially benefit from the access to market funding via bond issuance which they have intensively used as a complement or substitute for bank loans in the past years. [...]

The relatively difficult access to finance conditions for SMEs in those countries, further compounded for innovative SMEs, 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, 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*”.

Box 4.1.3: FINANCING SMEs AND ENTREPRENEURS 2013: AN OECD SCOREBOARD

The OECD published recently its Second Edition of Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard (OECD, 2013a)²⁶ as a step towards developing a comprehensive framework to monitor trends in access to finance by SMEs and entrepreneurs at the country level. The analysis covers 25 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 2011 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. This was also generally accompanied by modest or no growth in credit volumes, with the exception of a few countries. These diverging performances can be traced to the

²⁶ EIF closely cooperates with the OECD on this project and other projects related to SME finance.

different degrees to which countries were hit by the crisis and their subsequent recovery in 2009 and 2010.

On the whole, the analysis summarises that finance for SMEs remained tight but appeared to stabilise in 2011 and early 2012. However, there are strong indications that the sovereign debt crisis in several European countries will lead to further deterioration in bank lending in 2013. In a number of countries, where the crisis resulted in a high level of bankruptcies and left many SMEs in a weaker financial condition, reversing the severe post-2007 job losses in SMEs will be particularly challenging.

Additional liquidity, provided by the ECB to banks via its Long-Term Refinancing Operations (LTROs) has been only partially used to finance SMEs;. Given these circumstances, in many countries – from a risk/return perspective – lending to SMEs is only attractive for banks if they charge interest rates higher than justified by credit quality. Moreover the expected negative impact of the implementation of CRDIV shall be taken into account. According to Commission analysis compliance with the new capital framework is expected to reduce the stock of loans on average by 1,8% and increase loan rates on average by some 29 basis points by 2020-2030²⁷. However the flow of loans to SMEs should be less severely impacted taking into account the following factors:

- SMEs transact more with smaller banks, whose capital shortfalls are estimated to be lower than other banks;
- in the course of the negotiations it has been agreed to introduce a ‘supporting factor’ on exposures to SMEs which will ‘neutralize’ the increase in own funds requirements for loans to SMEs and should ease lending conditions for SMEs over time (see article 501 of Regulation n. 575/2013).

4.1.1.3 Supply side

Access to finance is crucial in particular for SMEs. As they depend heavily on bank financing²⁸ and the issuance of debt securities or bonds is usually not an option for them, they are hit by limited credit supply harder than other firms. SMEs are a significant part of the total number of European firms and they strongly contribute to economic growth and employment. Recoveries heavily depend on the composition of firms within a country and how those firms reacted to the recent credit crunch. Moreover, unlike in the US, it is more difficult for firms in Europe to substitute bank loans with debt securities. Since most European countries strongly depend on bank loans, credit constraints can be particularly disruptive for European economic growth (see Table 4.1.1).

TABLE 4.1.1 - NUMBER OF ENTERPRISES HAVING USED DEBT FINANCE IN THE EU-27, BY ENTERPRISE SIZE CLASS*

TOTAL EU27	1-9 EMPLOYEES	10-49 EMPLOYEES	50-249 EMPLOYEES	SMEs (COMBINED)	250+ EMPLOYEES
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²⁷ See COMMISSION STAFF WORKING PAPER IMPACT ASSESSMENT Accompanying the document Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms – SEC 949(2011) Final

²⁸ According to the latest European Commission (2011) and ECB joint Survey on the Access to Finance of SMEs (SAFE), in the EU27, 74.8% of all companies used debt financing (any source).

Used debt financing	Number	13,999,855	12,692,154	1,076,524	192,587	13,961,265	38,590
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** Publicly available information on the number of mid-caps does not exist. In a recent PWC (2012) study, the number of mid-caps (defined as companies with 250-2,999 employees) is estimated to be around 28,165. The estimated number of innovative midcaps is 14,000. Applying the arithmetic mean (86.7%) of the shares of medium-sized (85%) and large companies (88.4%) having used debt finance leads to an estimated 24,419 mid-caps and 12,138 innovative mid-caps which have used debt finance in the recent past.*

Furthermore, the ECB Bank Lending Survey in ECB (2013c) shows that, on balance, the reporting euro area banks have further tightened their credit standards to non-financial corporations; recently the overall net tightening has been applied more to SMEs than to large firms.

4.1.1.4 Demand side

The general economic and financial environment mainly drives demand side developments. Economic growth in the world and in Europe has been weak in the recent past, and while the macroeconomic outlook has turned more positive, a number of downside risks remain. In line with the difficult general economic situation, the business climate reported by European SMEs further deteriorated and the imbalances between the EU Member States are significant. For the country group composed of Italy, Spain, Portugal, Greece, and Ireland, the UEAPME Business Climate Index (UEAPME, 2013b) is back to the levels of early 2009, showing a clear **lack of confidence among SMEs** concerning the current and upcoming economic developments.

In fact, the lack of confidence among SMEs appears to be reflected in the ECB Survey from November 2013,²⁹ which estimated the percentage of firms not applying for a bank loan due to **fear of rejection** at 7%. On the other hand, the survey indicates that 5% of the SMEs reported an increase in their need for bank loans while 9% of the SMEs signaled an increased need for bank overdrafts. Looking in more detail at individual countries, SMEs in Italy and France contributed most to the net increase of the need for both bank loans and overdrafts whereby SMEs in Italy and Greece continued to report the highest increase in their need for bank loans. Such increased need for bank loans may result from the demand to finance working capital in an environment of still weak profits and also from insufficient internal funds available to SMEs.

4.1.1.5 Conclusion on supply and demand side

In the currently still difficult economic situation, European SMEs' demand for bank finance seems even to slightly increase lately, while the supply-side-driven difficulties in access to finance give reason for concern, especially in certain countries.

4.1.2 Assessing SME financial gaps

²⁹ See ECB (2013b), in particular the November 2013 survey, based on a sample size for the euro area of 8,305 firms, of which 7,674 (92%) had less than 250 employees.

The previous section has illustrated the difficulties encountered by European SMEs in accessing credit, as exacerbated by the financial crisis. A case can be made for public intervention to address these difficulties as such, regardless of the origin of the problem. Well-functioning credit markets make major contributions to growth and macroeconomic stability, and restarting credit plays an important role in economic recovery after a downturn. For example, recent studies show that recoveries are typically faster where the credit growth is more robust, at least for the first few years, especially after recessions that feature large declines in asset prices (as in the current financial crisis). In addition, as shown above, SME-dependent economies may be particularly damaged in their productive structure and economic growth prospects from a credit squeeze centered on this type of enterprise. Such economies may then legitimately adopt credit-supporting economic measures in the face of the evidence provided so far.

However, it is important to dig deeper into the underlying causes of SMEs' difficulties, especially in vulnerable countries. Whether financial hurdles stem from the credit supply or demand side, it is of the utmost importance both to assess the extent of the market failure, if any, and to design the appropriate specific policy measures. It may also be of interest to investigate the determinants of SME financial difficulties, in order to understand if they are rooted in market- or performance-driven considerations (see Box 4.1.4).

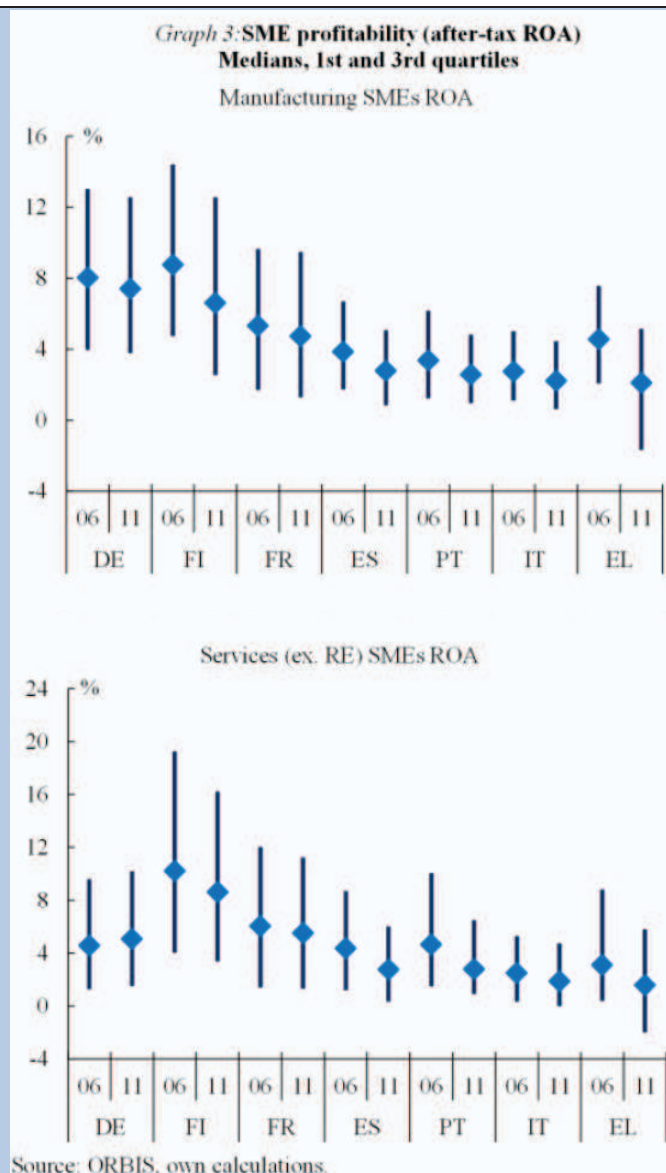
Box 4.1.4: BEHIND SMEs' LENDING CONDITIONS³⁰

[...] Alongside financial fragmentation on the loan supply side, other factors such as cross-country differences in SME's profitability or indebtedness are acting on both supply and demand of credit and are likely to contribute to the divergence in interest rates and lending volumes. The identification of the particular impact of financial fragmentation on credit-market conditions thus requires controlling for SMEs' fundamental variables. The subsequent analysis shows that there are still differences in funding conditions between comparable enterprises that are located in two different euro area countries. The sample³¹ covers independent SMEs (no majority-controlled subsidiaries) in vulnerable countries (Italy, Spain, Portugal, and Greece) and in core countries (Germany, France, Finland, and Belgium).³² The visible cross-country differences in profitability as measured by the after-tax return on assets (ROA) for both manufacturing and services firms indicate that part of the difference in lending rates may be explained by the SMEs' different credit risks (see Graph 3).

³⁰ Drawn from European Commission (2013e), Box 1.2: Financial fragmentation and SMEs' financing conditions.

³¹ Firm-level data are from the ORBIS database.

³² Results need to be interpreted with caution given cross-country differences in firm coverage in the database, reflecting both differences in the number of existing firms and different institutional frameworks on data reporting.



Controlling for differences in profitability is important because SMEs' profitability acts on both the supply and the demand side of the bank credit market. On the supply side, banks request a higher risk premium for loans to businesses with lower profitability, which in turn reduces further their profitability, while loan demand can also be negatively affected by low profitability, particularly when SMEs are facing generally high funding costs. The firm-level data on profitability suggest that SMEs in core countries are more profitable than those in vulnerable Member States³³ but that profitability declined moderately in almost all countries covered between 2006 and 2011 (last available financial year in the database). The only exception is Greece, which experienced a sharp deterioration. Differences in profitability are therefore rather country-specific and cannot be sufficiently explained by different cyclical patterns across the euro area, even though higher financing costs contributes to the differences in profitability. Instead, they could be due to, for example, the share of value-added in the produced goods, the technology used (the mix of capital and labour), R&D (and the possibility to

³³ German SMEs' profitability shows more cross-sectoral differences compared to other euro area countries. However, this may be due to the database coverage of German firms which differs from those of other Member States. In terms of staff, the median size of a German SME in the sample is around 60 employees, whereas the median size is below 20 employees in all other Member States. This could explain, at least partially, the observed differences in profitability.

finance it) and country infrastructures and institutional differences. Next, SMEs' financing conditions are assessed by examining whether firms' investment levels correctly reflect their fundamentals. This analysis is based on the assumption that funding flows are typically used for investment purposes.³⁴ The approach consists of comparing the investment rates of SMEs in the vulnerable countries to those of their closest possible match among firms operating in core countries. Specifically, the matching procedure looks for the most similar firm operating in Germany, France, Finland, or Belgium within the same industry as the vulnerable country's firm, and with the closest possible fundamentals: profitability, sales growth, company size, capital intensity and leverage. [...]

A different analytical approach to identify the impact of financial market fragmentation on SMEs was followed by IMF (2013).³⁵ It estimates the impact of variables that proxy for financial fragmentation on the lending rates charged to SMEs, controlling for the business cycle, the corporate credit risk and the monetary policy stance. The variables that reflect financial fragmentation measure sovereign risk and bank health.³⁶ The difference between the actual lending rate and the hypothetical one that would arise if the variables of sovereign risk and bank stress were zero, indicates by how much lending rates would be lower if fragmentation did not exist. The estimation was done for France, Italy and Spain and revealed that lending rates in Italy and Spain are between 100 bps. and 200 bps. above their theoretically justified value.

Thus, the above analyses suggest that the **geographical location of the firm emerges as a decisive factor in corporate lending and investment**. On the supply side, **financial fragmentation appears to play a role in constraining access to finance and/or in driving up lending costs for SMEs in vulnerable Member States**.³⁷ However, financial fragmentation should not be considered as fully accountable for the wide differences in funding costs of SMEs across euro area countries. As shown, cross-country differences in the average credit quality of the SMEs as measured, inter alia, by profitability is also an important contributing factor. Finally, deleveraging pressures may also contribute, although there is no clear evidence of higher SME indebtedness ratios in vulnerable Member States relative to core countries. Indeed, other demand-related factors could partially explain lower lending volumes as SMEs in the vulnerable countries are operating in a more uncertain economic environment and may be more prudent with respect to debt financing at the current juncture. [...]

Beyond the determinants of SME financial difficulties, it is crucial to assess whether – given the financial hurdles illustrated above – a financial gap exists in SME financing, and what is its extent. Obviously, such information is relevant in the calibration of financial policy interventions aiming to reduce this gap. The following section is devoted to an attempt at measuring such a gap in the EU.

4.1.2.1 Methodology adopted³⁸

Taking into account the relevant literature on the assessment of financial gaps, we adopted a methodology which appears appropriate for the data at our disposal and the purpose of this report; our approach uses SME survey data to gauge the number of enterprises unsuccessful in obtaining a loan, while being financially viable and thus apparently

³⁴ IIF/Bain & Co (2013) points to the fact that SMEs' capital needs have recently shifted from the financing of long-term investment to the financing of working capital.

³⁵ See Chapter 2 and Annex 1.1 in International Monetary Fund (2013) for a survey, pp. 63-103 and 53-56.

³⁶ More specifically, the trend deviation of the 10-year sovereign-yield spread and the banking system's price-to-book ratio. The business cycle is controlled for by adding industrial production and monetary policy by adding an interest rate to the estimation.

³⁷ See Pontuch (2013).

³⁸ See Annex 3 of Chapter 1 for alternative methodologies for measuring financing gaps.

creditworthy. Multiplying this number by the average SME loan amount, an estimate can be provided of the unmet financing needs of financially viable SMEs.

Survey data, with all their limitations, are used extensively in studies on financing gaps when time and data constraints prevent the quantitative assessment of demand and supply through deep analyses of the data, as suggested, for example, in the Court of Auditors recommendations.³⁹ For example, both Economisti Associati (2011) and European Commission (forthcoming) follow an approach very similar to this, and survey data have been recently used, among others, by the International Monetary Fund (2013) for estimations of SME financing conditions.

Theoretical framework

The methodology adopted in this Ex-Ante assessment can be outlined as follows:

1. Identify the number of *financially viable* SMEs that have been unsuccessful in obtaining loan financing (within an established time span). The definition of "unsuccessful" encompasses all SMEs who do not benefit from loan amounts meeting their financing needs (regardless of whether they have applied for a loan).
2. The loan financing gap is expressed as the average loan amount that is or would have been requested by each *financially viable* unsuccessful SME, multiplied by their number.

To provide actual estimations of the gap, it is necessary to make in some cases additional assumptions and in some others revert to the use of proxies.

Assumptions used in the estimation process

The following assumptions concern the additional requirements imposed by this study in order to consider the estimated gap a reliable measure of the real one. Each assumption therefore also entails an important disclaimer on the validity of final results.

Assumption 1. The proportion of *financially viable* SMEs is identified by the share of SMEs that have benefited from a positive growth in terms of turnover in the last six months

Assumption 2. A more stringent proxy for the proportion of *financially viable* SMEs is represented by the share of high-growth SMEs, *i.e.* firms that have benefited from a turnover growth higher or equal to 20% in the last three years.

Assumption 3. The causes that generate a "failure" in obtaining loan financing (as per the definition stated in the previous section) are represented exhaustively by the following three outcomes:

- a. Bank's rejection of the loan application
- b. Firm refusal of the loan conditions

³⁹ See European Court of Auditors (2012).

- c. Firm's unwillingness to apply for loan financing even when loan financing is needed

Annex 4 to Chapter 1 provides a detailed discussion of measurement issues and challenges and the solutions adopted in the study.

4.1.2.2 Analysis of the financing gap

Based on the illustrated methodology, it is therefore possible to carry out calculations of the financing gap in terms of number of SMEs and indicative loan volumes, both for the EU as a whole and, with more caveats due to data unreliability and unavailability, for each Member State.

EU-level financing gap

Number of SMEs

At the EU28 level, the proportion of SMEs that have faced problems in accessing bank financing between 2009 and 2012 is 12.63%⁴⁰, calculated as the weighted average of all countries participating in the SAFE Survey in a given year. This figure, in line with the estimates provided in the Ex-Ante Assessment for COSME (*Economisti Associati, 2011*), corresponds to approximately 2,650,000 SMEs.⁴¹

The estimated interval for the proportion of financially viable SMEs lies within 5.84%⁴² and 32.53%.⁴³ While this range may seem excessively broad, it is interesting to note that the average point of this interval is 19.18%, very close to the 20% figure, representing the proportion of financially viable SMEs arbitrarily set in the Ex-Ante Assessment for COSME.

Further insight can be gained from the data quoted in the Horizon 2020 Ex-Ante Assessment based on the 2012 Community Innovation Survey, which reveals that some 53% of enterprises reported "innovation activity" between 2008 and 2010; this suggests that at any one time, 150,000 to 500,000 innovating SMEs are originating bankable operations that the market cannot support.⁴⁴

Overall, the loan financing gap affected between 155,000 and 860,000 European SMEs in the 2009-2012 period. Therefore, up to 4.11% of European SMEs were not able to obtain a loan for reasons unrelated to financial viability.

Amounts

By matching data obtained from Orbis Database with information on loan shares provided by BACH-ESD Database,⁴⁵ this study attains an average SME loan size of €130,850⁴⁶ which is

⁴⁰ Standard deviation within countries: 5.46%. Standard deviation within years: 2.40%.

⁴¹ 95% Confidence interval for 2009-2012 figures: 2,018,300 - 3,486,154.

⁴² Standard deviation within countries: 2.56%. Source: Eurostat.

⁴³ Standard deviation within countries: 9.81%. Source: ECB SAFE.

⁴⁴ Eurostat (2013), http://europa.eu/rapid/press-release_STAT-13-5_en.htm

⁴⁵ Median figures from Orbis were used instead of averages, as the samples were deemed too much biased towards larger enterprises. Outlying values (usually occurring in countries with low sample representativity) were excluded from final calculations.

⁴⁶ Standard deviation within countries: 66,160. Standard deviation within years: 3,830. Sources: Orbis, BACH-ESD.

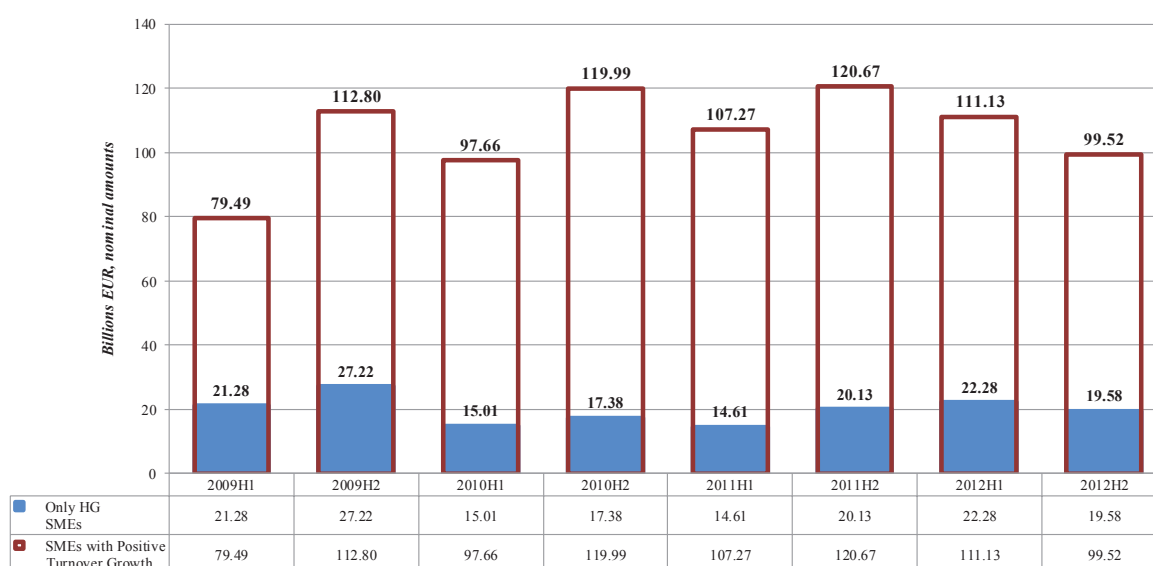
considerably close to the one previously imputed by Economisti Associati (2011) who consider an indicative figure of €100,000.⁴⁷

By multiplying the average SME loan size with the aforementioned number of SMEs with problems in accessing loan financing, an EU-wide gap can be quantified within the range of €20 bn to €112 bn. Again, the range may seem particularly broad, but once again the average value of this interval is €66 bn, which lies in the range of amounts estimated in the Ex-Ante Assessment for COSME.⁴⁸

Recent Trends

The following chart (Figure 4.1.1) provides an estimated trend for the loan financing gap in the 2009-2012 period, where the lower bound corresponds to the debt financing needs of *high-growth* SMEs (*i.e.* SMEs that have shown a turnover growth rate higher than 20%, source: Eurostat), and the upper bound indicates the financing needs of EU SMEs with a *positive turnover growth rate*⁴⁹. Data on financing needs is based on ECB SAFE.

FIGURE 4.1.1: ESTIMATED EU28 LOAN FINANCING GAP 2009H1 - 2012H2 (€ BILLIONS)



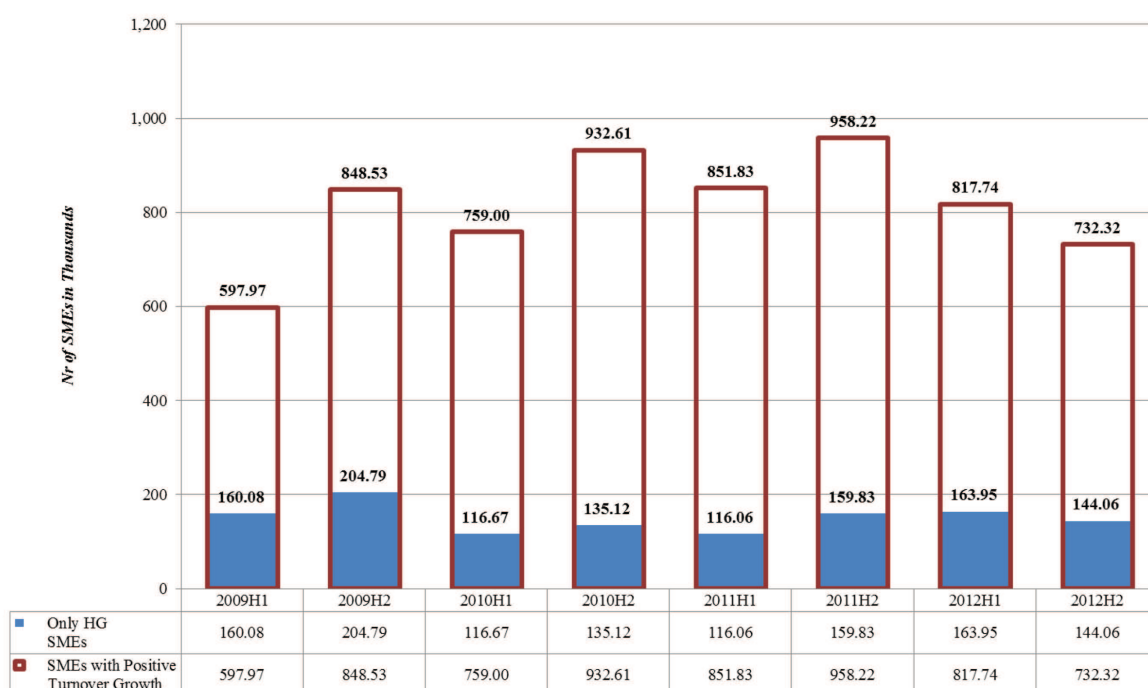
Similarly to Figure 4.1.1 above, Figure 4.1.2 shows the recent trends in the number of financially viable SMEs that have been unsuccessful in obtaining loan financing.

FIGURE 4.1.2: NUMBER OF FINANCIALLY VIABLE SMEs THAT HAVE BEEN UNSUCCESSFUL IN OBTAINING LOAN FINANCING

⁴⁷ Identified as half of the average loan guaranteed by Credit Guarantee Schemes associated with AECM.

⁴⁸ Between EUR 40 bn and EUR 70 bn. Source: *Economisti Associati* (2011).

⁴⁹ In the six months preceding the survey period.



Both figures above show an overall improvement of the conditions in accessing loan financing at the EU28 level in 2012 compared to earlier years. However, it is important to note that such a positive trend might in part be caused also by a decrease in the population of financially viable SMEs. In other words, the negative effect brought by the crisis on the turnover growth of EU28 SMEs may generate a downward bias in the number of SMEs that "deserve" loan financing but are unable to obtain it, especially compared to previous years in which the effects of the financial crisis were not yet apparent.

Moreover, it is crucial to underline that the reported figures only represent the measured gap in terms of *loan* financing. Due to the fact that the SME Initiative also supports alternative debt financing instruments (*i.e. leasing, bank overdraft, trade credit, etc.*), the overall *debt financing gap* at EU28 level is expected to be higher.

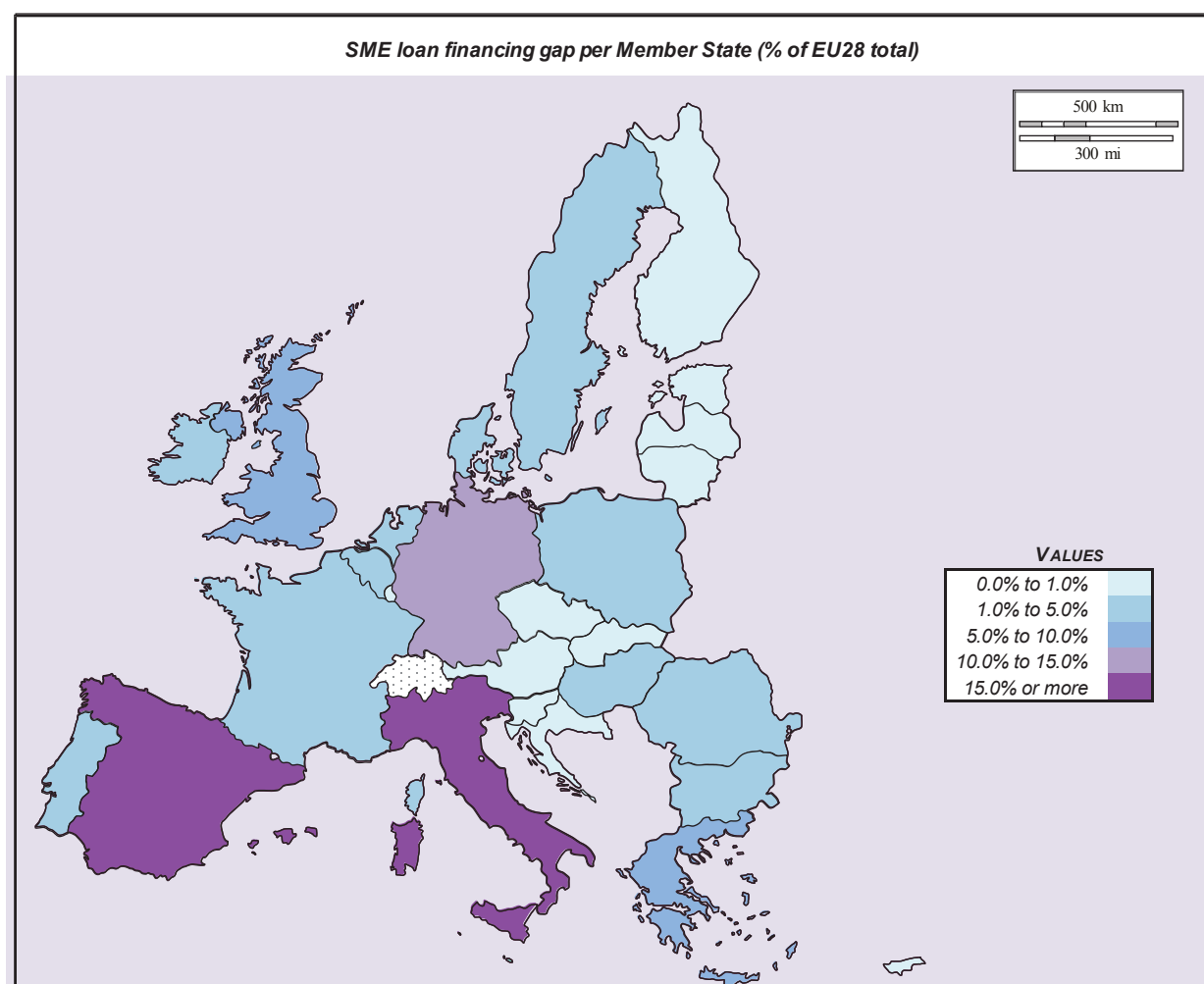
Country-level profiles and financing gaps⁵⁰

Annex 6 to Chapter 1 embeds the financing gap analysis, based on the adopted methodology, in a country-by-country portrayal of the economic and financial situation of the macro-economy in general and of SMEs in particular, focusing on the demand and supply features of SMEs' debt finance.

As an overview of the figures contained in the country fiches, Figure 4.1.3 (next page) displays the distribution of the loan financing gap across EU Member States.

⁵⁰ Data availability and robustness analyses are presented in Annex 5 to Chapter 1.

FIGURE 4.1.3 - SME FINANCING GAP IN EU28 MEMBER STATES



Note that values are expressed as percentages of EU28 total and they reflect the *average values* observed during the 2009-2012 period (thus, countries that may have recovered significantly – in terms of provision of loan financing to financially viable SMEs – during later semesters might currently show a lower percentage of the gap⁵¹)

The reader should also keep in mind that, since the financing gap is calculated taking into account the number of financially viable SMEs in a given country who have been unsuccessful in obtaining loan financing, and multiplying this number by the average loan size, the resulting loan financing gap is to be interpreted only in absolute terms and bears very little comparative power. In other words, a country like Germany, in which one tenth of all EU28 SMEs operate, will have a higher share in the aggregate EU 28 finance gap even though the percentage of its financially viable SMEs unsuccessful in obtaining loan finance is lower compared to several other countries. For a complete overview at Member State level of

⁵¹ For the latest contribution to the loan financing gap at Member State level, the reader is referred to Table 1 in the Executive Summary for an overview in percentage of EU28 total, or to Annex 6 to Chapter 1 for absolute figures

the share of financially viable SMES unsuccessful in obtaining loan financing, the reader is referred to Annex 6 to Chapter 1.

The reader is also referred to the beginning of Annex 6 to Chapter 1 for a complete description of the indicators used in the Country Fiches.

Access to finance of agricultural SMEs

There is currently no study available that covers the ability of SMEs in the agricultural sectors to access loan financing. Furthermore, this topic seems to be only marginally included in the various strands of the existing literature on SMEs' access to loan financing. However, in order to partially address the informational gap in this field, some crude measures can be provided (mostly at the aggregate EU level) concerning the financial attributes of EU SMEs in the agricultural sector. An overview of the main findings and available data on the topic are provided in Box 4.1.5 and Box 4.1.6.

Box 4.1.5 : ACCESS TO LOAN FINANCING IN THE EU28 AGRICULTURAL SECTOR

The agricultural sector contributed 3.15% in 2012 at the European Union level to the overall Output of the Economy⁵², and constituted 1.4% of its gross value added.⁵³ If we consider the entire primary sector⁵⁴, the overall contribution to the EU27 gross value added in 2012 increases to 1.7%⁵⁵. The 2012 Report on "EU agriculture – Statistical and Economic information" recently issued by the Directorate General of Agriculture and Rural Development states that:

"The 2012 agricultural year in the EU was characterised by a stable real agricultural income per labour unit, after the income growths recorded in 2011 (+8%) or in 2010 (+17%). On aggregate, since 2005 the EU-27 agricultural real income per labour unit has increased by 28.5% driven by an increase in factor income (+3%) and a decline in labour force (-20%)".

Although the importance of the agricultural sector, not only in terms of its contribution to the total economy, is indisputable, several challenges hinder the ability to perform a comprehensive economic and financial analysis in this area. This aspect becomes particularly relevant when the focus of the analysis is on agricultural SMEs. The ambiguity of country-level information and the unavailability of harmonized detailed data make it impossible to follow the conventional criteria set forth in the previous sections concerning the identification of SMEs.

In order to overcome the major challenges found in collecting and aggregating agricultural SMEs' data at the country level, for the purpose of this study we identified agricultural SMEs using the criteria of economic size in terms of standard output. The definition of economic size in terms of standard output follows the guidelines specified in Regulation 79/65/EEC of

⁵² Calculated as the EU28 output of the agricultural industry at current basic prices over the Gross Domestic Product at current prices for the given year. Sources: Eurostat, Annual National Accounts and Eurostat, Economic Accounts for Agriculture.

⁵³ Calculated for the EU27 Member States. Source: Eurostat

⁵⁴ Which also includes forestry and fishery

⁵⁵ Source: DG AGRI, Annex to the "Common context indicators for rural development programs (2014-2020)"

15 June 1965 and subsequent amendments, providing for a harmonized method to identify agricultural holdings across European regions.

The second Economic Brief of July 2011 issued by the Directorate General of Agriculture and Rural Development,⁵⁶ provides a comprehensive analysis on the different alternative ways to identify small agricultural holding in EU27 regions. Although the conclusion of this study is that no particular method prevails on the others, it is stated that the "economic size is closely related to concerns about a farm's ability to survive in the market and its need for special support measures", thus resembling quite closely to the SME definition in terms of turnover adopted for industrial SMEs. The cited brief also provides an indication of the economic size threshold that could be used to identify small holdings (*i.e.* under €15.000 of standard output), although it advocates the use of relative thresholds when looking at small farms across countries. As an additional source of reference, the IFC study "*Scaling Up Access to Finance for Agricultural SMEs: Policy Review and Recommendations*" published in 2011 (*International Finance Corporation, 2011*) provides alternative means to identify agricultural SMEs in terms of the annual net income⁵⁷. A comparative analysis of these two measures shows that they are significantly correlated⁵⁸, sharing the same ability to identify agricultural SMEs among all agricultural enterprises.

Therefore, the following analyses are based on holdings that showed a standard output in the range of 0 to 100.000 Euro, which are assumed to represent the SME counterparts in the agricultural sector.

Using data from the Farm Accounting Data Network (FADN, containing data up to 2011 covering the entire EU27 area), and Eurostat's Farm Structure Survey (2010), and comparing these with data from the SME Performance Review Database⁵⁹. Table 4.1.2 below reports the contribution of agricultural SMEs to the entire category of SMEs⁶⁰ at the national level, in terms of structural, demographic and financial indicators.

TABLE 4.1.2 – RELATIVE CONTRIBUTION OF AGRICULTURAL SMEs TO THE A-N (WITHOUT K) SECTOR.
REFERENCE YEAR: 2010⁶¹

Country/Region	Number of Enterprises	Employment	Output ⁶²
Austria	25.7%	8.1%	0.86%
Belgium	3.5%	1.8%	0.18%
Bulgaria	39.7%	17.9%	2.37%

⁵⁶ DG AGRI: EU Agricultural Economic Briefs, "What is a small farm?", Brief N° 2 – July 2011

⁵⁷ Compared to the average salary of a national skilled worker in order to account for country-specific characteristics

⁵⁸ Spearman's rank correlation coefficient = 43.98%

⁵⁹ Which only considers SME operating in NACE sectors B to N without K (financial and insurance services)

⁶⁰ As of footnote 59, thus referring exclusively to sectors A to N, without K (financial and insurance services)

⁶¹ In order to counter the negative effect that measurement error would bring on the reliability of data provided in this table, the distribution of agricultural SMEs per economic size of each country was compared to the average EU28 distribution, so that outlying data was excluded from the analysis.

⁶² The total operating returns for the agricultural sector are obtained by assuming that the proportion of standard output of agricultural SMEs to total agricultural enterprises is representative of the proportion of total output

Country/Region	Number of Enterprises	Employment	Output ⁶²
Croatia	50.7%	23.2%	n.a.
Cyprus	35.7%	16.5%	1.45%
Czech Republic	4.4% ⁶³	1.8%	0.15%
Denmark	9.3%	2.9%	0.34%
Estonia	22.2%	5.7%	0.67%
Finland	15.4%	9.7%	0.91%
France	10.0%	5.1%	0.74%
Germany	5.8%	2.3%	0.29%
Greece	41.9%	17.6%	8.07%
Hungary	37.8%	21.2%	1.64%
Ireland	38.1%	12.2%	1.46%
Italy	26.2%	10.9%	0.86%
Latvia	41.2%	16.1%	1.64%
Lithuania	56.3%	19.6%	3.42%
Luxembourg	3.0%	1.2%	0.08%
Malta	20.6%	5.7%	0.81%
Netherlands	4.6%	1.6%	0.15%
Poland	46.7%	28.1%	2.98%
Portugal	23.5%	20.9%	1.11%
Romania	79.8%	54.5%	8.18%
Slovakia	21.1%	7.5%	0.37%
Slovenia	33.4%	14.2%	1.67%
Spain	24.2%	8.3%	1.24%
Sweden	7.8%	3.1%	0.38%
United Kingdom	6.4%	2.3%	0.28%
EU28	28.0%	11.9%	0.84%

SOURCES: FARM ACCOUNTING DATA NETWORK (2013), FARM STRUCTURE SURVEY (2010), SME PERFORMANCE REVIEW (2012), ECFIN ELABORATIONS.

BOX 4.1.6 : ACCESS TO FINANCE OF AGRICULTURAL SMEs

Unfortunately, there is no existing study covering agricultural SMEs' ability of accessing the loan financing market⁶⁴. However, some crude measures can be still provided (using the FADN Dataset) at the aggregate EU level concerning the financial attributes of EU SMEs in the agricultural sector:

⁶³ Source: Czech Statistical Office, 2013

⁶⁴ Indeed, ECB Survey on the access to finance of SMEs in the euro area excluded from the survey enterprises active in the NACE Rev 1.1 sectors A, B, J, L, P, Q, as well as holdings and non-profits.

1. The share of short term loans over total liabilities is around 15% at EU27 level. This means that agricultural SMEs tend to place most of their financial burden in the medium-long term, whereas in the other sectors of production debt financing seems to be more evenly split between the two time horizons.
2. Because of this specific allocation of debt during the available horizons, the resulting loan financing gap may be interpreted more statically than in other sectors. Thus, it is assumed that even though the data collected refers to the 2010-2011 biennium, it is still representative of the current situation.
3. At the EU27 level, it is estimated that loans to agricultural SMEs represent around 3-5% of all loans issued to the agricultural and nonfinancial SMEs together.
4. The average loan size of agricultural SMEs is estimated between one third and one fourth of the average loan size of nonfinancial SMEs (*i.e.* between €25.000 and €40.000).

Assuming that agricultural SMEs would respond to the SAFE Survey in the same way as non-financial SMEs would, and assuming also that the share of financially viable SMEs in the non-financial sector is also representative of the agricultural sector, the expected range for the loan financing gap of EU28 agricultural SMEs is projected between €1.5 Billion and €9 Billion.

Taking into account the heterogeneity among EU countries, it is possible to estimate a country-specific gap in the agricultural sector, although the reliability of such figures is heavily compromised by the lack of any consistent data on the access to finance of EU agricultural SMEs.

4.1.3 Expected evolution of SME financing gap

Future conditions for SME access to finance, and thus impinging upon SME financing gap, are likely to be affected by several specific factors, notably:

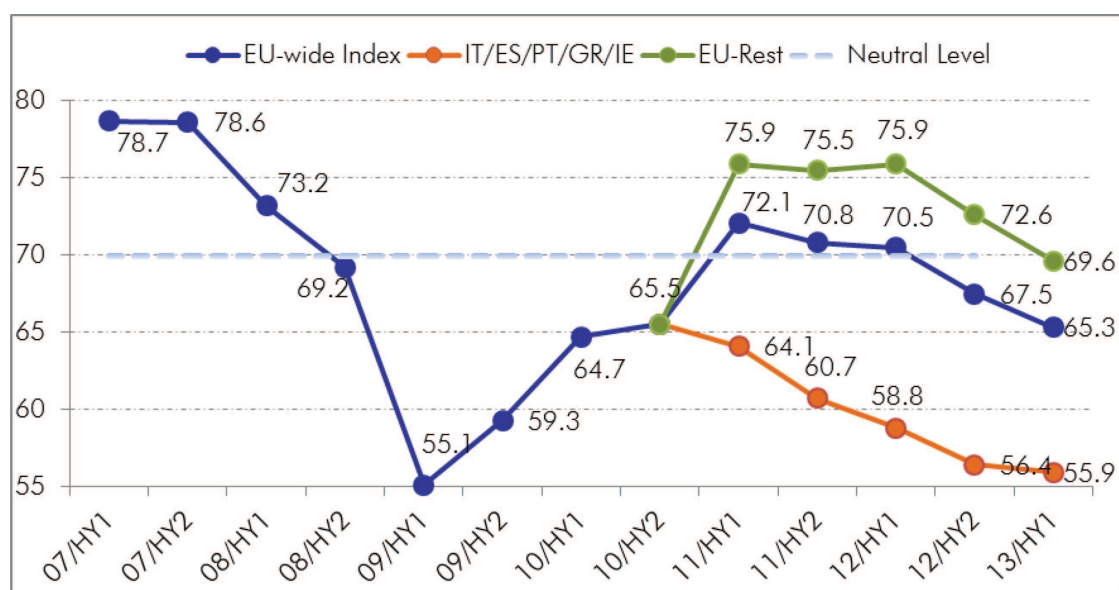
- the EU economic outlook;
- the evolution of the financial conditions of banks;
- the developments of credit guarantee schemes;
- the developments of the SME securitisation market;
- the introduction of measures against late payments;
- the development of alternatives for bank finance;
- the launch of the banking union.

The influence of these factors is briefly summarised below.

4.1.3.1 EU economic outlook

After one and half year of stagnation or contraction, the EU economy has posted positive growth in the second quarter of 2013⁶⁵ and also the positive results of some sub-indicators in the business sentiment index and other business climate indexes for Europe, as a whole, could be seen as a sign that “*the economic downturn is set to bottom out*” (Eurochambres, 2013). On the one hand, the recovery is expected to continue and even somewhat accelerate next year; on the other, the growth will probably still be held back by deleveraging needs, financial fragmentation as well as by several sectoral adjustments and employment displacements related to the crisis. However, these impediments will gradually weaken and are likely even to disappear in a context of expanding economic activity,.

FIGURE 4.1.4: SME BUSINESS CLIMATE INDEX



SOURCE: BASED ON UEAPME (2013B)

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

In parallel, according to Euler Hermes (2013), insolvencies increased by 8% in the Euro area in 2011 and by 16% in 2012. Further increases are forecast for 2013 (+21%) and for 2014 (+7%). As SME insolvency rates are not publicly available, one has to assume that general developments in insolvencies carry over to SME insolvencies.

In this context, further policy effort appears necessary to support the recovery and accompany the various dimensions of adjustment to growth as well as make the EU

⁶⁵ European Economic Forecast Autumn 2013, European Commission ECFIN, 7/2013

economy more resilient, also in relation to SMEs which appear to remain still vulnerable in the light of current developments. ..

4.1.3.2 Evolution of the financial conditions of banks

The SME lending environment will be framed by the Capital Requirements Directive (CRD IV) and Regulation, which will enter into force on January 1st, 2014. These two legislative texts implement in the EU legislation the Basel III agreement. Box 4.1.7 contains a survey of studies on the effect of Basel III on SME finance.

Box 4.1.7: IMPLEMENTATION OF THE BASEL III ACCORD⁶⁶

The proposals formulated by the Basel Committee on Banking Supervision, commonly known as Basel III, deal with the tightening of capital and liquidity requirements in the banking industry, with the objective of strengthening supervision and creating robust crisis management mechanisms. Adjustments to new capital requirements are anticipated to start in 2014 and should be completed by 2019, therefore overlapping with the period of implementation of the proposed new Programme. The impact of Basel III was the subject of two main studies, the first carried out by the Bank of International Settlements, and the second done by the Institute of International Finance (IIF), representing the banking industry. The two studies concur in predicting that the implementation of the new capital requirements will have negative impact on the credit market and, through this, on economic growth. The two studies significantly differ regarding the estimated magnitude of the impact, which ranges from a modest 0.2% reduction in GDP growth in four years in the case of the Bank of International Settlements report, to a much more substantial GDP loss of 1.5% suggested by the IIF study.

In terms of long-term economic impact, analysis conducted by the Basel Committee found clear net long term economic benefits of Basel III. This analysis implies net economic benefits of annual increase in the EU GDP in the range of 0.3%-2%. They stem from a reduction in the expected frequency of future systemic crises and are optimised when CET1 is calibrated in the range of 6% to 9%.⁶⁷

Another model developed by the Commission and academics found that the proposals would reduce the probability of a systemic banking crisis in seven Member States within the range of 29% to 89% when banks recapitalise to a total capital ratio of at least 10.5%.⁶⁸ The issue was recently reviewed from an EU perspective by Bruegel, a Brussels-based think tank.⁶⁹ While no quantitative estimate can be provided, the study confirms that Basel III is likely to bring about a worsening in the conditions in access to finance, although its impact is likely to be differentiated depending upon the countries and the sector of operations.

The CRD IV package contains a range of proposals to increase the capital charges on all lending activities, including a proposal for a 'capital conservation buffer' of 2.5% of risk-weighted assets, in addition to the current 8% requirement, to be phased in from 2016 to 2019.

⁶⁶ Drawn from Economisti Associati (2011).

⁶⁷ See COMMISSION STAFF WORKING PAPER IMPACT ASSESSMENT Accompanying the document Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms – SEC 949(2011) Final

⁶⁸ Ibidem

⁶⁹ Marzinotto and Rocholl (2010).

According to Commission analysis, compliance with the new capital framework is expected to reduce the stock of loans on average by 1,8% and increase loan rates on average by some 29 basis points by 2020-2030.⁷⁰ However the flow of loans to SMEs should be less severely impacted taking into account the following factors:

- SMEs transact more with smaller banks, whose capital shortfalls are estimated to be lower than other banks;
- in the course of the negotiations it has been agreed to introduce a ‘supporting factor’ on exposures to SMEs which will ‘neutralise’ the increase in own funds requirements for loans to SMEs and should ease lending conditions for SMEs over time (see article 501 of Regulation n. 575/2013)..

The risks of a possible impact on SME lending, and the specificities of SME lending have therefore been acknowledged and taken into account in the CRD IV package. In practice, the SME correction factor should neutralise the impact of the more stringent capital requirements on SME lending.

Overall, therefore, the combination of excess in leverage before the crisis, increased losses from the recession and provisions and uncertainty in the financial and regulatory environment has encouraged banks to reduce their exposures, including on the SME lending books, with a drive towards loan quality and to a lesser extent a reduction in SME lending duration. Most of these contractionary effects are going to be transitory, and peter out in particular once the on-going process of bank restructuring is complete; once financial institutions' capital adequacy aligns, and borrowers' riskiness diminishes with the end of the financial crisis, the volume of lending to SMEs will be likely to recover. In addition, the prospects of completion of the Banking Union will exert an expansionary effect on lending after 2015.

4.1.3.3 Developments in Credit Guarantee Schemes⁷¹

In Europe credit guarantee schemes – vital elements of SME financing – “are used widely across economies as important tools to ease financial constraints for SMEs and start-ups” (OECD, 2013b) and to alleviate market failures in SME financing by reducing the risk of lenders and favouring the provision of financing to viable businesses that are constrained in their access to finance (OECD, 2013b).

Interpretation of longer-term developments of guarantee data is difficult. At a European level, AECM statistics are the key data source, but suffer from several limitations⁷² that prevent their use to formulate forecasts of future credit guarantee schemes' developments. For instance, the data covering SME loan guarantees are provided only by AECM members but the AECM membership varies from year to year. Moreover, there are also time lags in data reporting which need to be taken into account. Hence, the available volume of credit

⁷⁰ See COMMISSION STAFF WORKING PAPER IMPACT ASSESSMENT Accompanying the document Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms – SEC 949(2011) Final.

⁷¹ See Annex 1 to Chapter 1 for an analysis of the SME credit guarantee schemes in the EU.

⁷² See Annex 1 to Chapter 1.

guarantee schemes for SMEs, as well as its impact on access to finance over the following years is difficult to quantify. However, on a qualitative basis it is reasonable to argue that, given the increased amount of ESI Funds devoted to credit guarantee schemes in the next MFF, the overall availability and use of such programmes is likely to increase in the 2014-2020 period, thereby reducing SMEs' financing gap.

4.1.3.4 Developments in SME securitisation market and expected impact of CRDIV/CRR provisions ⁷³

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 SME securitisations.

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 SME securitisation have to be duly analysed. Based on the current Basel III/CRD IV framework, capital requirements for credit risk, including for credit risk relating to securitisation positions, will be increased quite significantly. At the same time both CRD IV and the Second Directive on Insurance and Reinsurance ('Solvency II') have increased requirements for appropriate asset quality and liability matching, reducing demand for the highest quality long dated instruments from insurance companies and banks for re-financing purposes.

Bank of America/Merrill Lynch estimates that European banks must increase their capital against securitisation bond holdings by (depending on the approach used) EUR 23bn to EUR 47bn (Bank of America/Merrill Lynch, 2013). Investors will only return in volume if they regain trust in the quality of the transactions and if there is satisfactory secondary market liquidity. Originators will return if transactions are economically feasible.

In the current market, securitisation is virtually only funding driven: the most senior *tranche* is either placed or – more frequently – retained and used as collateral for ECB loans. Despite some promising first attempts to revive this asset class, the primary SME market – both in terms of number of transactions and volumes placed with market investors – is still expected to remain well below pre-crisis levels for some time and the image of securitisation in general is still damaged (with related negative impact on the image of SME securitisation as well),⁷⁴ due to the understandably bad reputation of the US sub-prime products and the unfortunate negative association of the European structured finance markets with its US peers, despite the fact that the former performed substantially better than the latter.

Rebus sic stantibus, the latency of the SME securitisation market is likely to continue to negatively affect both the volume and conditions of loans provided to SMEs.

⁷³ See Annex 2 to Chapter 1 for an analysis of the SME securitisation market in the EU.

⁷⁴ The contagion effects for SME securitisation have been discussed in more details in Kraemer-Eis, Schaber and Tappi, 2010 (http://www.eif.org/news_centre/research/index.htm).

4.1.3.5 Introduction of measures against late payments

The implementation of the recently recast Directive of Late Payments is expected to favourably impact on enterprises cash flows and, through this, on their access to finance. As the late payment phenomenon primarily refers to transactions with the government bodies, the whole enterprise sector is expected to gain. However, measures regarding inter enterprises transactions are also expected to bring about some additional benefits to SME, which are currently in a weak negotiating position vis-à-vis larger clients and suppliers. The cost of late payments for the EU SME sector was estimated at some € 1,141 billion in terms of delayed turnover,⁷⁵ a quite significant figure equivalent to more than 8% of SME turnover in 2008. Therefore, any improvement in payment terms over the current situation is expected to bring about a significant improvement in enterprises' financial conditions, which in all likelihood will contribute to reduce the demand for short term working capital loans, thereby easing overall credit constraints. This would be a one-off improvement, although it is expected to materialise over a certain period.

4.1.3.6 The development of alternatives for bank finance

The proposals on venture capital funds and social entrepreneurship funds are applicable as from July 2013; the MiFID regulation, when agreed, will create a dedicated SME market; the follow-up of the Green Paper on long-term financing of the European economy⁷⁶ might include further developing the venture capital markets and dedicated markets and networks for SMEs, the development of credit scoring assessments of SMEs, and promoting other "non-traditional" sources of finance, like crowd-funding. The European Semester process and its priorities⁷⁷ will equally encourage Member States during 2014 to develop alternatives to bank finance. All of these measures should impact positively the financing of SMEs. Some of the benefits of these measures would materialise rather soon, some others will take more time.

4.1.3.7 Banking Union

The Banking Union should place the banking sector on a sounder footing and restore confidence in the Euro as part of a longer-term vision for economic and fiscal integration.

It is important to curtail the increasing risk of fragmentation of EU banking markets that significantly undermines the single market for financial services. The Banking Union will aim to ensure that the funding cost of a bank depends on the quality of its assets and not on the jurisdiction, in which its headquarters are located.

The Banking Union can help boost credit provision through two key channels:

1. First, through the Single Supervisory Mechanism (SSM) by increasing transparency over the quality of banks' assets, which is a key to distinguish strong from weak banks and hence reinforce confidence in the EU banking sector. Second, through the Single Resolution Mechanism by ensuring that banks, which are not in a position to lend, can be restructured without creating financial instability.

⁷⁵ European Commission (2009).

⁷⁶ COM (2013) 150.

⁷⁷ COM (2013) 800.

2. In addition, the reinforced supervision within the Banking Union will help improve the robustness of banks and restore normal lending conditions to firms and households.

In October 2013 the Council gave its final approval for the Single Supervisory Mechanism, which was the first decisive step towards the Banking Union. In November, the European Central Bank has launched a comprehensive assessment of the credit institutions of the Euro Area, involving more than 120 credit institutions in 18 Member States (covering approximately 85% of the Euro Area bank assets). This preliminary stage of the SSM, involving a comprehensive risk assessment of European Credit institutions, will be followed by an asset quality review and a stress test of banks across the Euro Area.

Thus, while the full agreement over the attainment of a banking union may soon be confirmed, its full implementation is likely to require additional time. However, the assessment phase of the SSM will already produce beneficial effects to the economy, as it will enhance the quality of information concerning the condition of Euro Area banks, thus increasing transparency. Moreover, it will help identify and implement necessary corrective actions, if and where needed. Overall, it will act as a *confidence building* mechanism on which bank stakeholders will already be able to rely in terms of bank soundness and trustworthiness.⁷⁸

In the longer run (*i.e.* after 2015) the newly established banking union will reach out to the real economy by providing positive effects in the area of financial market fragmentation and SMEs' access to finance..

4.1.3.8 Conclusion

While the evolution of some specific factors affecting the future development of SMEs' access to finance remains uncertain, the overall prospects appear to point towards stable or better outlook for SMEs in the EU in terms of access to finance. However, the gaps identified in the previous section are such that even an improvement or a positive trend will not be sufficient to allow meeting the SMEs' financing needs, particularly in certain countries (see country fiches). As a consequence, the gap estimates presented in this chapter are relevant in portraying the financing challenges SMEs are likely to face also in the coming years.

4.2 Chapter 2: Rationale for policy action and proposed initiative

In this chapter the general justification for public support and the European Value Added is analysed. A more detailed analysis of the Value Added of the proposed measure is presented in Section 4.2.2.

4.2.1 Rationale for policy action at EU level⁷⁹

⁷⁸ See ECB Note: "*Comprehensive Assessment Within The Framework Of The SSM*" October 2013

⁷⁹ This section is to a large extent based on Kraemer-Eis, Lang, and Gvetadze (2013a), Kraemer-Eis, Lang, and Gvetadze (2013b), and Kraemer-Eis, Passaris, and Tappi (2013).

4.2.1.1 Need for SME policy intervention

According to the ECB executive board member Benoît Cœuré, *“credit tightening currently appears to be very severe for SMEs [...] because SMEs are often unable to switch from bank credit to other sources of external finance. [...] Difficulties in borrowing, which influence not only their day-to-day activities, but also their ability to grow, may then easily transform liquidity constraints into solvency risk.”* As the substitution of bank loans by trade credit, leasing or factoring is *“strictly related to the business activity of companies and in recessions their buffer role might be limited by the reduction in the exchange of goods and services”*, additional public policy support measures such as guarantees or investments in venture capital, which help to alleviate SMEs’ collateral and equity shortages, might prove valuable to improve SMEs’ access to finance and to reduce the cost of financing.

Furthermore, supranational support measures to SMEs *“could be enhanced”* such as *“traditional instruments [...] related to the European Investment Bank (EIB) lending to SMEs and the European Investment Fund’s (EIF) actions in the ABS market designed to revive investors’ interest and confidence, by facilitating large and liquid transactions”*. In addition, improvements in regulatory framework conditions can facilitate SMEs’ access to finance, as well as current initiatives to revive SME securitisation.

A. Justification for SME-specific measures

As discussed above, the bulk of SME financing is based on bank loans and the banking sector is therefore instrumental for more SME financing. Alternative financing sources are important as well (e.g. venture capital, mezzanine, crowd funding), but they are not in a position to replace bank financing.

In this context, soundness of the banking system is a key to SME financing and reducing the financing gap. To achieve this, the public support at the EU level appears necessary. On the one hand, this is proposed for 2014-2020 through ESIF and centrally managed EU level instruments, notably COSME and Horizon 2020. On the other hand, there is also a further specific need for capital relief and liquidity to be met by the envisaged SME Initiative which may take the form of uncapped portfolio guarantees and/or securitisation operations using funds from COSME, Horizon 2020 and ESIF in combination with the EIB and EIF own resources.

The proposed SME initiative envisages the guarantee instrument in the form of an **uncapped guarantee (a guarantee instrument with a defined guarantee rate, covering 100% of the guaranteed portion)**, which allows to fulfil the above-mentioned need for capital relief. It is important to note that the guarantee structure offered under the Initiative has been conceived as a crisis time measure transferring risk to government and European institutions to encourage new lending now at more affordable rates in market conditions where that has not otherwise been done by banks.

Apart from the uncapped portfolio guarantees, a recovery of the primary securitisation markets could also play a role in unlocking credit supply to SMEs and economic recovery - via both true sale and synthetic transactions - supported by the proposed Initiative which could also address the challenges of SME securitisation as discussed above. In order to restore confidence in the securitisation market and to revive primary market activities, greater standardisation and transparency is needed as well as the avoidance of overly complex

structures. In this context, matching these features with a combination of market-driven signalling approaches and public support measures addressing the key (real and perceived) risks - e.g. through purchase of junior *tranches* in properly structured transactions with the overall objective to attract private investors – **will contribute to addressing the financing gap faced by the European SMEs.**

This is corroborated by the Report prepared by Oliver Wyman on behalf of AFME (AFME (2013c), which was based on in-depth interviews with borrowers, investors and banks in eight EU countries.⁸⁰ With regard to the topic of “*improving access to finance for SMEs*”, the report summarises that “*Interviewees believe that lending to small businesses (SMEs) is likely to remain primarily in the hands of banks due to the small size of transactions and the local nature of commercial relationships, although they say that non-bank sources such as fund managers could add some capacity over time. **Securitisation could play a larger role,***⁸¹ *if the economics of SME loan securitisation can be restored, as an efficient way for banks to be able to free up capital and raise cash for further lending to existing or new SME borrowers. SMEs also said that it was not easy to understand the range of government and central bank schemes at national and European level. Improved information and communications would help them to understand what was available and how to obtain it and improve competition and transparency.*”

More specifically, the report says, “*SME securitisation is currently not economic. Due to the relatively low interest margins on bank-originated SME loans and issuers needing to pay credit spreads on AAA securitisation tranches which are not economic to issuers, SME securitisations are typically not cost effective for banks. However, securitisation structures offer potentially valuable mechanisms to implement public sector support for bank-SME lending, through senior tranches (focused on funding), junior tranches (providing risk transfer), or a combination of the two. For banks, the securitisation of SME loans is seen to have significant potential for additional capital markets funding, but only if the economics of securitisation can be restored. For a variety of reasons, including capital charges on SME loans but also other factors, bank-SME loans have relatively low interest rates of around LIB + 200bps or slightly higher, as compared to the rates which direct capital markets investors such as fund managers are currently originating SME loans for funding through investment funds. As a result, the interest rate on highly rated securitised tranches sold to investors must be sufficiently low for the cost of funding to be economic to the issuing bank. As a result, the economics of SME securitisation simply does not work for most banks, unless some type of public support is provided.*”

B. Need for development of uncapped guarantees for the benefit of SMEs

The recent developments in SME guarantees in Europe, shown by data from AECM activity, generally seem to mirror the economic situation in the different countries (details can be found in Kraemer-Eis, Lang, and Gvetadze, 2013a). Those countries suffering relatively strongly from the sovereign debt crisis and experiencing a weak economic growth or even a fall in the economic activity, see poor developments in the guarantee activities. This appears to be driven by both demand and supply side factors. In times of weak economic output

⁸⁰ 75 interviewees: 32 corporates, 26 investors, 7 banks as providers of funding, and 10 trade associations.

⁸¹ Highlighting added by the authors of this ex-ante assessment

growth, SME business activity, the related need for finance and hence implied demand for guarantees are low. At the same time, public budget tightening and high financial risk perceptions are weighing on guarantee supply.

In parallel to the securitisation, uncapped guarantees may also prove important to SMEs. To understand their usefulness for SMEs, the same key logic as discussed above for securitisation can be applied. Since the lending capacity of the banks is based not only on macroeconomic development motives but also on the complex calculation of profitability of their SME lending business, capital requirements are here again a crucial factor to be taken into consideration.

In this context, uncapped guarantees are able to provide capital relief to the banks and thus enable them to extend their loan volumes, and possibly also to SMEs which is considered more risky than lending to large enterprises. In this way, uncapped guarantees can also play an important role for capital relief purpose with a view of increasing bank-lending capacity towards SMEs in view of the EU political objectives.

C. Need for revival of the SME securitisation market

The pressure on European banks to deleverage continues (see e.g. above Box 2, or e.g. EB, 2012), and banks have to raise fresh capital or to reduce their balance sheets, based on existing and/or increasing credit risk and also in order to anticipate and fulfil future Basel3/CRD-IV rules. One possible reaction is to downsize lending activities while another direction could be to use the securitisation market for SMEs aiming at maintaining or even increasing SME lending activities.

“A reopening of the ABS market may be one way of enhancing funding conditions for SMEs,” as ECB executive board member Peter Praet (2013) recently stated. For these reasons, the ECB *“Governing Council decided to start consultations with other European institutions on initiatives to promote a functioning market for asset-backed securities collateralised by loans to non-financial corporations”* (Draghi and Constâncio, 2013). In particular, initiatives are currently being pursued, with potential additional support by the EU budget.

Also the three pan European regulators – European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) – stated recently that *“given the deleveraging of the EU banking sector, market expectations for future changes in the current low interest rate environment and a general need for an increased availability of funding to the real economy, a thoroughly risk-managed and transparent securitisation has the potential to step in as an alternative for financial intermediation”* (ESMA/EBA/EIOPA, 2013).

A key feature of securitisations for SMEs is that banks will lend to SMEs based not only on macroeconomic development motives (i.e. supporting the economy) but also on a complex calculation of the profitability of their SME lending business. In these calculations, **three areas will have an overriding impact on the profitability of SME lending and hence on the potential loan volumes directed to SMEs: risk costs, refinancing spreads and capital requirements. While risks costs in the form of expected losses (based on underlying credit quality and collateral) cannot be transferred easily to third parties, securitisation can play an**

important role in the funding strategy as well as for capital relief purpose with a view of increasing bank-lending capacity towards SMEs.⁸²

Advantages of SME securitisation

There are many advantages of SME Securitization – for banks, for investors, for the economy, and – most importantly - for the SMEs. At first sight, the advantages are mainly for banks and investors, but these benefits channel through to a positive effect on SME's access to finance and hence to the SMEs themselves (see e.g. Ranné, 2005).

From a lender/issuer perspective, the reduction of credit risk exposure due to the corresponding economic and regulatory capital relief can be reflected in replenishing the portfolio with new loans up to a pre-set maximum amount and according to certain quality criteria. Hence, banks can originate new loans and include them into the existing securitisation structure, thus generating new SME loans at relatively limited capital cost.

Moreover, SME securitisation could also be an option for the regional banks, which are typically deposit-driven institutions relying on inter-bank borrowing for the medium term funding and only rarely tap the capital markets due to their size and rating. As such, securitisation can be a means to diversify their funding base, as well as to gain access to medium term funding at costs consistent with top rated issuers that could not be achieved otherwise through direct borrowing on an unsecured basis.

From an investor perspective, SME Securitisation allows for investments in assets, which would otherwise not be available. This can be attractive from a risk-return as well as from a portfolio diversification perspective. Investors can diversify their portfolio risk by adding SME exposure (additional investment possibilities); moreover, the bundling of portfolios from various regional banks can have positive effects on portfolio diversification.

From an SME perspective, SMEs with uncovered financing needs can have facilitated access to loans, as the banks are able to expand their SME lending even to more risky enterprises due to the capital relief resulting from their securitisation transactions. As such, SME Securitisation has a positive impact on the overall availability and financing conditions of loans to SMEs.

Possible challenges to SME securitisation

An objection could be raised that the loan portfolios are less homogenous than residential mortgages as the SME loans are more heterogeneous in particular with regard to size, legal forms and collateral. Apart from that, the underwriting criteria are also less standardised and there is often a lack of long-term historical data on loan performance (Ranné, 2005).

Nevertheless, SME loans are typically analysed thoroughly by credit experts and systems (e.g. most banks apply detailed quantitative internal rating methodologies on top of more qualitative assessments). Moreover, the banks usually follow a relationship banking approach, which enables them to know their customers very well and thus manage the risk over the long term in contrast to the more automated lending decisions taken in the mortgage

⁸² See European Investment Fund (2013).

and credit card markets. This distinguishes SME Securitisation from the one involving other asset classes.⁸³

Furthermore, SME securitisation will only be to the benefit of SMEs if the freed-up capital / fresh liquidity is going to be used to finance the real economy (i.e. for new SME lending) and not for e.g. regulatory arbitrage. In order to avoid undue refinancing risks and significant reliance on central bank balance sheet, longer-term SME financing requirements may need to be addressed through a resuscitation of more traditional securitisation techniques (see Box 4.2.1).

Box 4.2.1: HOW TO AVOID THE US EXPERIENCE

In the years running up to the crisis there were first signs also in Europe of a drift away from key principles and main success factors for SME Securitisation – i.e. granular portfolios (highly diversified in terms of obligor concentration, sector diversification and regional distribution) and transparent structures – for example in the form of hybrid transactions (i.e. the so-called German Mezzanine CDOs) with non-granular portfolios, larger (mid-cap) borrowers and non-aligned incentive structures. Also, some banks created portfolios with a view to selling them on, without proper risk retention (“originate-to-sell” approach). The generally poor performance of these transactions provides lessons for the future of SME Securitisation.

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 more qualitative assessments). Moreover, banks normally have a relationship banking approach and know their customers very well, thus enabling them to manage the risk of the customer over the long term in contrast to the more automated lending decisions seen in the mortgage and credit card markets. This distinguishes SME Securitisation from those other securitised asset classes.

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 (e.g. some risk retention by the originator)*
- Loans originated in line with relationship banking;*
- Investors/guarantors should perform their own analysis/due diligence and should not be only “external rating driven”.*

Properly applied, SMESec can enhance access to finance for SMEs and it is a replicable tool for SME support that provides a multiplier effect.

Finally, in the current market environment, the economics of SME securitisation transactions does not work for the originators if these want to place transactions on the primary market:

⁸³ Idem

either the spreads demanded by investors have to go down or the asset spreads charged from the SMEs will have to rise. Currently, without any supranational intervention, it is more attractive (i.e. cheaper) for banks to access ECB liquidity than to sell to investors (Fitch, 2013d).

4.2.1.2 General justification for public and EU level intervention⁸⁴

Economically, public intervention in the fields of entrepreneurship and innovation finds its justification primarily in the presence of a series of market, policy, and institutional failures, such as information asymmetries, transaction costs and ineffective policy and institutional coordination. In particular

- Information asymmetries and transaction costs
- Spill-over effects
- Lack of policy coordination.

A. Information asymmetries and transaction costs

Information asymmetries are a key determinant of the problems experienced by SMEs in accessing funding, as they are the basis for a structural hesitancy of providers of SME finance. Transaction costs first and foremost tend to magnify the impact of information asymmetries in financial transactions, thereby aggravating the conditions faced by smaller firms.

Economic literature often discusses that in the area of access to finance for SMEs, a market imperfection/failure is not only present during a deep recession but also on an on-going basis as a fundamental structural issue. The reasons for the 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).⁸⁵

Asymmetric information is a more serious problem in SME financing than in banking activities of larger firms. OECD (2006) states that: *"The entrepreneur has access to better information concerning the operation of the business and has considerable leeway in sharing such information with outsiders. However, the entrepreneur is also likely to have less training/experience in business than those in a larger company, although more adapted to operating in an uncertain environment. Hence, it may be difficult for the outside provider of financing to determine whether the entrepreneur is making erroneous decisions or for the outsider to understand the business adequately. In addition, the entrepreneur may have incentives to remain opaque, not only in dealings with financiers, but also with outsiders such as regulators and tax authorities."*

⁸⁴ This chapter uses *inter alia* thoughts raised in the High Level Expert Group (HLG) as well as ideas and concepts mentioned in several ex-ante evaluations for EU programmes to support SME financing.

⁸⁵ Agency theory / the principal-agent approach is often applied in the economics literature for the analysis of relationships between lenders and borrowers (e.g. contract design, selection processes, credit constraints, etc.).

Information asymmetry can be reduced via three ways: a firm's ability to signal its credit worthiness (including an institutional assessment or rating by an independent agency and the provision of collateral), a strong relationship between lender and borrower, and through due diligence/lenders' examination (screening). Small enterprises, young companies, or start-ups have, by definition, no track record, no long standing relationship with lenders and often only limited collateral. One could even generalise or simplify that the smaller the company, the bigger the information asymmetry and thus the higher the transaction costs in relative terms (Pelly and Kraemer-Eis, 2012).

Moreover, the use of collateral increases the cost of lending (from the perspective of the borrower, e.g. legal and administrative cost), and the collateral may be worth more to the borrower than to the lender. Credit guarantee mechanisms are intended to address these market failures as they reduce the financial loss of the lender in case of default of the borrower (OECD, 2013).

According to the OECD (2013), *"in many countries, the demand for collateral increased significantly during the crisis, and the sharp drop in property prices has had a strongly negative impact on the availability of credit to SMEs owing to the reduced value of collateral. This problem has been especially acute for small enterprises, which often use real estate as collateral for loans. As such, the financial crisis has revived the long-standing debate on the so-called "SME financing gap". It has brought to the forefront of the policy agenda the need to respond urgently to the increasing lack of funding for SMEs, as well as to implement innovative "structural" solutions for easing SMEs' and entrepreneurs' access to finance."*

B. Spillover effects

In these times, public support from the European level can improve at least the situation on the supply side. In general, a wider use of risk-sharing instruments, by also using EU funds to partially guarantee portfolios of SME loans would allow generating a leverage effect in terms of the volume of SME lending. The added value of public support in the form of guarantees has been shown by various assessments in the past and the success of the guarantee mechanisms in the context of SMEG/MAP/CIP or FP7 RSI fully underline this observation.⁸⁶

Moreover, positive spill-over effects are an additional justification for public action: SME activities and dynamics have positive spill-over effects that are spurred by SME financing (see e.g. CEB, 2013). Just to recall: SMEs are at the heart of European industrial R&D and innovation. They are crucial for tracing new paths to more sustainable and inclusive growth, thanks to their role in developing and diffusing innovation. Far from being the poor cousin of larger companies, they are a vibrant and innovative part of the European economy. SMEs account for 99% of all firms in Europe, approximately 2/3 of total private sector employment and play a disproportionately important role in generating employment.

These effects are important for economic growth, innovation, and social inclusion as well as for attainment of the Europe 2020 objectives. However, private financiers do not take them into account and this - without a public support - might lead, from an overall economic

⁸⁶ See for example Economisti Associati (2011) and European Commission (forthcoming).

perspective, to a sub-optimal level of access to finance for SMEs, with particular difficulties in accessing finance experienced by the innovative SMEs.

Therefore, public intervention to improve access to finance is justified because of the market failure, caused by significant information asymmetries, high transaction costs and spill-over effects, and exacerbated by the credit crunch provoked by the financial crisis. For debt finance in Europe, public intervention is needed to increase the likelihood that loans are made and guarantees extended to the benefit of SMEs. Otherwise, the current gap in the market between the demand and supply of loans and guarantees for SMEs is likely to persist or even increase, with banks remaining largely absent from higher-risk lending.

C. Lack of policy coordination

Lack of policy coordination prevents the reaping of benefits associated with the dissemination of best practices and at the same time may lead to duplication of efforts and wasteful use of scarce resources. Lack of EU action, or the undertaking of fragmented or uncoordinated action by a Member State alone may limit and further hinder the competitiveness and innovation capabilities of European SMEs.

Moreover, existing barriers faced by SMEs may become even more complex and have negative influence on achievement of the Europe 2020 targets. In this respect, there is apparently a strong need for EU wide initiatives. Given the large extent of the challenges faced by European economies, the size and scale of action organised at the EU level is expected to generate positive impacts across Europe through crowding-in and multiplier effects.

4.2.1.3 EU Added Value – providing support at the right policy level

Policy support has to be provided at the most appropriate level, and consistency in support has to be ensured. In a world that is increasingly interlinked, government measures will generate effects that go beyond the sheer local, regional and national level. Multi-level governance means finding the most optimal combination of government intervention at all policy levels in order to create synergies which none of the policy actors will be able to achieve on their own. SME support policy can only be effective if a multi-level governance approach is applied both in designing and implementing as well as in evaluating the success of the policy.

European added value is in reality a complex concept which has been the subject of much discussion. Nevertheless, there is broad agreement on a number of particular cases where EU intervention is justified. The case of action at the EU level relies essentially on the existence of five main sources for European Added Value, namely:⁸⁷

- EU policy objectives and consistency: Helping achieve EU policy objectives: EU-level financial instruments (see also Box 4.2.2) can support the achievement of the EU 2020 objectives by addressing market failures that lead to insufficient funding of SMEs being available from market sources, typically because the field is perceived as

⁸⁷ Based on other ex-ante evaluations, e.g. Economisti Associati (2011), but in a modified and extended form.

being too risky. This is even more the case for the most innovative ones. In this sense, policy measures have to support the EU policy objectives. Moreover, different instruments have to be consistent.

Box 4.2.2 : WHY USING FINANCIAL INSTRUMENTS (FIs)?

In the Commission's "A Budget for Europe 2020" policy paper, FIs are highlighted as a way of advancing the EU's key policy priorities, thanks to their leveraging of investment: "By working with the private sector on innovative financial instruments it is possible to magnify the impact of the EU budget, enabling a greater number of strategic investments to be made, thus enhancing the EU's growth potential. Experience in working most notably with the European Investment Bank (EIB) Group, national and international financial institutions has been positive and will be taken forward in the next MFF.

In general, concerning public financial support, there is the positive trend towards the use of risk tranching to catalyse SME lending and to facilitate higher lending volumes. This is as such an efficient way of deploying public sector support. Guarantees and risk sharing arrangements can allow the financial sector to provide more equity and lend more money to innovative companies, or to infrastructure projects. In this way, such financial instruments can also contribute to the overall development of post-crisis financial markets."

The Commission considers FIs particularly suitable for addressing sub-optimal investment situations in a wide range of policy areas whenever activities or operations are potentially capable of being financially viable – but are not yet attracting funding from market sources that is either adequate or available on reasonable terms.

- Demonstration, signalling, and catalytic effects: The possibility of achieving significant demonstration and catalytic effects, through the provision and dissemination of best practices, and the development of new paradigms (e.g. in the context of the revival of the SME securitisation market). Transferring skills and knowledge across frontiers could play a significant role in aligning MS policies, reducing the gap between European economies, and to a larger extent, enhancing competitiveness. If all Member States were to emulate best practices and approaches, Europe could be in a position to maintain and accelerate growth. If public support can for example 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.⁸⁸ In this context not only the volumes for the intervention matter, but also the positive signalling effect triggered by the public involvement and support.
- Multiplier effects and economies of scale: EU-level structured financial instruments multiply the effect of the EU budget by attracting other public and private financing along the implementation chain comprising entrusted entities (such as EIB Group), financial intermediaries (such as banks) and final beneficiaries. Through risk sharing and structured guarantees, the EU intervention may induce financial institutions to provide loans (or more loans) in cases where they would have not lent (or lent less) without support from the EU budget. This can be achieved through, for example, the

⁸⁸ However, this will only be to the benefit of SMEs if the freed-up capital / fresh liquidity is 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.

additional debt volumes banks and guarantee institutions are requested to provide to final beneficiaries. Moreover, joint actions lead to the pooling of resources, leverage effect of public contributions, and crowding-in of private capital.

FIs at the EU level also have the ability to achieve **economies of scale and/or to minimise the risk of failure** in areas where it would be difficult for individual Member States to achieve the **required critical mass**. In the field of SME guarantees and securitisation, Member States (respectively market participants within the Member States) sometimes lack the necessary resources and skills for these activities, with a related negative impact on SME finance. Therefore, EU intervention will contribute to leverage national public and private resources, avoid duplication of efforts, and promote cooperation between Member States. To this one must add **the ability to minimise risks in areas where initiatives at Member States level would be exposed to high risk of failure**. The argument is particular relevant in the area of SME loan securitisation. Under the market conditions, described above, even in the case of the largest EU countries, purely national initiatives are likely to be limited to a relatively small number of operations, which would involve a significant concentration of risks, whereas for smaller Member States it might prove impossible altogether to undertake any action of a certain significance;

- Capacity building: There is unique experience acquired by EU institutions. This is the case of the EU financial institutions, EIB and EIF, whose experience in designing and implementing SMEs financing schemes is unparalleled (i.e. in the case of guarantees and SMESec (see Box 4.2.3 as example). As demonstrated by the success of several financial initiatives under the current MFF (notably CIP, FP7 RSFF, FP7 RSI and EPMF), EIF's experience is unique and constitutes an extremely valuable asset, and so is the expertise in the design and implementation of financial instruments of several European Commission services. National and local institutions can benefit from EU-level entrusted entities' know-how in relation to the design of financial products which otherwise would not have been available to them.
- Addressing market fragmentation: The benefits associated with the strengthening of the Common Market, by addressing persistent market fragmentation in important areas such as SME loan guarantees and securitisation. Existing public measures to fight the crisis and to enhance SMEs' access to debt finance helped in the past, but they are not sufficient. Moreover, the real kick-off of the revival of the SMESec market – with its benefits for SME financing – will depend on significant public support. As mentioned above, the original development of SMESec has already been spurred by stimuli from national and supranational support measures.

Box 4.2.3 : CAPACITY BUILDING - EIF'S ROLE IN SME SECURITISATION

EU capital markets (and their need for transparency and standardisation) and the relative complexity of the securitisation techniques require considerable know-how and show the necessity for specialised institutions. In general, as an established and respected player in the European market, EIF can play a role via market presence, reputation building, and signalling. The respective tranches are enhanced with the EIF's AAA/Aaa rating and investors in the guaranteed tranches can benefit from EIF's risk

weighting of 0% (MDB status/AAA rating). In addition to the direct benefits of its guarantees, other factors of EIF's involvement can play an important role in facilitating the execution of a securitisation transaction:

EIF's involvement can facilitate placement of tranches with investors. From the originator's point of view, EIF reduces uncertainty and supports the marketing of a deal through its "anchor" investor status.

Smaller banks profit from EIF's experience and knowledge of the SME securitisation process (support and spread of best market practise). Usually, EIF is involved very early in the transaction and can assist the originator. The EIF facilitates (on average) overall lower transaction costs.

EIF acts in the "traditional" securitisation markets and with "traditional" key players, but expands the idea of SME securitisation into non-core market countries (e.g. Central and Eastern Europe), and to new originators.

In general, EIF facilitates standardisation, improves transparency, and spread of best securitisation market practise.

4.2.1.4 General principles of EU intervention

Efficient markets do not require public intervention. However, as outlined above, beyond the normal scarcity of credit for SMEs that would be typical at this point in the recovery, the confluence of a variety of austerity, growth, and regulatory initiatives may be compounding the difficulties. In particular, increased capital requirements for banks and insurance companies may be shrinking the supply of debt to private enterprises. Moreover, difficult access to finance for SMEs may also create a significant barrier to innovation and growth for the entire economy (Pelly, Kraemer-Eis, 2012).

There are market imperfections for SME finance, serious enough to warrant a public intervention. 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. In other words, public support has to improve the conditions for entrepreneurship and the overall business climate for SMEs without distorting efficient market forces. In this context, the EU intervention, in view of an efficient support of pre-determined policy objectives, has to be made under the following assumptions (Kraemer-Eis, Lang, and Gvetadze, 2013b):

1. *Public money is not enough:* Public money alone cannot finance SMEs and cannot be the solution to the current crisis – instead, it is one element of the solution. **Public money is often best used as seed money to attract private investors.** For the same reason, there should also be a move away from grants and towards 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 financing. In many instances, these instruments have greater amplifying effects in the market and provide a more efficient deployment of public money than would outright grants.
2. *Risks must be shared:* Public support cannot remove the risk associated with commercial activity at the enterprise level – and it should not attempt to do so. Public financing can best be used to make investments more attractive to private investors, not to shoulder the entire risk.

3. *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 from political decisions.
4. *One size does not fit all*: it is not feasible to design catch-all policy instruments –a toolbox of targeted instruments appears more appropriate. To be of optimal value to the market, this toolbox must be constantly under review; the relevant markets have to be duly analysed, new instruments must be tested, and constant adjustments have to be made to meet the evolving needs of the market.
5. Given SMEs' importance in the EU economy and their dependence on bank loans for their financing needs, measures to support SME finance in general, and finance for innovative SMEs specifically, should form a part of any initiative to revive growth and jobs. One difficulty here is that in the countries that are hardest hit by the crisis, sovereigns have only limited scope for support as they are facing budget issues themselves. Hence, it is of particular importance for the public support to combine efforts at both European and national level.

Against the background, as analysed above, there is a clear rationale for policy intervention at a European level.

4.2.1.5 Legal bases of EU intervention

The EU **right to act** hinges on the Treaty on the functioning of the European Union, particularly from Article 173, where it is stated that the EU action should be aimed at “*encouraging an environment favourable to initiative and to the development of undertakings throughout the Union, particularly small and medium-sized undertakings*”. Art. 6 of the same Treaty also specifies that: “*The Union shall have competence to carry out actions to support, coordinate or supplement the actions of the Member States*” in areas that include also industry, the main platform for the SMEs targeted by the proposed Initiative.

In terms of competence distribution between the EU and Member States in shared sectors – such as economic coordination – the main criterion to refer to is the **subsidiarity principle**, according to which the EU is entitled to act only if “*the objectives of the proposed action cannot be sufficiently achieved by the Member States*” (Article 5 of the Treaty of the European Union). It ensures that decisions are taken as closely as possible to the citizen and that constant checks are made to verify that action at Union level is justified in light of the possibilities available at national, regional, or local level. In other words, EU action has to be proportional and its efforts and means have to fully justify the pre-set goals.

In this context, Member States' contributions to the SME finance initiative have to be compliant with the applicable State aid rules.⁸⁹

Furthermore, the SME Initiative also builds on the already existing and politically agreed concept of Joint Instruments, to combine EU level financial instruments and European Structural and Investment Funds (ESIF). Article 33(2) of the Common Provision Regulations

⁸⁹ For instance, a distinct State Aid regulation for agriculture and EAFRD is foreseen at the level of final recipients (Agricultural Block Exemption Regulation, RD Regulation, Agricultural de minimis).

and Article 139(5) of the Financial Regulation allow for Joint Instruments, intended as financial instruments that bring together ("pool") resources from programmes managed directly or indirectly by the Commission and ESIF allocations for the pursuit of the same policy objectives, using the same delivery mechanism (i.e. involving the same counterparties) and applying the same requirements (e.g. terms and conditions, reporting, audit, etc.) Differences exist only for eligibility criteria related to the final beneficiaries, in particular the geographical criterion.

4.2.1.6 Positive externalities of EU intervention

Addressing the financial market failures outlined above through an EU-level intervention may also trigger off positive externalities throughout the area.

First of all, the **scale** of the EU-wide policy measure may enhance its efficiency, especially in the presence of non-linearities. In targeting the re-launch of the securitisation market, a highly leveraged EU intervention might reach the critical mass necessary to pass a threshold ushering in the set off of endogenous forces leading to the revival of the market.

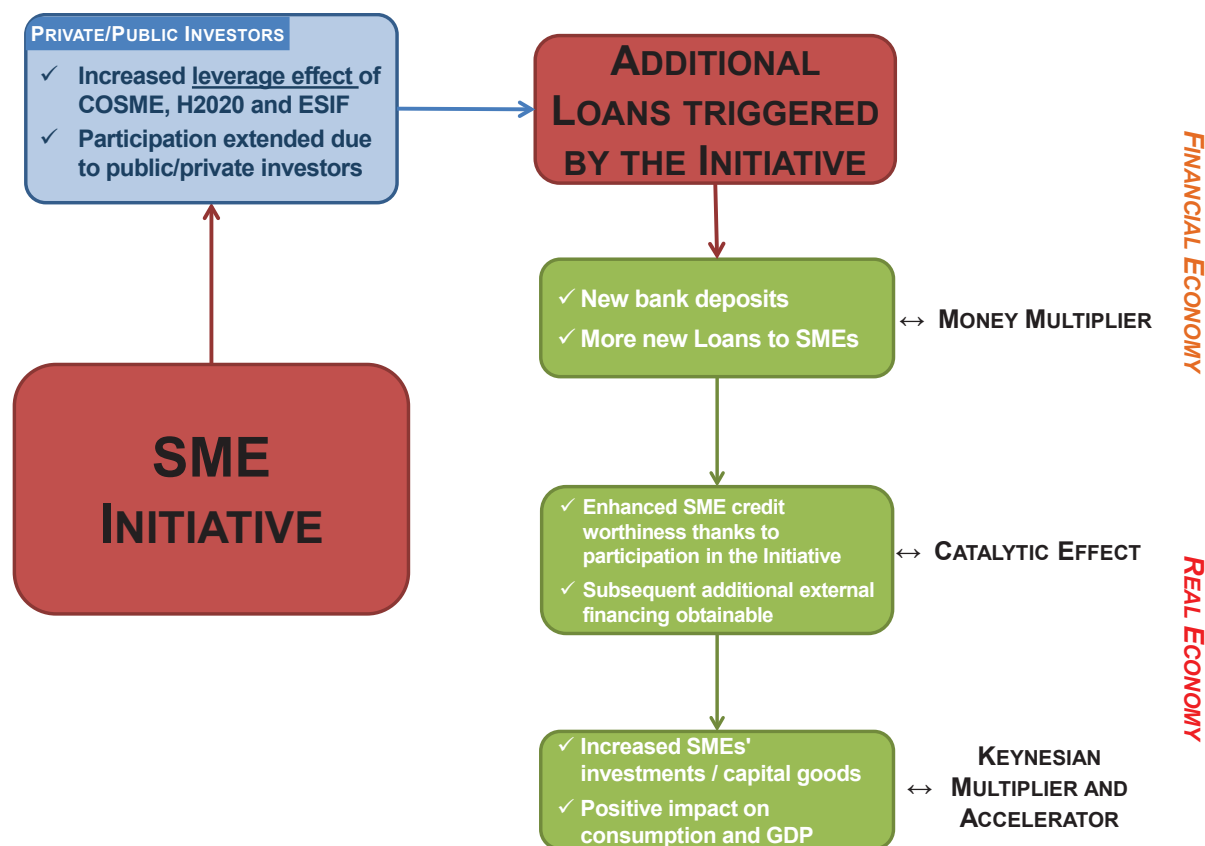
Similarly, when addressing the fragmentation of financial markets, the sheer size of the intervention together with its **supranational thrust** may bring about faster and stronger convergence in financial conditions across countries, by exerting a relatively larger impact on weaker markets.

A common interest may also be served through the contribution of an EU-wide initiative to repair the **monetary policy transmission** channels. Such a contribution may be provided at least in various ways. First, by enhancing bank lending throughout the area, which will restore the credit channel transmission; this channel is of great importance for the transmission of monetary policy – both conventional and unconventional – and could facilitate the support to the real economy (including SMEs) provided by the ECB. Second, by enhancing – both quantitatively and qualitatively – the ECB refinancing operations with securitisation notes as collateral. Third, by addressing financial fragmentation across countries and markets, an EU-level intervention might reinforce the singleness of the monetary policy, which would be facing more homogeneous financial conditions across the Eurozone.

The EU banking system as a whole can benefit from the **"bank multiplier" effect** of additional SME loans. Indeed, each additional loan may trigger off a cumulative chain of new bank deposits (largely in EU banks), which in turn allow further lending, and so on. Moreover, there is another multiplier effect at the level of SME creditworthiness (SMEs may obtain additional financing given their access to a loan supported by the Initiative) and at the level of SME **investment** (Keynesian multiplier and accelerator) in view of boosting GDP growth.

In addition, a financial intervention carried out through the EU budget can overcome pressing **public finance problems** facing individual Member States – especially the most financially vulnerable – in the aftermath of a financial crisis that has increased average EU public debt from 59% of GDP in the last quarter of 2007 to 85.9% in the first quarter of 2013. In this context, addressing the pressing SME financing gap in individual Member States may benefit from a complementary intervention offered at the EU level.

FIGURE 4.2.1 – MULTIPLIER EFFECTS



4.2.2 Description of the envisaged SME Initiative and its value added⁹⁰

Under the SME Initiative – which involves resource commitment on the part of the EU – joint financial instruments are proposed. The proposed SME initiative does not require new legal bases, but uses the legal framework that already exists, namely the COSME and Horizon 2020 legal acts, together with the Financial Regulation and the Common Provisions Regulation (CPR). It is an implementation option for COSME, Horizon 2020 and the European Structural and Investment Funds (ESIF). This means there are clearly defined rules and principles on addressing market failures, non-distortion of competition, additionality, selection of financial intermediaries through which the instruments are implemented, such as reporting, monitoring, intervention modalities and many other aspects.

In addition, the financial instruments are thoroughly scrutinised by the Court of Auditors as well as Commission audit teams and are subject to periodic internal or external evaluations. The joint instruments set out below require that Member States make voluntarily available a designated amount of national ESI Funds allocations.

Two financial products, in the form of three options, have been proposed, two of which have required limited amendments to the CPR. We have in each case assumed that up to EUR

⁹⁰ This section draws heavily on High Level Working Group to the EFC (2013b).

8.5 billion⁹¹ ERDF and EAFRD Funds will be made available for the period 2014-2020 alongside up to EUR 360 million central budget funds from the COSME and Horizon 2020 programmes (EUR 180 million each). In what follows, it is suggested to allow for both true-sale / traditional securitisation and synthetic securitisation under the proposed Joint Securitisation Instruments. The recent revision of the ECB's collateral framework in respect to ABS¹ is considered helpful to support securitisation and thus capital market financing and thereby addresses the impairment of monetary transmission in the euro area. However, regulatory aspects (such as risk weighting) generally remain a fundamental constraint for ABS investors. Under this Initiative, two financial products can be envisaged.

4.2.2.1 Option 1: Joint SME Guarantee Instrument

A facility is foreseen to be launched in January 2014 under the new MFF in the form of a joint guarantee instrument (pooling resources under COSME and Horizon 2020 and ESIF Funds), providing uncapped portfolio guarantees and partial capital relief to banks building up new portfolios of loans, guarantees for loans and leasing to SMEs, including innovative SMEs.

The joint guarantee instrument will operate under the Financial Regulation and Rules of Application related to EU level instruments, and ESIF contributions by Member States to COSME and/or Horizon 2020 will be ring-fenced for support to SMEs in their respective region or country. Under this uncapped guarantee instrument, EIF will issue uncapped portfolio guarantees and ESIF will be used to cover the first loss piece. EU funds from COSME (for SMEs that are perceived as risky) and Horizon 2020 (for RDI-intensive SMEs and small mid-caps) and the EIF will join in to absorb, together with ESIF, the second loss piece. The residual risk of the senior *tranches* will be guaranteed by EIB and – to the extent possible – by national/regional development/promotional banks. The public sector's uncapped guarantee should not exceed 80% of the SME loan portfolio and the originating bank should keep a 20% stake in each SME loan to help avoid moral hazard by ensuring sound originating and monitoring standards. Nevertheless, capital relief will be substantial for the originating bank. The proposed instrument takes 80% of the risk of each SME loan from the on-lending banks and therefore provides a corresponding amount of capital relief due to the involvement of multilateral development banks that benefit from 0% risk weighting (EIB/EIF) under CRD IV. The facility ensures earmarking of bank credit to SMEs/mid-caps, for the on-lending bank will have to clearly demonstrate the transfer of benefit of the EU SME instrument to the SMEs in form of acceptance of higher risk clients (young companies, start-ups, low scoring companies, etc.), reduction of collateral requirements and/or reduced pricing. Thus, this instrument would provide originating banks with gradual capital relief (as portfolios are being built up) and cover of losses for defaulted loans. ESIF contributions extend and amplify the volume of funding from EU level instrument (up to EUR 180 million from COSME and up to EUR 180 million from Horizon 2020) for the Member State or region concerned which contributed with its own ESIF programme resources. The EU contribution will be capped in order to shield the EU budget from contingent liabilities. This use of EU and ESIF contributions ensures that banks build up portfolios of new debt finance to SMEs and improve the credit transmission channel to the real economy.

⁹¹ Maximum amount for ERDF and EAFRD funds for the SME Initiative, as agreed in the October 2013 trilogue. The contributions from COSME and Horizon2020 were adjusted accordingly.

The main operational aspects of the Joint SME Guarantee Instrument are outlined in the following paragraphs.

A. Modus operandi and structuring

The portfolio of SME loans of bank is guaranteed by EIF, which does the fronting vis-à-vis the financial institutions, and the risk is then shared with various risk-takers. The instrument could cover up to 80% of the total portfolio through an uncapped guarantee (*pari passu*, “vertical” *tranche*). As a consequence, the originator (on-lending bank) retains at least 20% of the risk of each loan included in the guaranteed portfolio. Managing Authorities, who are willing to participate in the scheme, guarantee (via the EIF, but at the risk of the ESI Funds contribution) up to 80% of the Junior *tranche* (First Loss Piece) and – to a limited extent – of the mezzanine *tranche*. Contractual arrangements would ensure that access to public guarantees for partner banks would be strictly conditional on passing the benefits on in the form of new loans to SMEs.

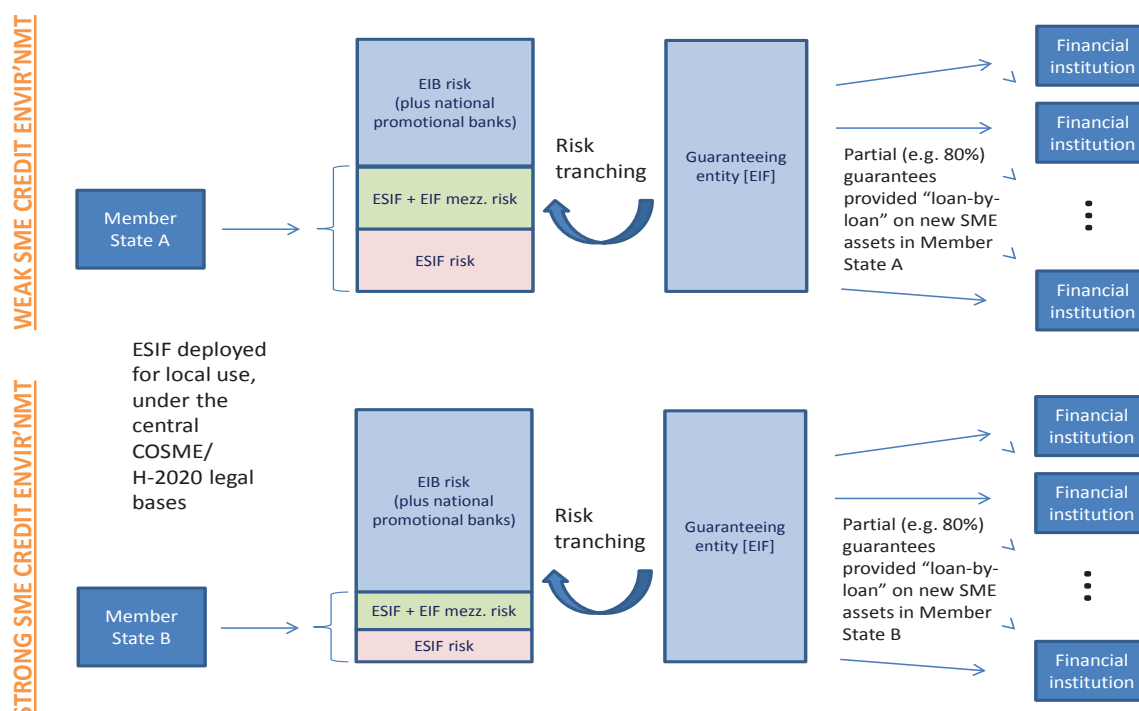
ESIF, COSME and/or Horizon 2020 and the EIF share the Mezzanine *tranche* (Second Loss Piece), where the EU would take the riskiest part and the EIF the residual risk of the Mezzanine *tranche*.

EIF's AAA rating and multilateral development bank status allows for 0% risk weighting on the guaranteed part with full capital relief in respect of up to 80% of the newly created underlying portfolio.

The EIF provides credit enhancement, allowing for EIB and potentially promotional/development banks to step in (their participation would typically be in the form of counter-guarantees to EIF or co-guarantees alongside EIF). It is not expected that private investors would consider guaranteeing/investing in senior *tranches* of such portfolio guarantees.

In effect EIB and promotional/development banks offer their balance sheet risk-taking capacity at rather low risk pricing of investment grade *tranche* protection.

FIGURE 4.2.2 : STRUCTURE OF OPTION 1



B. Leverage

Leverage is calculated as the ratio of new SME assets generated to ESIF resources employed.⁹² As shown above, obtaining an acceptable risk profile on the senior exposure implies utilising different levels of ESIF resources (depending on the credit profile of underlying SME assets), resulting in differences in minimum leverage factors across Member States.

The modalities of EIB Group's involvement are assumed to be that EIB participates in the senior risk with relatively high volumes and that EIF retains a mezzanine risk with relatively lower volumes. EIF's participation is therefore assumed to be relatively high-risk compared to EIB's senior involvement.⁹³

Given the leverage and the cap on the EIB maximum volume, and the fact that there will be no private investors, the total volume achievable under the facility is dependent on the amount of NPB involvement available.

Assuming well diversified SME portfolios with an average credit quality equivalent to a portfolio rating in the range of B2/B1 (somewhat close to the current SME portfolios under FP7 RSI and EIF SME securitisation transactions), the leverage effect would be around **5**

⁹² The assumptions underlying the leverage calculations are spelled out in Annex 1 to Chapter 2.

⁹³ In fact, EIF's involvement (insofar as it relates to activities under the EIB mandate) is expected to be relatively capital intensive for the EIB Group (EIF exposure likely in the range of Ba1/Baa3).

times the ESIF contribution on average, with the potential for higher leverage depending on the overall credit quality of the portfolios.

C. Pricing

The ESIF cover for the Junior *tranche* will be granted for free. The Mezzanine *tranche* will be priced in a way to sustain the risk. EIF and the other risk takers will charge a price according to their respective pricing policies and objectives, while ensuring sustainability of the instrument and avoiding overlapping, competition and cannibalisation effect with existing practices under other EU financial instruments (such as the successor of FP7 RSI under Horizon 2020).

Pricing on the guarantees should be relatively attractive due to a) zero pricing on the ESIF first loss contribution and b) EIB Group's competitive guarantee pricing.

It is important to note that the guarantee structure could be seen as a crisis-time measure transferring risk to government and European institutions to encourage new lending now at more affordable rates in market conditions where banks would not normally do so. Option 1 does not have a catalytic effect to create a broader non-governmental solution for the long term.

D. Reporting and monitoring

The proposed Initiative foresees the following principles, which are also reflected in the context of COSME and Horizon2020 and also under other financial instruments planned in parallel under the next MFF:

a) *Public access* to the relevant documents concerning the legal framework of the Initiative, such as the Financial Regulation and CPR (Commission's proposal), is already available. The access to more specific documents concerning the Joint SME Guarantee Instrument (e.g. basic acts under COSME and Horizon2020, calls for expression of interest launched by implementing body (EIF) as well as the operational guidelines of the joint SME guarantee) is also foreseen and will be, upon completion, made available to the broader public.

b) *Financial intermediaries shall be selected* on the basis of open, transparent, proportionate and non-discriminatory procedures, avoiding conflicts of interests, with due account of their experience and financial capacity in view of the nature of the Joint SME Guarantee Instrument. The selected intermediaries shall be then obliged to cooperate in the protection of financial interests of the Union and of the participating Member States.

c) *Reporting on the Joint SME Guarantee Instrument* pursued by the Commission and the participating Member States will comply with the requirements specified under the Financial Regulation and CPR. In substance, the reporting will take account of the gradual capital relief provided by the joint SME guarantee to the originating financial intermediaries, the transfer of such benefit to the SMEs and the specificity of portfolios subsequently built-up for providing new debt finance to SMEs. In this context, the reporting will deliver information on the leverage achieved during the implementation and provide data that can be used, notably in the context of the Initiative's evaluation, for further analysis on how the EU and ESIF contributions improve the credit transmission channel to the real economy.

Moreover, results of the reporting will be strongly supported and, to a large extent, complemented by monitoring activities which shall be performed by the implementing body (EIF). Monitoring shall assess fundamental parameters such as progress of the implementation of the joint SME guarantee, contractual compliance of agreements between the implementing body (EIF) and financial intermediaries or eligibility of such financial intermediaries under the proposed guarantee.

d) Concerning *ex-post publication of recipients* under the joint SME guarantee, the names of the recipients of financial support shall be published by the implementing body (EIF), with due observance of the confidentiality and security requirements as well as of the protection of personal data. The criteria for disclosure and the level of detail to be published shall take into account specificities of the sector and the nature of the Joint SME Guarantee Instrument.

The detailed modalities for the activities a)-d) above shall be further specified both in the Delegation Agreements between the Commission (regarding contributions under COSME, Horizon2020) and the implementing body (EIF) and in the Funding Agreements between the participating Member States (regarding ESIF contributions) and the implementing body (EIF).

The two Agreements shall be, to the extent possible, aligned, with a view to ensuring a smooth and timely implementation of the Joint SME Guarantee Instrument.

4.2.2.2 Option 2 and Option 3: Joint Securitisation Instruments for both new and existing SME loan portfolios

Under Options 2 and 3, a joint securitisation instrument could be created, not only for new but also for existing portfolios, by combining EU resources (COSME and/or Horizon 2020) with ESIF. Under a securitisation instrument, a portfolio of SME loans⁹⁴ is built up by partner banks and subsequently used as collateral for a tradable security. In the classic case this could be achieved through the sale by each financial institution of a portfolio of SME loans to a dedicated vehicle (unfunded risk transfer would also be possible). The vehicle would finance itself through the issuance of various classes of notes representing different levels of risk. The EIF and the EIB (potentially alongside national promotional banks) would subscribe or guarantee these notes up to agreed maximum amounts, while the originating financial institutions would retain a material interest in the transaction, in order to avoid moral hazard, by ensuring the necessary alignment of interest and a focus on performing loans to viable companies. The senior *tranche* of this asset-backed security will have to achieve a target rating that is compatible with the risk tolerance of EIB and other institutional investors like pension funds and insurance companies that currently shy away from SME risk in their investment portfolios. As under the joint guarantee instrument, the junior and mezzanine *tranches* are covered by a combination of ESIF, COSME/Horizon 2020 and EIF own resources.

Such instrument would grant the possibility to increase leverage and outreach by attracting private investors (more likely to join in as risk levels of *tranches* of existing portfolios can be assessed). It is also possible that the securitised portfolio could be used as collateral to benefit from refinancing operations at the ECB and/or other central banks.

⁹⁴ Under Horizon2020, also small mid-cups may be included in the securitised portfolio.

Option 3 builds on Option 2, but provides for a further boost in leverage due to the pooling of risk by Member States. Under this option, ESI Fund resources would be ‘pooled’ and used to provide protection on the aggregate exposure, particularly to the mezzanine *tranches* guaranteed by EIF. Such a pooling mechanism would allow more suitable structuring and would provide a more efficient loss protection on the mezzanine *tranches*, thus enabling an overall higher leverage. The fundamental principle underlying Option 3 is therefore achievement of improved risk diversification – a principle that underlies successful and efficient management of risk across the financial sector. In order to maximise leverage, it would be necessary to pool ESI Funds and EU-level funds at EIB/EIF level, enabling EIB/EIF to undertake the requisite securitisation investments across participating geographies. While pooling the risk, Member States and regions would be assured that the amount of funds contributed by a particular Member State from its ESIF programmes would generate loans to a value of several times the amount through lending to SMEs in that Member State for the benefit of the respective programme areas. National public promotional banks could play an important complementary role in achieving the required level of leverage of public funds. Full pooling across all Member States could potentially increase the instrument's leverage, depending on the credit risk of the portfolios. As a result of risk pooling, the lending capacity would increase in all Member States.

The main operational aspects of the Joint Securitisation Instruments are outlined in the following paragraphs.

A. *Modus Operandi and structuring*

Under Options 2 and 3, the joint instrument foresees the origination by financial institutions of securitisation transactions, backed by portfolios of SME assets. This could be achieved through

- the sale by the originator of a portfolio of SME assets to a dedicated vehicle (“true sale”, funded structure);
- synthetic risk transfer, without the use of a dedicated vehicle (unfunded structure, providing credit risk protection in the form of a guarantee).

In the case of a true sale, the vehicle would finance itself through the issuance of various classes of notes representing different levels of risk.

The portfolio of SME loans of bank is securitised in *tranches*. The originators retain 50% of the most risky *tranche*, the Junior *tranche* (First Loss Piece), and possibly 5% in the mezzanine to ensure they have proper “skin in the game”. Managing Authorities who are willing to participate in the guarantee scheme (via the EIF, but at the risk of the ESI Funds contribution) 50% of the Junior *tranche*. Subject always to adequate alignment of interest rules, the portion of the Junior *tranche* to be covered by the ESI Funds might need to be modulated as a function of Regulator’s requirements, in order to achieve regulatory capital relief for the originators. Contractual arrangements would ensure that access to public guarantees for partner banks would be strictly conditional on passing the benefits on in the form of new loans to SMEs.

In Option 2, Managing Authorities cover the risk of the most junior part of the Mezzanine *tranche* (Second Loss Piece) under the explicit condition that the new finance is provided to

SMEs in their country. COSME/Horizon 2020 provides cover (via the EIF, but at the risk of COSME/Horizon 2020) for the middle part of the Mezzanine *tranche*. EIF guarantees (on its own resources) the upper part of the Mezzanine *tranche* (credit enhancement).

In Option 3, EIF guarantees or finances the Mezzanine *tranche* (Second Loss Piece), while the pooling mechanism would be available to credit enhance the portfolio of such mezzanine investments / guarantees to be undertaken by EIB Group. ESIF resources would be used first locally for each transaction in the first loss piece investments to ensure that the corresponding mezzanine pieces achieve a common rating (e.g. of B2), irrespective of Member State and credit quality of the underlying SME assets. This condition ensures that there is a consistency in the level of risk from each transaction that is shared between Member States through the pooling mechanism. As a natural consequence, this implies that proportionally more ESIF resources will be consumed in lower-rated SME environments than in higher rated SME environments (where the attainment of the B2 mezzanine rating is less challenging). Residual volumes of ESIF resources would then be channelled to the Mezzanine pooling mechanism (in an amount that is proportional to its usage by the relevant Member State), so that the retained EIB Group risk is acceptable for EIB as “standard risk” and high volumes of EIB investments can therefore be envisaged.

The Mezzanine *tranche* with the credit enhancement through guarantees by the EIF can be sold. The Mezzanine *tranche* gives capital relief to the sponsor. If the Mezzanine *tranche* were to be sold, then the originating bank would also receive additional funding.

To the extent that other investors do not subscribe them and within EIB’s capped involvement in the initiative mentioned in section 2.2.1, the senior *tranches* may be purchased by the EIB. The sponsor gets capital relief and funding.

In contrast with Option 1, where only new SME assets would be guaranteed or securitised, in this case existing SME assets would also be included in the portfolio for securitisation. In exchange, financial institutions would be obliged to originate an adequate volume of new SME assets as additional portfolio in a specified timeframe.

The schematic representations below (Figure 4.2.3 and Figure 4.2.4) show – respectively for Option 2 and Option 3 – how ESIF resources could be used to invest in or guarantee SME ABS *tranches* within two Member States with different SME credit environments (weak in Member State A, strong in Member State B). In exchange for such investments / guarantees, financial intermediaries would undertake to originate a volume of new SME lending, that is a multiple of the volume of ESIF resources employed, corresponding to the capital relief obtained by the bank.

The thickness of the first loss piece and of the mezzanine *tranche* will be determined in each transaction in such a way that the risk of the senior *tranches* is substantially equivalent, in line with EIB standards and is capable, in principle, of attracting third-party interest. The greater the volume of non-ESIF resources mobilised by each transaction, the greater the volume of new lending that should be achievable by the originators. The volume of loans not retained by the originator – contributed by ESIF, COSME, Horizon 2020, EIF, EIB and possibly other investors – will generate a proportional amount of capital relief, which in turn will enable the originator to provide a manifold amount of new loans to SMEs.

FIGURE 4.2.3 : STRUCTURE OF OPTION 2

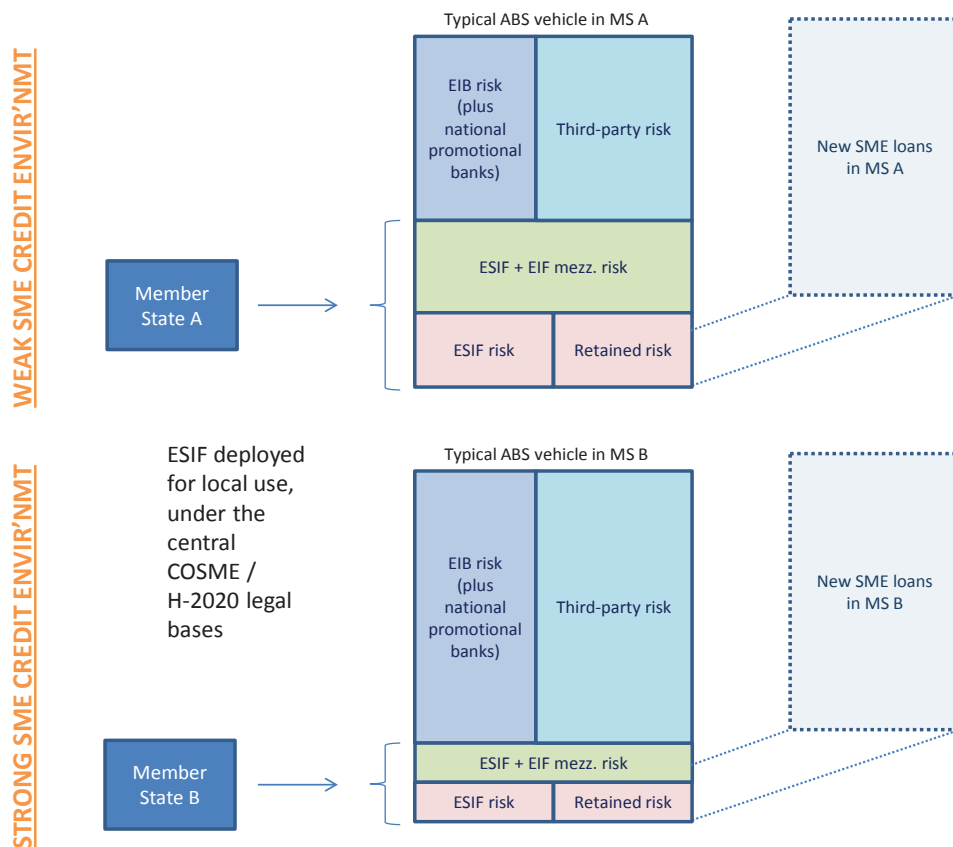
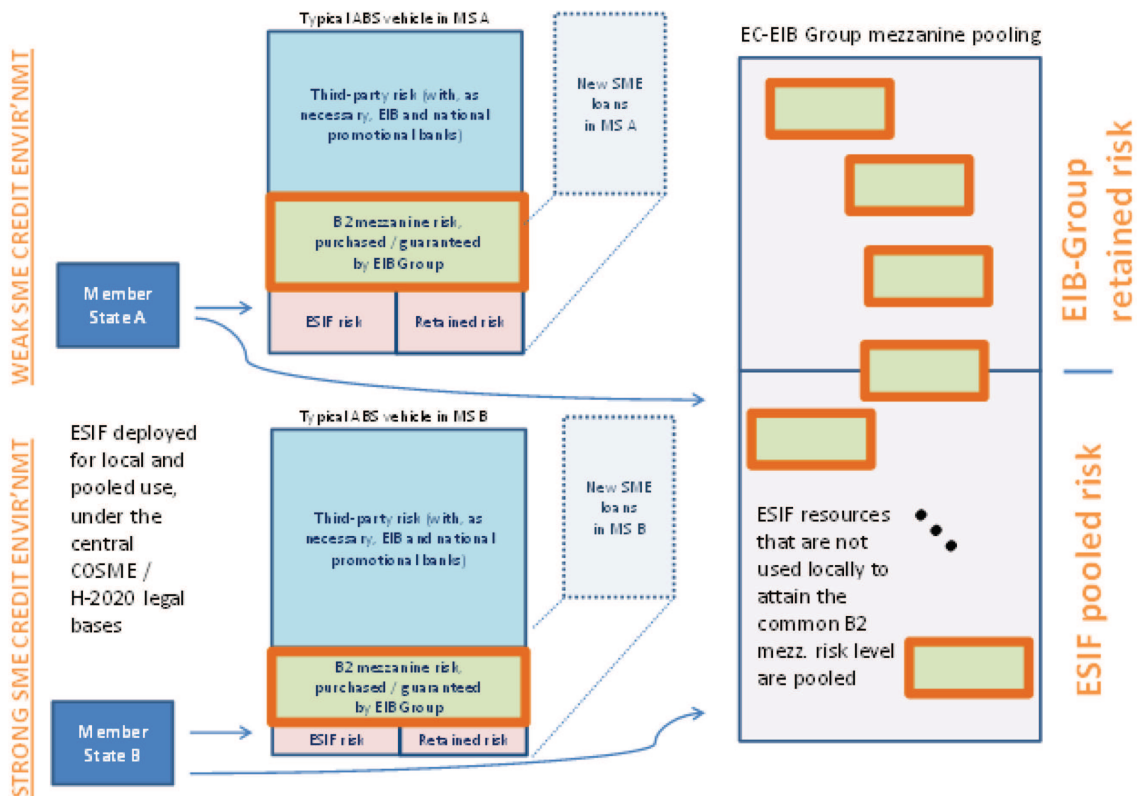


FIGURE 4.2.4: STRUCTURE OF OPTION 3



B. Leverage

Leverage is calculated as the ratio of new SME assets generated to ESIF resources employed. As shown above, obtaining an acceptable risk profile on the senior exposure implies utilising differing tranching (depending on the credit profile of underlying SME assets) and hence typically providing different leverage factors in different Member States.

The modalities of EIB Group's involvement are assumed to be that the EIB would participate in the senior risk with relatively high volumes with the EIF participating in the mezzanine risk (in a position senior to ESIF resources) with relatively lower volumes. EIF's participation is therefore of higher risk compared to EIB's senior involvement.⁹⁵

In Option 2, for well diversified SME portfolios with "standard" credit metrics (i.e. with an average credit quality equivalent to a portfolio rating in the range of B2/B1), the average leverage effects would be around **7 times the ESIF contribution and around 10-20 times the Horizon 2020 and COSME contributions**.⁹⁶ For the instrument as a whole, leverage will depend strongly on the mix of participating SME credit environments in the initiative.

The analysis of leverage for Option 3 is similar to that carried out under Option 2, except that ESIF resources for a given Member States would be in this structure distributed across first loss pieces and would also contribute to absorbing losses on the pooling platform (on mezzanine *tranches*). The intention is that the diversification achieved on the pooling platform results in a larger cumulated volume of mezzanine risk that can be covered and, consequently, a larger aggregate volume of ABS origination (which, in turn, allows for a larger volume of new SME lending and a higher leverage of ESIF resources).

It is important to note that under Option 3 there will be no pooling of assets as investors will look at and get exposure to individual transactions on a standalone basis. Pooling is rather a means to achieve credit enhancement for the EIF's aggregate exposure to the mezzanine *tranches*, by providing the EIF with a hedge on its exposure. As a result the EIF would be in a position to take more risk than under Option 2 and, as a consequence, tranching of the mezzanine *tranche* could also be more "aggressive" (i.e. with a lower attachment point), thus benefiting a wider group of SMEs.

Subject always to the portfolio selection criteria, since SME portfolios of weaker credit quality require higher credit enhancement to obtain similar ratings for the various *tranches*, they would absorb proportionally higher ESIF resources. The converse is true for a strong SME credit quality. Consequently, the leverage results will depend strongly on the underlying SME credit quality.

For well diversified SME portfolios with "standard" credit metrics (i.e. with an average credit quality equivalent to a portfolio rating in the range of B2/B1), the average leverage effects

⁹⁵ In fact, EIB's involvement is assumed to be via the purchase of an Aa3 rated senior asset, whereas EIF's involvement (insofar as it relates to mandate activity) is assumed to be relatively capital intensive for the Group (EIF exposure likely in the range of Ba1/Baa3).

⁹⁶ The COSME Basic Act requires a minimum leverage effect of 20-30.

would be around **9 times the ESIF contributions and around 10-20 times the Horizon 2020 and COSME contributions.**⁹⁷

The participation in the pooling scheme of a sufficiently high number of countries would be a precondition to ensure appropriate diversification, and therefore involvement of private investors and achievement of the desired leverage: indicatively, in order to start benefiting from overall portfolio diversification, the number of transactions should be at least 30, equally spread across a minimum of 5-6 countries. A minimum participation, both in terms of number of Member States and aggregate volume, is also necessary in order to justify the added complexity of Option 3 and to adequately cover the associated set-up, running and monitoring costs.

C. Pricing

Pricing will be determined taking into account State aid rules, transfer of benefit to Final Recipients and also complementarity with products offered under COSME and Horizon 2020, to avoid arbitrage between programmes and instruments.

The ESIF cover for the Junior *tranche* (corresponding to expected losses) is granted for free.

The mezzanine *tranches* will be priced at in a way to sustain the risk. EIF and the other risk takers will charge a price according to their respective pricing policies and objectives. The remainder of the price will be allocated to COSME, Horizon 2020 and ESIF.

Overall, the all-in pricing on the individual ABSs should be relatively attractive due to a) zero pricing on the ESIF first loss contribution and attractive pricing for the ESIF mezzanine loss contribution; and b) EIB Group's typically competitive investment / guarantee pricing.

Senior notes will be priced in a way to sustain the risk. The originator will receive funding equivalent to the cost of an EIB global loan (i.e. pass through of EIB funding cost plus minimum margins) through the compensation mechanism irrespective of market pricing of these *tranches*. For a proper cost benefit analysis for originators this component needs to be taken into account in addition to the pure market price of the senior notes. This preferential funding is also important for fragmentation issues as by construction all senior notes in any jurisdiction entail the same level of expected credit risk (as in high credit risk environments more credit enhancement and ESIF funds are used) and therefore are correcting the undue fragmentation of providing different prices for the same credit risk that currently the market is providing. Consequentially, this would allow the EIB to trade down these portfolios as market conditions improve, especially for banks in non-core countries, allowing the EIB a key role in breaking down the existing fragmentation.

D. Reporting and monitoring

Similar principles to those already indicated under the proposed Joint SME Guarantee Instrument (Section 4.2.2.1, point D, items a, b, d), are envisaged also under the Joint Securitisation Instruments.

⁹⁷ The higher the leverage, the greater the capital resources required, especially at EIF level, to provide the required credit enhancement.

Regarding point c), the Reporting on the Joint SME Securitisation Instruments pursued by the Commission and the participating Member States will comply with the requirements specified under the Financial Regulation and CPR. In substance, the reporting will take account of the capital relief provided by the joint SME securitisation to the originating financial intermediaries, the transfer of such benefit to the SMEs and the specificity of portfolios subsequently built-up for providing new debt finance to SMEs. Moreover, the reporting will deliver information on institutional investors like pension funds and insurance companies, which may be attracted by the senior tranche of this asset-backed security. In this context, the reporting will also deliver information on the leverage achieved during the implementation and provide data that can be used, notably in the context of the Initiative's evaluation, for further analysis on how the EU and ESIF contributions improve the credit transmission channel to the real economy.

Moreover, results of the reporting will be strongly supported and, to a large extent, complemented by monitoring activities which shall be performed by the implementing body (EIF). Monitoring shall assess fundamental parameters such as progress of the implementation of the joint SME guarantee, contractual compliance of agreements between the implementing body (EIF) and financial intermediaries or eligibility of such financial intermediaries under the proposed guarantee.

The detailed modalities for the points above shall be further specified both in the Delegation Agreements between the Commission (regarding contributions under COSME, Horizon2020) and the implementing body (EIF) and in the Funding Agreements between the participating Member States (regarding ESIF contributions) and the implementing body (EIF).

4.2.2.3 Case studies

Boxes 4.2.4 and 4.2.5 present two case studies involving both guarantee and securitisation transactions. The examples provided are taken from “real” market transactions without public support and with a certain credit quality of the underlying portfolio that may be higher than under the proposed SME initiative. As a result, the realised leverage under the SME initiative may differ from the examples given below. Both securitisation transactions in the two case studies are “true sale” transactions.⁹⁸

Each securitisation transaction requires substantial bespoke structuring work and fine-tuning, especially for true sale ABS transactions. The case studies presented herein are meant to indicate the possible effects of the different options analysed and should not be seen as “template” for deal execution.

We have chosen an SME loan securitisation from Germany and an SME leasing securitisation from Spain.

For each transaction we present 2 Options:

Table 1 shows the original tranching of the “standard transaction”, assuming no Joint Instrument intervention. In these real examples the most senior *tranche* in both transactions is externally rated “AAA”, although not necessarily by the same rating agency.

⁹⁸ The first Case study refers to a transaction privately placed with EIF involvement (October 2012). The second Case Study refers to a transaction recently placed (July 2013).

Table 2 shows the same transaction after a simplified desktop “re-tranching” with the following objectives:

- Achieve the same credit enhancement and target rating for the senior notes (disregarding possible country ceilings to structured finance ratings applied by Rating Agencies)
- Use ESIF and COSME/Horizon 2020 budget to directly guarantee (or purchase) the relevant *tranches*
- Introduce/fine-tune the mezzanine *tranches* so as to:
 - Achieve a Baa3 rating for the EIF exposure;
 - Achieve a B2 rating for the ESIF+COSME+Horizon 2020 (combined) mezzanine exposure
- Subject to the above targets, reduce the total size of the FLP, if possible, by lowering the attachment point of the mezzanine *tranche* (originator and ESIF being always *pari passu*)
- Ensure sufficient alignment of interest with the originator.

The table also shows the indicative Total Volume that could be achieved by the SME initiative, assuming that the underlying transactions are all similar to the one presented. This gives the indicative leverage effect that could be obtained.

Box 4.2.4: CASE STUDIES: OPTION 2

SPAIN

TABLE 1A - NO JOINT INSTRUMENT INTERVENTION

Country:	SPAIN
Underlying Assets:	Small ticket leasing
Replenishment:	No
Portfolio rating:	B2/B3

CASE STUDY 1 - SPAIN - SME SECURITISATION (Option 2)

Standard Securitisation Transaction

Senior Aaa	Aaa	57%
Class B		0%
Class C		0%
Class D		0%
Class E		0%
Originator FLP	NR	43%
Total		100%

TABLE 2A - SIMPLIFIED DESKTOP "RE-TRANCHING"

Step 1: Securitised portfolio with SME Initiative - Breakdown by investors	(%)	EUR
Senior	57%	48,081
Class B	28%	23,619
EIF	3%	2,531
ERDF/Cosme/Horizon2020	9%	7,592
Originator	1.50%	1,265
ERDF	1.50%	1,265
Total Securitised Portfolio	100%	84,352
Total ERDF/Cosme/Horizon2020		8,857
ERDF	98%	8,680
Cosme/Horizon2020	2%	177
Leverage (in relation to ERDF, with originator adding 20%)		11.1
Step 2: Additional portfolio:		96,727
out of which SMEs in line with COSME/Horizon2020 => [20 x 177]		3,543

GERMANY

TABLE 1B - NO JOINT INSTRUMENT INTERVENTION

Country:	GERMANY
Underlying Assets:	Small term SME loans
Replenishment:	Yes (up to 20 months)
Portfolio rating:	Baa3/Ba1

CASE STUDY 1 - GERMANY - SME SECURITISATION (Option 2)

Standard Securitisation Transaction			
Senior Aaa	Aaa	88%	
Class B		0%	12.0%
A1	A1	7%	12.0%
Baa2	Baa2	1%	4.6%
Ba2	Ba2	2%	3.3%
Originator FLP	NR	2%	1.8%
Total		100%	

TABLE 2B - SIMPLIFIED DESKTOP "RE-TRANCHING"

Step 1: Securitised portfolio with SME Initiative - Breakdown by investors	(%)	EUR
Senior	88.00%	288,673
Class B	8.30%	27,227
EIF	0.40%	1,312
ERDF/Cosme/Horizon2020	2.10%	6,889
Originator	0.60%	1,968
ERDF	0.60%	1,968
Total Securitised Portfolio	100%	328,037
Total ERDF/Cosme/Horizon2020		8,857
ERDF	98%	8,680
Cosme/Horizon2020	2%	177
Leverage (in relation to ERDF with originator adding 20%)		44.1
Step 2: Additional portfolio:		383,124
out of which SMEs in line with COSME/Horizon2020 => [20 x 177]		3,543

It should be noted that the targeted portfolios under the SME initiative would have lower average ratings (COSME B1 and Horizon 2020 B2) than those shown in these examples. This is due to the fact that the SME initiative aims to create additional transactions to what the market does already. As a result, the leverage of the SME initiative would be lower than in the given examples.

Box 4.2.5: CASE STUDIES: OPTION 1

Assuming the same amount of contributions from ESIF, COSME and Horizon 2020, namely EUR 8.857bn, the following tables illustrate the leverage that could be achieved under Option 1, uncapped guarantees, in Spain (Table 1) and in Germany (Table 2), for portfolios with the indicated average ratings. It should be noted that the targeted portfolios under the SME initiative would have lower average ratings (COSME B1 and Horizon 2020 B2) than those shown in these examples. This is due to the fact that the SME initiative aims to create additional transactions to what the market does already. As a result, the leverage of the SME initiative would be lower than in the given examples for Option 1.

TABLE 1: SPAIN

CASE STUDY 1 - SPAIN - SME GUARANTEE (Option 1)

Guaranteed portfolio with SME Initiative	(%)	EUR
Senior	45.6%	42,071
Class B	22.4%	20,666
EIF	2.4%	2,214
ERDF/Cosme/Horizon2020	7.2%	6,642
ERDF	2.4%	2,214
Guaranteed Portfolio without originator	80%	73,809
Originator's risk (bank own risk)	20%	18,452
Total amount of the guaranteed portfolio	100%	92,261
Total ERDF/Cosme/Horizon2020		8,857
ERDF	98%	8,680
Cosme/Horizon2020	2%	177
Leverage (in relation to ERDF)		10.6
Total amount of the guaranteed portfolio		92,261
out of which SMEs in line with COSME/Horizon2020 => [20 x 177]		3,543

TABLE 2: GERMANY

CASE STUDY 2 - GERMANY - SME GUARANTEE (Option 1)

Guaranteed portfolio with SME Initiative	(%)	EUR
Senior	70.4%	236,187
Class B	6.6%	22,277
EIF	0.3%	1,074
ERDF/Cosme/Horizon2020	1.7%	5,636
ERDF	1.0%	3,221
Guaranteed Portfolio without originator	80%	268,394
Originator's risk (bank own risk)	20%	67,099
Total amount of the guaranteed portfolio	100%	335,493
Total ERDF/Cosme/Horizon2020		8,857
ERDF	98%	8,680
Cosme/Horizon2020	2%	177
Leverage (in relation to ERDF)		38.7
Total amount of the guaranteed portfolio		335,493
out of which SMEs in line with COSME/Horizon2020 => [20 x 177]		3,543

4.2.3 Analysis of the value added of the SME Initiative

Existing public measures to fight the crisis and to enhance SMEs' access to debt finance are important, but improvements are needed and possible. Especially regarding SMESec, the real kick-off of the revival of this market - with its benefits for SME financing - will depend on significant public support. As mentioned above, the original development of SMESec has been already spurred by stimuli from national and supranational support measures.

As outlined in Section 4.2.1, there has to be a rationale for public action and in particular any central EU intervention has to be justified by its foundation on European added value. The main aspects to substantiate the strong EU added value of the SME Initiative are outlined below, following the criteria set out in the section previously cited.

4.2.3.1 EU policy objectives and consistency

The Europe 2020 Strategy defines a number of objectives for the EU that require significant budget. Some of these objectives could be financed by the private sector, but some require substantial public support. As outlined in Section 4.2.1, support of SMEs' access to finance is an area where public intervention is justified and needed and the European Commission is helping Europe's small and medium-sized enterprises to address their financing problems. The Europe 2020 strategy has to be implemented against the background of fiscal austerity and the pressure to maintain or even reduce the EU budget. There is the risk that the gap between the need to respond to future challenges and the available budgetary resources to meet these objectives is widening.

EU-level financial instruments can support the achievement of the EU 2020 objectives by addressing market failures that lead to insufficient funding of SMEs being available from market sources, typically because the field is perceived as being too risky. The SME initiative has the potential to significantly contribute to enhance access to finance of SMEs and would contribute as such to the achievement of the EU 2020 objectives. In particular, this initiative will contribute to improve access to finance for innovative SMEs by leveraging Horizon 2020 contribution, in line with the commitments of the Innovation Union, one of the European 2020 flagship initiatives.⁹⁹

The initiative does not aim at replacing other instruments that provide debt finance to SMEs, but complements them and ensures critical size. Given the widespread nature and the size of the market failure that SMEs face when seeking access to finance, there will be plenty of scope for other national, and/or regional initiatives and financial instruments to further address the market failure. As the SME initiative is being designed in parallel with the programming process of the ESIF, Member States will be in a position to take into account the SME Initiative when designing a coherent and consistent toolkit of financial instruments for SMEs.

4.2.3.2 Demonstration, signalling, and catalytic effects

In times of a European crisis, a central EU intervention and the combination and better use of public resources carry a strong political message about the European construction that would not only be captured by investors and originators alike and would contribute to the creation of a broader and more standardised market, but it would also give a strong signal to the public of the joint will to fight the crisis and would enforce the message to markets.

There is a strong positive feeling about the need for SME financing and the added value of a European solution, which is seen as paramount to restart the securitisation market given that:

⁹⁹ However, it must be noted that ESIF excludes support to mid-caps in the additional portfolio; small mid-caps with up to 500 employees can be part only of the securitised portfolio.

- domestic solutions cannot overcome investors' reluctance to invest as the bias is largely linked to the sovereign context;
- the involvement can take the form of a guarantee for new loans (preferred in certain cases) or mezzanine subscription on a portfolio of existing loans but in both cases the political significance of the involvement is as important as the amount/shape of the support at stake;
- the EIB/EIF involvement could be a catalyst in terms of standardization that would help to create a broader and more liquid market across Europe;
- subscription of mezzanine *tranches* by EIB/EIF is seen as an important feature.

Securitisation would result in new ABS supply and therefore would be a positive signal regarding the importance of the ABS market. The larger the SME finance programme becomes, the more liquid the SME ABS paper will be in secondary markets, helping boost investor demand for further SME ABS issuance – subject to supply/demand balance. The key driver of investor demand is not the chosen structure but the underlying assets. An SME ABS backed by a non-core country's SME loans will demand a very different yield to one backed by a core country's SME loans. It may not be recommended to mix SME loans from different countries, as investors will want to do their credit work on a specific portfolio and price accordingly.¹⁰⁰

Centralised management under defined objectives and high quality standards spurs demonstration and signalling effects, i.e. typically the consistent application and promotion of best market practices. This fosters the qualitative development of a market and increases intermediary sophistication over time (in addition to established players on supply and demand side: new market entry by new originators and new investor (or investor classes). A European structure which focuses on disclosing the performance of SME loans in different countries will provide investors with an asset class that the investors have had limited exposure to in the past. As more deals are promoted through the European platform, investor knowledge will grow through access to the credit performance and primary issuance and secondary trading prices of the bonds.

4.2.3.3 Multiplier effects and economies of scale

The SME initiative has been designed with a view to scaling up the available resources and ensuring a more critical impact in the market, for the benefit of SMEs, by pooling resources in a complementary way from the EU (COSME, Horizon 2020, and ESIF), the EIB, the EIF, and – depending on the Option – also national promotional/development/public banks and private investors, to pursue common policy objectives, as foreseen in the Europe 2020 Strategy and thus achieving a higher leverage effect.

A European solution has the possibility to overcome the limitations linked to national programmes, such as different (and unequal) structures, policies and availability.

¹⁰⁰ The senior *tranche* distributed to investors in the securitisation will remain the same in respect of size and credit risk in either of the securitisation options. Therefore, the involvement of capital markets investors should be neutral as to which of Option 2 or 3 is utilised. The difference in Option 3 is the extent to which the capital of the mezzanine risk provider can be further leveraged giving an overall greater size to the programme.

Concerning more specifically securitisation (options 2 and 3), a Europe-wide program, even if structured in line with local/national law/credit analysis for the purposes of securitising the assets (i.e. true sale, risk reserves, etc.) will be more likely to attract an international investor base than a number of domestic programs for the following reasons:

- investors in a larger European structure will understand that the credit analysis they perform on the structure will be relevant for a larger number of future deals than a local platform could provide;
- there will be greater liquidity in a program offered to an international investor base, rather than a program with a more regional investor grasp; and
- the proposed securitisation structures are expected to lead to more standardisation which investors will value.

The key to unlocking the leverage effects for the Initiative is the widest possible participation by Member States. While participation through contributions from ESIF programmes would necessarily be voluntary, all Member States would be strongly encouraged to contribute to the Joint Instruments from their ESIF allocations, in the knowledge that their contributions would support increased lending to SMEs on their territory.

The leverage of the SME initiative is calculated as the ratio of new SME assets generated to ESIF resources employed. Obtaining an acceptable risk profile on the senior exposure implies utilising differing *tranching* (depending on the credit profile of underlying SME assets) and hence typically providing different leverage factors in different Member States. The modalities of EIB Group's involvement are assumed to be that the EIB would participate in the senior risk with relatively high volumes with the EIF participating in the mezzanine risk (in a position senior to ESIF resources) with relatively lower volumes. EIF's participation is therefore assumed to be riskier compared to EIB's involvement in the senior *tranche*. For the instrument as a whole, leverage will depend strongly on the mix of participating SME credit environments in the initiative. Details of the leverage calculation are outlined in annex 2 to Chapter 2.

It is expected that the Initiative could help revive the appetite of investors for SME securitisation and contribute to market-building by making transactions viable in markets where without the EU support such transactions would not be feasible or cost-effective for originating financial institutions.

Market participants and stakeholders consulted by the HLG experts express a strong interest in a European financing initiative as it promises to overcome the limitations linked to national programmes, such as different (and unequal) structures, policies and availability across Member States.

From a capital markets perspective, local programs are likely to attract a smaller group of mainly regional investors, rather than an international investor base. The development of the investor base may initially be focused on core markets, but it will benefit peripheral markets

as well by providing a relative pricing point.¹⁰¹ The more participation in the program, the better the eventual pricing of the SME ABS notes will be as the asset class will be more common, transparent and liquid.

On the demand side, it will be important for the program's success to

- remove the regulatory constraints making it difficult for a wide range of investors to participate in the ABS market (i.e. Basel consultation paper increasing RWAs on securitisation, Solvency II punitive treatment of ABS held by insurance companies) and;
- promote the involvement of investors, even if just temporarily, by giving positive regulatory benefit to European banks buying SME ABS. For example, if the Liquidity Cover Requirement for European banks were to include high quality SME ABS, as the largest investor base for European ABS is European banks, this could have a significant impact on demand for the notes issued under the program, resulting in stronger demand in primary and secondary distribution of the senior notes and reduced cost of funding, creating additional motivation on the supply side for originating banks.

4.2.3.4 Capacity building

The experience of the EU institutions – European Commission, EIB and also the EIF in designing and implementing SME financing schemes is unique. National and local institutions can benefit from EU-level entrusted entities' know-how of the design of financial products, such as uncapped guarantees and securitisation.

Support through the EIF (as guarantor) has played a key role in the development of the European SME securitisation market before the crisis. Integrated EU capital markets (and their need for transparency and standardisation) and the relative complexity of the securitisation techniques require considerable know-how and show the necessity for specialised institutions. As an established and respected player in the European market, EIF can play a role via market presence, reputation building, and signalling. The EIB Group would structure transactions, offer their capital to take risk at different levels which has a signalling effect to further investors, such as other promotional banks.

Furthermore, it has to be considered that important public interventions to support the SMESec markets have been discontinued during the crisis.

European involvement is seen as paramount to restart the market as:

- i) Domestic solutions cannot overcome investors' reluctance to invest as the bias is largely linked to the sovereign context,
- ii) The involvement can take the form of a guarantee (preferred in certain cases) or mezzanine subscription but in both cases the political significance of the involvement is as important as the amount/shape of the support at stake.

¹⁰¹ For example, the existence of UK or Dutch RMBS is beneficial for investors looking at Italian RMBS, as the investor is able to benchmark expected market spreads versus the other markets.

- iii) An EIB Group involvement could be seen as “quality stamp” of the transactions especially in relation with the quality of information available, the reporting to be performed by the originator, modelling provided, etc. Such involvement could also be a catalyst in terms of standardization that would help creating a broader and more liquid market across Europe.
- iv) Subscription of the mezzanine *tranches* by the EIB Group should also be seen as an important feature providing some cost-benefit induced by the capital relief allowing for an acceptable yield at the senior level, where the involvement of private investors is also expected. The respective *tranches* are enhanced with the EIF’s AAA/Aaa rating and investors in the guaranteed *tranches* can benefit from EIF’s risk weighting of 0% (MDB status/AAA rating).
- v) Streamlining the process of negotiation on the mezzanine and junior investments and standardisation of products, eligibility criteria, reporting requirements and legal documentation through a coordinated Initiative is likely to lead to quicker processes and possibly also lower transaction costs.
- vi) A standardised programme with clearly defined data requirements is going to increase transparency and with the improved availability of data also analytical possibilities and the understanding of SME loans as asset class will improve. Data provision on SME loans (including SME portfolio-wide performance/losses and loan servicing procedures) has been a key issue across jurisdictions.¹⁰²
- vii) As with any rare asset class in the capital markets, investor appetite grows as the asset class performs and trades, giving price, market liquidity and credit performance indicators to investors. A European structure which focuses on disclosing the performance of SME loans in different countries will provide investors with an asset class that the investors have had limited exposure to in the past. As more deals are promoted through the European platform, investor knowledge will grow through access to the credit performance and primary issuance and secondary trading prices of the bonds.

Box 4.2.6: ECB STATEMENT (MONTHLY BULLETIN, SEPTEMBER 2013)¹⁰³

According to the ECB (Monthly Bulletin, Sept 2013), it is generally recognised that well-regulated, high-quality and transparent securitised products can play an important role in capital markets. These products can satisfy investor demand for secured, highly rated, and liquid debt instruments, and can provide maturity-matched funding for a bank’s assets. In addition, the structured nature of ABSs can attract a variety of market participants and help to transfer risks across the financial system, provided these are sufficiently understood, which in turn can help to build resilience against unexpected market shocks. More broadly, ABSs can also stimulate real economy funding, including financing for small and medium-sized enterprises.

¹⁰² Detailed borrower data (e.g. SME business description, financials/turnover, number of employees, locations), loan key terms (details of any security, financial covenants, any restrictions on transfer), credit quality (bank internal rating, bank LGD estimate, date of last review, historical performance/arrears data) where available, would be required for assessment by rating agencies and investors. In this context, as outline above, European Data Warehouse and PCS are seen as positive steps towards an attempt to standardize and make more accessible the information investors will require.

¹⁰³ This text box is to a large extent based on Kraemer-Eis, Passaris, and Tappi (2013).

An efficient and liquid ABS market would also be welcome from a central bank perspective: ABSs' role in "liquefying" difficult-to-sell assets provides an important collateral asset class. This can be crucial in times of crisis for ensuring that sufficient liquidity is provided to counterparties while adequately safeguarding the central bank balance sheet.

Investor uncertainty continues to present a major hurdle in the reactivation of European ABS markets. Such uncertainty exists on a number of fronts, which in turn has suppressed demand for all but the highest quality ABS tranches and has increased secondary market spreads. At the macroeconomic level, a lack of confidence in official data – such as the extent of loans in arrears in certain weak economies – and uncertainty over developments in variables such as property prices and unemployment, have continued to penalise ABSs across the EU, with particular emphasis on economies hard-hit by the sovereign debt crisis. The difficult issuing environment may have had an impact on new loan origination, particularly among SMEs in certain weak economies, a challenge recently highlighted in the European Commission's Green Paper on the long-term financing of the European economy.

*Concerning proposed initiatives to revive the SMESec market, the ECB **states that the EIB Group is going to leverage its expertise 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 SMEs. 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. The European ABS market has the potential to play a long-lasting and important role in European funding markets and real economy financing. 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.*

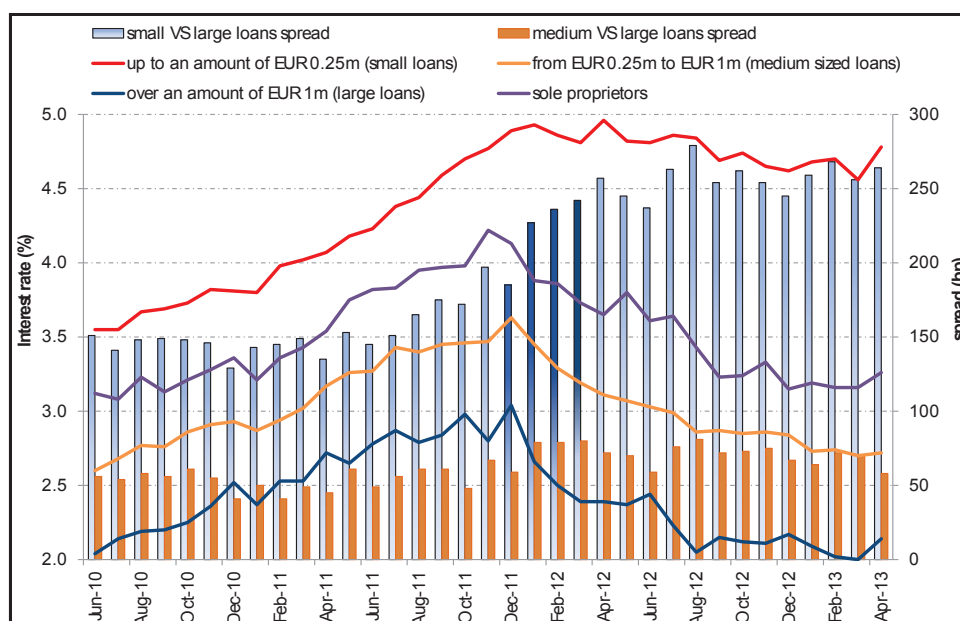
4.2.3.5 Addressing market fragmentation

There is evidence that financing conditions for SMEs are currently extremely tight in many parts of Europe. Bank lending volumes are low and declining. This is partly due to low credit demand but also a result of banks restricting the supply of credit as they deleverage, build capital and repair balance sheets. Furthermore, interest rates for loans to SMEs are often very high and fragmented across Europe, effectively deterring borrowing.

Given the difficulties faced by EU SMEs in accessing finance, as magnified by the financial crisis (see Section 4.1.1), in many countries – from a risk/return perspective – *"lending to SMEs is only attractive for banks if they charge high interest rates, also against the background that authorities are already considering increasing (Basel III) capital requirements"* (DZ Bank, 2013b). Due to new capital regulations and funding constraints, European banks started the deleveraging process (see Box 4.1.1 in Section 4.1.1).

The ECB MFI (Monetary Financial Institution) Interest Rate Statistics also indicate more difficult credit conditions for SMEs. The data show that the interest rate spread between small loans (up to an amount of EUR 0.25m) and large loans (more than EUR 1m) has shown an increasing trend from an average level of 145bp before July 2011 to a record high of 279bp in August 2012; since then, the spread has been rather stable at an average level of 258bp (see Figure 4.2.5).

FIGURE 4.2.5: EVOLUTION OF MONETARY FINANCIAL INSTITUTIONS INTEREST RATES ON NEW LOANS TO NON-FINANCIAL CORPORATIONS*



SOURCE: KRAEMER-EIS, LANG, AND GVETADZE ET AL. (2013A), BASED ON HUERGA ET AL. (2012), ECB (2013A) AND OWN CALCULATIONS

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

Using small loans as a proxy for the financing cost of SMEs (Huerga et al., 2012), this elevated divergence “may point to some degree of discrimination by banks against small firms” (ECB, 2012), in particular in the countries most affected by the deepened sovereign debt crisis.

The results found by Jiménez et al. (2012) point into the same direction. Based on a dataset for Spain, which contains monthly information requests by banks following loan applications from firms, they separate loan supply from demand, and find that “*higher short-term interest rates [...] reduce loan granting*” and that this effect is stronger for banks with low capital or liquidity. Hence, their findings “*suggest that, under tighter monetary and economic conditions, a reduction in bank capital begets a credit crunch.*”

The differences in lending conditions are also indicative of a more fundamental **fragmentation** of the EU's financial market, as lending spreads relate not only to the credit quality of the borrower but also to the geographical location, thus resulting in the borrower's discrimination and, on the whole, in a **fragmentation** of financial markets.

Banks in the EU have started to adjust relatively slowly, to reduce leverage levels. This adjustment has been to some extent market-driven (*i.e.* high leverage has been punished in terms of access to funding markets). This trend to necessary deleveraging has been accompanied by supervisory action (*i.e.* EBA recapitalisation requirements) and regulatory changes (implementation of Basel III/CRDIV).

In addition, access of SMEs to credit has been particularly affected and credit spreads for SME loans have increased substantially in many EU countries resulting in high borrowing costs. Fragmentation of funding rates for SMEs across different EU Member States is a key issue which undermines progress achieved in establishing the Single Market.

Furthermore, credit to SMEs in vulnerable countries is hampered by investors' concerns regarding the weak economic and financial environment as well as the credit risk linked to the sovereign. For SMEs, the access to financing is particularly challenging.

A European initiative would provide a political signal of the importance finance ministers and central banks put to the development of capital market financing for SMEs. The EIF and EIB would play an important role in structuring each deal, providing significant value added to investors in terms of credit assessment and pricing.

Banks will not lend to SMEs based purely on macroeconomic development motives (*i.e.* supporting the economy) which is sometimes indirectly asked by politicians and lobbyists. Banks will always make a complex calculation of the profitability of their SME lending business, especially relative to their other activities. In these calculations there are multiple parameters such as origination and marketing as well as credit assessment and servicing costs. Three areas will however have an overriding impact on the profitability of SME lending and hence on the required loan margins for SMEs: refinancing spreads, risk costs and capital requirements. While risk costs in the form of expected losses based on underlying credit quality and collateral (*i.e.* PD, EAD, LGD) cannot be transferred easily to third parties, securitisation can play an important role in the funding strategy as well as for capital relief. In respect to the senior notes, the originator could receive funding equivalent to the cost of an EIB global loan (*i.e.* pass through of EIB funding cost plus minimum margins) through the compensation mechanism irrespective market pricing of these *tranches*. For a proper cost benefit analysis for originators this component needs to be taken into account in addition to the pure market price of the senior notes. This preferential funding is also important for fragmentation issues as by definition all senior notes in any jurisdiction entail the same level of expected credit risk (as in high credit risk environments more credit enhancement and ESIF funds are used) and therefore are correcting the undue fragmentation of providing different prices for similar credit risks that currently the market is providing. Consequentially, this would allow the EIB to trade down these portfolios as market conditions improve, especially for banks in non-core countries, allowing the EIB a key role in breaking down the existing fragmentation.

4.2.3.6 Conclusion

The subsidiarity principle is intended to ensure that decisions are taken as closely as possible to the citizen and that constant checks are made as to whether action at Community level is justified in the light of the possibilities available at national, regional or local level. Specifically, it is the principle whereby the Union does not take action (except in the areas which fall within its exclusive competence) unless it is more effective than action taken at national, regional or local level. In designing the proposal, this principle has been carefully considered and respected. Based on the above analysis, it can be concluded that the intervention through the EU SME Initiative at EU level is fully justified and that the Initiative provides significant added value with regard to enhancing access to finance for SMEs.

4.3 Chapter 3: Consistency with other policy actions and proportionality of the intervention

4.3.1 Initiatives under Structural Funds

4.3.1.1 Existing initiatives under Structural Funds (2007-2013)

Financial engineering instruments (FEIs) have become an increasingly important delivery tool of cohesion policy during 2007-2013.

By the end 2012, 940 FEIs (70 holding funds and 870 specific funds) had been set up through 175 operational programmes in almost all Member States (except Ireland and Luxembourg). The total value of operational programmes (OP) contributions to all funds amounted to EUR 12,558 million, including EUR 8,364 million Structural Funds (*i.e.* ERDF and SF).

More generally, the majority of activity in FEIs supported through cohesion policy is for support to enterprises. This constitutes EUR 10,472 million of operational programme contributions (83% of the total), including EUR 6,924 million of Structural Funds. Products offered to enterprises include loans, guarantees, equity/venture capital, and other products (such as interest rate and guarantee fee subsidies).

Financial instruments in cohesion policy follow the logic and legal framework of the policy, including shared management and subsidiarity principles. Therefore, they contribute to the achievement of the goals set out under priority axes of the operational programme(s) agreed between the Member State and the Commission. However, the decision on implementation, financing and monitoring of performance of the specific instruments remains within the competence of the managing authority concerned.

Holding funds were managed either by the European Investment Bank or the European Investment Fund or by other financial institutions or bodies. They were either set up as a separate block of finance within a financial institution (two thirds) or as an independent legal entity governed by agreement between the co-financing partners and shareholders (one third). Additionally, managing authorities awarded direct contracts to the EIB or to the EIF to manage OP contributions allocated to FEIs.

In total, managing authorities reported EUR 4,684 million of Operational Programme contributions as being disbursed by specific funds to final recipients. Most of these disbursements *i.e.* EUR 4,540 million were reported for FEIs for enterprises.

In the period 2007-2012, a total of 38,501 loans were reported for an amount of EUR 1,984 million of OP contributions. In the period 2007-2012, managing authorities reported 96,989 guarantees committed for disbursed loans with an OP contribution of EUR 1,467 million. As of 31 December 2012, FEIs for enterprises reported 2,021 equity and quasi-equity investments in enterprises representing EUR 748 million of OP contributions.

Example of the existing initiative JEREMIE

In the context of 2007-2013 cohesion policy, EIF has collaborated with national partners and Member States as a way to address particular market gaps. Through partnerships with

national and regional counterparts, including governments and private and strategic investors, EIF is delivering a wide range of financial instruments tailored to the diverse needs of markets in individual countries across Europe.

As a manager of JEREMIE Holding Funds, EIF's role is essential to develop know-how transfer, capacity building and mandate development at the level of public authorities and the market. Through the JEREMIE initiative, EIF directly manages 14 Holding Funds, totalling EUR 1.27 billion of Structural Funds under management. In 2012 alone, 24 transactions were signed with 19 new financial intermediaries in the regions served. Through the JEREMIE Holding Funds, a total amount of EUR 2.7 billion has been catalysed.

Under JEREMIE guarantees, losses are covered using OP budgetary resources specifically allocated to this programme. The guarantees issued cover part of the expected loss for portfolios of SME loans or leases originated by financial institutions (also called "capped guarantees"). Final losses stemming from new SME loans granted during a predefined period are covered on a *pari passu* basis with the financial intermediaries up to the expected loss set at inception of the agreement.

4.3.1.2 Envisaged initiatives under ESI Funds (2014-2020)

Financial instruments represent a resource-efficient way of deploying resources in pursuit of the Europe 2020 Strategy objectives. In the light of the current economic situation and the increasing scarcity of public resources, financial instruments are thus expected to play an even stronger role in the 2014-2020 programming period.

One of the main issues under the current programming period (2007-2013) was the difficulty for a vast majority of Member States to be able to design and implement financial instruments in view of addressing the financing gap for SMEs with involvement of the respective financial intermediaries.

To respond to this issue, the European Commission proposed for the next MFF specific provisions for financial instruments,¹⁰⁴ introducing a clearer presentation of the instruments' specificities and more detailed regulatory requirements.

In this context, it is envisaged that Member States will have, apart from direct implementation of loans or guarantees by managing authorities themselves, three options of implementing the financial instruments:

- a) implementation via so-called "*tailor made instruments*" which should reflect specific conditions and needs of a Member State;
- b) implementation via allocating ESIF funds to an EU instrument like COSME or Horizon 2020 with ESIF disbursements geographically linked to EU contributions. This option is referred to as "*joint instruments*" and may benefit from incentives regarding the EU co-financing rate;

¹⁰⁴ Separate section on financial instruments in the draft CPR – Title IV (Articles 32 to 40). The details will be laid down in related secondary legislation (Delegated Acts and Implementing Acts).

- c) implementation via allocating ESIF funds to new EU-designed standardised instruments, the so-called "*off the shelf instruments*".

The "*tailor made instruments*" under option a) will be designed by managing authorities, who are invited to take account of the SME Initiative with a view to ensuring complementarity of all financial instruments envisaged for their territorial coverage.

Option b) consists of "*joint instruments*," under which the SME Initiative has been proposed.

Option c) concerns "*off the shelf instruments*" which should be ready-to-use for a swift roll-out and compliant with State Aid rules. In this context, the Commission prepared a set of four pre-defined financial instruments to enable a wider use of financial instruments supported by ESI funds in a more standardised way.

Three of the envisaged instruments target specifically SMEs:

- (1) Loan for SMEs based on a portfolio risk sharing loan model (RS Loan);
- (2) Guarantee for SMEs (Capped guarantee);
- (3) Equity Investment fund for SMEs and start-up companies based on a co-investment model (Co-investment Facility).

Based on lessons learned from the past implementation experience and know-how capitalised during the programming period 2007-2013, *off the shelf instruments* will

- provide standard terms and conditions for a set of predefined financial instruments that can be set-up and implemented by managing authorities under Article 33(1)(b) of the CPR and thus facilitate the design and the management of the most commonly used financial products within the European Structural and Investment Funds (ESIF), in particular for specific sectors where financial instruments are expected to play an important role contributing to the Europe 2020 objectives;
- support the managing authorities to deliver faster and safer financial means to SMEs;
- combine public and private resources aiming to achieve leverage on EU contribution.¹⁰⁵

Off-the-shelf instruments comprise risk sharing loans and capped guarantees which shall support increased financing offered to SMEs (such as loans, lease, guarantees, etc.). However, *off-the-shelf* instruments do not foresee any uncapped guarantees and securitisation instruments. Therefore, uncapped guarantees and securitisation envisaged under the SME Initiative appear to complement well the products offered under *off-the-shelf* instruments for support of SMEs in 2014-2020.

Furthermore, the SME Initiative and the *off the shelf instruments* shall be fully complementary as the latter will address the SMEs' needs at a given regional level. The SME Initiative may be generated with higher leverage effects and economies of scale than might

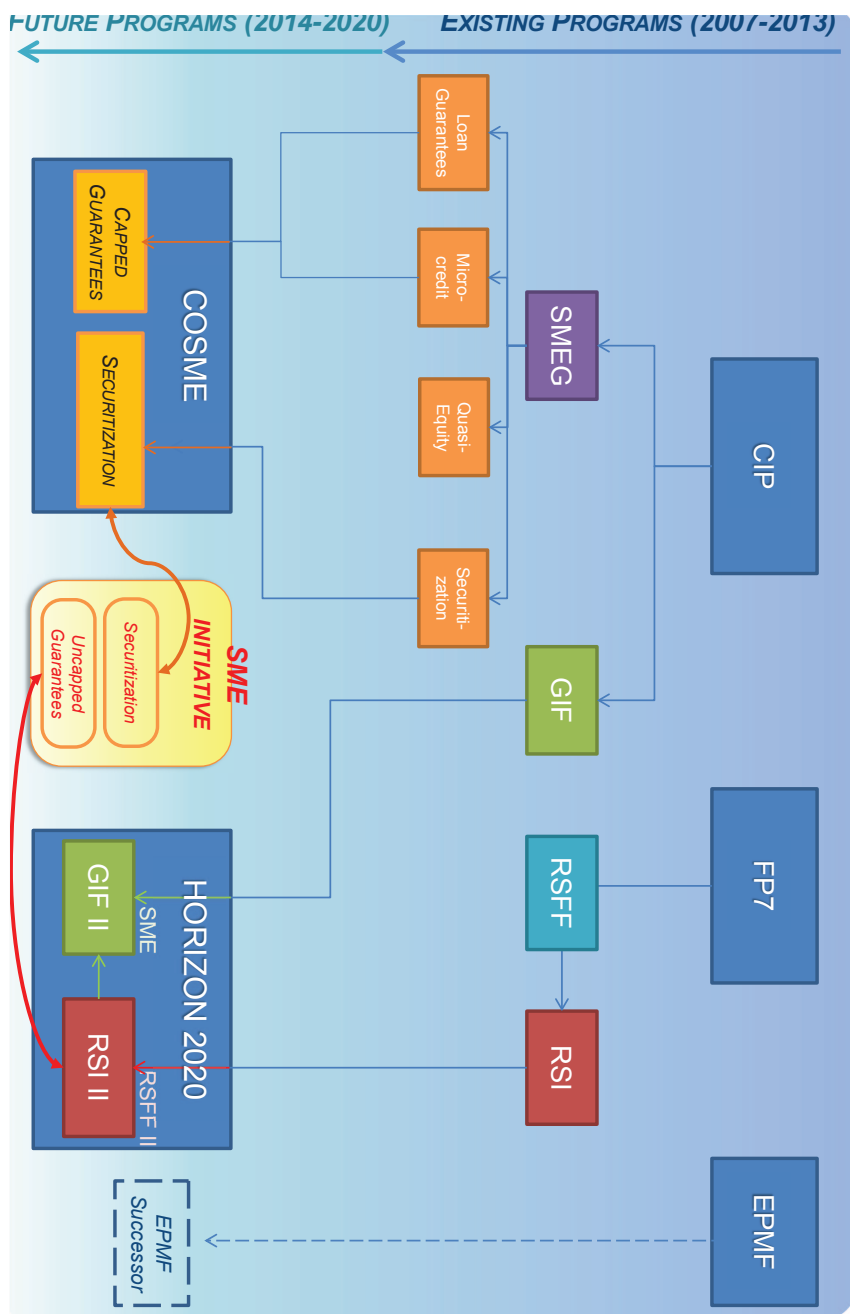
¹⁰⁵ The conditions for Off-the-shelf instruments are indicative.

be achieved domestically due to a favourable combination of national ESIF allocations with centrally managed EU funds, the resources of the EIB and EIF, and possibly also with those of national institutions.

4.3.2 Centrally managed EU financial instruments¹⁰⁶

Figure 4.3.1 provides an overview of the existing centrally managed EU financial instruments in the current MFF and of the proposed new EU financial instruments for the next MFF, including the SME Initiative.

FIGURE 4.3.1: OVERVIEW OF THE EXISTING CENTRALLY MANAGED EU FINANCIAL INSTRUMENTS IN THE CURRENT MFF



¹⁰⁶ Parts of this chapter are based on Kraemer-Eis, Lang, and Gvetadze (2013a), Kraemer-Eis, Lang, and Gvetadze (2013b), and Kraemer-Eis, Passaris, and Tappi (2013).

4.3.2.1 EU financial instruments in the current MFF (2007-2013)

A. CIP - Securitisation Window under the SME Guarantee Facility

Under the CIP Securitisation window, EIF provides, in the context of both cash and synthetic SME Securitisation transactions, EU Guarantees on *tranches* with low layers of credit enhancement. The objective is to facilitate access to capital markets for unrated or low-rated institutions such as smaller banks, and to find alternative solutions to allow financial intermediaries to circulate funding in the SME market. The aim of the CIP Securitisation product is to generate additional financing for SMEs, hence it combines an unconditional and irrevocable guarantee on an existing portfolio of loans at a market level guarantee fee with a separate undertaking to build up a new portfolio of SME loans (under a separate additional portfolio agreement). In exchange for the EU Guarantee, originators undertake to create a new portfolio of SME financing during an agreed period (known as the *additional portfolio*). The required size and composition of this portfolio depends on the size and the seniority of the EU Guarantee. The Additional Portfolio must contain medium- or long-term financing to SMEs. In case the targeted volume of the additional portfolio is not achieved, a commitment fee would become due, while the guarantee on the securitisation transaction would remain in place.

Thanks to the taking of second loss risk under CIP alongside a first loss *tranche* taken by the Confidi, UniCredit as well as the participating Confidi have reduced the respective capital requirements. This is particularly important during the current transition period as many Confidi decided to be regulated as a bank. In addition, UniCredit can free up its credit lines of the participating Confidi and therefore increase the volume of new loans with the same Confidi.

The CIP Securitisation Window will be closed for new transactions at the end of 2013. The financial instruments under the COSME programme will largely continue the activities under the current CIP in the next MFF, including the securitisation activities.

B. RSI – Pilot instrument under FP7 Risk-Sharing Finance Facility (RSFF)

A key objective of the RSFF is to improve access to debt finance for investments in research, development and innovation in the EU, notably by private promoters. It contributes to addressing the financing needs of innovative projects and companies of all size and ownership, including midcaps and SMEs.

The RSFF, co-developed by the European Commission and the EIB, was established in June 2007. The EU and the EIB are risk-sharing partners for loans provided by the EIB directly or indirectly to beneficiaries. The European Union, through budget resources of the 7th Framework Programme for research, Technological development and Demonstration (FP7), and the EIB have set aside a total amount of up to EUR 2 billion (EUR 1 billion each) for the period 2007-2013 to cover losses if RSFF loans are not repaid. Through these EU/EIB contributions for risk-sharing and loss coverage, the EIB is able to extend a loan volume of EUR 10 billion to companies and the research community for their investments in R&D and Innovation (RDI).

Risk-sharing between the EU and the EIB was initially made on a loan-by-loan basis (until 2010). Since 2011, following a recommendation by an independent expert group, risk-

sharing is made on a portfolio basis, with first-loss-taking by the EU. The EIB is assuming further risks above a certain threshold in case EU risk absorption has been fully used. The RSFF is being successfully implemented with a demand superior to its initial expectations illustrated by a total amount of signed loans superior to €11.3 billion as of 10 October 2013.

In early 2012, a new guarantee facility, RSI (Risk-Sharing Instrument for SMEs and small midcaps) was launched to improve access loan finance for RDI-driven/innovative SMEs and small midcaps (small midcaps being defined as an enterprise with up to 499 employees FTE which is not an SME). The RSI guarantee facility is part of the RSFF and its implementation is entrusted to the European Investment Fund (EIF), who also covers the residual risks. Under RSI, EIF is providing guarantee or counter-guarantee to financial intermediaries which loans and leases to RDI-driven/innovative SMEs and small midcaps. The (counter-) guarantee is up to 50%. The risk-sharing arrangement with the EIF leverages the EU contribution coming from FP7 by a factor of 8, thus generating a high impact on financing available for RDI-driven/innovative SMEs and small midcaps.

The RSI is being successfully implemented and there is a strong market demand for the guarantees offered. As of 15 November 2013, EIF received under RSI 35 applications and 4 requests for increase (including 2 counter-guarantees) covering 17 countries. Moreover, the deal pipeline included another eight applications (including a first multi-country transaction covering 5 countries) and up to four additional applications were expected before year-end. Out of the above mentioned 39 applications, 22 agreements have already been signed for a total amount of (counter-)guarantee of € 1.07 billion, covering 13 countries.

In total, for the entire period 2007-2013 under RSI guarantees to financial intermediaries for loans to RDI-driven/innovative SMEs and small midcaps, a total guarantee volume of EUR 1.125 billion was initially foreseen allowing the extension of loans amounting to EUR 2.25 billion to approximately 4,000 beneficiaries. Those amounts will very likely be exceeded, as an additional amount of (counter-)guarantee of €0.125 is already approved for 7 applications, and a majority of the 10 remaining applications will be assessed before the end of the year.

4.3.2.2 EU financial instruments for the next MFF (2014-2020)

A. Financial instruments under COSME

The following paragraphs describe the financial instruments envisaged under the COSME programme and their differences and complementarities with the proposed SME Initiative.

The COSME programme envisages under its loan guarantee window two products: a capped guarantee and a securitisation instrument.

Capped Guarantee under COSME

The capped guarantee product will provide counter-guarantees for guarantee schemes, including, where appropriate, co-guarantees as well as direct guarantees for any other financial intermediaries. The guarantees envisaged shall aim at reducing the particular difficulties that viable SMEs face in accessing finance due to either their perceived high risk or their lack of sufficient available collateral.

Individual guarantee agreements with a financial intermediary will have a maximum duration of 10 years, permitting the individual loans to mature over 10 years. The capped guarantee is provided for free, with a guarantee rate of 50% and a cap rate of 20%.

Uncapped Guarantee under the SME Initiative

The uncapped guarantee foresees a defined guarantee rate, covering 100% of the guaranteed portion, which allows fulfilling the need for capital relief. The guarantee rate is envisaged at 80%.

The objective of the SME Initiative is primarily to provide access to finance to SMEs, as well as to mitigate the effects of the obligatory deleveraging of balance sheets, required by the regulatory requirements, which would otherwise work against any such increase in access to finance for SMEs.

Complementarity/consistency between the two guarantees

Both guarantee products are targeting risky SMEs, are open to all intermediaries, and cover the first loss piece (20%) for free.

The difference comes in the guarantee rate and the cap feature. The capped guarantee under COSME will limit the guarantee rate to 50% and have a 20% cap rate, while the guarantee rate under the SME initiative is up to 80% and has no cap.

The complementarity may be observed in the following aspects:

- The capped guarantee under COSME should be seen as the "default instrument", offered over all 7 years of the next MFF, while the uncapped guarantee under the SME initiative is rather a crisis instrument, responding to the urgent need to kick-start the SME lending market in the current regulatory environment. The uncapped guarantee under the SME Initiative will be implemented with a view to ensuring complementarity and avoiding overlapping, competition and cannibalisation effect with the capped guarantee under COSME.
- The SME Initiative extends the range of available guarantee products for financial intermediaries providing SME lending. The capped guarantees under COSME cover only expected losses but are offered for free, while uncapped guarantees under the SME initiative cover all losses including expected and unexpected in view of providing the capital relief to the financial intermediaries but are priced.
On the one hand, for intermediaries such as commercial banks, for whom capital requirement considerations are of high importance (due to the banking regulations), guarantees covering not only expected losses, but also unexpected losses are of higher value than guarantees covering only expected losses. On the other hand, for some intermediaries, such as certain guarantee institutions or promotional banks, there is no clear need for coverage of more than just the expected losses.

Securitisation under COSME

The securitisation instrument under COSME is envisaged as a securitisation of SME debt finance portfolios, which shall mobilise additional debt financing for SMEs under appropriate risk-sharing arrangements with the targeted institutions. Support for transactions shall be conditional upon an undertaking by the originating institutions to use a significant part of the mobilised capital or the resulting liquidity for new SME lending in a reasonable period.

The amount of the additional debt financing shall be calculated in relation to the amount of the guaranteed portfolio risk individually for each originating institution, subject to its negotiations with the entrusted entity.

Securitisation under the SME Initiative

A similar approach to the uncapped guarantee instrument above is also adopted for securitisation with the same effect, which is to allow the intermediary to use resources otherwise set aside for capital requirement purposes. To ensure alignment of interest, the originator (the financial intermediary) will be required to retain 50% of the junior *tranche* (up to the first 20% of the portfolio).

Complementarity/consistency between the two securitisation instruments

Both securitisation products cover all SMEs (not only risky ones) and are open to banks particularly due to technical reasons as securitisation can much better be provided to banks, which are in a direct client relationship with SMEs, rather than to guarantors and other intermediaries more remote from the loans.

Both securitisation products allow securitising portfolios of SME loans, in order to mobilise additional lending to SMEs.

Conclusion

In each case, the SME initiative provides somewhat more generous conditions than the more "ordinary" EU instruments since it is a crisis instrument. In this context, the SME initiative is expected to be front-loaded in the first 3 years of the MFF, rather than the whole 7-year period.

The participation of Member States under the SME initiative is voluntary. COSME, instead, is envisaged to be available in all Member States and possibly also in non-EU participating countries, subject to bilateral arrangements. Thus, in some Member States, both COSME and SME initiative products will be available (in those Member States that opt to participate in the SME initiative), while in others only products envisaged under COSME shall be taken into consideration.

B. Horizon 2020 Financial instruments

Horizon 2020 is the EU's framework programme to support research and innovation in the years 2014-2020. A part of the Horizon 2020 budget, approx. EUR 2.8 billion, will be dedicated to financial instruments facilitating access to risk finance, implemented through the financial markets and supporting lending to and equity investments in research, development and innovation intensive corporates, entities or projects. More than one third of this budgetary allocation is envisaged for SME access to risk finance.

The Work Programme for the Access to Risk Finance part of Horizon 2020 for the years 2014 and 2015 foresees three instruments focusing on SMEs: Equity Facility for R&I, Technology Transfer Financing Facility Pilot and SMEs (equity) & Small Midcaps R&I Loans Service.

Equity instruments

The *Equity Facility for R&I* succeeds and refines the GIF-1 scheme under CIP¹⁰⁷, and is part of a single equity financial instrument supporting the growth of enterprises and their R&I activities (which integrates the intervention by Horizon 2020 and COSME). It is designed to improve access to risk finance by early-stage research and innovation-driven SMEs and small midcaps through supporting early-stage risk capital funds that invest, on a predominantly cross-border basis, in individual enterprises. It will be a purely demand-driven facility implemented by the European Investment Fund¹⁰⁸.

As a window of this equity facility, a dedicated pilot scheme for co-Investments with business angels in innovative ICT firms is foreseen. This pilot scheme will co-finance investments by business angels in innovative SMEs and small midcaps that are aiming to commercialise new ICT-related products and services with potential co-investors such as family offices and equity crowd-funders.

Another equity facility, the *Technology Transfer Financing Facility Pilot* will co-finance investments made by existing technology transfer (TT) funds and vehicles. It will focus on TT undertaken via the creation of new companies and the licensing of intellectual property (IP), and concentrates on the proof-of-concept, development and early commercialisation stages of the TT process. While it will focus on the pre-SME stage and the very early stages of the corporate life cycle, it can also be seen as an SME support measures as it broadly aims to support financing projects that are likely to become SMEs.

Complementarity/consistency with the SME initiative

The two equity facilities envisaged under Horizon 2020 may be deemed complementary to the SME initiative as they target slightly different final recipients: *i)* highly innovative enterprises at early-stage, who turn to business angels and/or family to obtain financing rather than to a bank and *ii)* pre-SME financing projects, which may become SMEs at a later stage.

Debt instruments

SMEs & Small Midcaps R&I Loans Service succeeds and refines the FP7 RSI pilot under the RSFF in FP7,¹⁰⁹ and is part of a single debt financial instrument supporting the growth of enterprises and their research and innovation activities. It targets research and innovation-driven SMEs and small midcaps requiring loans of between EUR 25 000 and EUR 7.5 million. The European Investment Fund will implement this instrument,¹¹⁰ which will be delivered by financial intermediaries (such as banks), who will extend the actual loans to final beneficiaries. Financial intermediaries will be guaranteed against a proportion of their potential losses by EIF, which will also offer counter-guarantees to guarantee institutions.

The uncapped guarantee under the FP7 RSI successor will cover the first loss piece (20%) for free and envisage the guarantee rate of up to 50%.

¹⁰⁷ See http://ec.europa.eu/cip/eip/access-finance/index_en.htm

¹⁰⁸ Subject to the successful conclusion of negotiations.

¹⁰⁹ See http://www.eif.org/what_we_do/guarantees/RSI/index.htm

¹¹⁰ Subject to the successful conclusion of negotiations.

In addition, the *Loans Service for R&I* will offer loans and hybrid or mezzanine finance for R&I projects emanating from large firms and medium and large midcaps; universities and research institutes; R&I infrastructures (including innovation-enabling infrastructures); public-private partnerships; and special-purpose vehicles or projects. It may also marginally finance SMEs, but they will not be the primary target group.

Complementarity/consistency with the SME initiative

Both uncapped guarantee products are open to all intermediaries, cover the first loss piece (20% of the portfolio) for free and would offer capital relief to financial intermediaries. The complementarity stems from differences in the guarantee rate and eligibility of final recipients. The uncapped guarantee under Horizon 2020 will limit the guarantee rate to 50%, while the guarantee rate under the SME initiative is up to 80%. Moreover, the uncapped guarantee under Horizon 2020 foresees as eligible recipients RDI intensive SMEs as well as Mid-Caps while the guarantee under the SME initiative targets only RDI intensive SMEs.

In general, the uncapped guarantees under the *SME Initiative* may be seen as a temporary, geographically restricted crisis-response booster for the guarantee product that will be offered by the *SMEs & Small Midcaps R&I Loans Service*. It will complement the *SMEs & Small Midcaps R&I Loans Service*, create awareness, and stimulate demand for the *SMEs & Small Midcaps R&I Loans Service*, which may support its take up and implementation.

Due to its crisis-response nature and the origin of the budgetary resources, the *SME Initiative* would offer guarantees with somewhat different and possibly more advantageous terms and conditions. However, its intervention would be limited to the first three years of the 2014-2020 MFF, while the *SMEs & Small Midcaps R&I Loans Service* would cover the whole MFF period.

As indicated above, the geographic coverage would be different. While the *SMEs & Small Midcaps R&I Loans Service* will cover all EU Member States and a large number of non-EU participating countries, the *SME Initiative* guarantees would only be available in those EU Member States that will decide to participate.

To ensure complementarity of the guarantee facilities under *SMEs & Small Midcaps R&I Loans Service* and the *SME Initiative*, the European Investment Fund as the entrusted entity implementing both facilities¹¹¹ would follow a clear deal allocation policy.

With regard to the securitisation instrument envisaged under the SME initiative, a *securitisation instrument* is currently not foreseen in the Work Programme for Access to Risk Finance under Horizon 2020, except in the context of the SME initiative.

Nevertheless, the Commission (forthcoming) Horizon 2020 ex-ante evaluation¹¹² identified a market gap for innovative SMEs seeking debt finance that is far larger than what the *SMEs &*

¹¹¹ Subject to the successful conclusion of negotiations.

¹¹² See the ISC on the Commission implementing decision adopting the 2014-2015 work programme in the framework of the Specific Programme Implementing Horizon 2020 – The Framework Programme for Research and Innovation (2014-2020):
http://www.cc.cec/cisnet/CisServlet.CISNet?A_ACT=ACT900&A_MTD=MTD905&A_CON=CIS_CONSULT9852123636

Small Midcaps R&I Loans Service can fill. Moreover, unlike the proposed securitisation instruments, the *SMEs & Small Midcaps R&I Loans Service* does not offer additional liquidity and would require a time horizon of several years in which such portfolios would need to be built up. Therefore, the proposed securitisation instrument under the SME initiative would very likely complement and expand the product offered under Horizon 2020. Namely, it may address a target market gap that is significantly larger than what Horizon 2020 could fill on its own and would offer complementary advantages to the currently planned instruments: quick and sizeable impact, additional liquidity for financial intermediaries and a possible kick-start to the European securitisation market. Figure 4.3.2 shows an overview of EU debt instruments together with the SME initiative products added in blue under uncapped guarantees and securitisation. Each of the instruments is highlighted in terms of eligible SMEs, Financial Intermediaries, Member States, conditions, and pricing for easy comparison.

		COSME	HORIZON 2020	E (off-th	
Risk-sharing Loan	Eligible SMEs	N/A	N/A	All	
	Financial Intermediaries			Ban	
	Eligible Member States			A	
	Conditions			Max. 80%	
	Pricing			Fo	
Capped Guarantee	Eligible SMEs	Risky SMEs	N/A	All	
	Financial Intermediaries	Open to all Intermediaries		Banks o Gua	
	Eligible Member States	All MS		A	
	Conditions	Max 50% Guarantee Rate Max 20% Cap Rate (only Expected Losses)		Max 80% G Max 25% Ca	
	Pricing	Capped Guarantee for Free		Capped Gua	
Uncapped Guarantee	SME Initiative (Option 1)	Eligible SMEs	Risky SMEs	RDI Intensive SMEs	I
		Financial Intermediaries	Open to all Intermediaries	Open to all Intermediaries	
		Eligible Member States	Only MS participating in SME Initiative	Only MS participating in SME Initiative	
		Conditions	Max 80% Guarantee Rate 20% First Loss Piece	Max 80% Guarantee Rate 20% First Loss Piece	
		Pricing	First Loss Piece (EL +UL) for free Residual Risk priced	First Loss Piece (EL +UL) for free Residual Risk priced	
		Eligible SMEs	N/A	RDI Intensive SMEs & small Mid Caps	
		Financial Intermediaries		Open to all Intermediaries	
		Eligible Member States		All MS	
		Conditions		Max 50% Guarantee Rate 20% First Loss Piece	
		Pricing		First Loss Piece (EL +UL) for free Residual Risk priced	
Securitisation	SME Initiative (Option 2)	Eligible SMEs	All SMEs	RDI Intensive SMEs	I
		Financial Intermediaries	Banks only	Banks only	
		Eligible Member States	Only MS participating in SME Initiative	Only MS participating in SME Initiative	
		Conditions	[20%] Junior tranche (ESIF) 50% Junior tranche retained by originator [%] Mezzanine tranche (ESIF, COSME, EIF)	[20%] Junior tranche 50% Junior tranche retained by originator [%] Mezzanine tranche (ESIF, COSME, EIF)	
		Pricing	Junior tranche (EL +UL) for free Mezzanine & Senior priced	Junior tranche (EL +UL) for free Mezzanine & Senior priced	
		Eligible SMEs	All SMEs	TBD	
		Financial Intermediaries	Banks only		
	Eligible Member States	All MS			
	Conditions	TBD			

FIGURE 4.3.2: EU DEBT INSTRUMENTS

4.3.3 National initiatives

4.3.3.1 General measures

A myriad of initiatives exist, both at the national and at the regional level, that add to EU-level measures to address SME difficulties. Box 4.3.1 tries to group them by theme, but it must be remembered that not all of them target specifically SME financial gaps.

BOX 4.3.1: POLICIES TO DIVERSIFY CREDIT OPTIONS FOR SMALL AND MEDIUM ENTERPRISES IN EUROPE

This box explores options for diversifying credit creation for small and medium enterprises (SMEs), which have traditionally been constrained in their credit channels.

Options for access to credit are much more restricted for SMEs than for larger firms. Larger companies have benefited from historically low costs of funding and ample liquidity through a variety of credit channels. Conversely, SMEs have virtually no access to bond markets and continue to face higher interest rates and restricted access to bank credit. Although the availability and conditions of external financing appear to have improved in the last year or so—including for bank loans, bank overdrafts, and trade credit—these improvements have been less obvious for SMEs than for larger companies. In a recent survey by the European Central Bank, for example, “access to finance” was the second most important concern mentioned by SMEs, on average, throughout the euro area, although the magnitude of the concern differed by country—38 percent of SMEs in Greece reported this as their biggest concern, 25 percent in Spain, and 24 percent in Ireland, while only 8 percent of SMEs in Germany and Austria viewed access to finance as a primary issue (ECB, 2013).

SMEs were also hit harder by the crisis. There is evidence (Iyer and others, 2013) that the magnitude of the reduction in credit supply was significantly higher for firms that (1) are smaller (as measured by both total assets and number of employees); (2) are younger (as measured by the age of incorporation); and (3) have weaker banking relationships (as measured by the volume of their bank credit before the crisis). Regulation may also play a role. Some studies (OECD, 2012; Angelkort and Stuwe, 2011) suggest that Basel III implementation could lead banks to reduce their lending to SMEs. This problem is likely to be larger in countries with bank-based financial systems and less developed financial markets.

Improving the availability of credit to the corporate sector in general, and SMEs in particular, is essential to supporting the economic recovery. The following policy measures may help achieve this goal.

- *Advancing the securitization agenda, including by:*
 - *Developing primary and secondary markets for securitization of SME loans: Of the total euro area securitized bond market of €1 trillion at the end of 2012, only some €140 billion was backed by SME loans. This contrasts with the much larger stock of bank loans to SMEs, which is estimated to be approximately €1.5 trillion.*
 - *Addressing the asymmetric treatment of securitized assets vis-à-vis other assets with similar risk characteristics: Currently, securitized assets are often treated less favorably by investors and central banks. For example, the haircut imposed by the ECB on asset-backed securities is 16 percent, much more than on other assets of similar risk—such as covered bonds with a similar rating—that are also accepted in liquidity facilities and direct purchases. Aside from the differences in the legal frameworks governing securitized assets and covered bonds, there are important inconsistencies in capital charges that provide incentives for covered bond issuance and bank cross-holdings of covered bonds, at the expense of securitizations with the same credit rating and duration risk (Jones and others, forthcoming).*
 - *Introducing government guarantees for SME securitizations (covering credit and sovereign risk): Guarantees could encourage private investment in these securities by offsetting some of the informational asymmetries*

and SME credit risk, especially from investors that can only buy securities with certain minimum credit ratings. The effect on lender incentives and the fiscal cost of these guarantees should be appropriately recognized (see the main text).

- *Including SME loans in the collateral pool for covered bonds: Currently, only mortgage, municipal, ship, and aircraft loans are eligible collateral for covered bond issuance; extending eligibility to SME loans will improve their attractiveness.*
- *Improving risk evaluation for SME securities by regulating and standardizing information disclosure: More uniform information disclosure would reduce investors' uncertainty about the quality of SME securities and thus would tend to reduce SMEs' cost of bond and commercial paper issuance.*
- *Encouraging development of factoring of SME receivables: By facilitating the sale of account receivables, SMEs can finance working capital. If this form of financing is underdeveloped, then better credit information and quality of credit bureau data will improve assessment of borrowers' ability to pay.*
- *Encouraging companies to lend to each other: Larger companies could provide financing to their smaller suppliers (for example, via faster payment cycles).*
- *Paving the way (including through appropriate regulation) for market-based credit guarantee programs and the development of small-bond markets: Government-backed partial credit guarantee and mutual guarantee programs (similar to microfinance) could support expanded credit to SMEs (Honohan, 2010; Columba, Gambacorta, and Mistrulli, 2010). Italy's introduction of fiscal incentives for the issuance of minibonds by unlisted firms in 2012 provides an example.*
- *Tax incentives for banks that expand credit to SMEs: These incentives could take the form of lower tax rates on earnings from SME lending. However, any tax subsidies should be carefully designed so as not to encourage excessive risk taking by banks or weaken loan underwriting standards, or create opportunities for tax avoidance, which will be very hard to reverse later. Also in this case, the effect on lender incentives and the fiscal cost of these guarantees should be appropriately and transparently recognized.*
- *Facilitating establishment of "direct lending" funds targeting SMEs that have difficulty getting other types of financing: These funds could include direct financing by distressed-debt firms, private equity firms, venture capital firms, hedge funds, and business development corporations.*

The relative effectiveness of these policies in providing credit to SMEs and their attendant costs would need to be evaluated on a country-by-country basis. The authorities should ensure that these measures are sufficiently targeted to address the root causes of lack of credit to SMEs. They must also minimize moral hazard and financial stability risk by ensuring adequate risk management practices are in place and requiring banks to hold a portion of securitized SME-backed assets on their balance sheets to be sure they have a sufficient financial interest in monitoring the loans.

TABLE 1: CREDIT POLICIES IMPLEMENTED SINCE 2007

	Enhancing Credit Supply					Supporting Credit Demand	
	Monetary Policy ¹	Fiscal Programs on Credit	Supportive Financial Regulation ²	Capital Market Measures	Bank Restructuring ³	Corporate Debt Restructuring	Household Debt Restructuring
Euro Area							
Austria	Y				Y		
Belgium	Y	Y		Y	Y		
Estonia	Y					Y	Y
Finland	Y						
France	Y			Y	Y		
Germany	Y	Y			Y		
Greece	Y	Y			Y	Y	Y
Ireland	Y	Y			Y	Y	Y
Italy	Y	Y	Y	Y	Y	Y	Y
Netherlands	Y	Y		Y	Y		
Portugal	Y	Y			Y	Y	Y
Slovak Republic	Y						
Slovenia	Y	Y	Y		Y	Y	Y
Spain	Y	Y		Y	Y	Y	Y
Other Advanced Europe							
Denmark	Y	Y			Y		
Iceland		Y			Y	Y	Y
Norway	Y	Y					
Sweden	Y						
United Kingdom	Y	Y		Y	Y		Y

SOURCE: INTERNATIONAL MONETARY FUND (2013)

While Box 4.3.1 points to a large variety of policy measures undertaken at the national and regional level, it must be noted that there is some fragmentation with regard to support measures concerning SMEs. Often these measures have been developed *ad hoc* as anti-crisis measures and therefore are not coordinated with other interventions. In this respect, the SME initiative is an approach to better integrate and coordinate financial instruments targeting the same policy areas and providing similar products. Budgetary difficulties experienced by several MS may also translate in a further reduction of government support to SME credit.¹¹³

In general, the SME Initiative should be regarded as complementary to the already existing (and envisaged) measures adopted to address the specific issue of SME financial gap. There are strong arguments in support of this view, drawing on the Value Added of the Initiative for EU SMEs laid out in Section 4.2:

A further consideration is that the SME Initiative aims to revive the SME securitisation market. As there is currently almost no primary SMESec market, there is no risk of having a substitution effect by the initiative (for little activity would take place in the market in the absence of the Initiative); here, the market simply needs a kick-start to trigger off the critical externalities to resuscitate a self-sustainable volume of trades.

From a more macroeconomic viewpoint, the **complementarity** of the SME Initiative with many existing measures stems from its etiologic nature, as described above. Indeed, our analysis has shown that, despite the decline in demand for finance on the part of SMEs, as a consequence of the financial crisis and general recession, there still exists a large portion of SME financing needs that continue to go unaddressed by existing financial institutions and policy interventions. This conclusion bears three implications for consistency. Firstly, the SME Initiative, by aiming to provide additional loans to SMEs, is **complementary** to all those

¹¹³ See Economisti Associati (2011), Annex.

measures – be they at the EU, national or regional level – addressing the SME access to finance issue **from the demand side** (e.g. corporate debt restructuring). Secondly, the SME Initiative, by addressing an existing financial gap, is **complementary** to current policy initiatives which attempt to enhance the **supply of loans** to SMEs with a view to alleviate the gap. Thirdly, the SME Initiative, by aiming to provide additional bank loans to SMEs, is **complementary** to measures supporting **alternative financing sources** (private equity/venture capital, trade credit, overdrafts...), for which there might well be unmet needs faced by EU SMEs.

4.3.3.2 Other initiatives by Member States (examples)

We also present examples of national initiatives in a few Member States (France, Germany, Italy, Spain)

France

The Initial Bond Offering (IBO) market in Paris¹¹⁴

Following the recommendations of the Rameix-Giami report, NYSE Euronext now allows listed and unlisted SMEs to issue bonds to retail investors on NYSE Euronext Paris and NYSE Alternext Paris. Since its launch in July 2012, this new public offering of bonds called Initial Bond Offering (IBO) has led to two offerings: the agricultural group AgroGénération listed on NYSE Alternext Paris and the property developer and promoter Capelli listed on NYSE Euronext C Paris, which raised EUR9.4m and EUR11.7m respectively. The IBO market is squarely aimed at smaller companies. Minimum issues are EUR5m on Alternext and EUR10m on NYSE Euronext. There is a concerted attempt to keep costs of issuance as low as possible by minimising disclosure requirements. There is also considerable flexibility in terms of covenants and maturities although the maturity date is expected to be between 5 and 10 years. A credit rating is mandatory when the market capitalisation of a company is below EUR100m.

Private placement (PP) market¹¹⁵

The French PP market, traditionally rather small, has grown significantly in the last year or two. Twenty-two companies arranged private placements in France in 2012 to raise EUR3bn. Société Générale expects the French private placement market to grow to EUR15-20bn per year in the near term and, to account for more than half of the total debt of unlisted mid-market companies. Until recently, most French PP s were very large companies. However, at the end of 2012 and in the first half of 2013, the market became more active for larger mid-market companies, opening with the inaugural EUR145m 6.5-year Bonduelle transaction in September 2012. Market observers see this deal as a watershed event in the French PP market. Since then there have been in excess of 30 deals. Issuance has ranged between EUR10m and EUR500m with the majority of these deals below EUR100m.

French insurers, looking for yield and diversification, have led the recent rapid development of the PP market for mid-market companies in France over the past year or two. These are most notably Federis (the asset manager of a large mutual insurer) and Crédit Agricole

¹¹⁴ Source: TheCityUK, 2013.

¹¹⁵ Source: TheCityUK, 2013.

Assurances. Crédit Agricole Assurances has invested EUR 1.5bn in the mid-market private placement market in 2012. Federis' first fund of EUR 288m was dedicated to private placements for French mid-market companies and has taken part in more than 15 private placement transactions. The rapid success of this first fund has led to the creation of a second fund of EUR330m dedicated again to French mid-market companies.

While still small the French PP market is in a state of very rapid development.

Germany

BondM: Mid Cap Bond segment¹¹⁶

In light of tighter banking regulations in the form of Basel III, SME-bonds (Mittelstandsbonds) have emerged as an alternative financing option to the traditional bank loan in recent years. New platforms at several German exchanges have been established to cater to the SME-segment. In 2009 there were six issuances with a total issuing volume of EUR225m. For 2012, that figure increased to EUR 2.15bn spread across 53 issuances. Despite the growing popularity of German Mittelstandsbonds, there have been signs of weak credit quality. A series of defaults, in particular among renewable energy companies, raised concerns over transparency, accounting and rating standards. Since 2009, only 84 of the 185 issuances have received a rating and reportedly 65% of all rated issuances between 2011 and 2012 were downgraded. The leading SME-bond exchanges in Frankfurt, Stuttgart and Düsseldorf have since made efforts to increase transparency and minimum reporting requirements for issuers. In Stuttgart for example, a proprietary risk classification has been introduced in an attempt to provide institutional and retail investors with comparable and standardised risk profiles for enterprise bond issuers. Regardless of early teething problems, the SME bond market in 2013 has seen 34 issuances raising a total of EUR1.37bn.

Private placement (PP) market¹¹⁷

The German Schuldschein market is a PP market. Although it is primarily used by German public institutions it is also used by German Mittelstand (and larger) companies to get financing direct from institutional investors. In 2012, company financing in this market amounted to more than EUR13bn. It has grown strongly over the past few years, with an increase of 67% between 2011 and 2012. Certain large German insurers we interviewed said they were looking to increase their direct lending activity in the Schuldschein market and, indeed, in other European private placement markets such as France.

Characteristics of the market include: the corporate market started 20 years ago; absence of a rating requirement; presence of buy and hold investors, predominantly German insurance companies, investment funds, and banks; use of light and standardised documentation governed by German civil law ("Bürgerliches Gesetzbuch"); and, typical issue sizes of between EUR50m-500m (with a EUR 20m minimum) and maturity predominantly in the 7 to 15 year range. These issue sizes once again indicate that this is a market for mid-market companies and above. Another feature of Schuldschein that increases its appeal is a favourable accounting treatment: plain vanilla loans do not have to be marked-to-market. They are also eligible for use as ECB collateral since 2007. A distinctive characteristic of this market is its dependence on German law. Schuldschein documentation is minimal because

¹¹⁶ Source: Fitch (2013e,f)

¹¹⁷ Source: TheCityUK, 2013.

many of the normally necessary legal/contractual provisions do not need to be in the documentation because they are simply part of the German Civil Code. The *Schuldschein* market has in recent times attracted a number of non-German borrowers who now account for 36% of issuance. Recent placements by foreign companies include Pirelli and Moulinex.

Italy

Mini Bond Market¹¹⁸

Background

Law 134/2012 (“Minibond Law”) was issued with the aim of (i) expanding the means of financing available to Italian non-listed corporations as alternative to banking financing, and (ii) creating new investment opportunities for banks and other institutional investors, including those of foreign nationality, by means of increasing the competitiveness of the Italian corporate system and bringing it into line with other European jurisdictions.

According to Minibond Law, short/medium term ordinary and convertible bonds (“minibonds”) may be issued by unlisted SMEs, with the exception of micro enterprises.¹¹⁹

Specifically, the Minibond Law provides for:

- a. The non-applicability of the previous issuance limits (i.e. total bond issuance not higher than twice the issuer’s equity), to the extent the bonds are listed;
- b. The applicability of the same tax regime as for bonds issued by listed companies, under certain conditions. Specifically:
 - I. Interests paid on the minibond are fully deductible from the issuer’s tax return if the minibond is (i) listed or (ii) unlisted but held by qualified investors with less than 2% stake in the issuer’s capital and resident in Italy or “white list” countries;
 - II. Interests paid on the minibond are not subject to withholding tax if the minibond is (i) listed and (ii) held by qualified investors resident in Italy or “white list” countries.

Minibond issues may also benefit from the guarantee for internationalisation of SMEs provided by SACE (up to 70% of principal) to the extent the investment is approved by SACE for program compliance and credit risk and complies also with the following requirements:

- Issuer’s turnover of EUR 250 M or less
- Minimum of 10% issuer’s turnover related to export
- Internationalisation project to be financed with the minibond issue
- Guarantee premiums will vary depending on issuer’s credit profile.

Market potential

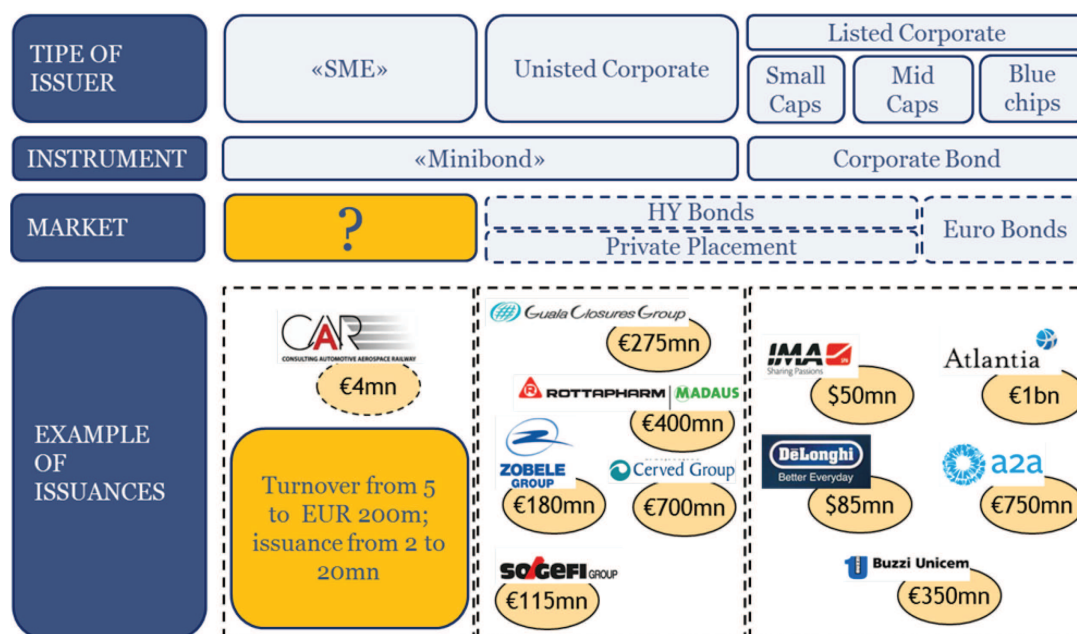
Market potential for Italian SMEs: EUR50 to 100 bn per annum

¹¹⁸ Source: EIF internal analysis / F. Battazzi.

¹¹⁹ Enterprises with less than 10 employees and annual turnover (or total assets) not higher than € 2m.

(<http://www.ilsole24ore.com/art/notizie/2013-08-11/minibond-mercato-miliardi-082202.shtml?uuid=AbwUGEMI>).

FIGURE 4.3.3: MARKET POTENTIAL FOR THE "MINIBOND" MARKET



Further considerations¹²⁰

With the aim of (i) expanding the means of financing available to mid-sized enterprises and small mid-caps as a complement to banking financing, and (ii) creating new investment opportunities for debt capital market investors, Member States are encouraged to review the experience in other countries concerning mini-bonds (for example in Germany and Italy).

"Mini bonds" were introduced in Italy to allow issuance of short/medium term ordinary and convertible bonds by unlisted mid-sized SMEs and small mid-caps. Although the issuer is unlisted, the mini-bonds are eligible for listing and subject to the same tax regime of bonds issued by listed companies.

Credit risk mitigation: given the unsecured nature of mini-bonds, guarantee schemes represent a highly effective way of mitigating the credit risk profile and reducing the interest rate of mini-bonds, therefore potentially broadening both demand and supply. For example, in Italy, mini-bond issues may benefit from a guarantee provided by SACE (up to 70% of principal) to the extent the mini-bond is issued to finance an internationalization project.

Spain

¹²⁰ Extract from High Level Expert Group (2013).

Bond market for small businesses

The newly formed SME bond exchange in Madrid set the minimum investment at EUR 100,000. At this level, retail investors are excluded, even though they are viewed as critical to the success of other vibrant SME bond markets. At the same time, the Madrid investment level remains far below the threshold for interest by institutional investors (IIF, 2013).

Spain's stock-market operator launched on 07 October 2013 a corporate-bond exchange for small and mid-size companies, the first of its kind in the country, to give them a way to get financing at a time when bank loans are scarce.

The Fixed-Income Alternative Market will have a EUR 3bn government credit facility to start the lending. The launch by Bolsas y Mercados Españoles SA came after official data showed last week that credit to Spanish companies and households had dropped to its lowest level since the country's real estate boom collapsed five years ago.

To issue debt via the new exchange, companies need to meet a set of criteria, notably they must have a credit rating, present audited financial reports for the previous two years, and promise to report relevant information to investors via public filings.

Analysts say mid-size Spanish exporters are likely to benefit from the new exchange, in light of the country's solid export performance in recent years. On the other hand, companies with less than EUR50-million-worth of annual sales are unlikely to benefit.

A previous attempt to widen corporate financing, through an exchange in which small companies and startups issue stock, fell short of expectations. The first listing was in 2009, the worst year of Spain's property bust and a time of significant capital flight; since then the exchange has raised just EUR 160m for the firms, some of which are now in bankruptcy proceedings.

The new exchange is being launched at a more propitious time. Financial pressure on Spain has eased in the year since the European Central Bank pledged large-scale bond buying to spare struggling euro-zone economies from default. That backstop has helped reduce the interest-rate risk premium demanded by investors for buying Spanish bonds by more than half. Last week the government issued 10-year bonds at the lowest yield seen since September 2010.

UK

Funding for Lending Scheme (FLS)¹²¹

In the UK FLS (since August 2012) 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); originally it was foreseen to stop the scheme in January 2014 but recently the Bank of England and HM Treasury announced an extension until end of January 2015. The scheme will now also be extended to non-bank lenders like financial leasing, factoring and mortgage and housing credit corporations, which were originally excluded from the scheme. Moreover, SME lending

¹²¹ Source: (Kraemer-Eis, Passaris and Tappi, 2013).

is further incentivised, with a higher multiple being included for SME lending. It can be expected that the FLS will keep the UK securitisation issuance on lower levels.

*Crowd funding*¹²²

Crowd funding, where the return to investment often consists of a copy of the finished product, is popular mostly for creative endeavours such as films, music, or games. This form of financing is thus not suitable for most SMEs.

Crowd investing usually collects some form of equity that remains in the company for a number of years (5-7) before it can be withdrawn again. It thus could be a useful funding vehicle for start-ups and SMEs in early stages of growth. So far, the German crowd investing market is quite small, but growing. While in 2012, EUR 4.3 m were raised via crowd investing for 45 start-ups, in the first half of 2013 the volume has already reached EUR 5.2m distributed to 80 companies. Currently, there are 13 platforms active in the market.

There are risks to the investors which will likely keep this method of financing a niche market: problems with effective screening of projects, adverse selection of projects and moral hazard. Regulating the market to limit these problems and introduce some measure of investor protection would probably eliminate the cost advantage of this form of funding vis-à-vis more traditional formats.

*Retail bonds*¹²³

Retail bonds are yet another way in which companies can raise debt finance without resorting to bank borrowing. In the past several years retail bond venues have appeared in Germany, France, and the UK. The German and French markets have been conceived from the outset as a means for mid-market companies and SMEs to raise debt finance. Results are mixed. The amounts raised in France so far are minimal. The German case demonstrates some success in raising significant amounts of new funds but concerns have been raised by a number of parties as to the quality and safety of the market.

*Equity markets*¹²⁴

A lack of equity or lack of ambition on the part of founders mean that many European SMEs do not grow to their full potential, nor they sell out in a trade sale (perhaps at the end of their VC investment period). It is crucial for Europe to develop channels for companies to IPO their business to continue to grow, creating an exit option for venture capitalists (roughly half the IPOs at the Neuer Markt had a venture capital market background). Such a move can also create a heightened public profile, stemming from increased press coverage and analysts' reports, helping to maintain liquidity in the company's shares, enhance the company's status with customers and suppliers and help diversify and reduce the cost of borrowings.

Establishment of stock market segments targeted at SMEs is one option for the development of European financial markets and has the potential to strengthen the provision of long-term financing instruments.

Smaller Equity exchanges and markets are currently most beneficial to the largest SMEs. There is scope for the exchanges to reach many more SMEs including all but the smallest

¹²² Source: High Level Working Group to the EFC (2013b).

¹²³ Source: TheCityUK, 2013.

¹²⁴ Source: High Level Working Group to the EFC (2013b).

categories but it is acknowledged that direct benefit is likely to accrue to medium sized enterprises or larger small enterprises that are expanding. There is of course the potential for indirect benefits to accrue across all SMEs as other funding sources are freed up.

4.3.3.3 Conclusion

In many countries policies and initiatives exist to diversify the range of funding options for SMEs. Some are new, some are more successful, some are less successful. In general, the diversification of funding options is desirable, but due to various reasons (e.g. bond issuance only attractive for “big” SMEs or rather mid-caps), these options will only be able to complement (not replace) the traditional bank financing. SMEs will also after the crisis be reliant on bank financing. Hence, the SME initiative constitutes a complementary solution with the aim to diversify the funding sources.

This was also underlined by the HLEG which states (HLEG, 2013, p. 23): *“The HLEG does not consider that for SME financing capital markets can replace bank finance in Europe. As a consequence, completion of the implementation of a fully functioning banking union should remain the number one priority. (...). In the SME domain, the role of capital market must nonetheless be seen as complementary rather than exclusive.(...)”*

4.3.4 EIB Intermediated SME Lending¹²⁵

EIB's intermediated SME lending has a broad scope and, apart from a series of exclusion criteria, does generally not focus on specific types of SMEs in terms of size, sector or risk profile.

4.3.4.1 Existing SME lending activities

In this area, since 2005, the EIB signed EUR 64 billion in loans to around 370 financial intermediaries within the EU27 by end 2012. Out of this amount, EUR 53 billion was disbursed to those financial intermediaries, which in turn had on-lent nearly EUR 48 billion to SMEs through around 300 000 sub-loans.

In these operations, the EIB does not share SME risk; it promotes on-lending via financial intermediaries at relatively longer tenors. In this context, the loan product (“L4SMEs”) offered under this programme generally provides for limited leverage potential which might be possibly better achieved through higher risk products such as for example risk-sharing instruments.

Moreover, as the financial intermediaries prefer to have little or no losses on the EIB portfolio for reasons of reputational risk, they prefer to choose comparatively larger and less risky SMEs to be financed under the EIB loan in comparison to their overall eligible SME portfolios. Thus, the latest evaluation suggests that *“EIB funding appears rather in most cases not “gap funding” but rather used to support SME “champions”*.

The SME initiative appears complementary to the existing EIB-Intermediated SME lending as it targets the identified financing gaps more rigorously but only in the participating Member States and is likely to achieve higher leverage effects due to its underlying risk-sharing

¹²⁵ Ex-post evaluation of EIB Intermediated lending to SMEs in the EU 2005-2012, by EIB.

structure established between the EIB/EIF, Commission, and Member States' contributions via ESIF funds.

4.3.4.2 Planned SME lending activities

According to the revised EIB Operational Plan 2014-2016 which is currently being submitted for the second reading to the EIB Board, for the next 3 years the Bank foresees to provide direct and indirect financial support to SMEs, in the form of loans to partner financial institutions for on-lending to SMEs amounting to EUR 18bn on average per year. In 2013, the revised EIB lending target for SMEs in the EU and Candidate and Potential Candidate countries amounts to EUR 17bn, up from a EUR 12bn target for 2012.

It is to be noted that the EIB Operational Plan is generally drafted on a 3 year rolling basis and is revised each year at Mid-term and before the year end.

The SME initiative is set to be complementary to the planned EIB-Intermediated SME lending as it intends to address specifically the financing gaps identified in this ex-ante in the participating Member States, and may also contribute, through SME loan securitisation, to addressing market fragmentation both in the sector of SME financing, and more generally in corporate financing.

4.3.5 EIB Group ABS Initiative for SMEs

Integrated EU capital markets (and their need for transparency and standardisation) and the relative complexity of the securitisation techniques require considerable know-how and show the necessity for specialised institutions. As an established and respected player in the European market, the EIF can play a role via market presence, reputation building, and signalling. It typically provides guarantees on mezzanine or junior AAA *tranches*, but can also act as guarantor for senior *tranches* of SME securitisation for funding driven transactions.

The respective *tranches* are enhanced with the EIF's AAA/Aaa rating and investors in the guaranteed *tranches* can benefit from EIF's risk weighting of 0% (MDB status/AAA rating). EIF charges a risk premium for its guarantees. In addition to the direct benefits of its guarantees, other factors of EIF's involvement can play an important role in facilitating the execution of a securitisation transaction:

- EIF's involvement can facilitate placement of *tranches* with investors. From the originator's point of view, EIF reduces uncertainty and supports the marketing of a deal through its "anchor" investor status.
- Guaranteeing e.g. a junior AAA *tranche* can also provide additional rating stability and shorter weighted average life to senior *tranches*, thus reducing their risk, which in turn should attract additional investors.
- Smaller banks profit from EIF's experience and knowledge of the SME securitisation process (support and spread of best market practise). Usually, EIF is involved very early in the transaction and can assist the originator.
- The EIF facilitates (on average) overall lower transaction costs.

- EIF acts in the “traditional” securitisation markets and with “traditional” key players, but expands the idea of SME securitisation into non-core market countries (e.g. Central and Eastern Europe), and to new originators.
- In general, EIF facilitates standardisation, improves transparency, and spreads of best securitisation market practise.

The *EIB Group ABS initiative for SMEs* has the objective to restart the SME securitisation market. It is an initiative by the EIB Group (EIB and EIF) to increase its involvement in ABS, combining EIB purchases of senior *tranches* of SME-backed ABS notes with EIF guarantees for other *tranches* of the same ABS, making them more attractive to market purchasers. This facility for SMEs will enhance EIB Group’s external effectiveness in the priority area of SME lending and better use complementarities of EIB and EIF in the ABS domain. EIB Group’s involvement is expected to encourage originators to initiate the launching of further new ABS transactions by facilitating deal execution through increased underwriting capacity and provision of credit enhancement to third party investors. It is foreseen that this initiative will be partially combined with the EU SME Initiative, so that the two instruments can operate in synergy and achieve economies of scale.

4.3.6 Consistency with other sources of financing

4.3.6.1 Leasing and factoring

An important element of SME finance is not directly provided by banks but rather by leasing or factoring companies. Various surveys on access to finance show that bank loans and overdrafts are the most widespread debt financing methods for SMEs, but that alternative sources like leasing and factoring have been growing in importance (see e.g. ECB, 2007). In a recent ECB survey, 30% of SME respondents mentioned leasing, factoring or hire-purchasing as one of their sources of financing.¹²⁶

In the past – sometimes used for tax reasons – leasing had become for many the main financing source for small to medium size investment in IT equipment, cars, and trucks. In many countries, leasing is used particularly by fast-growing SMEs, especially by those in Belgium, Finland, Ireland and Spain (Ayadi, 2009). Leasing and trade receivables have been used widely as collateral in securitisations pre-crisis, often through Asset-Backed Commercial Paper programs (ABCP).

Independent leasing and factoring companies have previously depended on bank finance (often secured) but availability of this finance has been *reduced* during the crisis. Main reasons are capital constraints, liquidity issues and operational risks in smaller leasing companies, which in total have led to lower availability of financing for leasing companies and in any case to significantly higher refinancing costs.

In this context, SME securitisation envisaged under the Initiative can effectively provide an additional important funding source also for these non-bank finance providers.¹²⁷

¹²⁶ ECB (2013c).

¹²⁷ European Investment Fund (2013).

4.3.6.2 Alternative financing sources

Alternative financing sources, such as venture capital, mezzanine or crowd-funding, are also important but they are not in a position to replace bank financing. Thus, the effect of the proposed SME Initiative on these sources of finance is likely to be rather negligible.

4.3.7 Proportionality of the envisaged Initiative to the size of the identified financing gap and critical mass of EU level contribution necessary for the initiative

4.3.7.1 Analysis of the prospective market demand for each product¹²⁸

A. General remarks

Market participants in the HLG and stakeholders consulted by the experts express a strong interest in a European financing initiative as it promises to overcome the limitations linked to national programmes, such as different (and unequal) structures, policies and availability (*i.e.* some jurisdictions do not have a framework) for SME finance across Member States.

From a capital markets perspective, local programs are likely to attract a smaller group of mainly regional investors, rather than an international investor base. By contrast, a Europe-wide program, even if structured in line with local/national law/credit analysis for the purposes of securitising the assets (*i.e.* true sale, risk reserves, etc.) will be more likely to attract an international investor base than a number of domestic programs for following reasons:

- i. investors in a larger European structure will believe that the credit analysis they perform on the structure will be relevant for a larger number of future deals than a local platform could provide;
- ii. there will be greater liquidity in a program offered to an international investor base, rather than a program with a more regional investor grasp; and
- iii. the proposed securitisation structures are based on a single European standard, which investors will value, rather than requiring investors to look at a series of domestic funding structures.

The main difference between the options described in the joint Commission-EIB paper, are between the guarantee option on the one hand (that could be characterised as a guarantee scheme without funding and focusing on new loans only) and the securitisation portions on the other hand (that could be characterised as a mezzanine *tranche* subscription scheme focusing on old and new loans and overall the possibility for some part of the capital structure - senior, mezzanine - to be sold to investors).

B. Originator perspective

It is worth recalling that under the guarantee option, without any combination with securitisation, originator could only benefit from the regulatory capital impact of the guarantee. In this context, it is likely that banks having greater difficulties to fund themselves will be less attracted by the proposed guarantee scheme even though they could still benefit from the liquidity provided by the Eurosystem. It is expected to find in this category of potentially less interested institutions some small/poorly rated institutions from across Europe

¹²⁸ The following is based in part on the conclusions of High Level Working Group to the EFC (2013b).

and even some well-established institutions from peripheral countries. Conversely, large/better rated institutions could be interested in a scheme that would allow them to optimize their regulatory capital consumption. Securitisation could attract interest from both type of institutions due to the potential to combine regulatory optimization and enhanced access to funding (outside of the Eurosystem).

In terms of practicality, it would seem easier to start and establish the credibility of a program with a handful of national champions in each country and to then let the number of participant expand naturally. This process is also the one most likely to meet investors' interest.

There is confidence that there is investor demand for SME ABS in core countries, but that the price of such transactions would be relatively high versus other forms of funding available to banks in those Member States in the absence of pricing benefits arising from this initiative. Therefore, it would be useful to motivate originators to be involved by providing, for example, regulatory benefits for originators to be involved. For example, if the originator is provided more cost-effective capital relief by using the securitisation versus the guarantee option, this would help to develop the SME ABS investor base.

Development of the investor base may initially be focused on core markets, but it will benefit peripheral markets as well by providing a relative pricing point.¹²⁹ The more participation in the program, the better the eventual pricing of the SME ABS notes will be as the asset class will be more common, transparent and liquid.

On the demand side, it will be important for the program's success to

- i. remove the regulatory constraints making it difficult for a wide range of investors to participate in the ABS market (i.e. Basel consultation paper increasing RWAs on securitization, Solvency II punitive treatment of ABS held by insurance companies) and;
- ii. promote the involvement of investors, even if just temporarily, by giving positive regulatory benefit to European banks buying SME ABS. For example, if the Liquidity Cover Requirement for European banks were to include high quality SME ABS, as the largest investor base for European ABS is European banks, this could have a significant impact on demand for the notes issued under the program, resulting in stronger demand in primary and secondary distribution of the senior notes and reduced cost of funding, creating additional motivation on the supply side for originating banks.

Smaller banks generally do not use the securitisation market. This is because they are less likely to have large enough SME loan portfolios to justify the work involved internally in developing securitization IT systems (i.e. which “tag” the securitized position for cash flow allocation, which provide historical loss and other performance data) and the high cost of a securitization (ratings, legal, etc.).

C. Catalytic effect

¹²⁹ For example, the existence of UK or Dutch RMBS is beneficial for investors looking at Italian RMBS, as the investor is able to benchmark expected market spreads versus the other markets.

There is a strong positive feeling about the SME risk and the added value of a European solution. European involvement is seen as paramount to restart the securitisation market as:

- i. domestic solutions cannot overcome investors' reluctance to invest as the bias is largely linked to the sovereign context;
- ii. the involvement can take the form of a guarantee (preferred in certain cases) or mezzanine subscription but in both cases the political significance of the involvement is as important as the amount/shape of the support at stake;
- iii. at the same time, non-peripheral countries related transaction could be facilitated (in particular for small enterprise financing). The EIB/EIF involvement could be a catalyst in terms of standardization that would help to create a broader and more liquid market across Europe;
- iv. subscription of mezzanine *tranches* by EIB/EIF is seen as an important feature provided some costs benefit induced by the capital relief (factoring EIB/EIF costs) allow for an acceptable yield at the senior level.

Securitisation would result in new ABS supply and therefore would be a positive signal regarding the importance of the ABS market. The larger the SME finance programme becomes, the more liquid the SME ABS paper will be in secondary markets, helping boost investor demand for further SME ABS issuance – subject to supply/demand balance. The key driver of investor demand is not the chosen structure but the underlying assets. An SME ABS backed by a non-core country's SME loans will demand a very different yield to one backed by a core country's SME loans. It may not be recommended to mix SME loans from different countries, as investors will want to do their credit work on a specific portfolio and price accordingly.

The senior *tranche* distributed to investors in the securitization will remain the same in respect of size and credit risk in either of the securitisation options. Therefore, the involvement of capital markets investors should be neutral as to which of Option 2 or 3 is utilized. The difference in Option 3 is the extent to which the capital of the mezzanine risk provider can be further leveraged giving an overall greater size to the programme.

As a capital market investment, timing is a very sensitive point as the marketing process needs to be able to react to markets events. This requires all of the parties involved in a transaction to be able to finalise documentation/negotiations in an efficient manner. Streamlining the process of negotiation on the mezzanine and junior investments will be essential to support this process.

As explained above, Option 3 does not present any specificity for investors or originators and both are agnostic / insensitive to the way EIB/EIF manage their exposure and build/optimize their “counter-guarantee” mechanism. That is to say as long as:

- For the investors / the originators, the support provided by EIB/EIF (guarantee or mezzanine subscription) remains straightforward and delinked from the counter-guarantee;
- For the originator, the origination process remains unaffected or undisturbed by the involvement of EIB/EIF counter-parties.

In a nutshell, as long as the risk is fronted by EIB/EIF and as long as those remain the interlocutors of the originator and the “prime” guarantor / credit enhancer for the originator or the investors, there will be no negative impact.

On a more general level, **the pooling under Option 3 would allow the EIB/EIF to better utilize public resources and it would also carry a positive political message about the European construction that would be captured by investors and originators alike and would contribute to the creation of a broader and more standardized market.** All the more so if, as proposed, EIB/EIF involvement assumes a minimum quality check of the transactions.

Where an originating bank concludes that either (i) there is no market demand or (ii) where market demand is at a price higher than the price of alternative financing (either markets based or central bank provided), that bank will not provide market investors a “look into” the ABS. The notes would be placed at the ECB instead, if structured into ABS. As mentioned already under section 4.2.3 the originators of a securitisation schema would also benefit from preferential funding costs passed-on by the EIB, which would be part of its cost benefit analysis.

Alternatively, as is more common today, banks would finance the assets directly via the ECB, without packaging these assets into securitisations. This is detrimental to the development of a market, as investors are not provided with public information regarding the portfolios and market pricing.

There is currently largest demand for German, UK, Nordic and Dutch asset backed notes. There is more limited demand for French and Italian asset backed notes, due to investor perceptions of higher credit risk on the underlying loan performance and also market factors like ratings volatility (due to the potential movement of the sovereign ceiling) and more limited market liquidity due to a smaller investor base.

D. Investor's appetite

Generally banks and money managers are the major investors in the European ABS market.

A number of investors are barred under their investment criteria from investing in ABS from peripheral jurisdictions – this is more often the case for money managers than for European banks. This is driven by investors’ concerns about the future of asset performance from peripheral jurisdictions, which they feed back to their money managers. This sensitivity is less common amongst bank investors due to the on-going relationships between banks in and outside of the peripheral jurisdictions.

In Europe, the ABS market relies on approximately 50 active investors, some being European accounts, some being US (by far the more important players) or Asian accounts (a growing role). Of these, around 50% are banks, 20% insurance companies and 30% fund managers.

Among this group of investors, some are focusing on senior exposure and will decide to invest in a given trade, even if supported by EIB/EIF (through a guarantee or the subscription of the mezzanine piece), on a relative value basis only. This group of investors (plus new entrants if the proper incentives are in place such as EIB/EIF involvement, proper regulatory

treatment –Solvency II, Basel III) could certainly provide for up to EUR 20 to 30bn of annual investment capacity but in the next year or so the demand is expected to be less as markets take time to develop confidence in a broader European SME ABS market.

Another category of investors (predominantly fund managers, hedge funds, private equity funds) would likely focus more on mezzanine *tranches* (i.e. to be clear their interest lies in the piece above the retention and below the senior, so more or less the *tranche* invested in by EIF/EIB). The interest for the junior piece has been evidenced in several transactions on SME portfolios driven by regulatory capital considerations with up to 20 participating investors. Their interest is not limited to non-peripheral portfolios, on the contrary. It is estimated that up to EUR 1bn p.a. could be raised for mezzanine *tranches*.

Money market investors have generally investment criteria that require minimum liquidity in notes that they purchase and "euro-bond" status. Bank investors are more flexible and are more likely to invest in size in a program structured as a standard "euro-bond" SME ABS. **The European ABS market is far more liquid due to larger investor involvement (European and non-European investors) than a number of domestic Member State markets. Therefore, accessing finance from the "euro-bond" investor base will provide a deeper, more highly tradable SME ABS market than a series of domestic programs.** The benefit of this wider investor base is that issuers have more certainty that funding can be raised against their SME loan book (where banks require such funding) even when local market conditions are negative and that the senior funding of the securitisation options will be cost effective versus the originator's other forms of funding.

Investor demand for synthetic ABS would be lower volume-wise by approximately a third, and come from a more select group of investors than cash ABS.

ECB eligibility and compliance with 122A (minimum retention and due diligence) is a key requirement for investors in Europe. ECB eligibility is important because it is perceived to provide back stop liquidity to investors in a market crunch. Similarly, ABS which does not comply with article 122A is perceived to not be liquid, as European banks would not buy such notes.

The main challenges are:

- i. The timing of the "take off". The EUR 30bn annual investment capacity would only be reached after 2/3 years, based on the success of well-designed initial trades (simple non-revolving transactions, sponsored by well-established institutions, a reasonable size between EUR 300 to 400 million and a tenor of between 3 to 5 years maximum to start with);
- ii. The economics of the transaction must make sense for the originators, EIB/EIF and the investors involved. The return targeted on mezzanine *tranches* ranges from 8 to 10% on non-peripheral countries (UK, Germany, France, etc.) to 12% and more for peripheral countries (Spain, Italy, Ireland, etc.) related transactions. On the senior side, the intervention of EIB/EIF and its benefits for the originators should allow to create some value in order to attract investors in senior *tranches*.¹³⁰ If securitisation

¹³⁰ Senior SME Spain 3y app. 300/325 bps, Italian Senior SME 2 y app 250 bp, UK Senior SME 3 y app 115 bps.

were to be further combined with a guarantee from EIB/EIF (but, to be clear, this is not the same as and must to be distinguished from the guarantee in option 1) expected pricing on the senior piece could be around EFSF benchmark plus a small premium.

Additional considerations

Liquidity: This is not an easily defined criterion. Deal size, number of book runners, probability of repeat issuance (or comparable issuance) are elements participating to the build-up of the liquidity. Whilst investors are not keen to see a TARP model build-up in Europe, eligibility to the Eurosystem/ECB repo is also an indicator that helps build the liquidity of a given product.

Rating: Unavoidable for many investors in particular due to the regulation itself, the lack of rating is for the time being a non-option.

Valuation / cash flow models: Investors expect to see more and more sponsoring / originating banks providing cash flow models and analysis allowing for the “valuation” of the underlying assets. It will not prevent investors to do their own analysis and modelling but starting from a common point delivered to all investors is a positive element and could play into the liquidity dimension as well. Information must be easily available (Bloomberg, ABSNet, etc.) and updated regularly.

Disclosure of credit enhancement mechanisms: With rating ceiling below AAA/Aaa applying more and more across Europe it is important for the investors to be made well aware of what a senior *tranche* means and what level of credit enhancement has been targeted.

Regulatory treatment: This remains a key criteria factored in the relative value calculation that drives the investment decision whatever the option faced. It has been argued that the relatively limited participation of insurance companies as investors in ABS transactions is driven by regulatory constraints as opposed to outright interest. Given the standardised set-up that is proposed, there may be a point for regulators to revisit constraints currently weighing on insurance companies when it comes to ABS investments.

E. Optimum structure and deal size

It is recommended to consider a minimum SME ABS deal size of EUR 250mm, with EUR 500mm+ to be considered a benchmark ABS transaction. Actual placed volumes of ABS (not just SME ABS) have been just EUR 43bn YTD and EUR 72bn in 2012 (Table 2 of the HLG Opinion citing EUR 238bn issuance in 2012 was predominantly retained by the issuers). The SME ABS market capacity is seen as up to EUR 5bn for the remainder of 2013, at EUR 5-15bn in 2014 and EUR 15-30bn in 2015. It is expected that 75% of this interest to be in core country SME ABS and 25% in non-core SME ABS. The pricing differential for core vs. non-core SME ABS could vary from 100-250bps differential, depending on the country and portfolio-specific credit characteristics.

There is a possibility for a market improvement due to i) the lower pricing, ii) the confidence/credential build-up of the “asset classes” and structure(s) with the benefit of some form of standardisation and quality stamping, iii) the possible boost provided by a wiser regulatory environment (regulatory capital as well as liquidity ratios treatment, for originators

as well as investors, iv) the macro environment (euro area stabilisation, growth, etc). However, it is difficult to quantify this increase. There is a preference for a widely placed capital markets transaction which would have strong secondary market trading and clear pricing points available to the market publicly. However, there is also a market for placement of notes with a small group of investors, which we generally call a “private placement” even though the notes are publicly marketed and pricing is publicly available. In such case, the deal size can be smaller (i.e. EUR 100mn) and is placed with a smaller group of buy and hold investors. In such a case, although the notes can technically trade in the secondary market, this is unlikely to happen as the investor base prefers to hold those notes until maturity.

It is expected that for the initial transactions under an European SME program a “private placement” to a group of supportive investors would be more likely and that smaller deal sizes would be appropriate (i.e. circa EUR 100mn senior notes, rated at the highest level possible in the market). This has generally been the case for transactions involving SME loan backed ABSs in the past 5 years in Europe and it is expected to continue to be the case until more market liquidity is available in SME ABSs.

F. Pricing

Initial pricing

Each individual bank will have alternative sources of funding which it will compare with the cost of funding under the securitisation options. Where those funding costs are lower than the combined benefit of funding and capital relief provided by the securitisation options, that bank will likely not use the SME financing program. Given the potential regulatory capital relief, it is not however just a matter of comparing funding costs, especially given capital constraints on many banks at present.

Table 4.3.1 shows an example of a UK, Dutch and Italian bank’s alternative costs of funding for comparison.

TABLE 4.3.1: COMPARISON OF ALTERNATIVE COSTS OF FUNDING

Entity	Senior Unsecured (5yr)	Covered Bonds (5-5.5yr)	FLS* (4yr)	ECB Repo (3mth)**	SME CLO; senior Tranche (3yr)***
Highly Rated UK Bank	88-94	26a	25-150		c.150
Investment Grade Dutch bank	80a	28a		50	c.150
Large Italian Bank	200-205	90a		50	180-200

All figures in basis points

Note: UK spreads over 3m£ Libor, Dutch/Spanish spreads over 3m Euribor and Italian spreads over 3m Mid-Swaps; unless otherwise stated

* Over Bank Base Rate

** Fixed rate

*** Over 3m Euribor/GBP Libor

In addition to the funding options above, originators will look at their current liquidity position through customer deposits to determine funding needs/overall cost of funds.

For banks in strong credit environments, the cost of SME ABSs is higher than other forms of finance for this asset class. They will, however, find the guarantee option to be effective to

strengthen their capital base. Therefore, these banks are less likely to use the securitisation options without an additional regulatory capital benefit.

However, peripheral banks are more likely to see benefit in using securitisation options on even just a cost of funds basis, as indicated for the Italian bank above, with the regulatory capital benefit being a significant added benefit.

Mezzanine pricing will vary significantly by credit and portfolio specific characteristics, given the increased risk the investor will take on. For strong credit quality environments: AAA SME ABS pricing is currently in low-mid 100s over Euribor. SME ABS mezzanine risk is currently in high 200s/low 300s (AA-rated risk) and mid 400s (A-rated risk) over Euribor.

Evolution of pricing

It is expected that the price will tighten as transactions become more common, product is standardized, credibility and track record build-up. As programme issuance grows and liquidity improves, one could expect pricing of senior *tranches* to tighten (as evidenced in the re-opening of the core RMBS and leveraged loan CLO markets – where spreads converged by over 100bps over two years). However, due to the nature of the underlying SME collateral we would not expect ‘convergence to the risk free rate’. One should not expect SME ABS pricing tighter than RMBS (given associated property security), which is currently at +50-100 over Euribor for core and +250-400 over Euribor for non-core RMBS, providing a floor for senior SME ABS pricing. There is little doubt that there is room for improvement on the basis of the first indications and benchmarks.

G. Other considerations

Data

Data provision on SME loans has been a key issue across jurisdictions. Detailed borrower data (e.g. SME business description, financials/turnover, number of employees, locations), loan key terms (details of any security, financial covenants, any restrictions on transfer), credit quality (bank internal rating, bank LGD estimate, date of last review, historical performance/arrears data) where available, would be required for assessment by rating agencies and investors.

Investors will want to see detailed loan level data to enable their credit analysis, therefore data transparency is considered as very important. Historical data on SME portfolio-wide performance/losses are key differentiators. Investors will also want a thorough understanding of loan servicing procedures – which vary significantly by jurisdiction.

Transparency and availability of information: as with any rare asset class in the capital markets, investor appetite grows as the asset class performs and trades, giving price, market liquidity and credit performance indicators to investors. **A European structure which focuses on disclosing the performance of SME loans in different countries will provide investors with an asset class that the investors have had limited exposure to in the past. As more deals are promoted through the European platform, investor knowledge will grow through access to the credit performance and primary issuance and secondary trading prices of the bonds.**

In this context, European Data Warehouse and PCS are seen as positive steps towards an attempt to standardize and make more accessible the information investors will require.

Leasing

SME lending should also include financing for leases from European banks (even if captive finance companies of corporates) as a number of SMEs finance large assets necessary for their operations through leasing and there is a developed leasing ABS market in Europe.

Deployment

While there has been some strong evidence of market interest in size for EIB/EIF supported transaction recently (albeit not for a SME portfolio), the first trades should reach EUR 300 - 400mn. This would be large enough to test the market and create some liquidity but not too big as to risk a failure. It is also a size that would allow originators to ensure an acceptable “churning rate” of their portfolio. One should also bear in mind that the first trade(s) will set the standard.

4.3.7.2 Market testing by EIF

A. Scope – Market Points of Contact

In order to obtain feedback from market participants on the SME financing options currently being contemplated, a market testing discussion document was created and sent to a selected group of banks across a number of EU countries.

The market testing document was designed to address issues pertaining to both Option 1 (a proposed guarantee instrument for new SME loans/leases) and Option 2 (a securitisation instrument allowing for the securitisation – either in a “true sale” or a “synthetic” form – of existing and new SME loans/leases).

The selected participating banks were split into two categories namely: (i) Arrangers and (ii) Originators of SME securitisation transactions, with the understanding that in most cases the contacted financial institution would be acting in both capacities (although through separate areas in the organisation) in at least one of the EU Member States. The contact of financial institutions in both an arranging and originating capacity was made in order to gain as best an overall market perspective as possible.

A total of 12 banks were selected under the banner of “Arrangers” based on our knowledge of the level of activity that those institutions have shown over the years, as active participants in the various forms of providing financing to SMEs (directly or indirectly).

In addition, the market testing document was sent to a total of 29 banks across 12 EU Member States. The chosen banks were identified as the most active originators of direct forms of financing to SMEs in their respective country of operation. The choice of countries was made considering the level of SME financing activity (through guarantees and securitisation) observed over the years.

Due to time constraints for the inclusion of the market testing results in the Exante Assessment document, a tight deadline, being the end of October 2013, was imposed for the delivery of the completed reports. This unfortunately impacted the number of responses that we received by the cut-off date.

Specifically, out the 12 Arranger banks contacted feedback was received from 8 of them; and out of the 29 Originator banks contacted, from 9. It's also worth highlighting the fact that we did not have a representative response from all of the countries included in our sample.

B. Contents

The document was split into four distinct sections; with each one looking to address a number of areas related to the proposed financing options.

Section 1 addressed general points for the financial institutions in connection to their lending attitude towards SMEs, as well as their broad view as regards the overall benefit that they may perceive through the application of the proposed initiative. Section 2 looked to elicit views from the participants in relation to the proposed general features of the financing structures in question (Option 1 & Option 2), while Section 3 addressed the proposed portfolio eligibility criteria for both Option 1 and Option 2 and sought the views of the market participants on them. Finally the last section, addressed features in connection to additionality under the initiative.

C. Result Aggregation

Due to the limited number of completed responses received, we must point out that the results obtained cannot be seen as providing a complete and detailed view of the potential participants under the SME Initiative. Therefore, it should not be assumed that numerical estimates or perspectives provided reflect the interests of all arrangers and originators in the European market.

For ease of reference, we have aggregated the received responses as a commentary beneath each one of the questions asked for all the sections in the market testing document. Moreover, at the beginning of each section, we have also provided a summary view that looks to distil themes/trends, etc. that we saw emerging across all the answers received.

Box 4.3.2: SECTION 1: GENERAL POINTS

Based on the responses received, there was broad agreement between both Originators and Arrangers that economic and regulatory capital constraints, credit risk considerations and SME demand were among the main challenges hampering more lending towards SMEs.

On the opposite end, respondents suggested that cheaper and easier access to capital and more SME demand would allow them to increase their lending volumes to SMEs. Interestingly, a number of survey participants also felt that initiatives such as the one proposed, will also be helpful.

In particular everyone agreed that, if attractively priced, the guarantee option will be very helpful in driving demand higher, although they refrained from providing us with specific ranges of the anticipated increase. In relation to potential overlap of the guarantee scheme under Option 1 with existing national and EU schemes, there was a mixture of responses as to whether such overlap was going to be an issue or not, or in fact as to whether there was to be an overlap in the first place. It appears that this is very much driven by the specific country's support framework.

When the above point was addressed in connection to Option 2, the broad consensus was again that this proposed financing method will also be helpful towards the increase of volume activity, in particular since a number of participants felt that the ability to securitise existing SME loan portfolios will lead to a faster release of capital that could then be deployed towards new SME lending. Respondents, mainly from the Arrangers group, were favourably disposed for both a true sale as well as synthetic forms of securitisation mentioning pros and cons for both alternatives. However, most respondents commented on the regulatory environment and the challenges that the current proposed changes may have on the successful uptake of such initiatives and also of the fact that these structures may not be acceptable in certain jurisdictions.

1. Are your (or your bank clients') current lending/leasing activities constrained by one or more of the following factors?

- A. (a) liquidity
- B. (b) economic/regulatory capital
- C. (c) credit risk considerations
- D. (d) SME demand
- E. (e) margins
- F. (f) other (please specify)

Arrangers: The largest constraints to leasing and lending activities for arrangers deal with (b) economic/regulatory capital, (c) credit risk considerations, and (d) SME demand. Other issues include uncertainty and change surrounding the economic environment in Europe, which is tied to the lack of an effectively functioning securitisation market.

Originators: The constraints of (b) economic/regulatory capital, (c) credit risk considerations, and (d) SME demand apply to originators as well, with originators also being concerned with (e) margins, collateral, and lack of long-term sources of low-cost funding.

2. What would be your (or your bank clients') main driver(s) to increase lending volumes to SMEs?

Arrangers: The main drivers include lenders having cheaper and easier access to capital, protection against credit risk, more SME demand, capital targeting SME financing, and a well-functioning securitisation market.

Originators: Some of the limiting factors mentioned to increasing SME lending were credit risk, economic and market recovery, as well as the cost of funding. In addition some respondents added that the above mentioned factors can be offset by loan and risk-sharing schemes such as guarantees and other initiatives.

3. Assuming that the loan guarantee price is set at an attractive level, do you believe that the proposed guarantee structure (Option 1) help to increase lending volumes to the targeted SMEs, and what do you think the magnitude of the increase would be?

Arrangers: The majority of responses commented that if set at an attractive price, loan volumes will increase significantly under Option 1. However, most responses were not specific in providing an estimate to the magnitude of the impact.

Originators: Broadly speaking the respondents agreed that this guarantee structure would help banks increase lending volumes to targeted SMEs. Once again, participants were not willing to commit into specific volumes, stating a variety of factors that would influence that, such as SME demand for credit and cost of funds.

4. Would you see a potential overlap or complementarity of the proposed guarantee facility (Option 1) with existing EU or national guarantee schemes?

Arrangers: Responses were mixed, with some indicating that overlap would not be an issue, while others expressed the possibility of some overlap being anticipated. For e.g. anecdotally in the UK, comments were made that under certain conditions there could be a potential overlap with the Enterprise Finance Guarantee scheme offered by the Department for Business Innovation & Skills, although only for loans with insufficient security or proven record. Moreover the Funding for Lending Scheme was also mentioned as a scheme for a potential overlap.

Originators: We did not have sufficient responses to draw any definitive conclusions; Once again anecdotally the Italian Fondo Centrale di Garanzia, the French OSEO guarantee scheme and a Belgium guarantee scheme were mentioned as potential overlaps

5. Would the proposed securitisation structure (Option 2) help to increase new lending volumes to SMEs, and what do you think the magnitude of the increase would be?

Arrangers: Again, it was very difficult to draw any conclusions or get an estimate of the magnitude of increase. Some arrangers mentioned that Option 2 will very much help increase new lending, and could potentially increase funding as well and also that Option 2 could be more practical than Option 1 in that there is no need to individually approve loans.

Originators: Most respondents agreed with the suggested question and commented that the proposed structure under Option 2, would increase lending but under specific conditions. A very wide range of increases was offered though, and varied between €20m to €1bn.

6. With regard to Option 2, what would be for you the possible advantages and disadvantages of securitisation, respectively (and why)? Please also consider potential investor appetite.

Arrangers:

True Sale Transaction Pros: The investor base is wider for synthetic transactions rather than true sale transactions, although there appears to be market appetite for both. In addition, the suggestion was made that it may provide favourable funding levels independent to an originators' rating. It could also lead to an improved balance sheet position.

True Sale Transaction Cons: Some commentators argued that junior *tranches* may not be as economic for funding. They have also referred to more restrictions and difficulties with revolving loans and allocation of securities that require a larger credit enhancement for

senior notes. Furthermore, portfolio transfer is necessary, which could be difficult in non-standard jurisdictions. Other issues included refinancing risk, and cumbersomeness from the perspective of documentation and data extraction.

Synthetic Transaction Pros: Most respondents commented that they view this transaction as less complex than a true sale one. This was found to be beneficial where true sale transactions are going to be difficult to implement and execute, like in Turkey. It was also mentioned that this could be a cheaper structure because it does not require an SPV. Finally comments also referred to the fact that refinancing risk is also mitigated.

Synthetic Transaction Cons: Ineligibility of this type of transactions in some jurisdictions was suggested as a potential drawback. Some comments also mentioned the fact that such a deal does not involve raising funds, and that the counterparty risk still remains with investors.

Originators: Responses here did not distinguish between cash and synthetic transactions.

Pros: The main advantages mentioned were funding, capital relief, and restoration of the ABS market.

Cons: The main disadvantages involved potential difficulty in getting investors to take on SME risk, which may require high spreads and challenges dealing with unfavourable regulatory environments.

7. What are in your view the main advantages and disadvantages of each instrument (Option 1 and Option 2)?

Arrangers:

Option 1 Pros: Among the comments received, participants mentioned that it provides direct capital relief, it's easier to implement, there is easy regulatory treatment, and supports the SME market. There was also reference to that fact that it is also useful for banks that want to scale up a portfolio but are challenged by capital. Other benefits mentioned were risk transfer and economic regulatory capital efficiency and capital relief.

Option 1 Cons: Participants commented to the fact that this option, requires on going reporting and monitoring, and needs time to get credit approval. Furthermore, the fact that it is only for new loans could end up being restrictive.

Option 2 Pros: This method was seen as more practical because there is no need to sign guarantees for each loan. There was also the perception by some respondents that can potentially allow more capital to be released. Moreover, Option 2 is not dependent on new origination, provides assistance with loan book and liquidity and transfer solutions. Some of the answers also pointed to the fact that they felt that it could be better for small lenders where cheaper access to liquidity is a challenge and will enhance their ability to lend to SMEs at attractive rates. Finally it was also mentioned that it has the advantage of potentially providing both funding and capital relief.

Option 2 Cons: There are potential consequences if the target is not achieved, and there are further reporting requirements for the additional portfolio. Some respondents commented that they viewed this method as more complex and time consuming.

Originators:

Option 1 Pros: Benefits included quick implementation, the simplicity of the structure, the creation of more lending capacity, and the ability for portfolio risk sharing.

Option 1 Cons: Drawbacks were mentioned as having a limited impact, and being less complementary to national schemes.

Option 2 Pros: The responses focused on the fact that this option is seen as beneficial for funding and capital, and allows more complementary solutions with third parties.

Option 2 Cons: Among the drawbacks mentioned was the fact that some participants felt that this option is more complex, and that capital relief may not be achieved.

Box 4.3.3: SECTION 2 - DEAL FEATURES

This is the section, where respondents were asked to provide more specific numerical feedback in connection to the proposed premium charged for the guarantee under Option 1, the proposed pricing for the mezzanine and for the senior tranches under Option 2, together with volume estimates per transaction that would be considered meaningful under both options.

Unfortunately the responses we received were either too vague or non-specific for either the indicative pricing or the volume, although there was somewhat more clarity in regards to expected volumes to be generated.

Pricing indications for the premium of the guarantee under Option 1 varied between free to 150bps, although we clearly need to highlight here that this is based on responses received from our Originator group which as we have pointed out at the outset of this section, was far too small to be considered representative of a broad market sentiment. A similar very wide pricing range was offered in response to our question about the cost for the mezzanine tranches and for the senior tranches for the securitisation proposal under Option 2.

The request for an indication for volume ranges per transaction size under the securitisation option, produced some more realistic ranges however the equivalent responses for volumes under Option 1, were coloured by the relative size of the institution and therefore were very wide. For Options 2 most respondents' indications fell within a range of EUR300m to EUR1bn.

1. For Option 1 (guarantee of up to 80% of each new loan/lease), what would be the maximum indicative risk premium (expressed as a % of the guaranteed volume) that you would consider appropriate for the provision of the described loan guarantee in respect of the targeted SMEs?

Arrangers: The premium should be tailored to the specific portfolio and be dependent on the underlying assets. Thus there was no uniform answer.

Originators: Various responses were received with no pricing consensus. Premium spread indications varied between 0-150bps, for SMEs. There were a few responses that provided some indication for spreads for midcaps, although we could not assign any trend that may indicate alignment between respondents.

2. For Option 2 (securitisation), the risk premium for the portion (up to 50%) of the First Loss Piece (“FLP”) covered by the Instrument is envisaged to be zero and the risk premium for the mezzanine tranche will be set at attractive conditions. The mezzanine tranche will have a risk broadly equivalent to a “Ba2” rating (and the First Loss Piece would be sized accordingly). Under these assumptions, please indicate a range of pricing (risk premium/spread) for the mezzanine tranche and (if applicable) for the senior tranche(s), respectively, that would make the securitisation transaction economically attractive, for transactions aiming at:

- a. Capital relief purposes; and/or
- b. Funding purposes.

Arrangers: The majority of respondents said this would be dependent on the underlying portfolio.

Originators: A similar pattern of responses to the other group was observed. Participants stated that pricing will depend on underlying portfolio and characteristics of transaction, such as FLP detachment point, exact eligibility criteria, and uncertainty relating to future regulatory capital treatment. Once again although we cannot consider the few data points as indicative of any meaningful trend, some of the ranges that we were shown for the mezzanine and senior *tranches* were:

Mezzanine: 125-175bps, 500-750bps, 400bps, and 1400bps

Senior: 75-100bps, 150-200bps

Clearly there is an even wider dichotomy when it comes to pricing of the mezzanine *tranches*, which is not all that surprising considering the lack of any meaningful public deal data points.

3. What would be the minimum transaction size (portfolio volume) that would make sense for using Option 1 or Option 2?

Arrangers:

Once again, we received a very wide range of disparate indications that provided no clear direction. This was more evident for the answers under Option 1, which is understandable considering the fact that the respondents would be more familiar with structures under Option 2. For Option 2, the ranges shown varied between €300m to €1bn

Originators:

A very wide spectrum of ranges offered by the originators contacted, which for Option 1 varied between €10-€2bn. We believe that this is also a reflection of the relative size of the institution in question. The ranges under Option 2 were a lot less diverse and varied between €500m to €1bn.

4. Under Option 2 (securitisation of existing portfolio), what would be the minimum %/amount of capital relief and/or the minimum amount of funding that would make sense?

Arrangers: No significantly meaningful answers were received; some responses showed a min amount range between €200m to €500m

Originators: Once again no meaningful conclusion could be drawn. We picked a handful of individual responses, although we do not purport those to signify any trend.

Capital Relief: €10mn, €30mn, 25%, 50%

Funding: €400mn, €500mn, no min amount of funding

5. Should working capital financing be covered under the SME Initiative and why? In case the Instrument was to be limited to medium-term loans (min. maturity 12 months), would they represent a sufficient volume? (For Option 2 please specify having regard to both the securitised portfolio and the Additional Portfolio).

Arrangers: The results here are mixed. Some respondents mentioned that working capital is in fact a very important factor and should be covered under the SME Initiative. Others commented that the focus should be on SME loans and leases, and working capital financing should be excluded.

Originators: Most of the responses agreed that working capital should be covered as it's essential for SMEs especially in the current economic environment. Revolving short-term facilities were also mentioned as a form of financing to be included as well.

Box 4.3.4: SECTION 3: PORTFOLIO ELIGIBILITY CRITERIA

Based on the responses received, the suggested portfolio eligibility criteria seem to have covered most of the main aspects that participants felt that they need to be tackled under those financing options. A relative common broad comment, was the fact the overly strict criteria will have an impact on the portfolio size and hence the effectiveness of generating big volumes.

It's also worth pointing out, that although the document made a reference to the fact that one may expect to see specific eligibility criteria related to COSME and Horizon 2020

programmes, that could be applied to the guaranteed portfolio under Option 1, we received no specific comments on that matter from those Originators that send us feedback. This though cannot necessarily be seen as an implied acceptance of this fact.

Portfolio eligibility criteria tailored to the characteristics of each transaction would apply to the portfolio to be guaranteed (Option 1) or securitised (Option 2), inter alia to ensure that each deal is compatible with EIB Group's risk tolerance and, more generally, with market standards. The main eligibility criteria related to the guaranteed/securitised SME pool are expected to be based in the following aspects:

- a. Maximum obligor concentration criteria;
- b. Geographical concentration criteria, where relevant;
- c. Sector concentration criteria;
- d. Loan/lease maturity criteria, depending on the loan amortisation profile;
- e. Potential restrictions on the loan/lease type;
- f. Replenishment criteria (Option 2);
- g. No loans in arrears/watch list (Option 2) or restructured loans (Option 1 and 2);
- h. For Option 1, change of control/change of origination policy clauses, requiring EIF consent to continue the build-up of the portfolio, if any such event occurred,
- i. For Option 2, portfolio to be randomly selected (no adverse selection bias).

In addition, please note that specific eligibility criteria related to COSME and Horizon 2020 programmes will apply to the guaranteed portfolio in Option 1.

FOR ARRANGERS:

Would you agree with these main aspects to be covered by the eligibility criteria? Are there any other significant aspects that you believe need to be included?

Most respondents agree with the main aspects covered by the eligibility criteria. Among the responses received, an aspect that was raised was a desire to have limits such as geographic focus for example to be set on the portfolio rather than the lending institution. This was felt that would allow smaller banks to focus on their area of expertise without being penalized and diversity can be built at a portfolio level. Some other areas mentioned for potential inclusion, were loan lease characteristics such as type of rate, repayment profile, and seniority of debt. Underlying assets from the lowest internal rating categories was also suggested that could be excluded. Moreover, some respondents mentioned that set-off risk could be mitigated by excluding debtors with deposits.

Would you expect significantly different aspects to be covered by the eligibility criteria in case the portfolio relates to a jurisdiction with non-established securitisation framework, in order to attract capital market interest? If yes, please elaborate

Some of the responses mentioned that broad eligibility criteria in those jurisdictions is overall a good framework, while others believe it should be more restrictive to attract capital market interests. Some of the requirements that were mentioned for consideration were portfolio average internal credit score, probability of default, loss given default, maturity, and the loan or lease collateral. Respondents also mentioned that in jurisdictions without a securitisation framework, any extra risk should be reflected in the price of the transaction. However, comments were made that requirements shouldn't be too severe, as restricting eligibility criteria could limit capital relief.

FOR ORIGINATORS

Would you consider that any of these main aspects would create significant constraints to the size of portfolio that could be guaranteed/securitised? If yes, please elaborate.

Concentration criteria could create constraints, especially for the real estate sector. Restrictions on portfolio size, geographic considerations, and restrictions on loan amortisation could also pose an issue. It was also suggested to avoid limitations to eligibility criteria, and maintain flexibility in the areas of maximum concentration criteria, and to involve short-term revolving facilities. Ultimately the degree of restriction from constraints would depend on the final limits that are set. Overly strict criteria could restrict portfolio size.

Box 4.3.5: SECTION 4: ADDITIONALITY

In the last section of the market testing document, we looked to get a sense from the market on a number of issues; (i) the estimated volume that could be built up over a period of 12 months under option 1 & 2, (ii) the time that it would take them to build a certain size portfolio under either of these two options, (iii) the respondents attitude towards the inclusion of mid-cap (up to 500 employees) and (iv) the acceptable level of financial consequences that are to be imposed if agreed volumes and timeframes are not respected.

Not many of the respondents provided volume levels that are expected to be built over a suggested 12 month period and therefore it was difficult to detect any meaningful trends. From the few of those who provided some guidelines, the suggested range under Option 1 was EUR100-150m and for Option 2 EUR250-300m.

Similarly we have received a multitude of answers when it came to the time horizon that it would take an intermediary to generate a portfolio of EUR200m under Option 1 and EUR500m under Option 2. A broad range of 1-24 months for Option 1 and 4-36 months for Option 2, cannot really be seen as providing a meaningful pattern.

As regards the inclusion of mid-caps, there was a broad consensus that it would be beneficial as it would help with a broader portfolio generation. A number of respondents have

also commented that the use of the number of employees for the definition of “mid-caps, was not the most preferred method and they would elect an alternative measure, such as turnover, or balance sheet size.

Finally on the issue of financial consequences, most responded were unsurprisingly against the imposition of any fees. The reasons offered varied and included things as: reduction in the efficiency of the capital allocation relief and hence the additional lending generation volume, the concern that in the event that there would be no on-going demand, intermediaries would be penalized unnecessarily, as well as the fact that such fees may prove to be a disincentive for intermediaries to be part of the proposed initiative. Interestingly, some of the respondents commented that as their respective national guarantee schemes do not include such penalties, they would not like to be treated differently.

The SME Initiative requires that - as a consequence of the intervention - new loans are granted to SMEs under both Option 1 (guaranteed portfolio) and Option 2 (Additional Portfolio). Under Option 2 it is assumed that the size of the Additional Portfolio to be built up will be equal to the size of the securitised portfolio (further assuming that the Instrument covers 50% of the FLP and up to 95%-100% of the mezzanine *tranche*).

1. Origination of new portfolios: assuming no further restrictions other than the SME definition on the eligibility of Final Beneficiaries

a. What would be the indicative size of the new portfolio that could be built up over a period of one year under Option1 (guaranteed portfolio) or Option 2 (Additional Portfolio), respectively? Please specify if the volumes refer to SMEs and/or innovative SMEs and how these volumes compare with your current annual lending volume to SMEs.

Arranger: Many respondents did not provide answers, and responses were mixed.

Originator: We did not receive many meaningful answers to get a sense of a trend. For those respondents that did not specify between Option 1 and Option 2, the range varied between €20mn-€1bn, and for those few that provided a split the ranges were:

Option 1: €100mn-150mn

Option 2: €250mn-300mn

b. Under Option 1, assuming that the new portfolio to be guaranteed is EUR 200 m (or equivalent size in other European currencies), how long would it take to build-up such portfolio?

Arranger: Most respondents did not provide answers on the time horizon.

Originator: There was a multitude of responses and most of the answers fell into the broad range of 1-24 months.

c. Under Option 2, assuming that the Additional Portfolio to be built up following the securitisation transaction is EUR 500 m, how long would it take to build-up the Additional Portfolio?

Arranger: Most respondents did not provide answers.

Originator: Similarly to the previous points, a wide range was offered that varied between 4 to 36 months

2. Both Options aim at supporting SMEs. However, loans to Mid-caps (defined as companies with “up to 500” employees) may also be considered eligible under such initiative. Please specify:

Multiple respondents suggested that number of employees is not a specific enough criterion to define Mid-Caps. The suggestion was made to define loans according to turnover or balance sheet size rather than number of employees.

a. With regard to Option 1, would the inclusion of MidCaps in the eligibility criteria be important?

Arranger: Overall it was felt that including midcaps would be positive, as it would broaden the portfolio generation.

Originator: A similar response was received from the originators responding to this question.

b. With regard to Option 2, would the inclusion of MidCaps in the eligibility criteria as eligible obligors in the securitised portfolio and/or in the Additional Portfolio be important?

Arranger: Including midcaps would be positive for most clients.

Originator: A similar response to the one received by the arrangers' sample

c. To what extent the inclusion of MidCaps would allow additional volumes under Option 1 and Option 2, respectively?

Arranger: Most comments agreed that the inclusion of MidCaps would allow for better diversification and make it easier to meet volume commitments, although most of them commented that this benefit is difficult to quantify.

Originator: Overall the comment was that midcaps have higher needs meaning higher lending volumes. Although broadly respondents agreed that there will be a volume increase, most of them qualified their answer mentioning that such increase will be dependent on the maximum size of the MidCap exposures and the eligibility criteria used.

d. Assuming a MidCap definition of “Up to 500” employees, which portion could they represent (% in number/loan volume) of the above volumes?

Arranger: Respondents did not provide answers or indicated it was difficult to quantify the results.

Originator: Based on the responses received, a very broad range between 5%-50%, was suggested.

3. In case the new portfolio to be guaranteed (under Option 1) or the Additional Portfolio to be built up (under Options 2) does not reach the agreed target volume within the agreed timeframe, there will be financial consequences for the originator in the form of e.g. commitment fees. Such fees would increase “ex post” the all-in cost of the transaction and are meant to - failing the origination of the new SME loans - compensate for any “undue benefit” provided by the SME Initiative to the originator. What should be, in your opinion, the acceptable level of such fees? Are there any legal or regulatory constraints to be considered?

Arranger: Most respondents believe that fees are unnecessary and should not be included. They commented that they will reduce the efficiency of the capital allocation relief. Participants were also concerned in the event that there would be no on-going demand for SME loans, they may still have to pay those penalties. Also, some of the responses mentioned that if such a fee was to be used, it should be linked to the cost of the guarantee.

Originator: The general consensus across the surveyed institutions is that no fees should be introduced. Commitment fees will lower the willingness of banks to participate in the SME initiative, which may impact banks that are willing but unable to provide loans in the program. A number of participants commented that current national guarantee schemes do not include such penalties

4.3.8 Percentage range of the financing gap of each Member State which may be addressed through the initiative

The analysis in the above chapters clearly shows the persistence of a financing gap for EU SMEs, both at the EU level and for each Member State. In this framework, the proposed SME Initiative can provide a significant and faster contribution, which will still be complemented by the other EU-wide and national actions addressing the same issue. To that purpose a gap interval has been identified for each Member State and two scenarios

have been evaluated to analyse the contribution of the loans generated by the SME Initiative to reduce the financing gap.

4.3.8.1 Estimation of gap-reducing financing in each Member State, per product

The present section illustrates, for each Member State, the possible reduction in the financial gap interval estimated through the methodology laid out in section 4.1.3.

4.3.8.2 Limits of country gap coverage

In our previous analysis indicative intervals have been derived, presumably containing the true country-specific loan financing gaps for each Member State. At this stage, it is also of interest to gauge the amount of such gap that could be bridged by the loans generated via the SME Initiative. In order to assess the ability of the SME Initiative to address the loan financing gap, we are forced to make some assumptions, each one representing a paradigmatic scenario. Therefore, the figures presented below are only to be considered as purely indicative.

4.3.8.3 Methodology and assumptions

The analysis of the gap coverage ability of the SME Initiative was performed as follows: we compared each estimated loan financing gap with the amount of ERDF and EAFRD funds that Member States will receive in the entire 2014-2020 period. Assuming that *all Member States* join the program, we computed the average percentage of ESI funds that need to be allocated under three scenarios:

1. *Best-case scenario*: total ERDF and EAFRD contributions amounting to € 8.5 billion in the 2014-2020 period. Accordingly, the average contribution per Member State is set at 3.31% of total ERDF and EAFRD funds received.
2. *Minimum case scenario*: total ERDF and EAFRD contributions amounting to the critical mass to activate Option 1 only, amounting to € 3 billion in the 2014-2020 period. Accordingly, the average contribution per Member State will be 1.17% of total ERDF and EAFRD funds received.
3. *Intermediate case scenario*: total ERDF and EAFRD contributions amounting to € 5 billion in the 2014-2020 period. Accordingly, the average contribution per Member State will be 1.95% of total ERDF and EAFRD funds received.

The specific allocation of ERDF and EAFRD funds among the different options that will be chosen by each Member State will also determine the leverage of the SME Initiative. For the purpose of our scenario analysis, we assume the following leverages for each option (Table 4.3.2):

TABLE 4.3.2: ASSUMED LEVERAGES

	Assumed Leverage
Option 1	5.5
Option 2	6.5
Option 3	9.5

Since the precise allocation of each Member State for each different option is unknown, it is assumed that some Member State will choose either option 2 or 3, so that the average leverage is expected to be higher than 5.5. In light of this consideration, we assume an intermediate leverage of 6.33.¹³¹ This leverage will serve as a multiplier of the contribution allocated by each Member State, to generate the total leveraged contribution (*i.e.* additional lending) that will reach EU SMEs under the assumed scenarios.

4.3.8.4 Envisaged impact

The impact of the SME initiative on the macroeconomic environment of access to debt finance will generate persistent beneficial effects, which will make it possible to reduce year by year the measured gap.

Table 4.3.3 summarises, for each Member State, the projected SME gap coverage over the next MFF period, under different overall contribution scenarios (3bn, 5bn, or 8.5bn total ERDF and EAFRD contributions, assuming full Member State participation).

The expected loan financing gap is based on the figures in column 2 (also presented in Annex 6 to Chapter 1), but its evolution will depend on two factors: i) the projected growth of the gap over the MFF period based on the historical growth during 2009-2012; and ii) the dynamic impact of the disbursements under the SME Initiative. The latter is an important feature of any policy aimed at reducing the SME financing gap: the sooner and the larger the front-loading of the disbursements, the bigger the overall coverage of the gap.

On point i), while a precise estimate of the annual increments of the loan financing gap for each Member State is currently unattainable, there is a case for placing the overall growth trend of the loan financing gap over the MFF period at around 10%.¹³²

On point ii), in order to calculate the estimated contribution levels, a realistic budget expenditure model was set-up, in which the overall contribution is considered to be allocated proportionally during the course of the first three years (*i.e.* 2014-2016),¹³³ whereas the impact on SMEs is spread over the course of 6 years in function of lending by intermediaries to SMEs. Moreover, Member State contributions are subject to a number of both legal and consistency constraints. The first constraint is imposed by the Common Provision Regulation, art 33bis, which limits the fraction of ERDF and EAFRD funds that can be invested in the SME Initiative to 7%. The second constraint concerns the consistency of the

¹³¹ This is the average leverage of two portfolios composed of the following contribution shares: a) 2/3 in option 1, 1/3 in option 2 (5.83); and b) 2/3 in option 1, 1/3 in option 3 (6.83).

¹³² Such range is based on the historical trend of the loan financing gap during the 2009 – 2012 period, which showed an average annual increase in the order of 5%. In addition, the trend on future availability of loans to SMEs, measured by the ECB SAFE Survey, must be taken into account, although in broader terms. It shows that in the period 2009 to 2012, an average net percentage of 5.6% of the surveyed SMEs believed that the possibility to access the loan financing market would deteriorate in the upcoming months. However, it is also important to note that, because of the potential catalytic effects brought about by the Initiative, the possibility to generate an increase in loan demand is significant. Therefore, to the extent this additional demand is not satisfied, it should be included in the overall calculation of the gap. Therefore it seems plausible to consider the annual increase of the loan financing gap well above the 5% threshold. As a result, a conservative 10% prediction is chosen in modelling the predicted trend of the loan financing gap of each Member State.

¹³³ It is assumed that the first disbursement will not take place before the second semester of 2014.

Initiative, where no additional amounts should be allocated if their marginal impact on the loan financing gap is estimated to be non-significant.¹³⁴

These considerations lie at the basis of the figures in Table 4.3.3. Here, columns two, three and four provide the latest available measures of the loan financing gap (upper bound) for each Member State,¹³⁵ as a percentage of the EU28 total. The fifth column reports the envisaged fund allocations (from ERDF and EAFRD) to each Member State for the 2014-2020 period, also expressed as a percentage over the EU28 total.

Using the previously described dynamic impact model, a maximum contribution rate is computed, subject to the conditions stated above. This rate represents the minimum between the rate necessary to completely fill the loan financing gap, and the 7% maximum contribution of ERDF and EAFRD amounts allocated per Member State. Therefore, column 6 reports the maximum contribution amount corresponding to the maximum rate.

However, the aggregate contribution level of 14bn at the bottom of column 6 exceeds the overall cap of 8.5bn ERDF and EAFRD funds set out by the CPR. Thus, column 7 portrays the amount of contributions scaled down to meet this additional constraint.

Column 9 illustrates the amount of contributions scaled down to meet the aggregate amount of EUR 3bn, which corresponds to the estimated critical mass necessary to make the Initiative economically viable (see Annex 1 to Chapter 2).

Column 8 represents an intermediate scenario, whereby the amount of contributions is scaled down to meet an aggregate amount of EUR 5bn.

The last three columns (10-12) describe the potential gap coverage attainable under the Initiative for each Member State in each envisaged scenario, at the end of the MFF period.

¹³⁴ Note that the non-significant impact would concern only the *loan financing gap*. No accurate prediction on the impact of the SME Initiative on the overall debt financing gap is currently available, nor does it seem feasible. However, it would be ill-founded to assume the projected *loan* financing gap to be representative of the entire *debt* financing gap, therefore the non-significant impacts described above are only to be interpreted in relation to the loan financing gap.

¹³⁵ Relative to either 2011 or 2012.

TABLE 4.3.3: LOAN FINANCING GAP COVERAGE CAPACITY OF THE SME INITIATIVE. ALL ABSOLUTE AMOUNTS IN € MILLION (UNLESS OTHERWISE STATED)

Country	Upper Bound of Latest Measured Gap (2011-2012)			Allocated ERDF+EAFRD Amounts (% of EU28 total)	Maximum Contribution ¹³⁶	Necessary Contributions			Projected Gap Coverage		
	Non-Agricultural SMEs	Agricultural SMEs	Total SMEs ¹³⁷			8.5 € Bln Scenario	5 € Bln Scenario	3 € Bln Scenario	8.5 € Bln Scenario	5 € Bln Scenario	3 € Bln Scenario
TOTAL GAP	95 EUR Bln	10 EUR Bln	105 EUR Bln	ASSUMED LEVERAGE: 6.33 ¹³⁸							
AT	0.44%	0.80%	0.47%	1.56%	147	144	79	47	98%	54%	32%
BE	2.15%	0.18%	1.97%	0.52%	94	48	27	16	8%	4%	3%
BG	0.73%	1.41%	0.79%	2.08%	273	192	106	62	71%	39%	23%
HR	0.46%	1.17%	0.53%	2.32%	181	181	118	70	100%	65%	38%
CY	0.06%	0.08%	0.06%	0.10%	18	9	5	3	42%	23%	14%
CZ	0.93%	0.14%	0.86%	4.86%	296	296	248	146	100%	84%	49%
DK	0.90%	0.22%	0.84%	0.27%	49	25	14	8	9%	5%	3%
EE	0.14%	0.27%	0.16%	0.94%	53	53	48	28	100%	90%	53%
FI	0.38%	0.39%	0.38%	1.10%	118	102	56	33	86%	48%	28%
FR	5.50%	2.67%	5.25%	6.44%	1,156	596	328	193	36%	20%	12%
DE	6.18%	3.47%	5.94%	6.82%	1,225	632	348	205	34%	19%	11%
EL	4.50%	9.21%	4.92%	4.45%	799	412	227	133	27%	15%	9%
HU	0.64%	0.92%	0.67%	5.25%	229	229	229	157	100%	100%	69%
IE	1.63%	2.61%	1.72%	0.92%	165	85	47	28	16%	9%	5%
IT	22.17%	17.99%	21.80%	11.62%	2,088	1,077	593	349	16%	9%	5%
LV	0.18%	0.32%	0.20%	1.17%	67	67	60	35	100%	89%	52%
LT	1.10%	5.96%	1.53%	1.78%	320	165	91	53	31%	17%	10%

¹³⁶ Computed as the maximum amount of resources that can be allocated by each Member State, without breaching the CPR 7% limit of ERDF and EAFRD.

¹³⁷ Calculated as the weighted average of the two previous column.

¹³⁸ Refer to Section 4.3.8.3 and Note 131 for a complete discussion on the assumed leverage.

Country	Upper Bound of Latest Measured Gap (2011-2012)			Allocated ERDF+EAFRD Amounts (% of EU28 total)	Maximum Contribution ¹³⁶	Necessary Contributions			Projected Gap Coverage		
	Non-Agricultural SMEs	Agricultural SMEs	Total SMEs ¹³⁷			8.5 € Bln Scenario	5 € Bln Scenario	3 € Bln Scenario	8.5 € Bln Scenario	5 € Bln Scenario	3 € Bln Scenario
LU	0.66%	0.01%	0.60%	0.04%	8	4	2	1	2%	1%	1%
MT*	0.07%	0.04%	0.06%	0.17%	22	15	9	5	71%	39%	23%
NL	3.56%	0.66%	3.30%	0.38%	69	36	20	12	3%	2%	1%
PL	2.99%	21.82%	4.67%	17.78%	1,602	1,602	907	533	100%	57%	33%
PT	2.10%	3.45%	2.22%	5.30%	694	491	271	159	71%	39%	23%
RO	1.50%	18.30%	2.99%	6.55%	1,027	606	334	196	59%	33%	19%
SK	0.30%	0.20%	0.29%	3.25%	101	101	101	97	100%	100%	97%
SI	0.91%	0.60%	0.88%	0.81%	145	75	41	24	25%	14%	8%
ES	28.22%	5.05%	26.17%	9.71%	1,744	899	495	291	11%	6%	4%
SE	2.19%	0.47%	2.03%	0.94%	170	88	48	28	13%	7%	4%
UK	9.39%	1.57%	8.70%	2.89%	519	268	147	87	9%	5%	3%
EU28	100.00%	100.00%	100.00%	100.00%	13,378	8,500	5,000	3,000	27%	15%	9%

*The sample size for viable SMEs was too small to be representative, so a broader SME sample was analysed

4.3.9 EU-level contributions to the initiative

The projected gap coverage illustrated in Table 4.3.3, columns 10-12, also takes into account leveraged EU-level contributions from COSME and Horizon2020. The contribution amounts envisaged for COSME and Horizon2020 depend on the size of ERDF and EAFRD contributions by individual Member States, and while it is impossible at this stage to provide exact figures, a mechanism has been foreseen in European Commission and European Investment Bank (2013). In that case, the originally envisaged maximum aggregate ERDF and EAFRD contributions of EUR 10bn were linked to EU-level contributions of EUR 420m (EUR 210m each from COSME and Horizon2020). This Ex-ante introduces 3 possible scenarios (see Section 4.3.8.3), where the best case refers to 8.5bn aggregate ESIF contributions.

1. *Best-case scenario*: total ERDF and EAFRD contributions amounting to € 8.5 billion in the 2014-2020 period. In this case, the maximum COSME and Horizon 2020 contributions would amount to EUR 360m (180m COSME and 180m Horizon 2020), proportionally corresponding to the reduction of the maximum ESIF contribution from EUR 10 bn to 8.5bn.
2. *Minimum case scenario*: total ERDF and EAFRD contributions amounting to the critical mass to activate Option 1 only, amounting to € 3 billion in the 2014-2020 period. Accordingly, COSME and Horizon 2020 contributions would amount to EUR 126m (63m+63m).
3. *Intermediate case scenario*: total ERDF and EAFRD contributions amounting to € 5 billion in the 2014-2020 period. In this case, COSME and Horizon 2020 contributions would be EUR 210m (105m+105m).

VI. GLOSSARY

Asset-Backed Securities (ABS)	Refers to a security whose income payments and hence value is derived from and collateralized (or "backed") by a specified pool of underlying assets.
Bank Multiplier Effect	Refers to the expansion of a country's money supply that results from banks being able to lend
Collateral	Refers to property or other assets that a borrower offers a lender to secure a loan
Collateralized Debt Obligation (CDO)	Refers to a type of structured asset-backed security (ABS), that pools together cash flow-generating assets and repackages this asset pool into discrete <i>tranches</i> that can be sold to investors
Credit Enhancement	<p>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).</p> <p>The credit enhancement could be provided in the form of:</p> <ul style="list-style-type: none"> (i) Structural credit enhancement (tranching of the transaction in senior, mezzanine and junior <i>tranches</i>); (ii) Originator credit enhancement (cash collateral, profit retention mechanism, interest sub-participation mechanism); (iii) Third party credit enhancement (EIF or monoline insurers)
Crowd-funding	Refers to the use of small amounts of capital from a large number of individuals to finance a new business venture.
Debt Consolidation	The act of combining several loans or liabilities into one loan.
Due diligence	Refers to an investigation or audit of a potential investment
Equity	Ownership in any asset after all debts associated with that asset are paid off.
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
Junior Tranche	<i>Tranche</i> or Risk, which is subordinated to all other risks (or <i>tranches</i>)
Mezzanine (financing)	Refers to debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full
Mezzanine Tranche/Risk	<i>Tranche</i> or Risk, which is subordinated to Senior risk (or <i>tranche</i>), 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)
Pari-passu	Refers to loans, bonds or classes of shares that have equal rights of payment, or equal seniority
Primary Market	The market in which securities are issued
Quasi-Equity Investments	Refers to an investment, in which the return received by the investor is linked to the financial success of the venture, without conferring ownership rights. An example is the Revenue Participation Agreement
Secondary	The market where issued securities are traded

**Market
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.

**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.

**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

**Traditional
Securitisation**

Refers to a true sale

**Tranche
True Sale**

A piece, a portion or slice within a structured transaction

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

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