Restarting the credit engine in Europe

Review of the Main European Policy Initiatives

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Introduction
Small and Medium seize Enterprises (SMEs) are the major concern of European policy-makers. The fixed costs to access the financial markets may be too high for them; therefore, their financing relies mainly on bank credit. However, as the unit size of loans to SMEs is usually smaller than the median size of loans, while screening costs are fixed, banks tend to minimise the cost of collecting and processing information on SME (for example using scores instead of ratings) (IIF-B&C 2013). On their part, SMEs are less transparent, in some countries also for tax reasons; their financial statements are less informative and often unaudited. This translates into greater informational asymmetries and higher transaction costs for potential investors, which can be mitigated by long-term customer relationships. In presence of imperfect information and adverse selection, banks tend to act as depicted in Stigliz-Weiss (1981), and credit rationing to SMEs may occur. When banks become more risk averted, as after the financial crisis, banks tend to increase credit rationing to SMEs. Firms faced by credit constraints are more likely to exit the market, to shed employment, to spend less on technology, to invest less in new capital and in marketing, and less likely to enter export or import markets.²

Long-term investment is also an important policy issue. There are major challenges to higher allocations to such assets. Infrastructure investments frequently involve very high up-front costs. The risks associated with them are often specific to the project. Examining these project-specific risks require dedicated resources that can take years to build up, and which many smaller institutional investors (such as many pension funds and insurers) in particular are lacking. Furthermore, there is lack of high quality data on infrastructure, making it difficult to assess the risk in these investments to understand correlations with other assets. Technological and environmental risks may be very difficult to quantify. In addition, in some countries there are regulatory barriers that prevent institutional investors from investing in these assets (Kaminker-Steward-Upton 2012, OECD 2013).

These challenges may have increased recently. Banks are now less willing to issue the kind of long dated loans required for the build phase of the largest projects (AFME 2013). The bank business model has become more and more dominated by non-lending activities. Coupled with increasing fiscal constraints on government spending, this is causing a growing mismatch between the amount and time horizon of available capital and the demand for long-term finance. New banking regulation also negatively affects the supply of long-term financing by both banks and institutional investors such as pension funds and insurance companies.

Several public and private-led initiatives have been taken to revive the credit to SMEs and infrastructure in Europe in the last few years. Many actors (described in Section 1) have taken initiatives (reviewed in Section 2) to restart credit to enterprises and long-term finance in general. In the second section, we will review these initiatives focusing on their different aims, trying to understand their pros and cons. In the third section, on the basis of the preceding critical review, we will examine what different players could (but also should not) do to revitalise credit, including some innovative proposals. Initiatives and proposals related to taxation, accounting standards or financial prudential regulation as well as proposals that are just suggestions or recommendations to the private sector are not considered.

² See the literature quoted in Holton et al. 2013 and Wehinger 2014.
1. The actors

1.1. Promotional institutions

Government intervention in credit can be direct (providing funds through debt, equity, or hybrid instruments) or indirect (improving the availability of credit information, providing explicit guarantees, or facilitating methodologies for financial statement analysis). These products and services may be provided through different channels and by different institutions.

Promotional Institutions (PIs) are defined by the existence of a public policy mandate. This mandate can vary in scope: from general missions, such as banking groups that target SMEs or firms located in certain regions as part of their general activities, to general—interest missions that comprise financial institutions targeting certain areas or sectors with a social value but are not necessarily profitable. Promotional institutions may have an important role during financial crises as far as their propensity to risk is more stable. In PIs, the Government is the implicit guarantor of funds (Robano 2014).

The oldest and probably biggest government promotional institution to support SMEs is the German KfW Group. The KfW Group, founded in 1948, is active in different financing fields (e.g. promotion of SMEs, housing, municipal infrastructure, environmental protection, international project and export finance, developing countries), but the focus is on the support of German SMEs through the business sector KfW Mittelstandsbank. The subsidiary KfW-IPEX Bank provides project and export finance. (Denzer-Speck-Lob 2013)

The Spanish public support to SMEs is developed mostly through two public institutions: the Instituto de Credito Oficial (ICO), a state-owned bank, and the Empresa Nacional de Innovacion (ENSIA), a public company attached to the Ministry of Industry, Energy and Tourism.

In Italy, unlike from the other four main countries, there is not a public investment bank dealing specifically with SMEs financing and the biggest role is played by the joint-stock company under public control Cassa Depositi e Prestiti.

Furthermore, governments may offset possible financial market failures by providing export financing directly or by insuring against certain risks through a PI commonly known as an Export Credit Agency (ECA). In addition, an ECA can offset market failures through auxiliary actions such as gathering and sharing information on risks and by providing relevant assistance to exporters. An examples of a wholly state owned ECA is UK Export Finance.

As for the role played by PIs in the infrastructure industry, the Canadian and Australian infrastructure financing models are widely recognized as best practices in government support to infrastructure investments. Though Infrastructure Canada and Infrastructure Australia, the respective Federal Government has bolstered significantly infrastructure spending. Infrastructure Canada has set up the Infrastructure Stimulus Fund, the Building Capital Fund and the Green Infrastructure Fund (Bassanini-Reviglio 2014).

Since the 2008/2009 global financial crisis, PIs have played an increasing role in financial markets, addressing short-term financing gaps and mitigating cyclical fluctuations in lending activities of private banks. Following the sharp reduction in business lending activities, PIs have been charged
with new functions or asked to target a broader set of areas and players. This change in the scale and scope of activities poses new challenges to PIs.

On December 2012, the French government created the Banque Public d’Investissement (BPIfrance), operational since February 2013. The role is similar to KfW. BPIfrance incorporated the major public institutions involved in financing and supporting French SMEs (including the Caisse des Dépôts et Consignations, the Fonde Strategique d’Invstissement). Portugal and the United Kingdom have announced the creation of new PIs for 2014. In the United Kingdom, the British Business Bank expects to start operating in the last quarter of 2014.

1.2. Central banks

When interest rates reach very low levels, as is currently the case, traditional monetary policy becomes limited. For this reason, central banks must look to nonstandard measures to further ease monetary conditions. Either these policies can affect the overall monetary stance in the economy (a general easing) or they can be more targeted towards sectors that are most acutely affected, or indeed a combination of both.

Collateral requirements to access central bank lending facilities can be changed in order to favour lending to particular sectors. Options include reducing the minimum rating requirements and the haircuts imposed on certain types of assets (for instance, on SME loans or Asset Backed Securities, ABS) or pools of assets. If a central bank makes the conditions on usage of a certain asset (for instance, loans to SMEs) more favourable, this can encourage bank lending to this sector. Changes to the collateral framework can clearly be effective in easing financing constraints to banks and access to finance to sectors of the economy, like SMEs. However, changes in relation to pools of assets can be complex and could increase risks for the Eurosystem.

Central banks around the world have also implemented purchase programmes or nonrecourse repo programmes for ABS and other credit related securities. By purchasing ABS in secondary markets, central banks could improve investor confidence through a portfolio balance effect, increased liquidity, or simply through signalling support for this asset class. This could have the effect of narrowing spreads and fostering activity in the primary issuance market. The Federal Reserve (Fed) undertook such asset purchases to reduce long-term interest rates and improve financial conditions. For example, the Fed bought mortgage-backed securities in order to attempt to increase the availability of credit for house purchase. Another version of this type of policy involves non-recourse loans (or repurchase agreements) given to investors through eligible counterparties using ABS as collateral with a haircut, similar to the Fed’s Term Asset-Backed Securities Loan Facility (TALF). This means that borrowers could leave the underlying security with the Fed, rather than repay the loan, should the value of the security fall below the amount of money owed. This arrangement leaves the investor with potential upside gains, while removing the chance of extreme losses.

1.3. European Institutions

The European Investment Bank (EIB) provides finance and expertise to promote investment activity that will increase growth and employment in the EU, with a special focus on SMEs, resource efficiency, infrastructure, innovation and skills. The European Investment Fund (EIF), which is part of the EIB Group, focuses on venture capital, guarantees and microfinance. In 2012, the capital of the EIB was increased by €10bn, which allows for an extra €60bn in lending between 2013 and 2015. This measure is expected to unlock €180bn in additional investments. The EIB supports SME
financing primarily through financial institutions that on-lend to SMEs and other counterparties, either directly or through guarantees.

The European Investment Fund (EIF) manages the Programme for Competitiveness of Enterprises and SMEs (COSME) of the European Commission. In the period 2014-2020, COSME will boost support for SMEs through a loan facility, as well as equity facility and finance for research and development.

As an example of the cooperation between the EIB and promotional institutions, in September 2013 the EIB and Bpifrance signed an agreement according to which the EIB group has made available a €200 million guarantee under the EIF Risk Sharing Instrument, co-financed by the European Commission, to support loans to innovative firms.

1.4. Public-private partnership

The public support is often essential to overcome market failures. However, government support should be designed to ensure additionality and avoid excessive transfer of risk from the private to the public sector. As general principle, all parties involved in addition to the government (SMEs, banks, guarantee schemes) should retain a sufficient share of the risk and responsibility to ensure proper functioning of the system. Furthermore, where the market failure is a coordination failure, or where the solution is potentially profitable, the public may act as catalyst for private initiatives.

Governments are increasingly turning to Public-Private Partnerships (PPPs) for investments in public infrastructures. The largest share of such investment to date has been in transport.

There are two main types of PPP: remunerated by tolls levied by the private partner or remunerated by the availability payments from the contracting agency\(^3\). Both types of PPP create liabilities for the taxpayer that need to be contained by transparent public accounting rules and budget procedures that identify them as on-balance sheet commitments. Tolled facilities tend to require larger equity investment, at higher costs. Availability payment-based PPP projects represent a lower risk for investors and attract bank loans with accompanying insurance and hedging instruments. Many availability payment-based projects involve only “pinpoint equity”, i.e. a very small equity holding, sometimes less than 1% of project finance.

Regulated utility-based models for investment attract a larger range of investors. They are a more familiar class of assets, with returns determined in relation to investment by a regulatory formula. An independent regulator is required in this model to arbitrate between the interests of investors, government and the users of the infrastructure. The regulator sets quality standards and user charges, subject to periodic review that provides a useful degree of flexibility in the context of long-term concessions (OECD 2013).

However, there are few “investment grade” projects in the pipeline, i.e. projects that are not only bankable but also adapted to more prudent categories of investors. The complexity of construction and financing of major projects, especially in sectors with high regulatory or macroeconomic risk, requires agreement with various entities working together.

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\(^3\) An availability payment is a payment for performance made irrespective of demand.
2. Initiatives by aim

This section reviews the main initiatives (mainly public, but also private-led) in place or recently announced to restart credit both at the EU and at the national level. Regarding the latter, the focus is on the largest countries (France, Germany, Italy, Spain, United Kingdom), but relevant initiatives on other countries (Austria, Ireland, Latvia, Portugal, Romania, The Netherlands) are also mentioned.4

A number of issues are important to consider when assessing policies in this area. Is lending directly supported by the policy “additional”, i.e. lending that would not have occurred in the absence of the policy? The policy must not distort the credit allocation mechanism by diverting funds to borrowers who do not have viable investment propositions. Similarly, policies must have structures in place to ensure lending decisions are made free of political or bureaucratic influence that would lead to suboptimal credit allocation. Finally, the transparent and rigorous ex-post analysis of policy must exist to ensure taxpayers’ money is being put to effective use (Holton et al. 2013).

2.1. Reducing the cost of bank funding

The leading intermediaries in most European countries are banks. In the years leading up to the crisis, European banks had relatively high loan-to-deposit ratios in international comparison and they relied heavily on credit from other sectors (namely, rest of the world and insurance), mainly through the securitisation market and maturity transformation (i.e. borrowing short and lending long) to fund their lending. As confidence vanished during the subprime crisis, the interbank market and the securitisation markets dried-up, increasing the cost of bank funding (EC 2013). With the sovereign debt crisis and redenomination risk, bank-funding pressures have increased again, particularly for banks heavily invested in certain sovereign. Private-sector borrowing costs have started to diverge substantially according to geographic location.

2.1.1. National Initiatives

Funding for Lending (FLS) is a joint flagship program of the Bank of England (BoE) and HM Treasury aimed at boosting lending of commercial banks to households and SMEs initiated in August 2012 and renewed until January 2015. The idea is to allow banks to borrow at a preferential rate from the BoE (collateral swap) on the condition that they increase their net lending positions towards non-financial corporations. In practice, FLS allows banks to borrow UK Treasury bills (which can be used to back cheap borrowing on financial markets) at the off-market rate of 0.25%. Banks are allowed to borrow up to 5% of their actual lending exposure and subsequently up to the new lending to SMEs; if this preferential borrowing does not lead to an increase in the bank’s net lending, the rate at which Treasury Bills need to be repaid is raised to 1.5% (Churm et al. 2012, Infelise 2014).

In the UK, there is also a National Loan Guarantee Scheme, launched by HM Treasury in March 2012, with the objective of lowering interest rates on loans by providing national guarantees on banks’ unsecured borrowing (Infelise 2014). However, the introduction of FLS made this scheme less appealing for banks.

While these funding programmes can be very effective in alleviating credit constraints particularly when banks have liquidity problems, the effectiveness of these programmes can be difficult to

4 See Appendix I. A review of policies in the four major EU countries is in Infelise (2014). Best practices are reviewed in IIF-B&C (2013). For an extensive review of policies to support credit to SMEs in Ireland, see Holton et al. 2013. Major initiatives at the EU level are reviewed in Giovannini-Moran (2013).
assess and communicate. It is difficult to know what the likely evolution of credit conditions would have been in the absence of the scheme (the “counterfactual”). Targeted programmes can be complex in their set up.

2.1.2. Europe-wide initiatives

The European Central Bank

Untargeted central bank refinancing operations (which could be at fixed or flexible rates) aim to alleviate bank funding pressures, with central banks being capable of supplying essentially unlimited liquidity to banks against eligible collateral, as the ECB did with its fixed rate full allotment policy. They can also increase the maturity of their operations to reduce banks’ uncertainty, as the ECB did with its Longer Term Refinancing Operations up to one year (introduced in the second half of 2009) and three years (introduced at the end of 2011).

Central banks can change the collateral requirements for their operations to alleviate banks’ funding stress and reduce financing obstacles. The ECB has made a number of such adjustments, for example by reducing the rating threshold for certain ABS and by allowing national central banks (NCBs) to accept additional “credit claims” (i.e. bank loans) as collateral. In July 2013, it reduced the rating requirements and haircuts on certain ABS in the collateral framework to ease financing conditions further.

Central banks can also pursue targeted funding operations, like the UK FLS. In June 2014, the ECB has launched the Targeted Long Term Refinancing Operations aimed at lowering the funding cost of credit to non-financial private enterprises. The initial allowance up to 7% of outstanding loans to the non-financial private sector (excluding mortgages) can be increased in the next two years up to three times the net lending in excess of a specified benchmark. The interest rate will be fixed at the rate of the main refinancing operations prevailing at the time of take up plus a spread of 10 basis points. If net lending is below the benchmark, the borrowings will have be repaid in September 2016.

In June 2014, the ECB announced the plan aiming at Outright Purchase of covered bonds (started in October 2014) and of simple and transparent ABS.

Prime Collateralised Securities (PCS)

Before the crisis, European banks had a large and increasing funding gap, i.e. the difference between deposits and loans. Between 2000 and 2007 in the Euro Area, the bank funding gap rose from € 830 bn. to € 1,540 bn., i.e. 18 percent of deposits in 2007. ABS issuance (including Residential Mortgage Backed Securities - RMBS, Commercial Mortgage Backed Securities - CMBSs, and Collateralised Debt Obligations - CDOs) filled about 77 percent of the increase in funding gap over the same period.

Due to different structural peculiarities (i.e.: diversified providers of collateral management services and no quasi-monopolistic recourse to tri-party system owned by systemic important financial institutions, minor recourse to sub-prime assets used as collateral, large adoption of international standard legal contracts), the collateralised funding market in Europe has proved more resilient and not a source of systemic risk. The downgrade ratio and the default rate of European ABS during the subprime crisis was significant lower than the one of US ABS, with the exception of Commercial Mortgage Backed Securities (see Fig. 1).
During the crisis, also the European securitization market closed down and new ABSs were mainly retained in bank balance sheets to be used as eligible collateral at the European Central Bank or the Bank of England (Fig. 2).

After the crisis, relevant financial regulation has being adjusted:

1. Credit Rating Agencies (CRA) conflict of interest has been addressed by oversight (EU Directive, Dodd-Frank Act);

2. Incentive misalignment has been addressed by the introduction of a 5% retention rate ("skin in the game"), which oblige sponsors of ABS to retain at least 5 percent of the credit risk of the assets underlying the securities;

3. Transparency is being addressed by the Global Joint Initiative of issuers associations and by the loan-by-loan initiative lead by central banks (see section 2.4);

Interconnectedness has been addressed by Basel 3 (particularly by the revision of counterparty risk).
Banks will need this product to refinance away from central bank funding and potentially to manage capital. In order for economic growth to be facilitated, a reconnection between capital markets and financial institution asset portfolios is essential. Other secured and unsecured bank debt products are not enough nor the answer in all cases. The need to restart the securitisation market has been stated since 2009.\(^5\)

To revitalise the securitisation market in Europe three things are needed:

1. To restore investors’ confidence;

2. To regenerate market liquidity overcoming the coordination failure that was freezing the market: “no investors without liquidity, no liquidity without investors”;

3. To tighten spreads to make issuance economically viable.

The PCS is a new, standardised, high quality and highly transparent, investment class. It is based on a market convention between representatives of issuers, investors, and arrangers that provides standards on quality, transparency and structure. EIB Group, the European Central Bank and Bank of England participated as “observers” in the PCS initiative. As the issuer can credibly certify the quality of the asset it is selling and private information is less relevant because the loans are less opaque or more standardized, spreads are expected to be lower. The market is organized and relies on a light

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\(^5\) “Given the pivotal role of securitization as an alternative and flexible funding channel, failure to restart securitization would come at the cost of prolonging funding pressures on banks and a diminution of credit.” [IMF 2009]

“Securitisation helped cause a crisis that killed it. A proper reincarnation should help the recovery” [FT 15/9/2010]
structure (the PCS Secretariat), which will also be engaged to improve over time the conditions and organisational market features of a liquid secondary market.

The PCS initiative has been publicly announced in June 2012 and formally launched in November of the same year with the announcement of the appointment of the PCS Board, chaired by the former head of Market Operations at the European Central Bank, Francesco Papadia. The first PCS labelled issuance followed in a few weeks (http://pcsmarket.org/). The PCS initiative is described in Appendix I.

The PCS includes four categories of assets: residential mortgages, auto loans, SME loans, and consumer credit. PCS eligible SME loans are loans or leases advanced by an originator to an obligor that is a small or medium enterprise for general business purposes, where the originator has full recourse to the obligor. Factoring type of instruments was not included in the PCS eligibility criteria, as they are not sufficiently standardized across countries yet.

In addition to the general eligibility criteria, which are applicable to all asset classes, each PCS Eligible Issuance, where the underlying assets are European SME Loans, must comply with additional criteria that were defined in close consultation with the European Investment Bank Group (EIB and European Investment Fund):

(a) The number of Obligor Groups is not less than 500;
(b) The aggregate outstanding principal balance of the Underlying Assets due from any single Obligor Group does not exceed 0.75 per cent of the asset pool;
(c) The originator of the Underlying Assets has provided a representation and warranty that the Underlying Assets in the asset pool are not of a lower credit quality (including tenor) than comparable assets retained by the originator (including previous securitizations) and (2) None of the Underlying Assets are loans in arrears, non-performing loans or restructured loans;
(d) Each Obligor Group has made at least one scheduled payment under each relevant Underlying Asset Agreement or (2) there has been a lending relationship between the originator and each Obligor Group for at least 12 months; and
(e) The number of Underlying Assets in the asset pool, which have no scheduled principal payments due in the next 5 years, is not greater than 25 per cent of the asset pool.

The securitization of SME loans creates indirectly a secondary market combined with funding for the originator. Investors buy a tranche (or several tranches) of the notes and often they intend to hold the notes until maturity, while the junior tranche is retained in full or in part by the originator.

The securities backed by SME loans (SMELBS) are traditionally a small fraction of the securitization market, which is dominated by RMBS: less than 15 percent of the European securitization volume over recent years. SME loans are in principle less homogenous than residential mortgages (with regard to size, legal forms, collateral etc.). Most SME securitization has traditionally been
originated in a few countries, such as Spain, Germany, Italy (especially leasing), Benelux, Portugal and United Kingdom.

The EIF typically provides guarantees on junior and mezzanine triple A tranches, but can also act as guarantor of for senior tranches of SMELBSs for funding driven transactions (Kraemer et al. 2010).

The only PCS labelled SMELBS (€600 million) so far has been originated by GEFA (Gesellschaft für Absatzfinanzierung mbH), the leasing German subsidiary of Société Generale.

2.2. Sharing risk and lowering interest rates

2.2.1. Direct lending
Government can provide funding to the SMEs either through the direct provision of funds through a state bank, or through the provision of funds that are leveraged by private sector investors. Both forms of intervention are common across developed countries. Government provision of SMEs’ financing can act as a counter-cyclical substitute for bank financing in times of financial distress. Furthermore, government involvement allows policy makers the opportunity to set strategic objectives and to target segments of the economy that are most likely to be disproportionately affected by a tightening of bank lending. This can include sectorial targeting e.g. for infrastructure purposes, or towards high-potential sectors of the economy with which banks are unfamiliar or where tangible collateral is less readily available.

The most pertinent risk associated with direct government funding for SMEs relates to the misallocation of capital deriving from either political interference or the lack of a profit motive to incentivise those making capital allocation decisions. Numerous academic studies have shown that higher state involvement in the banking sector is associated with weaker financial development, higher default rates, lower interest rates for firms in areas with stronger political patronage and a higher probability of incidence of a banking crisis (Holton et al. 2013).

With the above risks highlighted, it is often deemed preferable to follow the public-private model, where private firms, who then take full control of credit allocation decisions on a commercial basis, leverage government funds.

For example, in the Kfw Entrepreneur Loan programme, applications are submitted to Kfw by a commercial bank, which can be freely chosen by the applicant. Kfw finances up to 100% of the total investment. Kfw does not require any specific collateral, which in turn has to be negotiated by commercial banks. Kfw Entrepreneur Loan targets established enterprises (up to €500 million annual turnover) with more than three years in business, providing them with loans up to €25 million for medium and long term investment projects at favourable interest rates. Loans can be used for a broad set of activities such as the acquisition of land properties and buildings, construction costs, acquisition of machinery, external services or patents.

Kfw Entrepreneur Loan – Subordinated Capital aims at improving the capital structure of SMEs older than 3 years by providing loans up to €4 million in a two-tranches formula: a debt capital tranche of 50% and subordinated debt tranche of 50%. Loans applications need to be submitted by a commercial bank. Kfw can finance up to 100% of the total investment. The debt capital tranche has
to be secured by posting collateral, while the subordinated tranche does not; the latter will not represent a liability for the commercial bank.

The KfW ERP Innovation Programmes I and II support firms in meeting their long-term financing needs for investments in market-oriented research, Research & Development for new products, process and services (Programme I) and for the introduction of new products in the market (Programme II). Programme I provides loans up to €5 million to firms that are at least 2 years old and that have a turnover lower than €500 million; Programme II provides loans up to €1 million at favourable interest rates to SMEs that are at least two years old. The procedure and the package is the same as in the Entrepreneur Loan - Subordinated Capital, although the two tranches may vary between 50 and 60%.

2.2.2. Guarantee schemes
In many countries, Credit Guarantee Schemes (CGSs) represent a key policy tool to support credit to SMEs and to infrastructure projects (see Appendix I). Well-structured credit guarantee schemes spread some of the risk and thereby enable banks to extend loans to firms that would find it difficult to access credit otherwise. Relative to GDP the highest volume of guarantees is currently provided in Italy (2.3%), followed by Portugal (1.8%), Hungary (1.4%) and Romania (1.3%) (EIB 2014).

The actual costs of a well-designed guarantee scheme may be lower than the social costs (loss of output, rise in SME bankruptcy, increased unemployment) of not proving this kind of support. Some loans supported by guarantees displace loans that banks would have provided even without guarantee. However, guarantee schemes free up capital (the risk weight of the guaranteed portion is zero) and thus enhance banks’ total lending capacity (Infelise 2014).

Depending on the ownership structure and role of shareholders in the management of the schemes, CGSs can be classified into three main typologies: public guarantee schemes, public-private guarantee schemes, and private schemes.

Public guarantee schemes
Public guarantee schemes are generally managed by government-related agencies, but guarantee services may also be provided in a decentralised manner, through the financial system, with little intervention on how the guarantee scheme is run. In other cases, the public guarantee services are delivered through legal entities started on public initiatives and with majority participation of public entities. The government can play a direct role in the guarantee schemes by providing financial support, participating in their management, or, indirectly, by granting counter-guarantees whereby the government takes over the risk from the guarantor up to a predefined share of the guarantee.

Public CGSs are preferable to direct government lending schemes as, given that funds continue to be channelled through the banking system, appropriate credit quality assessments on prospective borrowers are more likely to be carried out. To achieve this, the risk coverage offered by the government on defaulted loans must be sufficiently low that banks have the necessary “skin in the game” to be incentivised to assess credit risk appropriately. A further possible advantage of CGS lies in the re-direction of credit allocation. Banks are likely to favour borrowers with tangible collateral and this could arguably lead to misallocation away from intangible-intensive sectors such as information technology, business services and other production involving research and development. By shifting the incentives of banks towards lending to such sectors, a CGS can increase
banks’ experience and expertise in lending to these sectors and, therefore, have a potentially positive long-run effect. However, the additionality of public guaranteed SME lending could be difficult to identify. It is possible that such a scheme will exist merely to allow banks reduce their exposure to default risk on loans that would have been made without the scheme, while charging borrowers an unnecessary premium.

The design of CGSs is crucial for their effectiveness and sustainability. Targeted enterprises, coverage ratio, credit risk management, and fee structure should ensure additionality. A major challenge for additionality of CGSs come from selection mechanisms. As financial conditions of guaranteed credits are generally more favourable than ordinary loan contracts, the scheme may attract borrowers with solid creditworthiness, which may able to obtain funds without the guarantee support. At the other extreme, loan guarantees may attract firms that seek finance for highly risky projects (adverse selection). In an attempt to maximise additionality, some schemes (e.g. the UK Enterprise Finance Guarantee and the Irish SME Credit Guarantee Scheme) restrict eligibility to those firms that have been denied credit on the loan markets. In some cases, additionality is sought by narrowly defining the target of the program, which may be a sector or specific categories of firms for which severe market failures were identifies (OECD 2012).

According to the IIF (2013) the Portugal’s guarantee schemes is highly effective in providing credit to SMEs. The Portuguese schemes focus on export or investment credit, providing mutual government guarantees for bank loans. The high uptake is related to the advantageous credit terms for SMEs, including extended repayment and grace periods; reduced costs of borrowing for SMEs; easy access to the guarantee lines, directly through the banks; high level of SME awareness. On the contrary, up-front fees and long lending terms were the main barriers to uptake in the Netherland.

Public guarantee are also used to support credit to infrastructure projects. The UK Guarantee Scheme for Infrastructure Projects, launched by HM Treasury in July 2012, assigns the UK sovereign rating to infrastructure project guaranteed debt instrument (Giovannini-Moran 2013).

**Mixed schemes**

Privately funded schemes and public-private schemes are characterised by the direct participation of the private sector, SME organisations, and banks in the funding and management of the schemes. An interesting model of private or mixed scheme is that of mutual guarantee schemes (MGSs). MGSs are private societies created by borrowers to improve their access to finance. Governments may provide financial support to MGSs, mainly in the form of counter-guarantee. These enhance the guaranteed credit volume that can be made available to SMEs, as well as the credibility and reputation of the scheme.

MGSs are characterised by strong ties with the local communities and territorial system and, often, members operate in a specific sector or value chain. This provides a specific information advantage to the schemes: they evaluate their members, assess their creditworthiness, express recommendations to lending institutions, and are involved in the recovery of losses should the borrower default. Therefore, MGSs act as signalling devise for large banks, which have more difficulties in accessing information on SMEs. However, MGSs may also provide incentives to moral hazard behaviours, as the collateral is external to the firm. However, the peer review process may act as a powerful mechanism for controlling risk and limiting opportunistic behaviour. Members have strong incentives to monitor closely their peers, which may prevent borrowers from excessively
risky behaviour and increase the repayment probability of the loan. Local and central governments may participate in the capital of MGSs or top up the guarantee: in these cases, incentives to moral hazard behaviours are higher. A multi-layered guarantee structure exists in Italy (Confidi) and Spain (Sociedades de Garantía Reciproca). The Italian system is very fragmented, but a concentration process is ongoing particularly in the North-East (Mistrulli-Vacca 2011).

Evidence shows that GCSs have been effective in mobilising large amount of credit and easing access to finance for a large number of enterprises (ADB-OECD 2013, Öztürk et al. 2014). Most countries have expanded credit guarantees to SMEs for inducing banks to reopen their credit facilities, thereby reducing the additional risk that banks need to take on their balance sheet when granting new loans. The amount of funds was increased substantially and eligibility constraints were eased, a higher percent of each loan was guaranteed, and applications were processed more rapidly (ECB 2014). In most cases, government guarantees provided to SMEs increased dramatically during the crisis. In some countries (e.g. France), as crisis measures were phased out and new programmes introduced to foster growth and job creation, some guarantee instruments were tailored to specific categories of SMEs, such as start-ups or innovative firms. In other cases, guarantee schemes were introduced to support equity investments, addressing, among other things, the need for deleveraging firms and supporting them in key transitions, such as expansion or ownership transmission.

MGSs have also been successful in providing support for lending to SMEs; however, their credit quality has deteriorated rapidly: in Italy, for example, the default rate for enterprises with mutual guarantees has been twice the default rate of other enterprises (Mistrulli-Vacca 2011). Nonetheless, the higher recovery rate for mutual guaranteed loans has maintained the Loss Given Default (LGD) lower than for un-guaranteed loans, keeping interest rates on guaranteed loans lower than on un-guaranteed ones (in Italy between 20 and 30 basis points).

The countercyclical expansion of MGSs has brought about an important change in scale and exposure to risk. This change is taking place with the ongoing transformation induced by Basel III. This has increased the need to upgrade the organizational efficiency and skill level of these schemes. The response to these challenges has been a change in scale with mergers and consolidation. This can help reduce the relative cost of service, as well as broaden the offer of guarantee instruments. At the same time, a trade-off may emerge between efficient scale and proximity to borrowers, which has been so far the competitive advantage of MGSs. This trade-off may be addressed by setting up a chain scheme, which includes a local layer close to the firms, a regional or inter-sector layer that provides mainly counter-guarantees and a national and/or European counter-guarantee fund.

**Europe-wide initiatives**

The European Commission and the EIB work together on blended risk-sharing instruments leveraging the EU budget with the EIB lending capacity to finance further special activities in EU priority areas. In November 2012, the Commission and the EIB launched the Project Bond initiative to support capital markets in financing long-term infrastructure investments (EC-EIB 2013).

**2.2.3. Credit Insurance**

Three European institutions dominate the private credit insurance landscape: Euler Hermes, Coface and Atradius. The firms provide insurance on accounts receivable, allowing SMEs to manage risk associated with financial default of their customers, both in the domestic market and abroad. Each has a detailed proprietary risk analyses by country, activity sector and company. Barriers to higher
uptake are low awareness and the relatively high cost of insurance. Regulatory risk weighting for prudential capital requirements of these private guarantees is significantly less favourable than for public guarantees (IIF 2013).

2.3. Favouring non-bank financing

European non-financial companies finance their investment largely through bank loans. During the crisis many banks have started to de-risk their business in order to adjust to pressures in their funding through deleveraging their balance sheets (by increasing equity capital and/or disposing of assets) as well as changes in funding structure. This process has been reinforced by changes in regulation (higher capital requirements, introduction of liquidity requirements) and may last for several years, with the consequence that credit may become less available and more costly. Therefore, since the onset of the crisis, non-financial companies have relied more on market-based funding, including different financial instruments, such as equity, debt securities, inter-company loans and trade credit. However, although EU corporate bond markets have developed in recent years, the non-financial corporate bonds account still only 15 percent of non-financial corporate debt compared to almost 50 percent in the US. Unless corporate – and especially SMEs – have access to alternative sources of finance, any decline in bank lending is likely to have an adverse impact on corporates’ ability to finance investment (EC 2013).

Insurance companies, pension and mutual funds are the biggest institutional investors in Europe. The investment strategies of insurers and pension fund are driven primarily by the characteristics of their liabilities in bonds, which provide stable and long-dated cash flows. However, for several reasons (increasing competition among insures, agency problems for pension funds, performance evaluation, recency bias) institutional investors are increasingly affected by sort-termism (OECD 2011). The largest share of their activities is invested in corporate bonds.

As banks are less able to meet the long-term funding needs of borrowers, this creates an opportunity for insurers and pension funds, because they tend to have long-dated liabilities that match the part of the credit market from which banks are retreating. Infrastructure investments are attractive to institutional investors as they can assist with liability driven investments and provide duration hedging. Infrastructure projects are long terms investments that could match the long duration of pensions and insurance liabilities.

Institutional investors have traditionally invested in infrastructure through listed companies and fixed income instruments. Although growing rapidly, institutional investment in infrastructure is still limited (OECD 2013). To encourage institutional investors to invest in infrastructure projects it is necessary that they are standardised and collected in dedicated portfolio (Bassanini-Reviglio 2014).

Long-term investors (principals) often invest via “agents” such as fund managers. Agents usually have better information and different objectives than their principals. The net result may be that agents misprice securities and extract rents. Large investors and authorities could address these problems requiring agents to adopt a long-term investment approach based on long term dividend flows rather than on short-term price movements (EC 2013).

2.3.1. Equity finance

Equity can be a better financing instrument for long-term, high-risk investments, as well as for investments with significant information asymmetries and moral hazard. However, since the crisis,
macroeconomic uncertainty and the low interest rates may have affected companies’ demand and risk appetite for long-term equity capital.

Current tax laws in most countries favour debt over equity. A welcome exception is Italy recent Allowance for Corporate Equity (ACE), which aims to enhance the capital structure of Italian companies by giving firms incentives to build up additional equity by allowing 3% of new equity to be deducted from income taxes.

Equity listings of SMEs remain limited. Initiatives aimed at developing trading platforms to raise equity capital for SMEs have been developed in each major country (see Appendix I). Access to these markets is typically designed for small and medium enterprises rather than for micro firms as the structure and the size of these operations still requires a structural minimum assets size. This feature allowed a relatively faster growth of these platforms in countries like UK and Germany where capital markets have been traditional more developed and where the share of medium firms is higher compared to other countries. In order to improve the visibility and the attractiveness of a public listing the operators of these markets are offering a broad range of complementary services aimed at supporting firms that could access these markets but that lack the necessary expertise to exploit this possibility (Infelise 2014)

One successful case is Alternext Paris, founded in 2005, which lists almost 190 SMEs. After the successful launch in more flush times, access has been eased in 2009 by adapting and streamlining the regulatory framework and rules (IIF 2013). The UK AIM (Alternative Investment Market) is also considered to have been successful due to a network of advisers that is experiences in supporting companies from the time they first consider a flotation, through helping them raise capital and a knowledgeable investor base (Giovannini-Moran 2014). Non-EU successful examples are the Stock Exchanges of Tel Aviv and Toronto as they enjoy a much localised, sector specific and interconnected ecosystem.

2.3.2. Capital markets
Capital markets represent an important alternative source of funding, but they are accessible mainly for large corporates domiciled in larger countries with more developed corporate bond markets. SMEs that face the more severe consequences of the credit crunch cannot afford the costs of bond issuance.

Alternative investment markets designed for issuance of SME bonds are relatively more recent and less developed compared to analogous platforms targeting SME stocks. Exploiting less stringent regulation, those markets aim at overcoming the major barriers in terms of costs and transparency requirements that usually prevent SMEs accessing external finance through bond issuance.

SME high yield bond issuance has become considerably important in Germany. Four of the eight German exchanges have started trading “Mittelstand bonds”. In Stuttgart, the BondM platform gives mid-cap SMEs the possibility of issuing bonds that can be directly sold to retail investors without an investment bank underwriting the issue. Covenant and documentation provisions and costs are also kept to a minimum (EC 2013).

Italy launched a bond market in 2013. It allows non-listed SME to issue mini-bonds, which enjoy tax relief on interest costs and issuance expenses. Mini-bonds issues may benefit from a guarantee
provided by the export credit and insurance public company (SACE) up to 70% of principal to the extent the mini-bond is issued to finance an internationalisation project.

Created in 2000, Euronext is the first pan-European exchange, spanning Belgium, France, the Netherlands, Portugal and the UK. In May 2013, Euronext launched EnterNext (https://www.enternext.biz/en) designed to develop and promote its stock markets specifically for small and medium-size enterprises (SMEs). Drawing on its pan-European presence, EnterNext brings together all Euronext Group initiatives for companies with market capitalizations under €1 billion, including companies listed on Alternext (the French equity market for SMEs). EnterNext has dedicated teams and offices across Europe in Belgium, Portugal and the Netherlands, as well as in several regions of France. EnterNext covers around 750 SMEs listed on Euronext markets in these countries.

However, the majority of specific SME markets or segments are struggling to attract companies. As a matter of facts, the smaller the company, the more disproportionate the cost to the benefits of being listed. The main barriers to accessing these markets and segments are (ESMA SMSG 2012):

- High cost of capital due to limited investor interest;
- Lack of appropriate research coverage. SME research is generally not in itself a profitable activity;
- Low liquidity; SMEs’ trading volumes tend to be limited;
- Higher transparency requirements impact on SMEs governance structure;

2.3.3. Funding escalator
There are other different sources of funding that firms can access at different stages of maturity (seed financing, business angels, venture capital, private equity and so on). These forms may combine to form a “funding escalator”, providing debt and equity as firms grow and their funding needs evolve. These schemes are more targeted than guarantee schemes and restricted to specific groups of firms (ECB 2014).

As a way to reinvigorate private funding sources, several countries are using tax incentives designed to attract new investment funds. The French scheme allows French citizens to invest up to €12,000 per year in pooled managed funds, which then invest in SMEs. The Irish Employment and Investment Incentive Scheme allows individual investors to make direct investments in SMEs and obtain income tax relief on capital up to €150,000 per year.

Public intervention is sometimes aimed at supporting young entrepreneurs to set up their own business. In UK the Start-up Loans support entrepreneurs aged 18-30 by providing them with loans even if they lack real collateral or proven track record. Loans are supplied upon evaluation of a viable business plan; started in May 2012, the programme backed more than 12 thousand business with an average loan size of £5,700. Applicants need to pay back the loans in five years at a 6% fixed interest rate.

In Germany, through the ERP Start-up Loan (StartGeld and Universell) KfW helps business founders, self—employed professionals and SMEs (up to €50 million annual turnover) with less than three years in business providing loans up to €100,000 at favourable fixed interest rate. Loans need to be used to finance growth of expansion of young enterprises, succession of an enterprise or take-over
of an enterprise. Applications are submitted to KfW by a commercial bank, which can be freely by
the applicant. KfW finances up to 100% of the total investment. KfW does not make any specific
requirement on collateral, which in turn has to be negotiated by commercial banks. The StartGeld
scheme (for small enterprises up to 10 million annual turnover) is supported by a guarantee of the
European Investment Fund (EIF), which implements the Competitiveness and Innovation Framework
Programme (CIP). The commercial bank bears 20% of the credit risk in the Start Geld scheme, none
in the Universell scheme.

The Netherland is pursuing private-public partnerships with the goal of securing more seed funding.
For example, banks and the state are pooling resources through Qredits, a microcredit institution, to
provide funding, while the EC and EIB Group are providing first-loss credit insurance.

In UK the Business Finance Partnership (BFP) is a programme run by the UK Treasury aimed at
stimulating funding through non-bank loans. The programme was started in autumn 2012 and will
invest £1.2 billion in different tranches. BFP stimulates private fund managers to invest in SMEs and
mid-sized companies by co-funding up to 50% of the loans’ value. The Treasury manages the BFP and
chooses which applicant funds to support, and fund managers operate independently according to
their investment strategies (Infelise 2014).

2.3.4. Non-bank financing: Credit Funds, Peer-to-Peer lending and Crowd Funding

Security lending
Regulated banks transform short-term deposits, redeemable at any time, to create medium/long
term credit. Convertibility is made possible because counterparties depositing money into a bank
need not to worry about their money deposited and counterparties receiving credit do not worry
about the value of the “check” received. Today, this is possible because of deposit insurance, the
purpose of which is precisely to ensure that no party to the transaction, where the bank acts as
intermediary, needs to be concerned about the value of the “check”. Deposit insurance makes the
value of bank deposits “information insensitive”. This means that, alike a currency, no one need
devoting many resources doing due diligence.

Similarly, securitised finance (such as covered bonds) and securitisation techniques (asset pooling,
tranching techniques and credit enhancements) creates information insensitive debt to be
“converted” into credit in the financial markets (such as repo markets). Like demand deposits in the
traditional bank sector, senior tranches of securitisations used as collateral to get credit in the
collateralised funding markets were perceived until the crisis as “information insensitive”.

In addition, there exist a wide range of credit intermediation activities, which take place without
official credit enhancement, such as security lending activities of insurance companies, pension
funds and certain asset managers (Pozsar et al. 2012). Corporates remain major users of
securitisation, through both the securitisation market as well as Asset Backed Commercial Paper
(ABCP) programmes. ABCP programmes are frequently used by large and mid-sized corporates to
raise cash from the sale of trade receivables and leases in a cost-efficient manner (AFME 2013).

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6 Gorton (2010). This was not the case before the ‘30s, when demand deposits were not insured.
**Direct lending**

There is a recent and growing interest for direct financing to SMEs by non-bank institutions, for example by the setting up of specialised debt funds. However, the leaner structures of funds and their management limit their ability to obtain efficiently the level of grass-root information.

In Germany, there is a large private placement market, known as Schuldschein (€10 billion issuance in 2012). Schuldschein are bilateral, unregistered and unlisted loan instrument that are sold directly to investors. In contrast to bonds, Schuldschein loans are not securities and are traded over-the-counter. The large German commercial banks and Landesbanken typically act as arrangers and intermediaries for Schuldschein loans. There is limited secondary Schuldschein market but it is less liquid that the bond equivalent. There is no specific Schuldschein regulation; however, their issuance is regulated under German banking regulations. There are several benefits of Schuldschein loans over bonds: short documentation, unrated issuance, confidentiality, flexibility of terms and conditions, restricted distribution only to institutions (Schuldschein cannot be sold to retail investors directly).

France has been an innovator in direct lending: since August 2013, insurance firms have been allowed to invest up to 5% of their liabilities in loans to unlisted companies (only listed bonds were allowed previously), either directly or through special funds (so called loan-to-real-economy funds or *Funds de Prêts à l’Economie*).

Partnership between direct lending funds and banks increased over the past years. In general, banks underwrite debt using their credit expertise and their close relationships with companies and distribute to insurers or asset managers looking to diversify their investments. In this way, banks limit the impact of these loans on their capital requirements and retain their clients while deleveraging. The lending funds enjoy indirectly of the official credit guarantee which banks enjoy directly. French asset manager Amundi, for example, has partnered with UniCredit to offer financial support to German mid-market. Likewise, in the UK, Barclays announced its partnership with private debt lender BlueBay Asset Management (a unit of Royal Bank of Canada) to provide a unitranche debt facility for mid-market private equity deals. Generali has signed a joint deal to finance Germany’s Mittelstand with Dusseldorf-based bank IKB and Gothaer, a local insurance group and IKB.

**Crowdfunding**

Crowdfunding is the practice of funding a project or venture by raising monetary contributions from a large number of people, typically via the internet. There are three types of crowdfunding (ESMA 2014): 1) reward-based crowdfunding, where the return to investment consists of a copy of the finished product; 2) security-based crowdfunding, where the return consists of securities or unlisted shares of the company, usually in its early stage; 3) loan-based crowdfunding, where the internet platform collects the credit requirements and matches them with pools of investors willing to accept the credit terms.

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*A unitranche debt facility is a single tranche term facility, provided principally by credit funds. More narrowly, it is a term facility which from a borrower’s perspective contains only one class of lenders and under which a common interest rate is charged.*
Reward-based crowdfunding is popular mostly for creative endeavours such as films, music, games, free software development and scientific research (Standard & Poor’s 2014). Example of loan-based crowdfunding platforms in the US are Lending Club and Prosper.

There are different types of risks associated with crowdfunding: fraud, liquidity, legal, platform failure. In Europe, the majority of countries do not have any specific regulation of crowdfunding, but rather leave it to be dealt with under the existing relevant regulatory framework. In the case of pure investment crowdfunding (security-based), absence of specific regulation leaves it under the limits as stated in the Prospectus Directive: European wide requirement of a prospectus for issues larger than € 5 million, and no obligation at all for issues under €100.000 (ESMA 2014).

Some EU member states have decided to take regulatory action on crowdfunding (among these Italy, the UK, France, and Spain). In July 2013 Italy become the first country in Europe to implement complete regulation on security-based crowdfunding, which applies only to innovative start-ups and establishes a national registry and disclosure obligations for both issuers and portals. Other EU member states have instead issued guidelines (Germany, Belgium and the Netherlands). Germany has not produced any specific regulation of crowdfunding, and yet is one of the European countries where equity crowdfunding has been more active.

In March 2014, the European Commission has published a Communication about “Unleashing the Potential of Crowdfunding in the European Union”. While the Commission does not intend to come up with legislative measures in the near future, it will carry out a study and will set up the European Crowdfunding Stakeholder Forum.

**Peer-to-peer lending**

A particular form of crowdfunding is Peer-to-Peer lending (P2P), whereby individuals lend to each other and small business via the website. P2P has been growing in the United States⁸, Germany and the United Kingdom⁹. By avoiding complex structures and procedures of normal banks and thus some overhead costs, as well as regulatory burden, P2P lender can offer credit at relatively low rates and offer relatively higher returns to their investors to whom the loans are sold in slices. Many of these lending websites are now becoming more active in lending to SMEs (Wehinger 2012).

Of the £1.2bn funding of the UK government’s Business Finance Partnership⁸, roughly £85m has gone to seven “alternative funding” providers. The inclusion of these platforms in the scheme is a signal of the growth potential and growing acceptability of P2P among UK policy makers. This process has been accelerated further by the inclusion of P2P lenders under the regulation of the Financial Conduct Authority from April 2014.

Survey evidence in the UK suggests that 60 per cent of SMEs that used Funding Circle had tried to get bank financing previously, and 32 per cent would not have received funds from any other source. Such numbers suggest that, when assessing P2P against the “additionality” principle, there appears to be scope for improving credit access for SMEs. However, as it currently stands, retail investors considering P2P are not protected by legislation on issues such as anti-money laundering or fraud,

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⁸ The most prevalent market participants are Lending Club and Prosper.
⁹ The main platforms in the UK are Funding Circle and Zopa, with the former focusing on SMEs and the latter on consumer lending. An overview of all P2P market participants in the UK can be found at [http://www.p2pmoney.co.uk/companies.htm](http://www.p2pmoney.co.uk/companies.htm).
nor are they guaranteed a transparent disclosure of the platforms’ credit checking processes. Furthermore, P2P platforms generally do to not have any “skin in the game” in the loans transacted on their websites.

**Sum-up**

These initiatives provide some useful lessons. First, non-bank institutions may compete with traditional banks as far as they are able to get information advantages alternative to relationship banking: this may be mainly achieved through specialization in the assessment of specific credit risks, related to either the company stage or its main activities. Second, non-bank lending can take-off independently of traditional banks only if it can benefit from a direct official enhancement or a well-functioning securitization market that allow transferring risks.

### 2.4. Reducing the information gap for SMEs

For mid-caps and SMEs the main cause of difficulties in accessing funding is the lack of credible low-cost information about them. This results in increased costs and difficulties in evaluating their credit worthiness by potential providers of funds. Research on SMEs is costly and investors are generally not eager to pay for it (EC 2013, IIF 2013). Few third-party providers offer sophisticated analyses of SME creditworthiness. In some countries (i.e. UK), the SME market is sustained by a market maker model based on spreads. In some countries (i.e. UK), the SME market is sustained by a market maker model based on spreads\(^\text{10}\) (ESMA SMSG 2012).

At the European level, the ECB – through the European DataWarehouse (ED) – is seeking to centralise and standardise loan-level performance data for Asset Backed Securities (ABSS), mainly mortgages but also SME loans (IIF 2013).

Broadening access to information and developing harmonised minimum quality standards on external credit scoring for SMEs would facilitate financing, also cross-border, of their investments and deepen market integration. For example, the Banque de France uses detailed loan-level data and additional information on SMEs’ performance to develop scoring for them. The scorings can be accessed by third parties – but not any underlying proprietary data (IIF 2013, Giovannini-Moran 2014). A credit rating system for SMEs has been developed in Austria (ECB 2014).

Under the aim of reducing the information gap we include also the Credit Mediation Schemes (CMSs) introduced in several countries during the recent crisis. CMSs aim at reducing the sources of conflict during credit negotiation processes by favouring the exchange of information between credit institutions and SMEs. This can be done by conducting an independent assessment and, if it is positive, submitting additional information to the financial institutions, or by bringing together SMEs and credit institutions often with the support of other experienced parties, in an effort to reconcile the differences between them. Through the intervention of external professionals, these programmes help SMEs in filing loan applications, thereby enhancing the quality of the financial information exchanged between companies and banks. The credit mediation activity is advisory in nature and neutral: it aims to facilitate lending relationship, but the mediator generally has no authority to impose a decision on a financial institution. CMSs are available for SMEs whose demand

\(^{10}\) Market maker spread is the difference between the price at which a market maker is willing to buy a security and the price at which it is willing to sell the security. The market-maker spread is the difference between the bid and ask price posted by the market maker for a security. It represents the potential profit that the market maker can make from this activity, and it is meant to compensate it for the risk of market making. Market-maker spreads widen during volatile market periods because of the increased risk of loss.
for credit has been entirely or partially rejected by a financial institution. In addition, credit meditators have been entrusted with other soft functions, such as monitoring the financial framework and providing advice to competent authorities. As is the case with other forms of government intervention in the credit market, the separation of the credit mediation body from political interference is crucial to its successful operation (OECD WPSMEE 2013).

The mediation scheme in France has been the first to be set up (2008) and it is the largest, consisting of 105 local mediators and mediation panels across the country, which build on local expertise and institutions, ensuring that in-depth specific and contextual knowledge is part of the mediation process. In Germany and Ireland, national mediator offices work in close collaboration with other institutions, such as Chambers of Commerce, and experts. In the course of the process, the mediator can provide firms with information and advice about available instruments to support their credit request, such as credit guarantees. In several countries (notably France) the central bank is a key player in the mediation process. In UK the credit mediation is carried out by a public-private partnership: the main banks launched the Appeal process in 2011. Since 2012, the banks have agreed on the appointment of an external independent reviewer, whose selection was backed by the UK Department for Business, Innovation and Skills and HM Treasury.

The evidence suggests that credit mediation mechanisms have been effective in responding to the appeals of credit-constrained SMEs and have facilitated, in most cases, the revision of lending decision by banks. Over time, the complexity of the cases submitted to mediation has increased and the scope of mediation broadened, from short-term loans to credit insurance and equity finance. Small firms with less than 50 employees have been the main users of the programmes, although the lack of awareness about the service often represents a key obstacle for a broader uptake by SMEs.

Publicly-supported credit mediation differs from consultancy services provided in the market by professionals and service firms, mainly because it has a system—wide target, such as restoring and smoothing relationships between banks and SMEs, it often works through concerted actions with several different actors and institutions, and implies a neutral role of the mediator. Nevertheless, the type of service provided may compete with that of business consultants, which provide SMEs advice on business plans, financial management and credit relations.

Information gaps can be reduced also favouring longer bank lending relationships, where banks accumulate a rich history of information on their borrower that allows them to access more efficiently their creditworthiness. SMEs with longer bank relationships have enhanced access to loans, but, at the same time, they incur higher costs for their debt. Hernandes-Canovas (2010) finds that relationship with banks based on trust is a better strategy to improve SMEs access to finance (less credit rationing) that the establishment of longer or more concentrated relationships.11

2.5. SME debt restructuring

The crisis hit some European SMEs harder than others, particularly those in construction, as well as SMEs that sell mainly to domestic markets, especially to local, regional and national governments. These enterprises could not meet their obligations on debt contracted before the crisis. Some of them defaulted; others are still viable but need to restructure their debt in order to survive to the

11 See also the literature quoted in Wehinger 2014.
worse economic conditions. The share of impaired loans in the balance sheets of banks have increased, particularly in countries more hit by the crisis. This has negatively influenced banks’ rating perspectives and increased their funding costs. As a result, banks’ risk aversion has increased.

Corporate debt restructuring is usually accompanied by enterprise restructuring when the enterprise is liquidity constrained but still fundamentally viable. Debt restructuring agreements are aimed at overcoming temporary difficulties in order to avoid default.

Corporate debt restructuring may also contribute to clean the banks’ balance sheets. According to the European Banking Authority single rulebook, after a one-year trial period, restructured loans can be reclassified in bonis, therefore reducing the share of impaired loans on banks’ balance sheets.

Debt restructuring agreements typically include asset sales, re-phasing of payments (e.g. postponements of some reimbursements, longer debt maturity), roll-overs, changes in interest rates, forbearance of interests due or part of the debt, debt-equity swaps12 (Garrido 2011). These agreements can also include changes in the management (typically the CFO). Independent advisors are involved in the valuation of the new business plan and of the restructured debt sustainability, as well as in monitoring the plan execution.

In some countries, SMEs operate within legal frameworks that force them to liquidate rather than restructure. Italy amended its bankruptcy statute to allow a company to ask a court for protection from creditors, typically lasting three months, while it comes up with a restructuring plan and tries to convince its creditors to restructure its debt. A company can also seek new financing, and those creditors automatically become the first to recover their money should the company be liquidated.

A typical example of the usefulness of restructuring agreement are unfinished projects. A building whose construction has been terminated because of the default of the construction company is an almost valueless asset in a static liquidation, as the sale price will recover only partially the value of the finished building. Furthermore, the sale may be finalised after a long period. For the bank, the loan to the construction company, possibly backed by the value of the finished building, is a defaulted loan with a very high Loss Given default (LDG). However, in a legal framework that allows contractual solutions, the immediate sale of the building project to a new building company willing to finalise it may provide a higher asset value in a shorter time span. However, typically the sale of the unfinished project would involve some debt restructuring.

The out-of-court debt restructuring, however, is not the optimal solution if the debtor situation requires certain specific effects, such as a stay on creditor actions that provide some breathing space from collection efforts, or the repeal of executory contracts (claw-back). In these cases a formal insolvency procedure may be the only viable option (Garrido 2011).

Market failures can inhibit the debt restructuring process. For example, attrition problems can plague voluntary loan workouts, with delays that are optimal for the individual negotiators but not for the economy as a whole. Rather than recognize and address unsustainable debt problems, firms and their creditors may instead attempt to ride-out the crisis in the hope that economic recovery will eventually bail them out (Laryea 2010). Agreements for debt restructuring and enterprise recovery,

12 The Spanish Decree of Refinancing Agreement and Debt Restructuring enacted on March 2014 aimed to promote out of court refinancing agreements by facilitating debt to equity swap, among other (IMF 2014).
for example, may be difficult because of multi-banking relationship: the bank debt is fractioned among several banks. The coordination of the banks is necessary to reach restructuring agreements and coordination failures among banks are the typical obstacles to debt restructuring agreements. Attrition wars can plague negotiations, with delays that can be in the interest of individual stakeholders, but not for the economy as whole. Banks sometimes lack sufficient staff that are skilled in identifying viable companies and supporting the restructuring of debt (IIF 2013).

The coordination is the more difficult the higher the number of banks involved (Garrido 2011). Besides the usual free riding problem, banks may have conflicting interests:

- the house bank may be more willing to reach an agreement, whereas marginal banks may be less willing to;
- some exposures may be collateralised by guarantees or insured, whereas others may be not;
- there may be information asymmetries which lead to strategic games;
- minor lenders may follow a strategy of “rational apathy”.

How to overcome this coordination failure? The most known initiative is the so-called “London Approach” started by the Bank of England in the mid-seventies: the central bank facilitate the negotiation between the enterprise and the lenders acknowledging self-regulation. Several countries relied on mediation by government agencies to facilitate voluntary workouts. The General Principles for creditors’ agreement published in 2000 by the International Federation of Insolvency Professionals (INSOL International) are based on the London Approach. The principles envisages the need to cooperate, to provide a “standstill” period in which the creditors and the debtor abstain from individual actions, the access (as well as the confidentiality) of relevant information on the debtor, priority repayment to additional financing during the standstill.

For the informal restructuring process to operate effectively there must be a sanction in case the negotiation process cannot be started or breaks down. For the debtor, this may be the swift and effective resort to formal insolvency laws. For this purpose, creditors may frame an inter-creditor agreement whereby, if the debtor does not comply with the restructuring process, does not provide information or does not comply with an agreed restructuring plan, the creditors will commence actions against the debtor to place it into formal insolvency procedures or take the appropriate legal actions.

Sanctions for creditors who do not comply with the guidelines (do not attend meetings, do not provide information, do not respect confidentiality or do not motivate disagreement) may take the form of “name and shame”: for example, their names may be published in a list of uncooperative creditors in the website of the central bank or of the advisory agency (see below).

Based on these principles, and drawing on IMF and World Bank assistance, a few countries such as Iceland, Latvia, Romania, and Portugal have recently issued nonbinding guidelines on out of court corporate debt restructuring. The debt restructuring guidelines may envisage the obligation to attend meetings, certainty on timing, the obligation to motivate disagreements from the majority, exclusion of pre-emptive opposition to the acquisition of the loan of the dissenting banks by the other banks, netting of financial positions.
In any case, the “London Approach” remains voluntary and based on social norms and unanimity among financial creditors and debtor. In countries where social norms are less compelling, debt restructuring may be enhanced by standardisation, contractual provisions and specific legislation. An independent entity could facilitate time-bound negotiations by fostering creditor coordination and arbitration.

A standardized menu of voluntary restructuring agreements could play an important role to facilitate debt workouts for SMEs. The large number of SMEs implies that centralized case-by-case mediations are unfeasible. Similarly, the in court bankruptcy system cannot handle so many restructuring processes.

In Ireland, for example, a debt-restructuring scheme allocates the debt into three tranches to allow viable SMEs to address the overhang of debt:

- Tranche A: sustainable debt serviced by SME, with interest and principal repayments;
- Tranche B: debt warehoused with low interest rate; principal repayment restarted in five or six years;
- Tranche C: debt warehoused, potentially without any interest payments, and written off if tranches A and B are repaid within an agreed period.

A standardized SME restructuring scheme could include also: i) a simple method to assess viability (e.g., interest cover ratio thresholds); ii) harmonized restructuring terms for viable firms (e.g., extension of loan maturities, improved interest payments terms, debt reductions/equity swaps); and iii) fresh funding for working capital for viable firms. The latter is particularly important, as successful restructuring requires that the debtor has access to finance that allows it to continue its operations.

In Spain, according to the new legislation, firm owners may be personally liable if they reject a debt-to-equity swap that is considered “reasonable” by an independent expert.

Successful workouts require the cooperation of independent advisors and experts. Advisors should help creditors to get a clear picture of the debtor’s situation and its viability according to a new business plan. The existence of arbitration may help creditors solve their coordination problems in negotiating a work out with the debtor. The arbitration techniques may include specific deadlines and penalties for parties that do not comply with deadlines.

Therefore, to promote corporate out-of-court workouts it could be helpful to have a public-private advisory agency, perceived as independent, acting also as a catalyst and arbitrator to facilitate debt restructuring. In some countries, this role is played by the credit mediation mechanism (see par. 2.4). Portugal adopted guidelines to facilitate out of court negotiations of a debtor’s recovery through mediation of IAPMEI, an agency of the Ministry of Economy, with a focus on SMEs (Liu-Rosenberg 2013). Since September 2012, a formal out of court regime to facilitate debt restructuring tailored to SMEs through mediation by IAPMEI, the so-called SIREVE, has been in force in Portugal. This regime is formalized in a law and for instance involves a standstill for participating creditors. There is no cram down (on dissenting creditors by a court) and only participating creditors are bound by an agreement. Given that this regime has only been recently adopted, there are many pending SIREVE cases but only a few cases have so far emerged successfully (IMF 2013).
The tax authorities should be allowed to participate in out-of-court debt restructuring based on clear criteria. Many times a large fraction of a firm’s liabilities are tax liabilities. Hence, tax authorities should be part of debt restructuring for viable firms under financial stress. Portugal made legal changes in 2011 requiring tax authorities to participate in out of court debt restructuring (Murphy 2014).

3. Some recent proposals

3.1. Additional aims

3.1.1. Lengthen time horizons
Investors with the appropriate time horizons, risk appetite, and liquidity needs would better match long-term investment opportunities. While banks have historically met a large part of long-term financing needs due to their expertise in credit origination and monitoring functions, bank loans are not the most appropriate instrument for all types of long-term financing. Financing for long-term investment has been too often provided by short term bank lending. However, much of banks’ activity is not the provision of long-term finance: a large portion of their loan assets are in real estate. Pension funds, sovereign wealth funds, insurers are seen as more appropriate long-term investors.

Households tend to be reluctant to commit long-term savings for both cyclical and structural reasons. During the economic and financial boom preceding the crisis, the increased availability of credit and the “wealth effect” of asset appreciation (including the real estate bubble in some countries) have lowered the level of households’ savings. In the following economic downturn, increased uncertainty and high unemployment have increased the preference of savers for liquidity. In addition, low interest rates make saving less attractive (EC 2013).

On the contrary, due to population ageing and the reduced possibilities of public pensions (pay-as-you-go), there is a need for funded complementary pensions and supplementary individual savings for retirement (pension gap). At the same time, older investors, which are an increasing share of the population, are shifting their portfolios toward lower-risk assets such as deposits and fixed income (G30 2013).

As voluntary private pension coverage has been generally low, mandatory pension savings might collect funds in a more regular way. They have been implemented in a number of EU member States: Sweden, some countries in Central and Eastern Europe (CEE) and the UK (EC 2013).

The European Fund and Asset Management Association (EFAMA) has proposed a plan to boost retirement savings by creating a “European brand” of personal pension products that could be distributed on a cross-border basis: OCERP, Officially Certified European Retirement Plan (EFAMA 2013). The OCERP would offer a limited number of investment options, an administrative support platform and professional advice. An EU legislative framework would have to define standards for the certification of an OCERP as a product, for the governance and administration arrangements that OCERP providers would have to comply with. Only investment products benefiting from an EU passport for distribution to retail investors should be eligible to preserve the quality and reliability of
the European label of an OCERP. These investment products should therefore include the European Long-Term Investment Fund (ELTIF, see below).

### 3.1.2. Increasing awareness and demand for alternative forms of finance

Access to non-bank financing may be prevented by a lack of awareness amongst smaller companies of alternative sources of financing outside the existing relationships with their banks, a lack of expertise required to access the appropriateness of these alternative sources and a lack of confidence in their ability to secure them. Usually SMEs are unaware of the many support schemes and initiatives that the Government has in place (ILWGADB 2012).

The programme ELITE, provided by Borsa Italiana (in partnership with advisors, financial intermediaries, legal offices, public institutions, and auditors), offers enterprises the industrial, financial and organizational skills they need to address the challenges of international markets. However, this programme does not address the issue of lack of awareness.

The creation of a single Business Support Agency, as proposed by ILWGADB 2012 would increase the scale and effectiveness of Government communication. Such an agency could expand current capabilities within business with the provision of training and management support, particularly in the area of finance expertise.

### 3.1.3. Improving access to capital markets financing for SMEs

The primary restriction on access to the bond markets is the need for institutional investors to invest in liquid securities. The mark-to-market requirements of institutional investors combined with the fact that the investors are often benchmarked against indices (which often limit investments to companies with an external credit rating) reinforces this bias towards large, highly traded, liquid issues.

An option that removes the requirement for investors to analyse the credit quality of many small issuances from individual SMEs would be to aggregate a large number of SME loans and finance them via the corporate bond market or the ABS market. An Agency for Business Lending (ABL) could aggregate and finance SME loans, for example by establishing a fund to buy SME loans and SME-loan high quality ABS (such as PCS, see section 2.1.2) from the originating banks. The Agency could finance these activities by issuing securities on the public bond markets to institutional and retail investors.

Creating an ABL would require co-ordinated action across banks, investors, rating agencies, infrastructure providers, industry associations and regulators. The ABL could be established through a PPP.

### 3.1.4. Increasing cross-border lending

Cross-border capital flows have been driven by short-term, volatile lending. During the crisis banks have reduced cross-border lending, which has led global companies to increasingly rely on their own domestic financial institutions further reducing the availability of debt capital for SMEs. Moreover, stress in bank funding, bank nationalism and national ring fencing have increased the home bias (EC 2013).

A first step could be to that promotional institutions (see paragraph 1.1) collaborate more actively with the European Commission and the EIB and with each other and operate on a cross-border basis.
Cross-border operations may require changes to the statutes in some cases (Giovannini-Moran 2013).

### 3.2. Europe-wide private-led initiatives

**Deal Documentation Standardisation**

One of the biggest barriers to the development of a cohesive direct funding or private placement market is the lack of standardised deal documentation throughout Europe. Indeed, the standardisation of legal documents would reduce transaction costs, and in that way attract new issuers and bring fluidity to the market. Several initiatives are in place (S&P 2014). The International Capital Market Association (ICMA) is taking the lead in coordinating the work of the Pan-European Private Placement Working Group (PEEP WG) that currently include the Association for Financial market in Europe (AFME), the Association of British Insurers (ABI), the European Private Placement Association (EUPPA), the French Euro Private Placement (Euro PP) Working Group and the London based Loan Market Association (LMA) together with representative from major institutional investors and major law firms and observers from the official sector (including Banque de France and HM Treasury).

**SME database**

The creation of a database-agency collecting and disseminating standardised information on SMEs across countries would reduce information gaps. This should ensure the collection of all SME available data, including audited accounts, payments information, ownership and structure, credit, banking relationship and guarantees. In this respect, national central credit registry data could be consolidated with that collected by the European DataWahouse, toward the establishment of a European central credit registry. In perspective, this could allow to set up European standards for credit scoring assessments of SMEs (Giovannini-Moran 2013).

**Convertible Loan Market for SMEs**

The creation of a database-agency is a key element of the proposal for a convertible loan market for SMEs aimed at lowering the cost of credit and rewarding the most productive firms. A convertible loan would give the holder the right but not the obligation to convert it into a specified equity stake in the issuing company (Stringa 2013)

However, as the PCS initiative has shown (see Appendix), for private-led initiative to be successful it is necessary to overcome national barriers and coordination problems and to mediate through contrasting interests. The catalyst role of a strong European Institution (such as the European central bank) may be necessary. In any case, there is need for leadership and expertise. It is also important that relevant authorities are open to discuss possible changes in regulation to facilitate the start-up of these initiatives if they find merit in them.

### 3.3. Europe-wide public-private partnership

Given the distortions that prevent many investors from capturing the returns from efficient long-term investing, there is a market opportunity for establishing new lending institutions or investment intermediaries with long-term mandates. Public sector institutions could provide wholesale financing to private banks, which would then lend those funds to long-term projects (G30).
However, though the jury is still out on the main causes and origins of the recent crisis, there is a certain consensus on the fact that the US Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, have played an important role. The lesson is that public institutions operating in the finance industry should be at least well capitalised and well regulated and aimed at remediying a clearly identified market failure (Acharya et al. 2011). The distortionary effects of implicit subsidies and the potential systemic risk of financial market distortions should be always considered when designing credit policies. As far as direct intervention in financial market is concerned, public-private partnership seems to be a better solution.

Since some public-private initiatives have not been successful, it is important to focus on best practices (G30 2013). According to AFME 2013, the Treasury should put skin-in-the-game (guarantee) to give confidence to investors. EU guidelines governing changes to project fee/tariff and compensation mechanism would create a better business environment (AFME 2013).

**European Infrastructure Guarantee Facility**

For projects that do not match the strict minimum credit quality standards of pension funds and other institutional investors, member states together with the appropriate EU level institutions could establish a pan-European institutional vehicle that would provide a European Infrastructure Guarantee Facility. A combination of the public sector, EU institutions and private sector investment could be fund this institution. The vehicle would need to have the capability to provide a controlling creditor role to manage its exposure to the project’s risk where it is directly guaranteeing the debt. Furthermore, the vehicle would need to demonstrate sufficient autonomy from individual governments to address potential conflict of interests (Bassanini-Reviglio 2013, Giovannini-Moran 2013)

**Eurosystem of Investment Banks (ESIBs)**

Many initiatives have been already taken at the EU level to enhance the cooperation of national promotional institutions. In the early months of 2009, *Caisse des Dépots, Cassa Depositi e Prestiti*, the EIB and KfW created the Long-Term Investors’ Club (LTIC). Cooperation between these institutions could lead to further new initiatives and new instruments. (Bassanini-Reviglio 2014).

Valla-Brand-Doisy (2014) propose establishing, by treaty, a Eurosystem of Investment Banks (ESIB), around a pan-European financial capacity that would coordinate the actions of the national public investments banks of Euro area member states (such as KfW, *Caisse des Dépôts et Consignations, Cassa Depositi e Prestiti, Istituto de Credito Oficial*) and add to their funding capacity. The ESIB would be structured around a federal centre and national entities. The central node, the Fede Fund, would be created by restructuring the European Investment Bank into a truly federal entity. The mandate of the ESIB, enshrined in the Treaty, would be to promote long-term growth, well-being and employment in Europe. The ownership and governance of the Fede Fund would be public and private; its equity should amount to 4% of Euro Area GDP (around €400bn). With a leverage ratio of 2.5 (in line with EIB statute), the Fede Fund would also issue debt to finance investment at an economically relevant scale (10% of Euro area GDP).

**Cross-border Equity Fund**

Oliver Garnier, chief economist of Société Generale, has proposed to set up a long-term investment vehicle funded by both private sector and government savings (or benefitting of a government guarantee) of Euro area surplus countries (namely Germany) and designed to take equity stakes in
periphery economies (Garnier 2014). The Equity Fund would complement the banking union by enhancing cross-border capital ownership of banks and corporates within the euro area. In theory, this process should take place spontaneously through market mechanisms. In practice, however, this process is hindered by political, regulatory and economic obstacles. Therefore, more centralised solutions combining private and public funds are necessary, at least as catalysts in the initial stage.

3.4. European Institutions

Joint SME Financing Initiatives
The Commission and the EIB are also working with the ECB to develop an EU strategy to alleviate the financing constraints for SMEs. The discussions focus on options for reviving the structured credit markets to support SME lending. The Commission has developed three broad options for Joint EC-EIB Instruments (EC-EIB 2013):

1) Joint SME guarantee instrument combined with a Joint securitisation instrument for new loans; this option would generate bank capital relief for new loan generation.
2) Joint securitisation instrument allowing for securitisation of both new and existing SME loan portfolios;
3) Joint securitisation instrument allowing for securitisation of new and existing SME loan portfolios and risk pooling.

Option 2, or better still Option 3, would also develop the European capital market, support a diversification of corporate financing from banks, and contribute to overcoming fragmentation of the Euro area financial markets (Giovannini-Moran 2013).

European Long Term Investment Funds (ELTIF)
The European Commission has proposed to set up a European Long Term Investment Funds (ELTIFs) in order to pool capital available for long-term investment. The ELTIFs would be granted a European passport, would be allowed to invest in real estate, unlisted companies or infrastructure projects, but not commodities; they would be open to retail investors but also closed-ended (no redemption) in order to avoid liquidity risks (EC 2013).

A European SME credit risk and rating database
The Commission could encourage a voluntary unified corporate SME information portal built on business registers and the implementation of an easily accessible SME credit risk database permitting greater pan European analysis of SME sector. The ECB and the European Commission, could encourage national competent authorities to develop an internal credit assessment system (if they are not already doing so) which would be accessible by banks (Giovannini-Moran 2013).

Pan-European Infrastructure and Infrastructure Projects Data Warehouse
In order to increase institutional investor participation in infrastructure financing, the European Commission, member states and the European PPP Expertise Center (http://www.eib.org/epec/) should establish a pan-European Infrastructure Data Warehouse containing information on state backed infrastructure projects (ongoing, in planning and procurement phases) and covenant performance, collating information from member states and various EU debt providers (Giovannini-Moran 2013).
Conclusions
Credit to SMEs and for infrastructure is constrained by large information gaps. The financial crisis, with rising risk aversion and mismatching between the amount and time horizon of available capital and the demand for long-term financing, has strengthened the constraints. The repairing regulation has also had unintended adverse consequences.

Promotional institutions and measures (mainly direct lending and guarantee) to support credit to SME and, in some instances also investments in infrastructures, already existed before the crisis. In the aftermath of the crisis promotional institution have been charged with new functions. In a few countries existing promotional institutions have been merged to gain in efficiency and effectiveness. The Bank of England and the ECB have taken unconventional measures aimed at supporting credit to enterprises.

Public initiatives have traditionally had different aims (sharing risk, reducing interest rates, reducing the information gap). New measures have been taken after the crises. New policy objectives have emerged: reduce the cost of bank funding, favouring non-bank financing, particularly from institutional investors, and facilitating SME debt restructuring. Private-led initiatives, catalysed by public institutions, have also been launched to repair some funding market shortcomings. They share, however, the same issues: additionality and political and bureaucratic influence.

The effectiveness of the new measures have still to be assessed, but there seems to be a general agreement on the fact that they are not sufficient to fully restart the credit engine in Europe. Non-bank institutions may compete with traditional banks as far as they are able to get information advantages alternative to relationship banking. This may be mainly achieved through specialization in the assessment of specific credit risks, related to either the company stage or its main activities. In addition, non-bank lending can take-off independently of traditional banks only if it can benefit from a direct official enhancement or a well-functioning securitization market that allow transferring risks.

Most of the new proposals have a European dimension. There is an increasing awareness that national measures are only partial as unable to address interdependencies and to create or complete wider European financial markets. Several recent proposals would add Europe-wide institutions and measures to the existing national ones: a SME Joint Initiative aimed at reducing the cost of funding, the ELTIF to provide direct lending to infrastructures, European databases to reduce the information gap, a European Equity Fund to promote cross-border ownership of capital.

Additional policy aims are also emerging: lengthen time horizons (namely long—term savings), increasing awareness and demand for alternative financing, improving access to capital markets, increasing cross-border lending.

One common factor among these proposals is the idea to set up new European agencies or institutions. It is the case for increasing awareness (a Business Support Agency), for easing the access to markets (an Agency for Business Lending), for infrastructure guarantees (a European Infrastructure Guarantee Facility), for infrastructure financing (a Eurosystem of Investment Banks or the ELTIF) and for data warehouses. Public institutions operating in the finance industry should be at least well capitalised and well regulated and aimed at remedying a clearly identified market failure. The distortionary effects of implicit subsidies and the potential systemic risk of financial market distortions should be considered when designing credit policies. As far as direct intervention in
financial market is concerned, public-private partnership seems to be a better solution. Furthermore, based on recent national experiences, the possibility to pool together different instruments should be considered.

There also several new private-led initiatives on the table (deal documentation standardisation, an SME database, a convertible loan market for SME). For private-led initiative to be successful, it is necessary to overcome national barriers and coordination problems and to mediate through contrasting interests. The catalyst role of a strong European Institution (such as the ECB) may be necessary. In any case, there is need for leadership and expertise. It is also important that relevant authorities are open to discuss possible changes in regulation to facilitate the start-up of these initiatives if they find merit in them.
## Appendix 1 – Main measures

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</table>
| REDUCE COST OF BANK FUNDING | Funding for Lending (August 2012). Initial allowance up to 5% of outstanding loans to non-financial private sector, which can be increased up the subsequent positive net lending. The fee is set at 25 basis points, which increases, as net lending declines, up to 150 bp at -5%.

<p>|                                                               |                                                                                       |       |        |         | European Investment Bank Competitiveness and Innovation framework Programme (CIP). Provides banks with capped guarantees partially covering their portfolios of financing to SMEs. |                                                                                       |
|                                                               |                                                                                       |       |        |         | EIF Credit Enhancement Operations provides guarantees senior and/or mezzanine tranches of securities backed by SME financing. |                                                                                       |
|                                                               |                                                                                       |       |        |         | ECB Longer Term Refinancing Operations (LTRO, second half of 2009)       |                                                                                       |
|                                                               |                                                                                       |       |        |         | ECB lower rating requirements and haircuts for ABS                      |                                                                                       |
|                                                               |                                                                                       |       |        |         | ECB Negative rate (June 2014) on average reserve holdings in excess of the minimum reserve requirements and other deposits held with the Eurosystem. This measure does not lower the |                                                                                       |</p>
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<tr>
<td>RISK SHARING /LOWERING COST OF BORROWING</td>
<td>Enterprise Finance Guarantee (January 2009) targets enterprises with an annual turnover lower than £41 million and that cannot access bank loans due to a lack of security or proven record of accomplishment. The scheme applies only to loans up to £1 million and,</td>
<td>Nuovo Plafond PMI Investimenti Provision of loans at off-market conditions to Italian SMEs financing investments or working capital. Plafond PMI Crediti vs PA Cassa Depositi e</td>
<td>Prêt Pour l’Innovation Provision of loans at off-market conditions for new products. Contrat de Développement Innovation Provision of equity capital or loans at off-market</td>
<td>Entrepreneur Loan targets established enterprises with more than three years in business. Loans up to €25 million for medium and long-term investment projects at favourable interest rates. Loans can be used for a broad set of</td>
<td>ICO Liquidity Facility Provision of loans at off-market conditions. ENISA Competitiveness Provision of participating loans at off-market conditions to SMEs to be used to improve manufacturing</td>
<td>European Commission 2012 Horizon Programme. Running from 2014 to 2020 with a budget of €80 billion provides research and innovation funding</td>
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ECB TLTRO (Targeted Long Term Refinancing Operations, June 2014) Initial allowance up to 7% of outstanding loans to non-financial private sector (excluding mortgages) which can be increased in the next two years up to three times the net lending in excess of a specified benchmark. The interest rate will be fixed at the rate of the main refinancing operations prevailing at the time of take up plus a spread of 10 basis points. If net lending is below the benchmark, the borrowings will be required to be repaid in September 2016. 

ECB announced Outright Purchase of simple and transparent ABS. (June 2014)
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<td>Guarantee Scheme for Infrastructure Projects (July 2012)</td>
<td>Precetti will finance the purchase by private credit institutions of SMEs credits towards the Public Administration</td>
<td>Garantie pour l’infrastructure</td>
<td>Provisions for innovations and modernisation</td>
<td>Garantie d’Investissement pour les PME Innovatrices</td>
<td>Garantie de Caution sur Projets Innovants</td>
<td>Medium-sized Enterprises (COSME) Loan Guarantee Facility (LGF). Operated by the European Investment Fund</td>
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<td>Fondo Centrale di Garanzia (2000) Guarantee Fund</td>
<td>Contrat de Développement Participatif Provision of loans at off-market conditions to established SMEs with high growth perspective</td>
<td>ERP Innovation Programmes I and II Support firms that are at least 2 years old in meeting their long-term financing needs for investments in market oriented research, Research &amp; Development for new products, process and services and for the introduction of new products in the market.</td>
<td>ERP Innovation Programmes I and II Support firms that are at least 2 years old in meeting their long-term financing needs for investments in market oriented research, Research &amp; Development for new products, process and services and for the introduction of new products in the market.</td>
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<td>European Investment Bank (EIB) in 2012 increased its capital base so that the annual amount of funding has been raised to approximately €60 billion per year.</td>
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<td></td>
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<td>Garantie Innovation Public guarantee on SMEs loans to established SMEs for new products</td>
<td>Garantie de Caution sur Projets Innovants Public guarantee on SMEs Loans to finance a business activity that represents an important change with respect to the ongoing business of the company.</td>
<td>ERP Innovation Programmes I and II Support firms that are at least 2 years old in meeting their long-term financing needs for investments in market oriented research, Research &amp; Development for new products, process and services and for the introduction of new products in the market.</td>
<td>Garantie de Caution sur Projets Innovants Public guarantee on SMEs Loans to finance a business activity that represents an important change with respect to the ongoing business of the company.</td>
<td>European Investment Fund (EIF) Risk Sharing Instrument (RSI) is a joint pilot guarantee scheme of the EIB, EIF and the EC to support innovative research-oriented SMEs through selected financial intermediaries.</td>
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<td>Biotech Garantie</td>
<td>Garantie de Caution sur Projets Innovants Public guarantee on SMEs Loans to finance a business activity that represents an important change with respect to the ongoing business of the company.</td>
<td>ERP Innovation Programmes I and II Support firms that are at least 2 years old in meeting their long-term financing needs for investments in market oriented research, Research &amp; Development for new products, process and services and for the introduction of new products in the market.</td>
<td>Garantie de Caution sur Projets Innovants Public guarantee on SMEs Loans to finance a business activity that represents an important change with respect to the ongoing business of the company.</td>
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<td>Garantie de Caution sur Projets Innovants Public guarantee on SMEs Loans to finance a business activity that represents an important change with respect to the ongoing business of the company.</td>
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<td>Garantie de Caution sur Projets Innovants Public guarantee on SMEs Loans to finance a business activity that represents an important change with respect to the ongoing business of the company.</td>
<td>EIB Credit Enhancement Operations (PBCE) to Trans-European Transport Networks (Ten-T) and the Trans-European Energy Networks (Ten-E) projects Guarantees on investment projects of the Lisbon Agenda</td>
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<td>FAVOURING NON-BANK FINANCING</td>
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<td>Enterprise Investment Scheme (Tax Incentives for equity investments)</td>
<td>Allowance for Corporate Equity (ACE) Elite programme (April 2012): Provision through private sector experts of tailored SMEs growth strategies, industrial, financial and organisational capabilities</td>
<td>Fonds Stratégique d’Investissement (FSI) (2008): Direct equity investment or fund investment</td>
<td>Garantie des Fonds Propres: Public guarantee on SMEs equity investments</td>
<td>ERP Participation programme: Provides refinancing loans at favourable interests rate to companies investing in SMEs equity</td>
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<tr>
<td>Capital markets</td>
<td>Order Book for Retail Bonds - ORB (2010): The ORB allows individual lots as small as £2,000 to be placed.</td>
<td>ExtraMOT PRO segment (February 2013): Multilateral Trade Facility for fixed income Securities tailored on SMEs needs</td>
<td>Entry Standard for corporate bonds, BondM, Mitellstandsmarkt (2010): SMEs bond trading venues.</td>
<td>Alternative Fixed-Income Market - MARF (October 2013): Multilateral Trade Facility for fixed-income securities tailored on SMEs needs</td>
<td>EnterNext (May 2013): The mission is to coordinate and promote the current available offers for SMEs and to provide support to entrepreneurs in the approach to public stock markets</td>
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**Notes:**
- **AIMS:** The Alternative Investment Market (AIM) is a market within the stock exchange in the United Kingdom. It offers SMEs access to capital without the strict requirements of the main market.
- **Enterprise Investment Scheme:** In Italy, there is an Enterprise Investment Scheme that offers tax incentives for equity investments.
- **Capital markets:** The table also includes details on capital markets, such as the Order Book for Retail Bonds (ORB) in the United Kingdom and the ExtraMOT PRO segment in France.
<table>
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<th>AIMS</th>
<th>UNITED KINGDOM</th>
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<tr>
<td>Funding escalator</td>
<td><strong>Start-up Loans</strong> (May 2012): supports entrepreneurs aged 18-30 by providing them with loans even if they lack real collateral or proven track record. Loans are supplied upon evaluation of a viable business plan. Applicants need to pay back the loans in five years at a 6% fixed interest rate.</td>
<td><strong>Fondo Centrale di Garanzia</strong> (June 2014) extended to minibonds</td>
<td><strong>Prêt Patacipatif d’Amorçage</strong> Provision of loans at off-market conditions to private investors and venture capital funds</td>
<td><strong>ERP Start-up Loans</strong> (helps business founders, self-employed professionals and SMEs with less than three years in business providing loans up to €100,000 at favourable fixed interest rate. Loans need to be used to finance growth, succession of an enterprise or take-over of an enterprise. KfW finances up to 100% of the total investment. KfW does not make any specific requirement on collateral, which in turn has to be negotiated by commercial banks.)</td>
<td><strong>ENISA Entrepreneur</strong> (Provision of participating loans at off-market conditions to SMEs not older than 2 years old with audited financial statements or registered accounts for constituted companies and not in real-estate or financial sector)</td>
<td><strong>European Commission Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME) Equity Facility for Growth (EFG)</strong> supporting EU enterprises’ growth and RDI from the early stage (including seed) to the growth stage (2014-2020).</td>
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<td><strong>Seed Enterprise Investment Scheme</strong> (April 2012) Tax Incentives for equity investments</td>
<td><strong>Fondo Italiano d’Investimento</strong> (2010) Direct equity investments or investments in venture capital funds</td>
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<td></td>
<td><strong>Venture Capital Trust Scheme</strong> (Tax Incentives for investments in venture capital trusts)</td>
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<td></td>
<td><strong>Business Angel Co-Investment Fund</strong></td>
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<td>Non-bank loans</td>
<td><strong>Business Finance Partnership - BFP</strong> (Autumn 2012): run by the UK Treasury aimed at stimulating funding</td>
<td><strong>A Law Decree</strong> (June 2014) on Competiveness contains measures to allow insurance companies</td>
<td><strong>Fonde de Prêts à l’economie</strong>. Insurance firms have been allowed to invest up to 5% of their regulated</td>
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<tr>
<td>Infrastructure</td>
<td>through non-bank loans by co-funding up to 50% of the loans’ value. The Treasury chooses which applicant funds to support, and fund managers operate independently according to their investment strategies. and securitisation companies to provide loans directly.</td>
<td>liabilities in loans to unlisted companies either directly or through special funds.</td>
<td></td>
<td></td>
<td>put money into companies and projects for the long term. These private European Long-Term Investment Funds (ELTIFs) would only invest in businesses that need money to be committed to them for long periods.</td>
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<td>REDUCING THE INFORMATION GAP</td>
<td>School construction scheme Each Special Purpose Vehicle builds groups of nine schools, called batches. The government pays an availability fee for thirty years to each SPV. The batches are then bundled in portfolios, issuing shares.</td>
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<td>Europe 2020 Project Bond initiative. The pilot phase was activated in November 2012. It is designed to stimulate capital market financing for pan-European greenfield infrastructure projects. It aims to attract non-bank investors to infrastructure debt by enhancing the credit worthiness of the project bonds through credit support (direct loan or credit facility).</td>
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<td>CORPORATE DEBT RESTRUCTURING</td>
<td>Credit Mediation Scheme (2012)</td>
<td>Banque de France uses detailed loan-level data and additional information on SMEs’ performance to develop scoring for them. Third parties, can access the scorings but not any underlying proprietary data.</td>
<td>Credit Mediation Scheme CMS (2010, phased out at the end of 2011)</td>
<td>Credit Mediation Scheme (2011)</td>
<td>European DataWarehouse (ED) (loan-t-loan data on securitised loans)</td>
<td>Long Term Investment Club (LTIC) initiative for benchmarking infrastructure projects</td>
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London approach (Under the leadership)
of the Bank of England, UK banks developed a set of informal guidelines on a collective process for voluntary workouts to restructure debts of corporates in distress, while maximizing their value as going concerns.

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<tbody>
<tr>
<td>TOTAL PUBLIC RESOURCES COMMITTED IN 2012 (€BN.)*</td>
<td>4.3</td>
<td>10.4</td>
<td>12.2</td>
<td>10.9</td>
<td>8.4</td>
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<tr>
<td>GOVERNMENT RESOURCES COMMITTED OVER GDP (%)</td>
<td>0.22</td>
<td>0.66</td>
<td>0.60</td>
<td>0.41</td>
<td>0.82</td>
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<tr>
<td>GOVERNMENT RESOURCES COMMITTED OVER SME VALUE ADDED (%)</td>
<td>0.91</td>
<td>2.49</td>
<td>2.45</td>
<td>1.47</td>
<td>2.58</td>
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Appendix 2 – The PCS: development of a private-led initiative

The Prime Collateralised Securities (PCS) initiative took almost four years of preparation. It required a lot of leadership, technical work, discussion among different stakeholders, expectation management, fact-finding, expert mediation, and consultancy.

In 2008, Alessandro Profumo, at that time UniCredit CEO, launched a private initiative to revitalise the securitisation through the ABS market. At the beginning, investment bankers were unexcited. UK investments bankers (which potentially dominate the market) were mad at it. They were expecting a natural revival of the “old good days” of unregulated markets, huge fees and outrageous bonuses. The initiative needed strong leadership as market practitioners were reluctant to depart from consolidated practices. Securitisation practitioners considered that the PCS initiative was necessary, but not sufficient, unless regulators acknowledge it in the Capital Requirement and in Solvency II Directives.

Since October 2009, the PCS initiative has been carried out by the European Financial Roundtable (EFR) in partnership with the Association of Financial Markets in Europe – European Securitisation Forum (AFME-ESF), in collaboration with several industry and market associations, and with the active involvement, formally as observers, of the ECB and of the EIB Group.

In October 2009, the EFR and AFME-ESF established a Steering Committee comprised of investors (represented by a fund manager, two insurance companies and one pension fund), issuers, traders and arrangers representatives of key types of securitisation market stakeholders to consider and define the possible parameters for PCS securities.

In the Fall of 2010, a reality check was performed and two surveys (46 investors and 21 issuers) confirmed that the direction was correct. A majority of investors indicated that the proposed PCS framework would increase the investor base (58%), improve liquidity (61%) and lower spreads (70%) without harming non-PCS products. Fifty-seven percent of issuers considered that the benefits of PCS would more than offset the reduced flexibility on assets and structures.

In early 2011, a legal assessment was undertaken with the main focus on the possible legal set up of the PCS structure and potential liability issues and to identify potential reputational issues for EFR or EFR Members. The result was that legal risks were minimal and the project was legally feasible. Moreover it was compiled a list of regulatory issues affecting the PCS initiative which may need to be addressed vis-à-vis authorities to make PCS work by ‘offsetting’ the additional burden and associated costs. Finally, 12 financial service providers were surveyed to provide substantiated cost estimates pertaining to the set up and running of the PCS initiative.

In February 2011, the EFR Members decided to advance and finalise the preparatory phase, which had also led to the hiring in April 2011 of a consultancy firm (Bishopfields) as Project Manager. A broad and representative PCS Working Group (PWG) elaborated the term sheet with the eligibility criteria, benefiting from the input of four asset class groups (mortgage, SME, auto, consumer). A few country groups have also provided inputs to the RMBS asset class group.

As time passed by, two things become clearer and clearer:
1) despite some feeble signs of recovery here and there, the European securitisation market was not taking off;

2) the reputation of the securitisation market with the authorities was so bad that the cumulative impact of the new regulation (both already approved and to be introduced) on the securitisation market could easily be to kill it forever, unless the market could restart on new and sounder grounds.

Informal feedback from the European Commission and the European Central Bank officials on the implementation of PCS were positive. If PCS would be implemented, regulatory relief could be possibly recognized in a number of ways. It was clear, however, that authorities could not act neither take explicit commitments before the PCS is implemented: a classic “chicken-and-egg” problem. It was also clear, however, that the ECB, through it involvement as active “observer” and later as clear supporter, was sharing part of the reputational risk with us.

A PCS Senior Advisory Group (PSA) with around 10 Chief Financial Officers (CFOs) and Chief Investment Officers (CIOs), including senior officers from ECB and EIB, was set-up. The PCS WG submitted its deliverables to the PSA for advising before the ultimate approval by the PCS Board (decision making body of the to-be established PCS association). The PWG prepared the final draft of the PCS Term Sheet and PCS Business/Implementation Plan.

At the end of 2011 major European banks and investors, as well as major industry associations, had to decide whether to support the initiative and if they were ready to launch it by the end of 2012. This involved also setting up a PCS governance structure to finalise the PCS market standards in a market convention and to grant the PCS label to ABS transactions which comply with the eligibility criteria.

The authorities express they support to the initiative. Mario Draghi, President of the European central bank wrote:

“The ECB welcomes the initiative, which aims at increasing the attractiveness of asset-backed securities among investors and originating banks. A well-functioning ABS market in the EU would allow investors to diversify their investments and ...thereby contribute to a smooth financing of the economy.

“The ECB has been able to follow this project since 2009 and we are pleased to see you are ready to launch the labelling process.”

Few weeks later Andrea Enria, Chairperson of the European Banking Authority added:

“EBA believes that the European securitisation market can play an important role in meeting the funding needs of the originators and the asset diversification needs in Europe in the future. The PCS label could be an important component to re-establish a sound and well controlled market for securitisation in Europe. The EBA will continue to monitor the securitization market closely once the PCS label starts to be operational.”

Eventually, the management of expectations of both issuers (willing to adopt new self-regulation in exchange for softer rules) and authorities (willing to discuss easing the rules in exchange for new
self-regulation proving to be effective) and the expert mediation of a consultant reached the goal and opened the doors for a successful launch of the initiative. More than 3.5 million Euro were raised among different market participants (including all major UK issuers) in order to start up the PCS Secretariat that will manage the new market.

Without improvement in regulatory support, at least to put PCS on a level playing field with other secured and unsecured bank debt products, the European securitisation market is gradually recovering, but not enough to play a material role in facilitating credit growth.

PCS provides an easy way for regulators and certain investors to bifurcate into PCS eligible and non-eligible securitisations, while recognising that many 'good' securitisations may also exist without being PCS eligible albeit without the asset class characteristics that many mainstream investors are looking for. Possible issue for an open dialogue between industry and authorities are:

1. Modify the retention rate for PCS;
2. Make PCS eligible as liquid asset in the Liquidity Cover Ratio;
3. Reduce Risk Weight for PCS;
4. Reduce regulatory reliance on Credit Rating Agencies.
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