



RESTORING FINANCING AND GROWTH TO EUROPE'S SMEs

Four sets of impediments and how to overcome them

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Foreword

Despite recent signs of renewed growth in the Euro Area core, economic activity remains weak in much of Europe, with risks skewed to the downside. Containing those risks will require finding ways to support small and medium-sized enterprises (SMEs), which account for disproportionately large shares of employment and value added. SMEs have been hit hard by the crisis, however, given their heavy dependence on weakened domestic markets and bank lending that has become both less available and more expensive.

To promote better understanding of the factors behind reduced financing for SMEs in Europe, Bain & Company and the Institute of International Finance (IIF) have conducted more than 140 interviews with a broad cross section of stakeholders in six Euro Area countries: France, Ireland, Italy, the Netherlands, Portugal and Spain. Interviews were also held with key European institutions. Discussions focused on identifying impediments to SME financing and exploring potential solutions. The perspectives gained were informed and shaped by listening not just to banks and banking associations but also to officials, academics, business and professional associations, and alternative providers of financing, including venture capital (VC) and pension funds, private equity (PE) and insurance firms, and exchanges.

Restoring SME health and growth has moved to the top of policy making agendas in Europe and elsewhere in the developed world. The challenges facing SMEs, especially access to finance, have been the focus of numerous studies by national and European authorities,

academic papers and reports from business and banking associations, not to mention daily media coverage.

The publication of these many detailed reports and recommendations—some several years ago now, during the initial years of the global financial crisis—has yielded uneven progress at best. More important than delineating the relative importance of tightened credit supply and reduced borrowing demand—a challenging task, the interviews made clear—is moving from reports to action, agreeing and implementing those policy initiatives and funding solutions that address the underlying structural challenges faced by SMEs, banks and nonbank investors. Progress is needed, then, on two fronts: improving SMEs' financial health and transparency, and broadening the base of financial institutions able to identify and fund promising SME activities. The first part of this report details four sets of impediments identified in the interviews, which will need to be addressed to make progress toward achieving these two overarching objectives.

To address these impediments effectively and to drive systematic decision making and faster implementation, we suggest that the European Council recommend the establishment of a coordinated European process, steered by the European Commission and focused on national task forces. Working to develop tailored, technical, nonpolitical action plans addressing each of the four sets of impediments, the task forces would be composed of the relevant national government and central bank officials, SME associations, banks and alternative funding groups to bring together all the

critical stakeholders needed to develop and implement the measures they agree. The final section of the report details how this process might work.

EU-level leadership will be critical, our interviews made clear, to ensure the close coordination of shared insights and potential solutions across national task forces. Advanced by the direct involvement of the European institutions, especially the European Council, a “drum-beat” of regular updates can act as an effective catalyst to press ahead with difficult decisions that may be

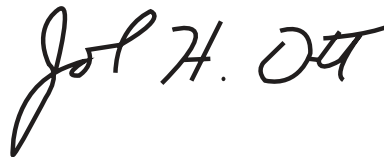
needed at the national level. Last but not least, European institutions can provide strong incentives—via EU and EIB Group funds—for national governments to engage fully in advancing those changes in incentives and regulations that will be needed to broaden SMEs’ access to finance.

Given the critical importance of this topic, we appreciate the generosity of everyone who has contributed to this report and want to thank them for their time.



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Overview: Restoring financing and growth to Europe's SMEs

SMEs are critical to European economies. They provide two of every three jobs and account for 58% of gross value added (GVA). SMEs play an even more prominent role in Italy, Portugal and Spain, where they account for 20% more employment than the European average. Sustained economic recovery in Europe thus hinges on restoring the health of SMEs across the EU.

SME competitiveness eroded substantially in the years prior to the financial crisis, by more than suggested by nationwide increases in relative unit labor costs, the broadest measure of external competitiveness. Larger firms could better limit wage costs by shedding labor and shifting production abroad. The actual rise in relative unit labor costs among SMEs, as a result, likely exceeded the nationwide figures from 2000 to 2008-09, which ranged from 33% in Ireland to 8% in France (*see Figure 1*).

Since then, the recession has brought these costs down in Ireland, Portugal and Spain, clawing back 85% to 95% of earlier increases. In France, Italy and the Netherlands, by contrast, only one-fifth to one-third of much smaller competitiveness losses have been reversed. ECB survey data make clear that SMEs have made less progress reversing such losses than larger firms, adding to the challenges they face in trying to shift toward exports.

The size of SMEs and how they are managed also vary significantly from country to country. For example, the average SME in Germany is more than twice as large as its counterparts in Italy and Spain. German SMEs—the *Mittelstand*—often have separate ownership and management, while firms in Italy and Spain typically are family owned and managed. The sophistication and professionalism of SMEs' management across the EU vary significantly.

Each country is unique, but common factors have contributed to a fall in SME lending

In the six countries under review, new bank lending to SMEs (using loans of less than €1 million as a proxy) has declined by 47% since the pre-crisis peaks. Declines from the peaks range from 21% to 45% for Italy, the Netherlands, France and Portugal and were 66% for Spain and 82% for Ireland (*see Figure 2*).

In fact, European Central Bank (ECB) surveys show tighter credit standards in the majority of quarters since 2009 (*see Figure 3*). In our interviews, banks also confirmed that they are setting more stringent collateral requirements and lower loan-to-value ratios on real estate, as well as seeking larger personal guarantees. SMEs have borne the brunt of these measures through diminished credit availability in most half-year periods since the ECB began surveying them in

Figure 1: External competitiveness has improved since the financial crisis by more in some countries than in others

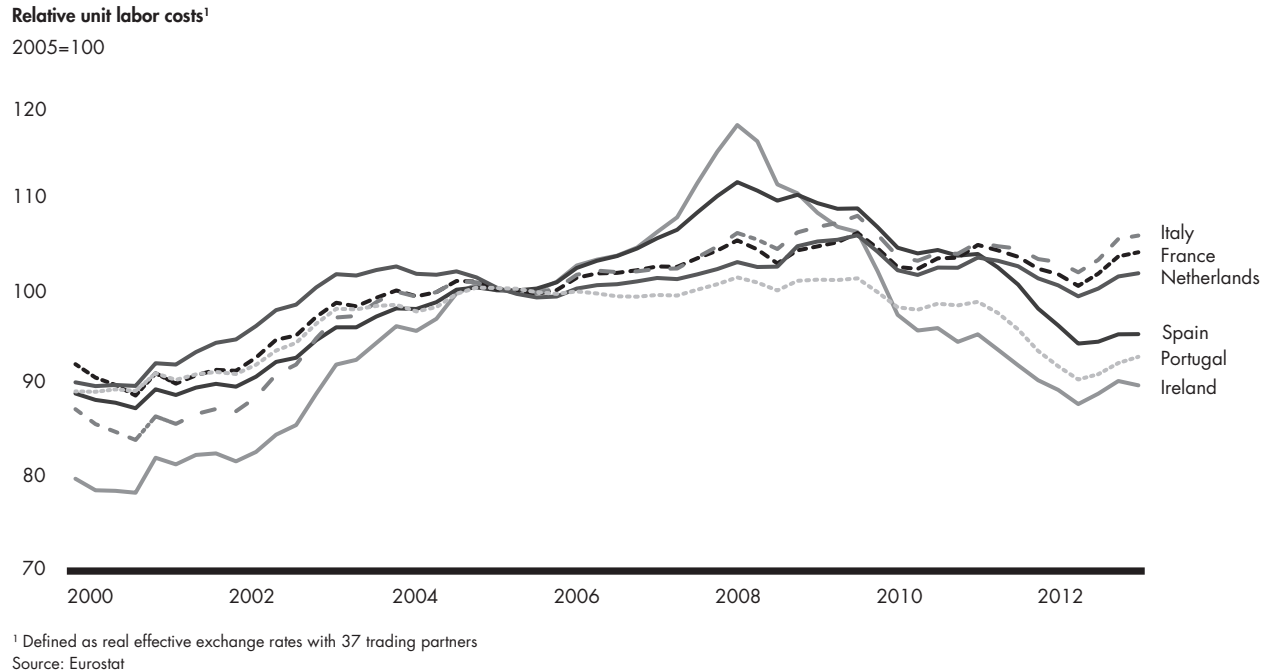
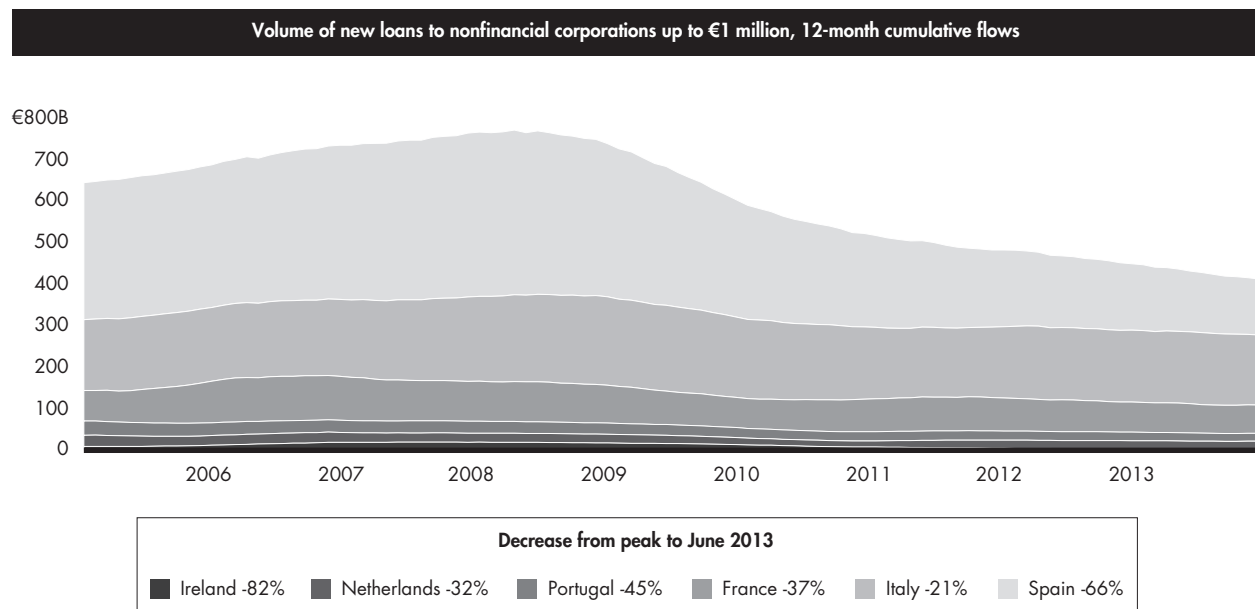


Figure 2: Each country is unique, but common factors have contributed to a fall in SME lending



Note: Percentage decrease calculated on a country-by-country basis from pre-crisis peak to June 2013
Source: National central banks

Figure 3: Credit standards have tightened according to banks ...**Supply of credit, according to banks: 2009-2013Q3**

	Tightened, most recent three months		Eased, most recent three months	
	Number of quarters	Average tightening, %	Number of quarters	Average easing, %
France	9	-13.8	5	3.8
Ireland	5	-23.8 ¹	0	—
Italy	16	-27.3	2	12.5
Netherlands	15	-41.8	0	—
Portugal	16	-66.3	3	33.3
Spain	9	-21.1	1	10.0

Note: Response to ECB survey question 1: "Over the past three months, how have your bank's credit standards as applied to the approval of loans or credit lines to enterprises changed?"; An increase in tightening corresponds to a negative number; average tightening/easing refers to the net percentage of banks indicating a tightening/easing of credit standards; ¹Ireland only reports a diffusion index rather than a net percentage, weighting answers so that "considerably" is given more weight than "somewhat."

Source: ECB Bank Lending Survey

2009 and higher funding costs in some, but not all, of the countries in the Euro Area core (see *Figure 4*).

Credit tightening has affected some SMEs more than others

Smaller and regional lenders, such as the former cajas in Spain and the regional banks in Italy, traditionally provide a much higher share of SME lending than their larger peers. As many of these institutions now are deleveraging faster than their peers, their customers have struggled to find credit from other lenders (see *Figure 5*).

At the same time, rapid restructuring of entire banking sectors, notably in Ireland and Spain, has left fewer

players in the market. As larger SMEs find themselves with fewer banking relationships, they are bumping up against the maximum share-of-wallet exposure, which limits how much credit banks are willing to extend to any one SME.

In addition, we heard in the interviews that the supply of bank loans available on the easier terms of the pre-crisis period has also been diminished by banks' responses to the financial crisis:

- **Rebuilding their capital bases.** Banks across Europe have been pressed by regulators and markets to strengthen their capital positions at a time when earnings and capital have come under pressure from increases in funding costs and rising non-

Figure 4: ... and to SMEs

Supply of credit, according to SMEs: 2009-2012H2

	Tightened, most recent six months		Eased, most recent six months	
	Number of half-year periods	Average tightening, %	Number of half-year periods	Average easing, %
France	8	-15.9	0	—
Ireland	8	-42.6	0	—
Italy	7	-20.9	1	1.0
Netherlands	8	-31.1	0	—
Portugal	7	-36.6	1	3.0
Spain	8	-30.8	0	—

Note: In response to ECB survey question 9a: "For each of the following ways of financing, would you say that their availability has improved, remained unchanged or deteriorated for your firm over the past six months?" referring to bank loans (excluding overdraft and credit lines); Average tightening/easing refers to the weighted percentage of banks indicating a tightening/easing of credit availability.
Source: ECB Access to Finance of SMEs (SAFE)

performing loans (NPLs) due to downturns in economic activity.

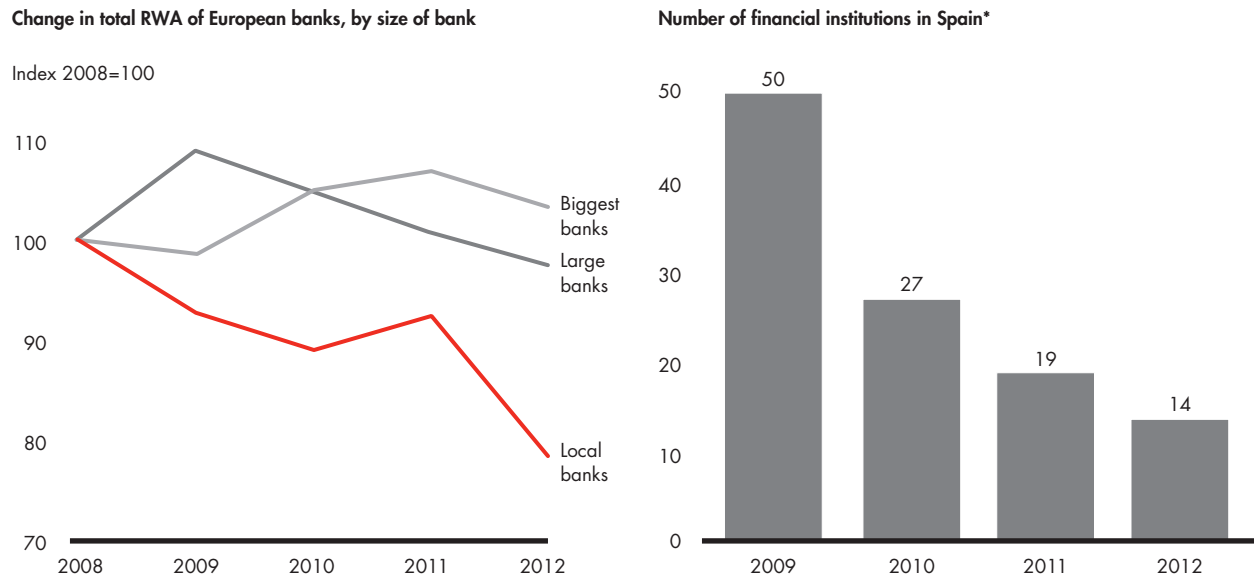
- **Enhancing risk standards.** Tightened credit policies since the crisis leave banks much less able to serve higher-risk segments, such as start-ups, real estate companies or firms with less certain credit records.
- **Rebuilding core risk management skills.** Banks are applying deeper financial assessments of their clients and leveraging stronger credit skills, for instance, to determine whether a business is capable of generating sufficient free cash flow to repay a loan.

Our interviews also suggested that some banks are using blunt tools to reduce demand. Some banks have introduced pricing caps and will not serve customers whose

risk pricing falls outside those caps, which can be as low as a 10% interest rate. Bankers in all countries made it clear SME demand existing outside of this range previously would have been served.

Interviewees also reported that banks are using more rigorous and elongated credit approval processes of four to six months, which have the effect of suppressing demand. For instance, the Irish central bank views this "slow no" as a significant issue and is tracking data on the length of time to approve a credit application.

A return to prudent lending practices should, over the long run, help create a more robust financial sector that funds a larger number of viable and high-potential SMEs. In the near term, though, this dynamic has

Figure 5: Banks' supply of credit has tightened differentially as they deleverage and restructure

Note: Biggest banks n=10; other large banks n=13; local banks n=65

*Banks covered account for almost 90% of total system assets; Excludes small private banks, international banks with operations in Spain, and the cooperative sector

Source: Bain & Company European Banking Report 2013; IMF

created a situation in which some SME segments have seen a significant decline in the supply of loans.

Credit demand has shifted from investment to working capital needs

Before the crisis, SMEs typically sought long-term funding (often collateralized by property-related investments) and leveraged personal guarantees or overdrafts. Due to steep declines in domestic spending throughout the six countries we visited, we heard that much business capacity is sitting idle. As a result, business investment has fallen sharply, with ECB and other surveys suggesting steeper drops among SMEs than larger firms. Most banks reported sizable declines in credit application volumes. The findings of our interviews are

confirmed by what banks and SMEs have reported in ECB demand surveys (see Figures 6 and 7).

Since the crisis, SME credit demand has shifted from long-term investment to short-term working capital. Some of the shift is driven by good demand, as when SMEs seeking new export markets require short-term funding to help them build new customer relationships or adapt their products.

However, some of the shift also comes from bad demand when, for example, an SME's customers delay payment. Payment delays by local and regional authorities were identified as the main cause of growing receivables in our interviews in France, Italy and Spain, and several European and national initiatives are underway to tackle this issue.

Figure 6: Borrowing demand has decreased according to banks ...**Demand for credit, according to banks: 2009-2013Q3**

	Decreased, most recent three months		Increased, most recent three months	
	Number of quarters	Average decrease, %	Number of quarters	Average increase, %
France	15	-38.5	3	9.2
Ireland	12	-36.9 ¹	2	11.5
Italy	9	-41.7	8	29.7
Netherlands	19	-47.9	0	—
Portugal	7	-42.9	6	20.0
Spain	10	-33.0	3	13.3

Note: Response to question ECB survey question 4: "Over the past three months, how has the demand for loans or credit lines to enterprises changed at your bank, apart from normal seasonal fluctuations?"; Average decrease/increase refers to the net percentage of banks indicating a decrease/increase in demand for credit; ¹Ireland only reports a diffusion index rather than a net percentage, weighting answers so that "considerably" is given more weight than "somewhat."

Source: ECB Bank Lending Survey

Figure 7: ... and to SMEs**Demand for credit, according to SMEs: 2009-2012H2**

	Applications for credit, % of respondents		Number of decreases from half-year to half-year
	2009H1	2012H2	
France	26	28	2
Ireland	17	14	4
Italy	33	25	3
Netherlands	17	12	3
Portugal	20	15	4
Spain	37	27	3

Note: Response to ECB survey question 7a: "For each of the following ways of financing, could you please indicate whether you applied for them over the past six months?" referring to bank loans (excluding overdraft and credit lines); Percentage weighted according to the number of employees in each firm.

Source: ECB Survey on Access to Finance of SMEs (SAFE)

Bad demand also takes the form of loss financing sought by firms facing great financial stress. Unprofitable and nonviable SMEs seek credit to stay in business, delaying hard choices about restructuring or winding down operations. Often, it is not clear to banks whether a company is seeking good or bad working capital, without detailed information that banks typically do not possess.

Banks face challenges in determining whether they are dealing with good or bad credit demand

Bankers confirm that making credit risk decisions has become much more difficult. In part, this stems from the shift toward working capital lending. It is typically more complex to assess risks of cash flow lending than funding for an asset-backed investment. But it has also become more difficult for banks to assess the strength of the prospective borrowers for several reasons:

- Bankers need to take a view on the prospects of the business, not just the future value of an asset. The skills needed to make more subtle judgments—understanding the prospects of the business, having a perspective on the ability and commitment of the owner and management—are complex and different from what was required before the crisis.
- Traditional warning systems are broken. Many banks have lost personal relationships with their small-business customers as they seek to restore profitability. Reductions in banks' frontline staff have vastly reduced their familiarity with these businesses and severed their personal connections to the owners.
- Lack of accurate, comprehensive and timely information. As the outlook for a business changes quickly during a downturn, banks need better and

different types of information to understand how SMEs' prospects are changing. We heard in Spain that some SMEs lack established relationships with banks that are able to lend to them, because their former banks were acquired or their existing banks have decided they have enough exposure. In such circumstances, SMEs are unable to receive credit for 18 to 24 months, as banks want to use that period to gauge the health of these firms, based on the transactions flowing through their own accounts.

There are SMEs in the middle ranges of credit risk that are not now able to access financing. These companies include younger firms, start-ups and viable older companies with manageable but still elevated debt.

From the interviews, it appears that both supply and demand have declined sharply, and SMEs' financing demand has shifted from investment to working capital during the crisis. Only a few respondents dissented from the more general view that borrowing demand has weakened more than supply has tightened. If this is correct, then banks in general have lending capacity that is currently underutilized—a point on which bankers broadly agreed. The larger issue, from this perspective, is likely to be how adequately banks will be able to support a recovery of borrowing demand once it takes hold, given their more limited capacity to shoulder credit risk than before the crisis. Recovery prospects could be constrained, as a result, without policy actions that would expand banks' effective lending

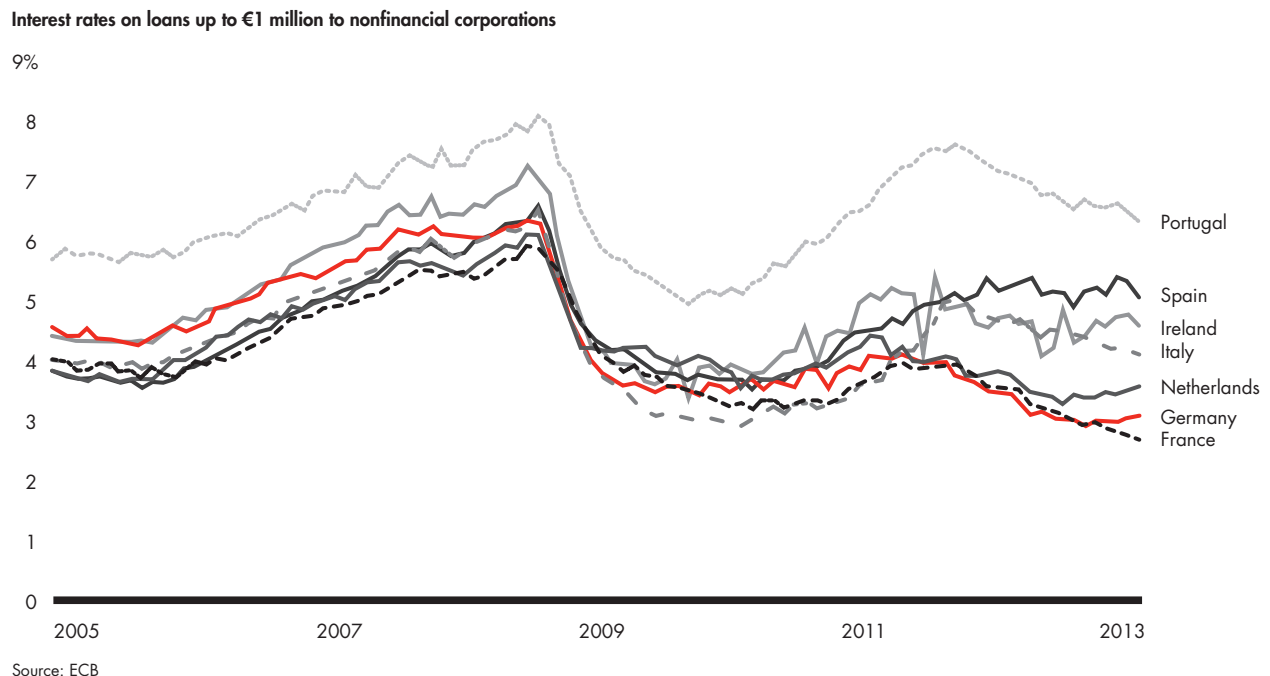
capacity or that of other investors to provide funding and shoulder risk.

Equally important, however, is a second conclusion that seems warranted by our discussions: There are SMEs in the middle ranges of credit risk that are not now able to access financing. These include younger firms, start-ups and viable older companies with manageable but still elevated debt. Absent steps to ease impediments to financing for such firms, structural reforms aimed at improving competitiveness will be less successful, with fewer resources redirected from inefficient incumbents to newer firms with more promising futures.

Spreads have widened relative to Germany

Officials and business leaders also told us they are concerned about widened interest rate spreads vis-à-vis countries in the Euro Area core. Higher credit costs are putting SMEs in some countries at a significant disadvantage; those SMEs cannot compete on level playing fields against foreign companies benefiting from lower-cost credit. In Ireland, Italy, Portugal and Spain, interviewees reported offered lending rates that were 400 to 600 basis points higher than those reported for German SMEs, rather than the 150 to 250 point spreads registered by the ECB on agreed and disbursed credits (see *Figure 8*).

Figure 8: Interest rate spreads have widened relative to Germany in Ireland, Italy, Portugal and Spain



Many interviewees believe that progress toward establishing a banking union (and the advent of Outright Monetary Transactions) has already contributed to reducing funding spreads across markets, partly mitigating the effect of the sovereign debt crisis on bank funding costs as the sovereign-bank feedback loop has begun to be weakened. Respondents also contended that a banking union that creates a uniform regulatory framework for banks, establishes a single supervisory mechanism, conducts credible asset quality reviews, provides a single resolution authority and protects private deposit holders should create a more level platform for banks to compete across Europe and thus reduce spreads for SME credit.

Without also addressing the four sets of impediments to SME financing identified in this report ...

- Information about SME creditworthiness and potential is too costly and difficult to obtain
- SMEs face many disincentives to achieving greater scale to be competitive and financially healthy
- Banks are able to shoulder less credit risk than before the crisis
- Alternative funding providers face many barriers to financing SMEs

... SMEs will not be able to compete effectively across Europe's single market. Overcoming these impediments should ensure access to a broad mix of funding sources, narrow spreads in funding costs across markets and ultimately help restore the health and resilience of the SMEs across the six countries.

Impediment 1: Information about SME creditworthiness and potential is too costly and difficult to obtain

The lack of such information substantially raises the costs of assessing creditworthiness, making it impractical for banks to serve some segments and raising barriers for new sources of funding to be developed. While the starting point varies widely by country, progress has to be made in each country to further reduce information costs and increase transparency. Only then will the credit supply increase and barriers to entry drop for new lenders and investors.

Access to accurate, transparent information has become even more critical since the advent of the financial crisis, in order for banks and other lenders to have confidence in the health of SMEs and to inform new credit decisions

The shift from property-based credit to working capital loans, as discussed earlier, entails more complex and time-sensitive judgments on whether a potential borrower is a good credit risk. Traditional methods of collecting information about SMEs no longer work effectively. Before the crisis, banks tended to assess creditworthiness by collecting numerous details about each firm: ownership; assets held both within the SME and those outside it that are available as collateral or repayment sources; management; products; and the industry sector over time.

Today, banks are under significant pressure to reduce costs and have reduced branches and frontline staff who can build personal relationships with customers. Many have moved to centralize credit decisions. As banks consolidate or fold, valuable information about past relationships with SMEs simply disappears. Small business

owners seeking a new bank relationship have not been able to carry that information with them and must start from scratch to build a new credit relationship.

We heard in our interviews that, during the crisis, public officials in the six countries realized that the lack of centralized credit data about individual borrowers from each bank was one cause of overlending and overborrowing, since banks had an incomplete picture of the total indebtedness of a single borrower.

Higher-quality, lower-cost information is a key to unlocking more sources of finance for SMEs

The availability and the cost of information loom large in SME lending. Several interviewees commented that the high fixed costs of assessing creditworthiness make it challenging for banks to provide relatively small, short-term loans, because the loan margin may not be sufficient to cover the fixed up-front costs to conduct due diligence.

Similarly, alternative providers of funding confirmed that the development of new financing sources has been hampered by a lack of transparent, low-cost

- “The biggest issue for setting up funds for SMEs is that there is no standard loan documentation, as opposed to mortgages, where there is standardization.” (Dutch bank)
- “Annual accounts are difficult to access and up to 18 months out of date ... it’s difficult to get more detailed data such as cash flows and positive credit information.” (Spanish bank)
- “The plan for the new credit registry is to improve the quantity and quality of data for analysts and for supervisors ... Having data on loan-by-loan interest rates could be useful.” (Spanish authority)
- “We are not used to tackling the SME business as a whole and do not have a coherent approach but try to put the pieces together ... Right now, to assess risk, we have to go across three different business segments.” (French bank)
- “Banks don’t have a front line but rather automated systems. They have lost practical information in terms of transactions and giving advice.” (Irish business association)

information to assess the credit risk of individual loans or portfolios of loans, or to make equity investments in SMEs in the six countries.

The status of information transparency varies significantly across the countries. To be sure, interviewees noted that a lot of information is collected by several departments within their central banks, as well as by tax and other official authorities, local or regional chambers of commerce and private sector players, including credit insurance companies. However, large gaps remain, and the available information often is not current or linked across the various sources. There is also no timely dissemination of such information. Interviewees identified barriers to collecting, storing, distributing and analyzing information—all along the creditworthiness assessment process.

Cultural preferences come into play as well, notably the desire to keep information closely held, maintain small scale and preserve family control of enterprises. Financial literacy, moreover, is often limited among smaller SMEs, with relatively few owners and managers understanding the need for business plans when approaching banks for new credit.

Information on creditworthiness is often costly and unavailable

Bankers emphasized that accurate and timely audited accounts, credit and payment information are critical to understanding creditworthiness of SMEs in need of working capital or seeking to expand financing in the current economic situation. However, banks require more comprehensive information, including infor-

mation about ownership, company structure, customer concentration, degree of integration into the supply chain of customers, the share of revenues from exports, banking relationships and guarantees. This level of detail allows a bank to understand, for example, an SME's exposure to distressed sectors or to default from any individual customer. In addition, banks require transparent information on business owners. Especially in the case of micro-SMEs, banks' loans are essentially also to individuals. Banks need to know that they can rely on those individuals or their families for repayment.

Gaps appear to exist across the six countries. For example, in only four of the six countries are banks able to consult credit registries run by the central bank as a way to check their own exposures against a small firm's aggregate outstanding debt. (Ireland and the Netherlands have no such central credit registry at present, although Ireland plans to establish one in 2015.)

A lot of information is collected by central banks, other authorities and private players. However, the information often is not current, linked across the various sources or disseminated in a timely way.

Central credit registries, moreover, vary in their rigor and comprehensiveness. Interviewees identified the bureau operated by the Banque de France (BdF) as collecting the most comprehensive set of data on SMEs. Our understanding is that BdF requires detailed reporting on all business loans larger than €25,000, including all transactions as well as interest rates, matur-

ities and the probability of default and loss given default assigned to each loan. This data, along with balance sheets and income statements, form the basis for credit scores assigned by the BdF to some 280,000 companies operating in France, the vast majority of which are SMEs. The BdF credit scores and related financial information, including aggregated bank claims for an individual SME, are available to French banks.

In Spain, the Banco de España (BdE) currently operates a simple credit registry that allows banks only to check their exposures against those of others; it plans to introduce more comprehensive reporting requirements for banks in 2014. This will enable the BdE to match very detailed loan-by-loan data with the income statements and balance sheet accounts that firms (including SMEs) have to provide to Mercantile Registers. This additional information will not be shared with banks, however, which will continue to be able to access only information on the aggregate reported claims against individual SMEs.

Interviewees also said that information on borrowers' finances is often out of date and unreliable. For larger SMEs that produce balance sheets, income statements and cash flow statements on an annual basis, banks face delays of up to 12 months or more until the information is publicly available. When these accounts are available, according to interviewees, they typically are not audited. Several banks in Italy, Portugal and Spain questioned the reliability of such unaudited accounts.

Access is hampered by dispersed storage and legal restrictions

In some markets, privacy laws have a significant impact on the ability of banks and other institutions to assess

the creditworthiness of SMEs. Privacy laws have to balance the rights of an individual or company with the need for information to better judge credit and investment risk. In several countries, banks, SME associations and public authorities agreed that privacy laws impose overly restrictive limits. For example, respondents in Portugal noted that restrictions on accessing historical information on potential new clients are hampering the ability of banks and investors to judge risk. The lack of available time-series data makes it difficult for banks or other lenders and investors to build appropriate credit models, given that they can only see the current credit position of a potential client.

Building a complete picture of SMEs' creditworthiness requires not just the appropriate collection of data, but also easy access. Data originate from many different sources and in a wide variety of formats. Annual reports and credit and payment data are collected and sometimes published by credit bureaus, central banks, regional chambers of commerce, and they can be paper-based, in spreadsheets, online databases or other formats. The difficulty of accessing dispersed data is a major barrier for a lender to build a complete, up-to-date financial picture of a single company.

One promising approach to making dispersed information more easily available is the Standard Business Reporting (SBR) program, launched in the Netherlands in 2008. SBR uses standardized reporting templates written in Extensible Business Reporting Language (XBRL), a financial programming language in wide use globally, including in Australia, Belgium and for listed US corporations reporting to the Securities and Exchange Commission (SEC). Dutch firms with revenues above a certain threshold use SBR to report the same annual accounts to tax authorities, chambers

of commerce, statistics offices and banks for credit assessment purposes. SBR has been credited with reducing the time it takes to approve credit applications and lowering costs.

At the European level, the ECB—through the European Data Warehouse (ED)—is seeking to centralize and standardize loan-level performance data for asset-backed securities (ABS) transactions. The ED intends to shed light on the underlying asset quality of securitized SME loans, and the ECB uses the data to assess and track performance of securities that serve as collateral with the bank. The information is also available to institutional investors and rating agencies, in hopes that it will contribute to the development of alternative funding instruments.

Interviewees also pointed to the rich information held by private players. For example, credit insurers hold detailed information on the health of up to 100 million firms around the world, including real-time payment information and comprehensive analyses of the businesses and sectors.

Of course, banks, credit insurers and other private sector players have valid concerns about sharing information at the heart of their business models. Developing a centralized storage model—either national or European—that gathers information from a wide range of sources, then aggregates that information into scores or ratings for individual SMEs, may overcome these concerns. The BdF's model provides some insights on how conflicting interests could be managed. The BdF uses detailed loan-level data and additional information on SMEs' performance to develop ratings for them. The ratings can then be accessed by third parties—but not any underlying proprietary data.

Markets for analysis are underdeveloped

Few third-party providers offer sophisticated analyses of SME creditworthiness in the six countries studied. Interviews with global rating agencies and credit scoring companies highlighted several barriers to entry, including the complexity of dealing with multiple regulatory frameworks, restrictive privacy laws, as well as unproven demand for their services.

The networks that do exist, including credit bureaus and central banks, are often closed, distributing data and analysis only to members who provide credit input. BdF's Fiben service, which provides financial information about companies, operates on a membership-based model and is open to banks that provide inputs. Alternative funding sources such as equity investors or institutional investors are disadvantaged in accessing credit information, and they find it harder to operate on an equal footing with established players.

Interviewees observed that the lack of competition in providing SME credit analysis, including scoring and ratings, increases the costs of information and analytical services. Current providers can charge high membership fees or fees for accessing each credit record (consider BdF's €20 fee per rating), which is required more often for stressed borrowers or in challenging economic trading environments. In the case of IPOs or bond issuances, the lack of specialist rating providers for SMEs also leads to higher costs for the business, several interviewees observed.

In a market with multiple competitors, our interviewees noted, the cost of analysis would decline. In addition, the deep expertise of these players could lead to devel-

opment of new business models or new sources of finance. For example, broader availability of credit scoring and sector benchmarks for SMEs might lead to actuarial approaches to assess credit risk for portfolios of loans. Similar approaches appear to work in the US and have cut the costs of making credit decisions. The ability to access scoring information on SMEs and ratings of securities backed by SME loans would likely draw in new sources of funding, such as institutional investors who are restricted to investing in rated securities.

Impediment 1 solutions: Measures to reduce cost and expand availability of information

Interviews across all countries confirmed that the need to improve the collection, storage, distribution and analysis of data is well understood. The interviews suggest that countries can and should take a programmatic approach to defining what information should be collected, where it should be held or how it should be aggregated and analyzed, to boost credit supply and lower barriers to entry for new lenders and investors.

Measures toward this end that should be considered by officials, lenders and SMEs would include standardization, strengthened incentives and broader access to information collected by both the private and public sectors, central banks included. Proposals that could entail subsidies or tax incentives might best be considered as options for using public funds with greater effect, rather than further increasing already substantial amounts of existing or promised official support.

More specifically, measures to be considered could include the following:

Measures to support information collection

- Ensuring the collection of all available data, including audited accounts, payment information, ownership and structure, credit information, banking relationships and guarantees
- Establishment of rigorous, comprehensive central credit registries along the BdF model, encompassing information on payments performance as well as financial transactions and balance sheet positions
- Amendment of privacy laws and easing of other legal restrictions to enable holding, analysis and distribution of the most critical information
- Greater use of digital repositories, such as the SBR, with standardized submissions used for tax authorities, business registers and statistics offices, as well as for credit assessment by banks and other lenders
- Publicity campaigns by banks, showing their readiness to extend more credit on easier terms to firms undertaking to report quarterly financial information via SBR mechanisms
- For firms below the agreed revenue thresholds, consideration of tax credits to cover costs of publishing audited quarterly financial statements and providing the information needed to secure stock exchange listings
- Consolidation of national central credit registry data with that collected by the European Data-Warehouse, toward the eventual establishment of a European central credit registry

- Setting national or Europe-wide standards for information collection and reporting to enable cross-company and cross-national analyses
- Introduction of Europe-wide unique company identifiers, to the extent possible, to integrate data from multiple sources

Measures to support information dissemination, rating and scoring

- Publication of information on payment performance and financial position to facilitate private sector provision of credit scoring and ratings
- Support development of market for private rating and credit scoring by providing baseline of demand (e.g., regulator buys scores to aid supervision of banks or testing of portfolios)
- Consider using EU funds to facilitate existing rating agencies' participation in rating or scoring SMEs they do not currently cover or to establish new market entrants that would do so instead
- Publication of SME credit scores and ratings by public sector institutions, including central banks and those providing credit guarantees

Impediment 2: SMEs face many disincentives to achieving greater scale to be competitive and financially healthy

We heard from interviewees that SMEs in France, Italy, Portugal and Spain face a battery of hurdles that discourage growth and scale, two of the most important criteria for determining credit or investment. Regulatory reforms and public sector resources should target the easing of these burdens where feasible. This will encourage companies to grow larger and allow banks and other lenders or investors to lend to and invest more in SMEs, including high-potential businesses, as well as to shift their financial resources more easily from nonviable SMEs to those with greater promise.

SMEs have been particularly vulnerable to the recent crisis, both because of its severity and duration and because of structural weaknesses that developed over decades.

With a heavy dependence on domestic markets, SMEs have been coping with a sharp drop in demand as businesses, consumers and governments cut expenditures. Domestic demand has fallen in five of the six countries under review, with France being the sole exception, by amounts ranging from 7% in the Netherlands to 26% in Ireland, compared with pre-crisis peaks (*see Figure 9*).

Unlike larger companies, SMEs have struggled to switch sales to established export markets or find new ones. For example, in France, export revenues accounted only for 7% of SME revenues compared with 21% for large corporates. In some of the other countries, especially in Ireland and Spain, the low propensity of SMEs to export results in part from a legacy of property booms that created outsized construction sectors.

Domestic focus, lack of scale and limited financial sophistication mean that SMEs have been less agile in responding to the crisis. They experienced a stronger decline in revenues than larger firms: For the 27 countries in the EU, SME revenues fell by 10% between 2008 and 2010, while large enterprises saw their revenues decline by 7%. This top-line decline has not only affected SMEs from the periphery. In France, SMEs saw a decline in revenues of 12%, while large companies saw a decline of 3% over the same period.

Three themes were identified by interviewees as creating barriers for SMEs to reach their potential; the importance of each theme varies by country.

SME growth is held back by regulatory burdens and disincentives

For SMEs, size does matter. Larger scale allows SMEs to more easily withstand economic cycles, build deeper expertise, find new customers and markets, link into global supply chains, obtain easier access to bank financing and broaden funding sources. SMEs that fail

- "The smallest companies don't have all the 'antibodies' to reinvent themselves: Some are in the domestic market trying to optimize, while others are just trying to sustain daily life." (Italian bank)
- "We have a lot of viable firms that just got caught up in the property madness. The viable core is unable to cope with the debt from buy-to-let mortgages." (Irish bank)
- "There are too many laws in France that do not incentivize companies to grow; the complexity of taxes is one such example." (French insurer)
- "There are very good SMEs in Portugal, but they stay as micro-SMEs ... Management is not prepared to become global ... Portugal is a very small country, so it's difficult to expand alone and create economies of scale ... The mindset of entrepreneurs is to stay small and retain control." (Portuguese association)
- "Exporting is a matter of survival; many SMEs are looking at Latin America. They need fresh money to do so—but that's risky lending." (Spanish bank)

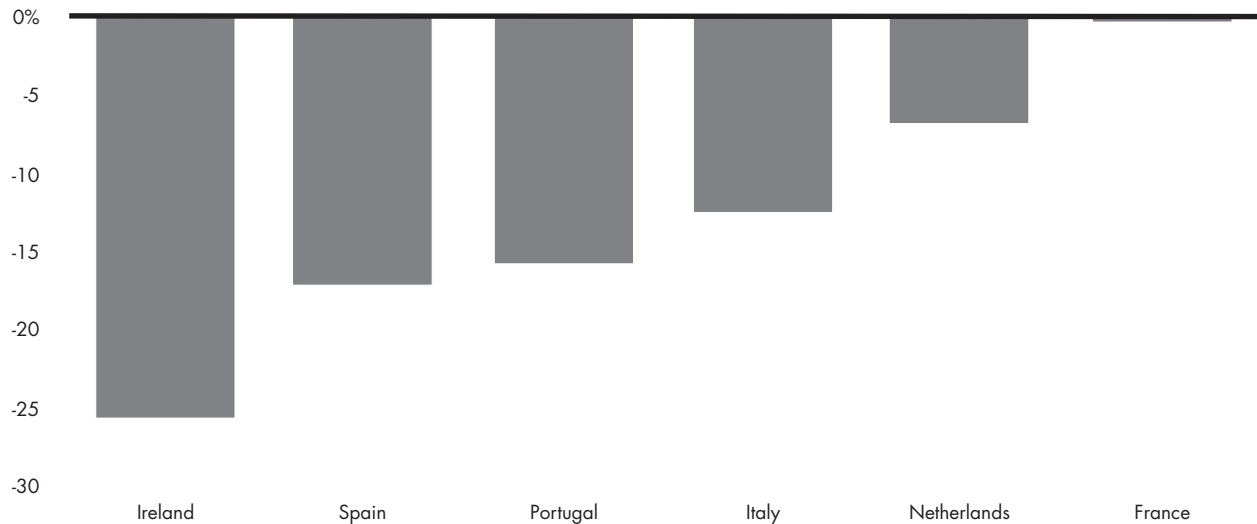
to garner the benefits of scale secured by competitors in other markets will not reach their full potential. As a result, these SMEs do not contribute as much economic growth and employment in their home markets as they could and are at a disadvantage compared with SMEs from markets where scale is easier to achieve.

We recognize that the shape of the SME sector and size of SMEs vary significantly from country to country. In Italy, Portugal and Spain, SMEs account for a significantly larger share of employment than in the rest of Europe. Microenterprises, with fewer than 10 employees, account for 47%, 41% and 39% of employment in Italy, Spain and Portugal, respectively, compared with 30% across Europe (*see Figure 10*).

In France, Italy, Portugal and Spain, several efforts have been undertaken to reduce the administrative

and regulatory barriers that a number of interviewees believe are holding back the natural growth of healthy SMEs. They agreed that disincentives to growth of individual firms often result from well-intentioned policies to capture appropriate tax revenues, protect consumers or investors, safeguard workers and their health, or pursue other equally worthwhile goals. These policies do, however, create unintended thresholds (by number of workers or revenue) above which effective tax rates increase, audits are more likely, subsidies are less available, and labor costs and other social commitments increase. These barriers were seen as much less relevant in Ireland and the Netherlands.

Growth thresholds in France appear to be tied to the number of people employed by an SME, as regulatory requirements for companies increase based on that

Figure 9: Domestic markets that SMEs serve have contracted since the financial crisisChange in domestic demand from peak¹ to 2013Q2

¹Peaks in domestic demand occurred as follows: in Ireland, 2007Q4; in Spain, 2007Q4; in Portugal, 2008Q3; in Italy, 2007Q3; in the Netherlands, 2008Q3; in France, 2008Q1

Source: Eurostat

number. For instance, there are roughly 60% fewer companies in France with 50 employees than those with 49 employees. One report suggested this may in part be explained by the fact that growing from 49 to 50 employees involves 34 additional regulatory requirements, resulting in additional costs of about 4% of total payroll.

Interviewees in Spain suggested that labor and auditing regulations create disincentives to growth, notably an external audit requirement triggered when firms grow beyond annual operating revenues of €6 million. Similarly, tax thresholds, meant to help firms in their early stages, can discourage growth. Portuguese SMEs face a 3% state surcharge on taxable profits of more than €1.5 million and up to €7.5 million and a 5% surcharge on profits exceeding €7.5 million.

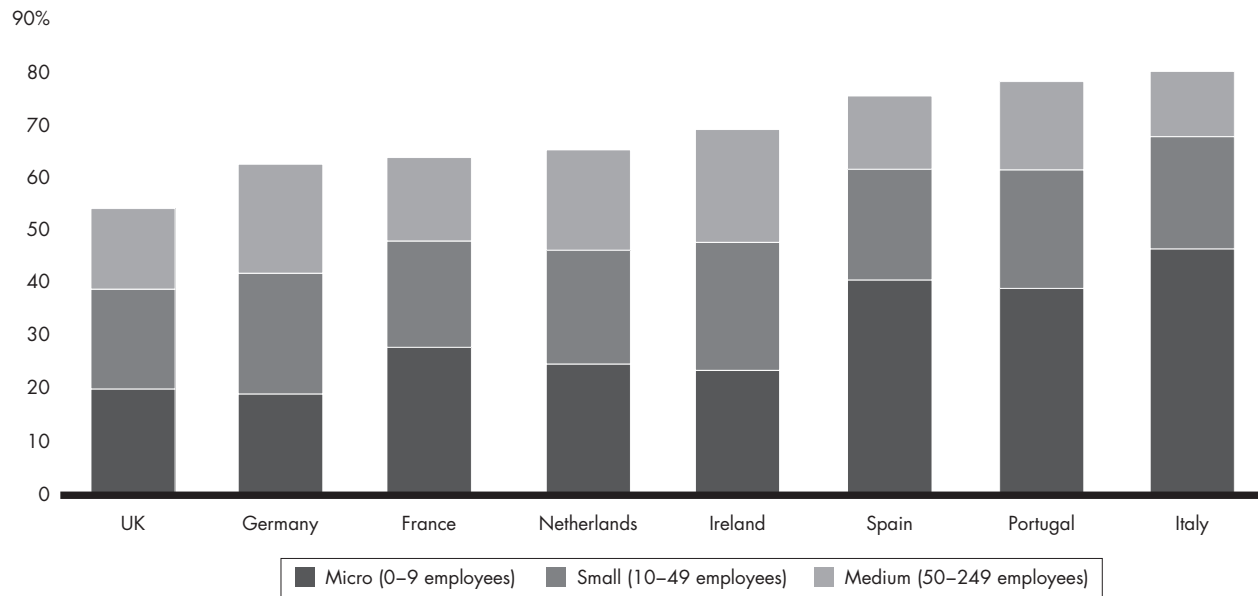
Some governments have recognized that many regulations and laws pose an unintended burden on SMEs and are taking corrective steps. In Italy, a reform program to reduce the costs of SMEs' compliance with environmental codes, labor regulations and pension schemes is forecast to save SMEs €8 billion a year.

Funding and investment do not flow toward the highest-potential SMEs

Interviews confirmed that, across all six countries, there are a wide number of healthy, high-potential SMEs that have thrived in the downturn but often find it hard to access appropriate funding. Sectors with promise included some surprises—Irish or Spanish agribusiness and Dutch deep-sea extraction technologies, for example. While each sector at the national

Figure 10: The mix of SMEs varies significantly across Europe

SME employment as a percentage of total employment, 2010



Source: European Commission Annual Report on Small and Medium-sized Enterprises in the EU, 2011-12

level has unique dynamics, high-potential SMEs appear to share one or more of the following characteristics:

- Deep expertise allowing them to attain a high market share in a specialized global market (e.g., Irish innovation in whey-based products)
- Innovation derived from centers of expertise, to shape new markets (e.g., Irish social media start-ups based on the strong presence of global media firms and Dublin's private-public collaboration through Dublin's Digital Hub)
- Integration in large global supply chains (e.g., Spanish suppliers to German auto manufacturers, Spanish aerospace suppliers tied to EADS-CASA and Airbus)

- Advanced IT and R&D used to develop innovative products and services (e.g., French biotech in Alsace, Dutch deep-sea engineering)
- Globally competitive skills and cost structure (e.g., Irish dairy sector, which benefits from a low-cost structure due to the long growing season)

Several countries have programs to support high-potential sectors. Spain provides targeted assistance to high-potential SMEs through medium- and long-term loans as well as risk capital and quasi-equity instruments. The ICEX Next plan launched in 2012 focuses on export-oriented SMEs by giving them access to expert and management advice, and FINING provides a funding line for small engineering firms looking to internationalize.

Portugal launched its Partnerships for Internationalization scheme in 2011, whereby AICEP Capital Global and Caixa Capital (part of Caixa Geral de Depósitos) form partnerships to support the internationalization of Portuguese SMEs, for example, through financing production facilities abroad.

Barriers remain to restructuring distressed SME credits

The financial crisis and subsequent recession hit some European SMEs harder than others, particularly those in construction, property-related sectors and hospitality, as well as SMEs that sell mainly to domestic markets, especially to local, regional and national governments. A significant volume of distressed businesses is being liquidated across the six countries we visited; approximately 100,000 companies were liquidated in Italy alone in 2012. We heard in our interviews that too many cases ended in liquidation, rather than with the company getting a fresh start.

With insolvencies rising fast across Europe, many of these firms need to restructure if they are to emerge as viable entities. Interviewees stressed the importance of creating favorable legal, regulatory, accounting and tax rules to:

- Allow winners in challenged sectors to restructure and consolidate (*see Figure 11*)
- Help viable SMEs to restructure unsustainable debt and adequately recapitalize
- Give incentives to owners and lenders to wind down nonviable SMEs, so capital and other resources can be redeployed to more promising activities

These processes of healthy structural adjustments are not functioning effectively in many markets. Two specific

problems surfaced across the six countries. First, SMEs operate within legal frameworks that force them to liquidate rather than restructure. Second, firms often require access to both debt and equity, as well as accounting, legal and tax expertise to successfully restructure; this group of components often is not available from their banks. Most countries have legislative tools to allow large corporates to restructure and get a second chance to grow. This benefits the common interest, because restructuring protects jobs and tax revenues. But this type of legislation does not always exist for SMEs. In fact, bankruptcy laws in some European countries traditionally have been punitive; in some cases, business owners who declared bankruptcy were barred from starting a new business. That has reinforced a stigma attached to bankruptcy in Europe and led to the unnecessary failure of businesses that could be restructured.

Interviews in Ireland and Italy identified two interesting initiatives to create bankruptcy protection and give SMEs time to restructure.

Italy amended its bankruptcy statute in 2012 to introduce Chapter 11-style bankruptcy protection, similar to that in the US, for SMEs. According to one press account, a company can ask a court for protection from creditors, typically lasting three months, while it comes up with a restructuring plan and tries to convince 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. Finally, the new law requires banks to respond by the end of the protection period—a major improvement given that Italian debt restructurings can take up to 18 months. We heard that these changes have led to a surge in business filings—in some cases, triple the previous rate.

However, some experts argue that the stigma of bankruptcy is delaying firms from seeking bankruptcy protection until it is too late. For example, more than 50% of firms in Milan that sought protection under the new statute reportedly still ended up being liquidated.

Ireland is considering legislation known as Examiner-ship Lite that should make it easier for viable SMEs to restructure their debts while giving proper consideration to creditors through Chapter 11-style bankruptcy protection. A company would seek a period of court protection from creditors, up to 100 days, during which time it would negotiate a formal debt arrangement. This legislation targets businesses with fewer than 50 employees and either a balance sheet not exceeding €4.4 million or turnover exceeding €8.8 million.

Impediment 2 solutions: Measures to lessen disincentives to growth and strengthen the financial health of promising and viable SMEs

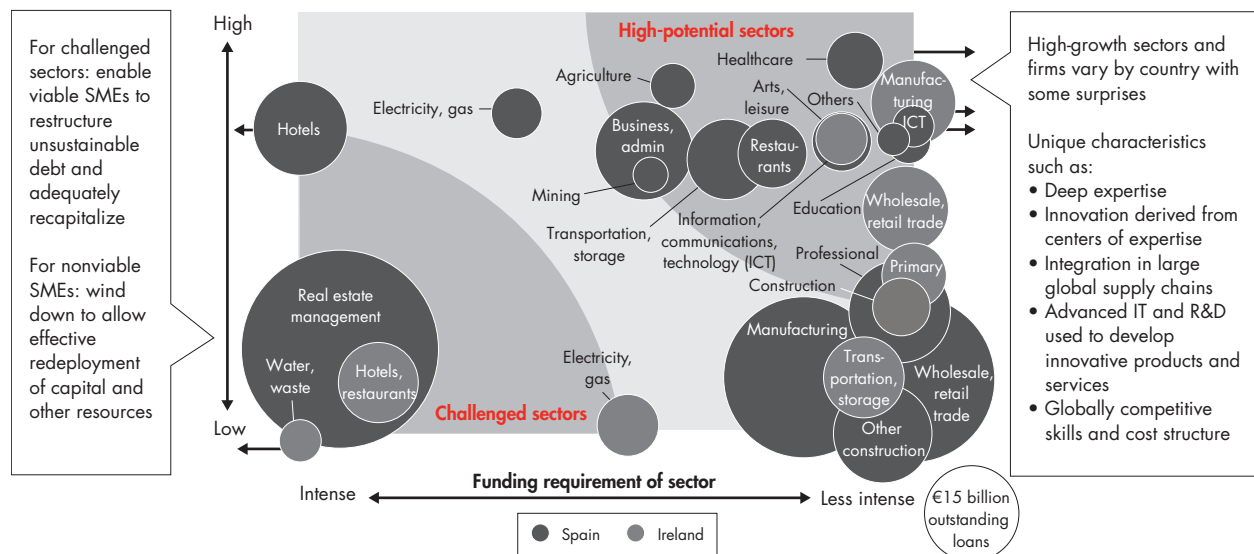
Addressing most of these structural challenges would be best served at the national level, as regulatory and incentive structures are highly specific to each country. The following were among the initiatives already being enacted in some countries or viewed as worthy of consideration by interviewees:

Measures to improve incentives for achieving greater scale

- Reductions in costs of SME regulatory compliance (as in Italy where “Simplify Italy” measures were enacted in 2012)

Figure 11: SME sectors have diverged during the financial crisis

The crisis has hit some sectors harder than others



Note: Funding requirement of sector estimated using 2011 data on loan to deposit ratios; outstanding loans data is for 2011; sector resilience for Ireland estimated using a ranking that incorporates 2010–11 data for GDP growth, GDP size and the number of large companies; sector resilience for Spain estimated using 2010–11 data for GVA growth

Sources: Bank of Spain; INE BACH; Central Bank of Ireland; Central Statistics Office, Ireland; IHS Herold; Bain analysis

- Reductions in administrative burdens for start-ups and smaller SMEs (as in France where “Individual Entrepreneurs” judicial status was enacted in 2009)
- Examining effective tax rates to avoid steep inclines at specific thresholds
- Design reporting and auditing frameworks seeking to reduce disincentives to growth

Measures to support SME expansion and exports

- Provide education in management and business strategy for SME owners looking to expand their businesses, by using public funding, perhaps in conjunction with private funding (e.g., banks, investors, SME associations)
- Help SMEs integrate into large enterprise supply chains
- Help SMEs develop connections to untapped foreign markets by redirecting existing public agencies to work with banks and associations toward that end
- Introduce support for SMEs looking to internationalize through medium- and long-term loans or equity investments and educate SMEs in how to access trade financing

Measures to bolster SME financial health

- Continue efforts on repaying public sector arrears and enforce legislation on late payments
- Develop a voluntary code of conduct for the private sector to ensure timely payment of invoices; work with industry associations to promote invoicing best practices
- Strengthen ability of mutual, cooperative and collective structures to lend to SMEs by providing them with support from public funds
- Make new equity tax deductible and eliminate or reduce the tax advantages of debt by developing tax-based incentives (e.g., “Allowance for Corporate Equity” enacted in Italy)
- Increase access to equity, including risk capital, and revise social and other legislation to support consolidation for challenged but viable firms
- Consider legislation allowing “second-chance,” Chapter 11-style debt restructuring (e.g., Examiner-ship Lite in Ireland) in order to sustain going concerns and limit recourse to time-consuming, value destroying liquidations

Impediment 3: Banks are able to shoulder less credit risk than before the crisis

Banks' ability to take on new credit risk continues to be affected by ongoing efforts to rebuild capital bases, de-risk lending portfolios and reduce costs. At the same time, the lack of effective instruments to restructure distressed SME loans means that significant amounts of bank funding and provisions remain tied up with unproductive firms. To ensure that credit flows to healthy, growing SMEs and supports the restructuring of viable but possibly overindebted SMEs, cost-effective solutions are needed to restructure NPLs in the back book.

Deleveraging and reduced risk appetite are constraining banks' ability to extend fresh credit

Banks' ability and appetite to lend to SMEs have clearly been affected by their need to focus on strengthening capital bases and rebuilding profitability. Improved liquidity and lower funding costs, therefore, have helped but not changed these basic facts.

A return to prudent lending practices will help create a more robust financial system. In the near term, though, banks may need support to lend more without putting scarce capital and profitability at greater risk. For SMEs in countries with weaker economic performances and more distressed banking sectors or for SMEs with a long-term credit relationship with a particular bank that is deleveraging, these circumstances create an uneven playing field for SMEs across the Euro Area.

Encourage new lending where banks would not lend unaided

Broadening the scope for increased amounts of new

lending to SMEs hinges in part on restoring the health of the banking sector and individual banks, as well as creating sufficient flexibility on banks' balance sheets so that they can target more new lending to healthy, growing SMEs. Bank restructuring and deleveraging will play out over many years. In the near term, reviving a robust lending channel to healthy SMEs, especially those that are higher risk and high potential, will require targeted actions that allow banks to make new loans, even as they conserve or rebuild their capital and lower the overall risk of their loan portfolios. A credible and detailed asset quality review by the ECB should be one critical step toward that end. Interviewees cited two important types of initiatives that support banks in this regard: credit guarantee schemes and credit insurance.

Credit guarantee schemes

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. Banks, SME associations and officials agreed that shifting risk to a public or quasi-public balance sheet

- “There has been a huge change in the way we approach credit. The effect of the crisis is clear—we have started trying to be more rigorous in our approach to credit analysis ... The single biggest mistake of credit expansion was to underestimate the strategic side, as there was not enough attention and scrutiny to understanding particular players and industries.” (Italian bank)
- “The mutual guarantee system works well in a period of crisis ... Mutual guarantees in Portugal are public-private initiatives: The private mutual guarantee forms the basis of funding while the public authority guarantees form a reinsurance fund or counterguarantee fund.” (Portuguese authority)
- “Export finance needs to be further developed, and we have to adapt all the tools of financing. For the SMEs, documentation is expensive, so we have to find ways of reducing costs.” (French bank)
- “The guarantee scheme was set up for investments. The up-front fee and five- to seven- year lending terms do not address the real need for working capital.” (Dutch authority)
- “To address the problem of SME debt, banks are considering debt resolution strategies that provide sufficient incentives to viable borrowers to work through the debt overhang.” (Irish business association)

has costs. But they also pointed out that, in their view, the actual costs of a well-designed guarantee scheme are significantly lower than the social costs—loss in output, rise in SME bankruptcies and increased unemployment—of not providing this type of support in the current economic climate.

Several interviewees also said they believe credit guarantees schemes have significant multiplier effects, making them highly effective in unblocking funding to SMEs. For example, SMEs have accessed €13.3 billion in loans between 2007 and 2012 through schemes supported by the EC's Competitiveness and Innovation Framework Program (CIP). With just €500 million in capital, these counterguarantees are delivering a multiplier effect of more than 25 times.

Some loans supported by guarantees no doubt displace loans that banks would have provided even without a guarantee scheme, interviewees acknowledged. Several banks countered that even in those instances, credit guarantee schemes free up capital (the risk weight of the guaranteed portion is zero) and thus enhance banks' total lending capacity.

Current credit guarantee schemes at the national level come in many different designs and structures for both banks and SMEs. Our interviews indicate that some schemes work better than others.

Portugal's scheme has consistently been identified as highly effective in providing credit to SMEs. Portugal launched SME Invest in 2008 and its successor

SME Growth in 2012. These schemes focus on export or investment credit, providing mutual government guarantees for bank loans. As of October 2012, SME Invest and SME Growth lines provided €9.2 billion to 17% of SMEs in Portugal. The high uptake stems from several features: advantageous credit terms for SMEs, including extended repayment and grace periods; reduced costs of borrowing, from 10% to 6% for SMEs; easy access to the guarantee lines, directly through their banks; as well as a high level of SME awareness.

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.

On the other hand, programs in the Netherlands and Ireland have seen relatively low uptake. In the Netherlands, the key barrier identified by interviewees was the focus of the main guarantee scheme, BMKB, on longer-term investment financing. Dutch interviewees observed that the up-front fee of up to 3.6%, as well as the typical five- to seven-year lending terms, did not address the current need for shorter-term working capital financing of most SMEs.

Ireland's SME Credit Guarantee Scheme, launched in October 2012, had been designed to give companies that have been declined by banks a second chance. Officials confirmed that, so far, less than 5% of the €150 million envelope has been accessed. The scheme requires an SME to have been officially rejected by a

bank. This is seen as a barrier to higher uptake, as SMEs that have been rejected by their banks do not tend to apply again through the same banks for an alternative scheme. We understand that officials are considering a redesign.

Credit insurance

Three European institutions dominate the private credit insurance landscape: Euler Hermes, Coface and Atradius. They account for roughly 70% of the private credit insurance market in Europe and also play a role in supporting the implementation of public programs, such as administration of public export credit schemes.

The firms provide insurance on accounts receivable from up to 100 million firms from around the world, allowing SMEs to manage risk associated with financial default of their customers, both in the domestic market and abroad. Each has detailed proprietary risk analyses by country, activity sector and company. They track a web of SMEs' customer relationships and provide early warnings to SMEs if customers show signs of distress like a delayed supplier payment.

Today, credit insurance is used by 10% to 20% of SMEs (though about 30% of trade receivables are insured), according to the insurers' trade association. Industry experts cite the key barriers to higher uptake as low awareness by SMEs of these instruments and the relatively high costs of insurance.

Many banks told us they look more favorably on clients that are using credit insurance and are more likely to extend credit if such coverage is in place; in some cases, they even require credit insurance. From our interviews, it appears that credit insurers could have a more direct impact on availability and cost of lending by directly

insuring banks against losses from SME loans or loan portfolios. One barrier to the development of such an “alternative private guarantee” scheme, though, is the capital requirements of insured loans or portfolios. While public guarantees lower the risk-weighted assets to zero (assuming the counterparty attracts a zero risk weight), insurance of the same portfolio does not provide the same benefit. Banks that use internal ratings to set risk weights for insured credits have the formal scope to adjust loss given default and probability of default—to account for risk mitigation provided by credit insurance. However, we understand that some supervisors discourage the practice. Under the standardized approach, no adjustments are made to risk weights for insured credits.

Capital relief would be possible, it seems, for insured portfolios of SME loans sold to nonbank investors. Several interviewees reflected on the beneficial effect that such insurance of loan portfolios would have on institutional investors’ appetite for these assets. In their view, institutional investors are actively assessing the opportunities to acquire SME loan books, but they typically lack the capabilities to conduct detailed credit assessments on small-ticket SME loans. Portfolio credit insurance could be one option to overcome this barrier, one credit insurer told us.

For example, interest by institutional investors to cooperate with banks on originate-to-distribute schemes has been well documented, with AXA, Generali and Allianz all active in this segment. The interviews indicated that portfolios composed of smaller-ticket loans with insurance against some of the losses would be of interest to a wide number of institutional investors. The potential for institutional investors to create capacity on banks’ balance sheets is large; one interviewee, for example,

indicated that his institution had been able to generate €1 billion in SME loan portfolios for institutional investors since the beginning of 2013.

Lack of mechanisms and incentives to restructure back books of distressed SME loans keeps funding and provisions tied up in unproductive firms

Increasing fresh lending to healthy SMEs that are finding it difficult to access credit is necessary but not sufficient. Banks also need to cleanse their back books of loans to distressed SMEs through debt restructuring, to allow banks to deploy more funding to healthy and viable firms.

Although few reliable statistics are available on the health of SME loan books across markets, anecdotal evidence suggests that the level of impairments appears to be significant and rising. For example, the Irish central bank has suggested that nearly half of SME loans are impaired or under stress.

In Ireland, Italy, Portugal and Spain, bankers said that, today, they lack the incentives and mechanisms to effectively restructure the debt of firms that are viable but have an unsustainable overhang of debt, wind down failed companies or help the winning SMEs acquire failing competitors. Banks sometimes lack sufficient staff who are skilled in identifying viable companies and supporting the restructuring of debt. Nascent distressed debt markets and a small pool of investors with business restructuring expertise make it difficult to bring in outside skills and capital to drive the turnaround of stressed firms.

In the case of winding down lending from nonviable firms, banks said they do not have incentives to seek a swift resolution. In particular, lengthy credit write-downs

and bankruptcy enforcement procedures make it difficult for banks to resolve the cases. Italian bankers said they are especially hampered by a regulatory structure that works against their ability to retain earnings, including an 18-year amortization of write-downs.

Spain and Ireland have used national asset management agencies to cleanse balance sheets, mainly from commercial real estate debt. Most SME debt remains on bank balance sheets, however.

Potential solutions might include debt for equity swaps; private asset management transactions funded or guaranteed by government schemes; and new ways to restructure, again possibly with a government guarantee.

Interviews identified three potential solutions: debt for equity swaps; private asset management transactions funded or guaranteed by government schemes; and new creative ways to restructure, again possibly with some sort of government guarantee.

We heard that, in the past, banks would have used debt-for-equity transactions frequently to restructure their impaired back books. Under Basel III, banks have much higher capital requirements—nearly 50% higher, according to one bank—than under Basel II. Post crisis, however, more difficult financing conditions and pressure from regulators about capital adequacy have left few banks comfortable in maintaining equity positions with high capital requirements.

Many interviewees noted that, since 2008, very few private transactions have moved significant assets off banks' balance sheets, due to wide differences between prices that asset managers, private equity and other players are willing to pay versus prices at which banks are willing to sell. The asset quality review may reduce this bid-ask spread, but many interviewees thought it would not completely reduce the gap. Therefore, many interviewees suggested the use of guarantee schemes to help bridge the difference.

Finally, one initiative under discussion in Ireland is the adoption of the Irish mortgage resolution model for restructuring SME debt. This scheme would allocate an SME's debt into three tranches to allow viable SMEs to address the overhang of debt:

- Tranche A: Sustainable debt serviced by the SME, with interest and principal repayment
- Tranche B: Debt warehoused with a low interest rate; principal repayments restarted in five or six years
- Tranche C: Debt warehoused, potentially without any interest payments, and written off if A/B are repaid within an agreed time frame

For such a scheme to make meaningful contributions to SME debt restructuring, issues that led to the low takeup of the mortgage restructuring scheme will need to be addressed in the design. For example, bank provisions will need to be sufficient to limit further negative effects on bank capital. In addition, banks will need to be better incentivized to participate via guarantees, perhaps, for deferred portions of debt and appropriate tax incentives for subsequent write-downs. Finally, appropriate restructuring mechanisms such as Chapter 11-style legislation need to be in place.

Impediment 3 solutions: Measures to help banks lend more

Solutions should encourage new lending where banks are not lending unaided and incentivize the restructuring or sale of distressed back book loans. Interviews suggest that the following measures should be given consideration:

Measures to reduce uncertainty

- Press ahead with banking union, asset quality reviews and stress tests in a timely fashion, with adequate fiscal backstops
- Unify provisioning requirements on restructured credits to more fully take into account higher-quality borrowers seeking to restructure or refinance and take advantage of lower interest rates
- Reduce uncertainty about likely capital requirements going forward

Measures to optimize official support

- Share knowledge and best practices to improve the design and implementation of national guarantee schemes
- Channel support to SMEs by establishing government-backed development banks (e.g., ICO in Spain)
- Investigate pan-European (counter-) guarantee schemes offering standard terms to ease access by addressing concerns about potential effects on competition

- Encourage broader reliance on credit insurance, where doing so is cost effective, to insure portfolios of unsecured SME loans that banks could then sell to nonbank investors
- Establish voluntary credit mediation for SMEs that are refused loans by banks to help borrowers clarify and strengthen their credit portfolios

Measures to incentivize NPL restructuring and support lower lending margins

- Share learnings and best practices from innovative debt restructuring schemes across markets
- Allow loan loss provisions and write-downs to be written against tax liabilities more quickly and consistently
- Enable banks to recover collateral more quickly by selling or restructuring SMEs and their assets, notably by facilitating out-of-court settlements and accelerating bankruptcy procedures
- Lower effective corporate income tax rates on banks where they are elevated, as in Italy, by asset-based surcharges

Impediment 4: Alternative funding providers face many barriers to financing SMEs

Besides bank loans, alternative longer-term financing sources are important, especially for high-growth firms that want to diversify their funding basis or need a mix of debt and equity. As Europe's recovery gains steam, it will be critical to supplement bank lending with new sources of finance, so that bank capacity constraints discussed in Impediment 3 do not hold back the necessary financing for SMEs.

All six countries and the EIB Group have launched initiatives to foster alternative funding sources. However, our interviews highlighted the need for a broad range of alternatives that support SMEs across different stages of maturity and the importance of building an entire ecosystem of players to source, warehouse, structure, rate and invest in alternative instruments.

Lack of alternative funding sources impedes the health and growth of SMEs

We heard that SMEs of all sizes, especially young and fast-growing firms as well as those that are restructuring, require a more diverse set of funding sources. Interviewees agreed that increasing the availability of alternative sources from today's estimated 10% to 15% of total SME funding by only five to 10 percentage points would make a marked difference. Companies would be able to gain access not only to equity but also to debt—both of which play a critical role in allowing firms to accelerate growth or restructure. Moreover, we heard that more equity and alternative sources of funding often now serve as prerequisites for SMEs to access further bank funding. Banks comfortable lending to companies with debt equity ratios of 4 to 1, for example, would be able to provide €4 of new credit for each €1 of new equity raised by the borrower.

Lack of access to equity holds back the restructuring of challenged but viable firms while delaying the wind-down of nonviable firms. Current tax laws in most of the countries we visited favor debt over equity, which is a barrier to substantial structural changes in financing for challenged SME owners and new investors. A welcome exception is Italy's recent Allowance for Corporate Equity (ACE). ACE 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.

The development of alternative funding sources has also been held back by the high cost of assessing information about SME creditworthiness and potential. Moves to improve transparency and reduce the costs of accessing information should help stimulate the emergence of alternative sources.

- “The lack of alternative funding sources is partly structural—the markets have not been set up, debt issuances need to be high—and also partly regulatory—institutional investors struggle to invest in SME debt.” (Spanish investor)
- “Partnerships with insurance companies are a solution for the biggest SMEs—those with revenues above €500 million—to diversify their sources of funding, but this is much more expensive than traditional credit.” (French bank)
- “When Portuguese companies are growing and selling €20 to €40 million they are often bought out by international funds ... there are not enough local PE firms to invest in these firms.” (Portuguese authority)
- “The asset management industry, which is subject to a whole cascade of regulations, is immature and shrinking in the Netherlands.” (Dutch investor)
- “Institutional investors currently have a low percentage of funds invested in nonlisted assets—there is room to expand this type of investment. But this would require an intermediation scheme for financing by large institutional investors.” (Italian authority)

Alternative funding sources require specific ecosystems

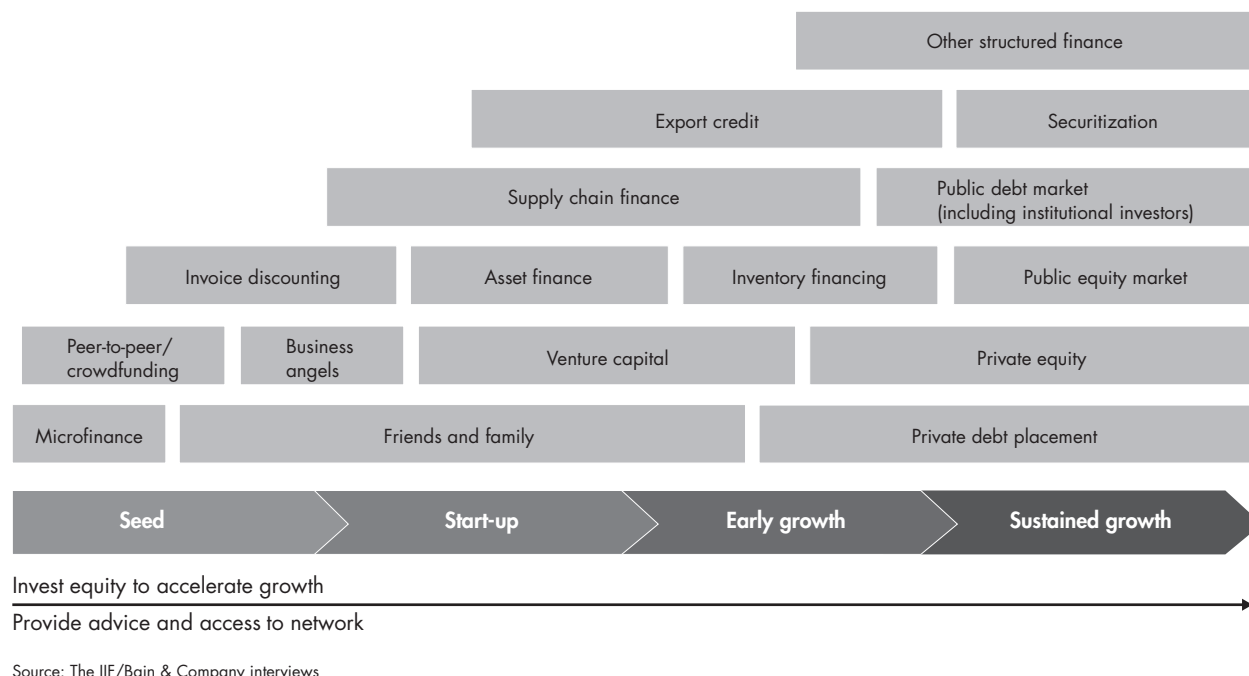
Broader challenges also must be addressed, as each funding source requires a specific ecosystem in order to flourish. In the case of developing capital markets, for example, the interests and incentives of many actors have to be aligned, including SMEs, investors, exchanges, advisory services, listing agents, lawyers, auditors, PR agencies, accountants and rating agencies. Such alignment may require changes to regulation and taxation that affect some or all of the actors.

Figure 12 provides an overview of different funding sources that firms can access at different stages of maturity. In vibrant economies, we heard that these sources combine to form a “funding escalator,” pro-

viding debt and equity as firms grow and their funding needs evolve.

Funding escalators don’t exist today in most of the six countries, interviewees agreed. Instead, policies and public funding concentrate on supporting stages adjacent to either end of the funding escalator—very early-stage firms on one end and the largest SMEs that can access more sophisticated instruments on the other end.

France is the exception. There, the effective interplay of public and private sector schemes has created a more seamless funding model. French banks have partnered with the official sector to provide early-stage funding, with some banks managing significant equity investment portfolios either directly or indirectly through stakes in PE firms. BPI France, the government devel-

Figure 12: As companies grow, their financing needs change

opment bank, also plays an active role in funding and supporting firms at different stages of development. This model has come under increasing pressure, however. Representatives from one bank confirmed that they divested their substantial VC and PE exposures as the capital requirements on the holdings under Basel III have increased to nearly 50%.

Gaps in the funding escalator can have a significant, negative effect on small businesses in some countries (see Figure 13). Irish interviewees noted that the lack of growth funding for loans of more than €10 million likely contributes to the early sale of ventures to foreign investors, which often prompts enterprises and jobs to move to the US. They said few companies remain that will grow to a point where capital market issuance is a viable financing option.

The mix of funding sources has regressed, which impairs development of high-growth firms

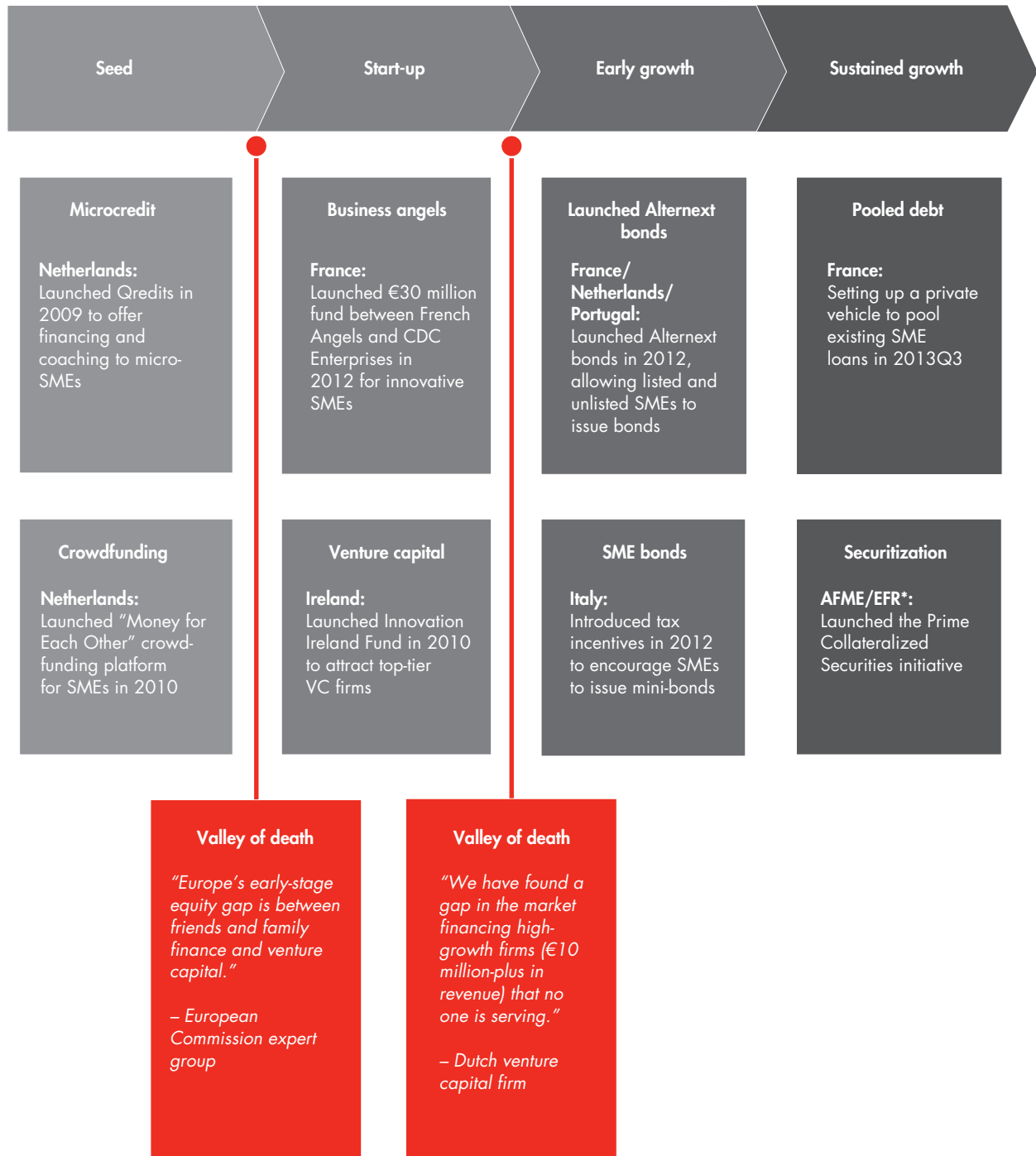
It is clear from the interviews that high-growth SMEs in the six countries do not have the same access to a broad base of alternative debt and equity funding sources—seed funding, VC, PE and restructuring or risk capital—that SMEs enjoy in other vibrant markets. Moreover, private sources that support high-growth firms or assist in restructuring appear to have retracted since 2007.

Early-stage funding

Officials in all six countries worry about the firms that are not being founded as the result of a sharp fall in

Figure 13: Initiatives to develop an ecosystem of alternative funding sources

Select initiatives to develop alternative funding sources



*AFME=Association for Financial Markets in Europe; EFR=European Financial Services Round Table

Sources: Interviews by Bain & Company and the IIF; European Microfinance Network; Douw & Koren European Commission; Bloomberg; ICO; DJEI; Financier Worldwide; The Wall Street Journal; PCS website; EIF

available seed, VC and PE funding. Most of these markets had only nascent venture and equity markets before the crisis; for example, the Italian funds represent less than 5% of the funding that is available in the UK. Fundraising of PE firms across Europe has dropped from €81 billion in 2008 to €24 billion in 2012. As private funding has dried up, public sources increasingly stepped in; for example, the share of public VC funding in Europe increased from 10% in 2007 to 57% in the first half of 2011.

As a way to reinvigorate private funding sources, several countries are using tax incentives designed to attract new investment funds. The French FCPI scheme, one of the most successful schemes, raised €6 billion in retail funds between 1997 and 2010. FCPI allows French citizens to invest up to €12,000 per year in pooled managed funds, which then invest in SMEs, with significant investment and capital gains tax breaks for investors.

The Irish Employment and Investment Incentive Scheme allows individual investors to make direct investments in SMEs and obtain income tax relief on capital of up to €150,000 per year. It is a promising initiative, but uptake has been low, with only €13.4 million invested in 2012. Observers said that the current structure deters individuals in the highest-income tax bracket and also effectively excludes syndicates of angel investors.

The Netherlands 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 of up to €150,000 per loan, while the EC and the EIB Group are providing first-loss credit insurance.

Funding is not always the main barrier, though. Interviewees suggested that SMEs lack awareness of alternative fund sources, such as public funding schemes, equity investors and nascent peer-to-peer lenders. Awareness-building campaigns thus would be beneficial.

Funding for growth and expansion

At the other end of the maturity spectrum, more funding options now exist for the largest SMEs, many focusing on capital markets. These options may only be relevant for a small number of companies. In Ireland, the Netherlands and Spain, interviewees suggested that perhaps 100 or 200 SMEs have the requisite characteristics—size, growth trajectory and profitability—to access public equity or debt markets.

Uptake of these newer instruments has been limited, with only a handful of equity and bond listings at most exchanges. The most notable exception is Alternext Paris, founded in 2005, which lists 166 SMEs. Several factors likely contributed to its success, including a launch during more flush times, as well as efforts in 2009 to ease access for SMEs by adapting and streamlining the regulatory framework and rules.

Italy launched a bond market this year that allows SMEs to issue mini-bonds, which enjoy tax relief on interest costs and issuance expenses. To date, a dozen or so firms have issued mini-bonds, though only one was an SME, raising €3 million. The government now is creating a central credit fund to buy mini-bonds and will look to fund itself in the future by issuing larger bonds to institutional investors.

One current drawback noted by interviewees: The cost of using exchanges is so high that only a select few

SMEs could consider the option. Costs for an initial public offering (IPO) raising €5 million to €10 million in capital can range from €300,000 to €600,000. These costs stem from the absence of effective ecosystems tailored to the needs of SMEs. Instead, SMEs are forced to resort to costly services typically designed for large corporations, including advisory services, listing agents, lawyers, auditors, PR agencies, accountants and rating agencies.

Interviewees in Spain also raised the importance of designing new exchanges consistent with their respective ecosystems. Consider the newly formed SME bond exchange in Madrid, which sets the minimum investment at €100,000. At this level, retail investors are excluded, even though they are viewed as critical to the success of other vibrant SME bond markets. At the same time, the Madrid investment level remains far below the threshold for interest by institutional investors.

Some interviewees cited the launch of EnterNext in April 2013 as a potentially significant move to create a deeper, more liquid pan-European equity market for SMEs. EnterNext could lay the foundation for an effective ecosystem, which would stimulate greater competition among providers of ancillary services and greater standardization. In turn, those features would lower the costs of accessing capital markets. Other interviewees, however, suggested that domestic ecosystems will need to be established because each country has different legal, regulatory, accounting and tax systems for SMEs, banks and investors.

Securitization of SME debt

Securitization in the form of ABS liquefies assets like SME loans, creating more capacity on banks' balance sheets and providing an important collateral asset.

Before the crisis, securitization of loans to SMEs was prominent in Spain and Italy, where banks used it to access funding. But the financial crisis disrupted European securitization markets as the difference between the pricing of the loan on the balance sheet and the price investors were willing to pay widened significantly, according to our interviews. According to the EIF, with the exception of securitizations structured to benefit from ECB refinancing, only a small number of transactions backed by SME loans have occurred since mid-2007.

Most interviewees from European authorities agreed that securitization should be added to a bank's toolkit as a means to strengthen its funding position, especially if further capacity is required in the future, and to share risk. The ECB hopes to stimulate SME-backed securities through measures that include broadening their eligibility as collateral. Already, the decision to start accepting ABS with a lower credit rating (single-A instead of triple-A) and at a lower haircut (10% instead of 16%) is expanding eligible collateral by about €20 billion.

The ECB is also addressing a general lack of confidence in the quality of the underlying assets, which in turn raises information costs for potential investors. For example, the European DataWarehouse, the ECB's loan-level data initiative, establishes requirements for transparency and standardization before any ABS can be eligible as Eurosystem collateral. By taking on the issues of confidence and information costs, the ECB expects to stimulate demand from private investors.

The EIB Group is further developing instruments to support securitization structures, through ABS purchases and guarantees, with the aim to broaden investor demand by reducing uncertainty.

In addition, the Prime Collateralized Securities (PCS) initiative aims to create a sustainable market for asset-backed securities with standardized criteria. The PCS label is awarded to securitization issuance meeting the strict criteria set by PCS. These focus on issues of quality, transparency, simplicity and liquidity. Thirty transactions have been awarded the PCS label since 2012.

Other initiatives are taking shape at the national level; for example, since 2012, the Banque de France has been working on a proposal to help banks package SME loans into tradable securities. The project would create a private vehicle to pool existing SME loans and then issue new securities that can be traded. If successful, the project would make it easier for banks to refinance existing loans and prompt them to extend credit to small businesses.

Impediment 4 solutions: Measures to create an ecosystem for the emergence of alternative funding sources

No single initiative or policy can solve the challenge of creating a more diverse funding environment. To attract and develop alternative sources, policy will most effectively focus on the development of robust ecosystems that lay the foundation for alternative finance. Interviews and research to date suggest that such an ecosystem requires consideration of the following measures:

Measures to address regulatory impediments

- For each alternative funding source, address legal, regulatory and tax barriers for key stakeholders (SMEs, investors, supporting institutions) to encourage use

- Broaden scope for investments by pension funds and insurance companies in SMEs; review restrictions on investments in illiquid and unrated instruments
- Support establishment of innovative funding models (e.g., peer-to-peer funding networks) by creating the necessary regulatory framework (including protection of retail investors) and considering short-term public support

Measures to support the emergence of alternative funding

- Educate SMEs on available alternative funding options and the benefits of participating in alternative funding programs
- Use tax incentives to encourage emergence of broader investor base (including retail investors) in SMEs or SME funds
- Provide incentives to PE and VC investors to broaden financing to SMEs to address gaps in funding
- Provide additional equity investments through development banks and other national funding, in order to bolster SME capital and borrowing capacity
- Support business angel investment and investor-readiness programs, encouraging potential investor groups to become angels and building the capacity of angel network managers
- Encourage supporting institutions and professionals to develop tailored solutions and enable provision at a viable price point for SMEs, stimulating more competition in professional services

Measures to support market liquidity and securitization

- Improve liquidity and facilitate greater SME access to additional sources of funding (e.g., by reconsid-

ering regulations governing secondary debt and equity markets)

- Kick-start the development of new and emerging alternative funding sources by providing targeted incentives and acting as a market maker (e.g., increase the attractiveness of ABS of bundled SME loans by increasing EU-level guarantees and insurance via first-loss guarantees)
- Support initiatives bolstering market liquidity that address issues of transparency, quality and simplicity (e.g., those that are addressed by the PCS label)

A well-defined process is needed to assure progress easing impediments to SME financing

SMEs' access to finance can be improved, helping to generate jobs and boost growth, if Europe puts in place a well-coordinated EU-wide process to advance innovative actions to ease key impediments. Banks, other lenders and investors could do their part and extend more financing if governments and regulators act to expand access to information about SME creditworthiness and SMEs provide more of the information needed. To broaden the base of creditworthy borrowers, fiscal and regulatory disincentives to SME growth and financial health will need to be eased, too, including by strengthening incentives for lenders to restructure debts owed by overleveraged and distressed firms. A refocus of the increased official financial support that is in prospect, especially at the EU level, can continue to catalyze lending by banks and others. These funds will be used most effectively, however, via risk sharing, first- and second-loss guarantees for securitizations and equity injections to support larger numbers of SMEs with the scale, financial health and potential to meet the challenges of the future.

Action to address impediments to SME finance will need to take place mainly at the national level. Each member state will continue to have SME policies and approaches that differ from those in other states. The main value that EU-level institutions can bring will be in helping to assure that information is shared among the member states about promising initiatives in other member states. That said, Europe can usefully take several steps to assure that sufficient progress is being made at the national level to build stronger SMEs with better access to financing in the post-crisis world.

Tailored solutions for each member state might best be advanced by establishing national task forces of key stakeholders—officials, regulators, business and SME associations, banks and alternative finance providers—to identify and agree solutions aimed at each of the four

sets of impediments. Task forces comprising some of these participants already exist in some of the countries reviewed. Each EU member state, for example, has appointed an SME envoy to represent and promote SME interests at home and at the European level (see the box on page 41). Success developing useful solutions has been limited, however. What seems essential is a technocratic, nonpolitical, consensus-oriented approach with participants focused on practical improvements, prepared to reach compromise in order to secure better outcomes for all stakeholders.

Give and take focused on improving information about creditworthiness could prove a useful example of how such task forces might work. Were governments, regulators and SMEs able to agree on well-crafted adjustments to legal restrictions, paying due attention to

legitimate privacy concerns and departing from long-standing practices by more widely releasing information about financial and payments performance, several banks have indicated they would be prepared to consider more lending and to pass on savings on information costs. Whether banks will really lend more to firms providing more information might best be established by practice: lenders reporting back to the task force and SMEs confirming increased lending where creditworthy borrowers had offered more information. How to cover the costs to the SMEs providing such information would be a key issue for the members of the task force to take up. Steps that lower those costs could be very important toward expanding SME participation in information provision.

Although progress toward easing impediments needs to take place mainly at the national level, examples from elsewhere in Europe may be key to making progress within individual national task forces. Many innovative measures have been taken, indeed, within each of the six countries under review. Interviewees were mostly unaware, however, of innovations in other countries. Disseminating “best practice” innovations across the various national task forces is where Europe can and should play a pivotal role.

Doing so might best be done via a call from the European Council to establish such national task forces (see *Figure 14*). That recommendation should advise the national task forces to resolve impediments to SME finance and help draw up or renew national action plans toward the same end.

Figure 14: An EU-wide process to drive information sharing and implementation

European Council	European Commission	National task forces
<ul style="list-style-type: none"> • Recommend establishment of national task forces • Mandate the European Commission to produce semiannual progress reports 	<ul style="list-style-type: none"> • Draft semiannual reports • Ensure dissemination of “best practice” innovations • Elevate issues to EU-level as needed • Identify funding to support priority EU-level initiatives and pilot projects 	<ul style="list-style-type: none"> • Convene key officials, regulators and representatives of business and SME associations, banks and alternative finance providers • Develop technocratic, consensus-based proposals to ease SME financing impediments • Help formulate national action plans • Liaise with other national task forces to share “best practice” innovations to address SME financing impediments • Drive implementation and track progress at the national level

Source: Bain & Company and the IIF

European SME envoys

At the invitation of the European Commission, member states nominate a national SME envoy to represent and promote the interests of SMEs throughout all levels of government bodies. Interfacing between the Commission and national policy makers, these envoys contribute toward the implementation dialogue of the Small Business Act for Europe and encourage the sharing of good practices across member states.

The SME envoys in the six countries under review at the time of the interviews were as follows:

France:	Mr. Pascal Faure Director General of Competitiveness, Industry and Services Ministry of Economy, Finances and Industry
Ireland:	Mr. John Perry, TD Minister for Small Business Department of Enterprise, Trade and Innovation
Italy:	Mr. Giuseppe Tripoli Head of the Department for Enterprise and Internationalization Ministry of Economic Development
The Netherlands:	Mr. Rinke Zonneveld Director Entrepreneurship Ministry of Economic Affairs, Agriculture and Innovation
Portugal:	Mr. Franquelim Alves Secretary of State for Entrepreneurship, Competitiveness and Innovation Ministry for Economy and Employment
Spain:	Mr. Manuel Valle Muñoz General Director of Industry and SME Ministry of Industry, Energy and Tourism

Operating under the same Council recommendation, the European Commission might play the role of coordinating secretariat, making sure information on initiatives is shared among the national task forces and reporting to the Council semiannually on the progress


being made, or the lack thereof, by each of the national task forces. Emphasis in those semiannual reports should be both on best-practice innovations (such as the SBR) and initiatives that might be needed at the EU level (such as an expansion of the European Data-

Warehouse). The Commission might also take the lead in securing EU funding for cross-border initiatives (such as the establishment of central credit registries) or pilot projects (including, perhaps, the establishment of national-level ratings agencies focused on SMEs). Semiannual progress reports could be expected to play a more prominent role in encouraging action within the national task forces, thanks to the regular drumbeat of publicity that would be given to adoption of innovative initiatives.

National task forces will need to link directly to legislative agendas and be able to influence budget priorities. This will require a nonpartisan process and the inclusion of relevant stakeholders on each task force.

The required solutions will be complex to deliver and require active coordination across different official institutions, business associations and their members, and among banks, other lenders and investors. Each task force will need to set out clear strategic agendas to help shape the design of action plans detailing key initiatives, new and old, ensuring resources and funding are directed at agreed priorities. Given a clear mandate to identify solutions and reinforce the implementation of national action plans, national task forces will need to link directly

to legislative agendas and be able to influence budget priorities. This will require a nonpartisan process and the inclusion of relevant stakeholders on each task force, including senior representatives from appropriate government ministries, national regulators, government development banks and credit guarantee institutions, as well as key representatives of SME and business associations, banks and alternative finance providers. The composition of each task force will be critical to expedite required legislative changes, clarify funding priorities and drive public and private cooperation toward effective implementation.

Ireland's experience suggests that a coordinated effort at the national level can create a highly productive dialogue between the public and private sectors and link initiatives in a coherent program supported by focused funding. Interviews in Ireland showed that officials had a deep understanding of the actions taken by the private sector, for example, the sector-lending policies implemented by an Irish bank. Similarly, business associations, private lenders and investors were fully aware of key public initiatives and actively engaged in redesigning schemes to make them more effective. While many interviewees were quick to point out areas for further improvement, the Irish effort looks to have achieved a great deal of success in creating a shared agenda and responsibility for action between the public and private sectors. 

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