FINANCE FOR GROWTH

REPORT OF THE
HIGH LEVEL EXPERT GROUP
ON SME AND INFRASTRUCTURE FINANCING

Foreword

During the recent turbulent crisis years, the supply of bank funding to European economies has been very significantly curtailed exposing gaps in the way Europe finances economic activity. These issues have limited and even threatened to prevent Europe's ability to generate economic growth to leave behind the current difficulties and to reduce the unacceptably high levels of unemployment which prevail in most EU Member States.

The European Commission's Green Paper on the long-term financing of the European economy, published on 25 March 2013, initiated a broad debate on how to foster the supply of long-term financing and improve and diversify the financial system for long-term investment in Europe. It provides a comprehensive framework to assess the obstacles hindering the financing of growth in the EU following the financial and sovereign debt crisis. The consultation which ended on 25 June 2013 will assist the European Commission in developing follow-up actions. The form and timing of this follow-up is yet to be determined, but could include: new or adapted regulation, stronger promotion of best practices, and specific follow-up with individual Member States in the context of the European semester.

To complement the work on the Green Paper, the informal ECOFIN Council on 12 April invited the Economic and Financial Committee (EFC) to consider setting up a High Level Expert Group (HLEG), benefitting from specialised market expertise, to further the analysis of the issues raised. The HLEG was set up in May 2013 with a mandate to make recommendations on increasing access to capital markets for SME and long term infrastructure financing in Europe. This group comprised 15 experts from as many different institutions. There was a broad and healthy spread of backgrounds and opinions represented and these were drawn upon to understand the issues at hand. However, in a small number of cases the views of Members on specific recommendations diverged and consequently the organisations represented by a minority of Members may not support these few recommendations.

The completion of this final report under the co-chairmanship of the undersigned fulfils the mandate given by the EFC. The report has benefited from the contribution of all the members of the Group, who have always been generous with their ideas and feedback, and as a result have ensured the relevance and the quality of this report: Stefan Adamec, Arnaud Caudoux, Lukasz Dziekonski, Carlos Guille, Cecile Houlot, Patrick Kanters, Spencer Lake, Fernando Navarrete, Diego Rodriguez Palenzuela, Charles Roxburgh, Markus Schaber, Fabrice Susini, Alessandro Tappi, Jörg Zeuner, Deborah Zurkow. In addition, a secretariat drawn from the European Commission and the Department of Finance, Ireland (David Byrne, Frank Kohlenberger, Almoro Rubin de Cervin, Robert Specterman Hubert Strauss, Damian Thomas and Dominik Zunt) have been instrumental in the drawing up of the report and the filtering and consolidation of the many contributions.

Alberto Giovannini *John Moran*

11 December 2013

Executive Summary

What is……

…the state of pan-European capital markets financing in Europe currently? Perhaps the answer is there is none!

Europe has been overly reliant on a bank financing model for its economy.

The best one can say is non-bank financing exists in some of the core EU Member States but even there not at the level of other developed economies.

With the advent of the banking crisis and the regulatory reactions to this, bank funding has become fragmented or threatened to dry up completely. Levels which were never entirely robust have seen dramatic withdrawals:

- for example spreads for SME lending between German rates and those in Portugal and Greece have increased by circa 300 basis points since 2008 and are yet to reverse
- In the most recent ECB SAFE survey on financing for SMEs, access to finance remains the second largest concern of SMEs across Europe but with a wide divergence in the level of concern between Member States
- project finance volumes in the EU27 took a disproportionately large drop of over 40% from 2008 to 2009, recovered somewhat in 2010 and 2011 before dropping by further 40% in 2012 to reach their lowest level since 2004

This is of major concern! A considerable brake to economic recovery needs to be released.

What might be……

Imagine a world in which;

- banking union provides fairly priced bank funding in a genuine single EU market,
- investors see transparency and have access to data on a consistent basis about upcoming infrastructure projects and about the performance of SMEs and the various SME classes,
- the business environment is conducive to growth and enterprise financing,
- savers, pension funds and institutional investors have alternative and direct links to provide funding for SMEs or infrastructure projects saving scarce public monies,
- banks can originate loans with their customers and access funding cheaply to do this through use of securitisations or capital markets,
- European SMEs do not need to sell out their companies or go to other jurisdictions like the US to access growth capital or offer shares to the public and
- the growth potential of Europe is not constrained by lack of funding.

How to get there

In the report which follows, the HLEG identifies key steps which if followed might lead to this world. Given the current point in the political calendar large EU level legislative change cannot be part of the short term plan. The HLEG has therefore especially focused on steps which national governments and other agencies might take in the short term. The HLEG considers all recommendations as necessary in helping improving financing for SMEs and infrastructure projects. However, the degree of effectiveness of a specific recommendation will depend on the specific circumstance prevailing in a Member State and will likely differ across Member States. Therefore Member States can view this as a checklist of sorts in the model of the World Bank's doing business reports.

In a break from tradition, we will not summarise those steps in this Executive Summary. We hope that people will find the time to read the entire report. However, for those who cannot we have included short summaries throughout the document and structurally highlighted and grouped the recommendations.

For each recommendation, the HLEG indicates the entity or entities to which it is addressed. It will be apparent, from the content of the recommendations and the entities to which they are addressed, that the HLEG does not advocate a reform effort that requires complex (and difficult to manage) coordination among governments and the private sector, or with specific sequencing. Indeed, the majority of the reforms that are advocated have been designed so that they can be undertaken by Member States' governments on their own initiatives. The HLEG considered this important given the seriousness of the funding crisis against the backdrop of the political calendar in Europe in 2014. In some cases it will be evident that the role of the European Commission is essential, either as a coordinating actor or in the production of rules that need to be uniform across the union.

RECOMMENDATIONS TABLES
RECOMMENDATIONS[1] RELATING TO CHAPTERS:

3. CROSS-CUTTING FRAMEWORK CONDITIONS FOR LONG-TERM AND SME FINANCING

3.1 The Financial Environment, Banking Union and the Business Environment

3.1.2 Business Environment

Short Term Recommendation – CCS1 (Members States)
Finance does not flow in markets where the business environment is sub-standard: Member States to set up regulatory reform committees, coordinating all relevant agencies and authorities, to evaluate their own business environment against best practice, and to coordinate the appropriate reform processes.

3.1.2 Bankruptcy and Enforcement Rules

Short-Term Recommendation – CCS2 (Members States)
Best practice to be identified in terms of bankruptcy regulation from a "finance for growth" perspective, focusing in particular on the following key areas;

- The transparency of the bankruptcy process;
- The tenor of the procedure, including its relative effectiveness and efficiency;
- The consistency of the bankruptcy process and its associated outcomes especially in relation to key elements such as the claw back period and ranking of claims; and
- The provision of out-of court settlement arrangements; early warning systems and fast-track court procedures.

Medium-Term Recommendation – CCM1 (Members States, European Commission)
Member States, working with the European Commission, to make available, on an annual basis, a due diligence review that will allow mapping of existing national bankruptcy regimes against best practice from a "finance for growth" perspective.

3.2 Transparency – Credit Ratings and Data Infrastructure

3.2.1 Credit Ratings & Sovereign Effects

Medium-Term Recommendation – CCM2 (Credit Rating Agencies)
Credit Rating Agencies to provide greater transparency on their methodology for rating a financing transaction (be it SME or infrastructure) in terms of explaining fully the rating result with and without the impact of the sovereign effect.

[1] For ease of reference and in order to avoid a subjective numbering or a completely simplistic sequential numbering of recommendations, each **recommendation includes a unique reference code**. The code for those recommendations which relate to Cross-cutting issues begin with the letters **CC**, SME related recommendation codes begins **SM** and Infrastructure codes begin **IN**. The third position in the codes represent whether the recommendation is either a recommendation that can be acted upon in the Short-Term, **S**, or in the Medium-Term, **M**. The final position in the coding simply represents a sequential unique identifier e.g. **1, 2 ….**

3.3 Addressing Fragmentation from the Supply Side

3.3.1 Pooled Investment Vehicles

Short-Term Recommendation – CCS3 (Members States, European Commission)
Member States to work with the European Commission to finalise the new investment fund framework "European Long Term Investment Fund" (ELTIF). The European Commission should take on board industry proposals to ensure that the ELTIF has the broadest possible acceptance among investors and intermediaries.

Medium-Term Recommendation – CCM3 (European Commission, Members States)
The European Commission to investigate how to facilitate the passporting of assets in a manner that would enable investment funds to acquire assets on cross-border basis including allowing them access to both the corporate and SME loan market. This will require the European Commission to work with Member States to ensure that national tax, regulatory and legislative rules do not act as barriers to investments by such vehicles.

Medium-Term Recommendation – CCM4 (Members States)
National and regional development banks to collaborate more actively with the European Commission/EIB and with each other.

Medium-Term Recommendation – CCM5 (Members States)
Governments of Member States that have national development banks to allow these institutions to operate on a cross-border basis. Cross-border operations may require changes to the statutes in some cases.

Medium-Term Recommendation – CCM6 (Members States)
Governments of Member States that have national development banks to proactively encourage cooperation between these institutions.

4. SME

4.3 Data Infrastructure

4.3.1 Direct Lending in the Local Markets

Short-Term Recommendation – SMS1 (European Commission, Members States)
A study be initiated immediately by the European Commission and/or interested Members States to assess how a privately run database might be implemented to collect both SME credit risk performance on a portfolio basis, as well as credit performance of individual SMEs on an anonymised basis. This should investigate overlaps with existing European Commission work on pan European availability of business register information. The study might also investigate the feasibility of allowing companies to self-elect to have their information made available with their consent on a named basis to identified third parties.

Medium-Term Recommendation – SMM1 (Private Sector, European Commission)
Implementation of a fully robust easily accessible SME credit risk database permitting greater pan European analysis of the SME sector to be promulgated on a portfolio basis to complement the surveys in recommendations SMS2 below.

Medium-Term Recommendation – SMM2 (Private Sector, European Commission)
Build on the European Commission's work on business registers by creating a voluntary unified corporate SME information portal. If feasible, the database should be developed to deliver a single portal fully integrated with the European Commission's work on business registers, the database outlined in SMM1 and voluntary information submitted by individual SMEs.

Medium-Term Recommendation – SMM3 (European Commission)
Consider the conditions under which the Legal Entity Identifier, sponsored by the Financial Stability Board, could be used for the unique identification of SMEs, whichever their size, with a view to setting the fees low enough especially for very small ones.

4.3.2 Indirect Lending through Securitisation (see more fully Section 4.6 below):

Short-Term Recommendation – SMS2 (National Central Banks, European Central Bank)
Develop and improve statistical surveys to better capture the SME finance markets in Europe. These should be commenced immediately by National Central Banks (NCBs) lacking such information for their own countries, perhaps responding to common sets of criteria promulgated by the ECB.

Medium-Term Recommendation – SMM4 (Eurostat)
To ensure maximum utility and pan European comparison, the organisation of SME finance surveys and the dissemination of information over the medium term will be turned over to a pan-European institution such as Eurostat in cooperation with the European System of Central Banks (in order to avoid duplication of tasks and the overburdening of SMEs) and with the help of national statistical institutions and national or European associations relevant for the SME finance markets.

4.4 Credit Ratings and Credit Scoring of SMEs

Medium-Term Recommendation – SMM5 (Member States)
Member States where the national central banks are not already doing so are encouraged to assess the feasibility and business case for developing an internal credit assessment system for SMEs for their own jurisdiction. As a pre-requisite for the development of a credit assessment system, Member States should consider the establishment of a national credit register if it does not already exist.

Medium-Term Recommendation – SMM6 (European Commission, ECB)
The European Commission in cooperation with the ECB and national central banks to consider whether and how SME credit scores computed by national central banks or other authorities could be made widely available.

4.5 Start-Up, Venture Capital and Private Equity

Medium-Term Recommendation – SMM7 (European Investment Fund)
The EIF to further strengthen its strategy to support the development of more robust Venture Capital funding structures based on public sector cornerstone investment and leveraging private sector funding.

Medium-Term Recommendation – SMM8 (European Investment Fund)
The EIF to continue and further strengthen its investments in funds directed towards young technology companies and to further its attempts to incentivise additional investor classes (like Business Angels and Corporates) to invest in this segment.

4.6 Securitisation – Supporting Bank Funding

4.6.2 Best Industry Practice

Short-term Recommendation – SMS3 (European Commission, Member States)
National and European policy makers to issue clear supporting statements about the important role securitisation has to play in financing the European economy's growth.

Short-term Recommendation – SMS4 (National Financial Regulators)
Regulators are invited to monitor labelling initiatives established by the financial industry to increase transparency and standardisation in order to determine whether the labelled deals are proven superior to non-labelled ones (e.g. in terms of market liquidity, performance metrics) with a view to supporting the use of such labels.

Short-term Recommendation – SMS5 (National Financial Regulators, European Commission)
Regulators are invited to consider how best to identify high-quality, simple and transparent securitisations and how this could subsequently be reflected in regulatory treatment.

4.6.3.3 The EU-EIB SME Financing Initiative

Short-Term Recommendation – SMS6 (European Commission, Member States)
The High Level Expert Group endorses initiatives like the EU-EIB SME Financing initiative but is of the view that the harnessing of the full potential of this measure requires a clear political commitment not just for pursuing a guarantee option but also those which encourage securitisations.

Medium-Term Recommendation – SMM9 (Member States)
Member States should consider the appropriateness of establishing/supporting a AAA guarantee scheme for securitisation in their market aimed at the ramp-up phase of a SME loan portfolios, thus encouraging development of securitisation for SME loans and reducing fragmentation within the EU.

Medium-Term Recommendation – SMM10 (Member States)
Member States should consider the appropriateness of establishing a AAA guarantee of securitisation securities or loans in their market that is aimed at SME loan portfolios that are affected by economic stress in their main market thus reducing fragmentation within the EU.

4.7 Covered Bonds

Medium-Term Recommendation – SMM11 (European Commission, Members States, Central Banks)
The European Commission, Member States and Central Banks review the existing regulatory framework to ensure that it is supportive of SME loans forming part of the collateral for covered bonds.

4.8 Private Placements

Short-Term Recommendation – SMS7 (Members States)
Drawing on successful bespoke private placement markets, e.g. the German Schuldscheindarlehen market, Members States in the EU to take action to establish a national private placement regime in order to further develop direct funding sources for SMEs paying particular attention to the items discussed above.

Medium-Term Recommendation – SMM12 (European Commission, Members States, National Regulators)
The European Commission working with Members States to undertake joint initiatives to standardise documentation and regulatory and accounting treatment across all EU countries and establish best practice for other areas like taxation and data availability.

4.9 Funds of Loans

Medium-Term Recommendation – SMM13 (European Commission)
The European Commission introduce a single market "passport" of EU loan funds to enable such vehicles to acquire assets and advance credit on a cross border basis and not just be able to use (as is currently the case) their passport to generate investment into the fund on the liability side of the fund's balance sheet.

4.10 Public Equity Markets

Short-Term Recommendation – SMS8 (Members States)
Member States review the experience of other countries to benchmark best practice in addressing the specific needs of mid-sized SMEs and mid-caps when accessing equity capital markets. Member States should then take action to import applicable best practices.

Short-Term Recommendation – SMS10 (Members States)
Member States investigate (and report on) as a matter of urgency what is required in their market to (re)build an ecosystem comprised of dedicated analysts, brokers, market makers, ratings etc., that can both advise and support issuers and investors, and foster the liquidity of equity growth markets. This will aid in the development of small and mid-cap financing through equity growth markets and will also support the private placement mechanism which relies on the same ecosystem.

Medium-Term Recommendation – SMM14 (National Stock Exchanges)
National Exchanges explore ways to provide dual listings with other EU exchanges with a view to approximating a European platform for stocks.

Medium-Term Recommendation – SMM15 (National Stock Exchanges, Members States)
In seeking to build an ecosystem around SME markets, Member States consider the development of sector specific markets which should not necessarily be limited by geography. This could lead to pan European SME markets in certain sectors.

4.11 Mini-Bonds

Medium-Term Recommendation – SMM16 (Members States)
To address the specific needs of mid-sized SMEs and smaller mid-caps to have access to debt capital markets Member States to review the experience of other countries for example Germany and Italy in order to benchmark best practice. In the long-term coordinate national markets with a view to create a European platform for mini-bonds. To address the needs of smaller SME the HLEG encourages the development of mutual issuance platforms that would allow sufficient aggregation for mini bond issuance.

4.12 Other Financing Sources

Short-Term Recommendation – SMS11 (Members States and National Central Banks)
Member States and National Central Banks support peer-to-peer financing and crowd-funding to the greatest extent possible.

5. INFRASTRUCTURE

5.2 Facilitating access to Information on Infrastructure Projects

Short-Term Recommendation – INS1 (Members States, European Commission)
Member States to collate information on State backed infrastructure projects for the previous 10-15 years and publicise this in a Data Warehouse. A list of the minimum data requirements should be agreed across the EU without delay but Member States can record further details.

Medium-Term Recommendation – INM1 (Members States, European Commission)
The European Commission to work with Member States to establish a pan-European Infrastructure Data Warehouse whose functions would include tracking a pre-set list of covenant performance, collating available information from various EU debt providers and defining the criteria for assessing risk.

5.3 Transaction Pipeline Information

Short-Term Recommendation – INS2 (EPEC)
EPEC or a similar appropriate body develop and manage a pan-European real-time database of infrastructure projects in planning and procurement phases.

Short-Term Recommendation – INS3 (Members States, Industry Associations)
Organise an annual forum where governments and institutional investors can engage in a dialogue and find solutions for the long-term financing of infrastructure projects. The first of these should take place in Q1-2014 at the latest.

5.4 Developing a strong PPP market across Europe

Short-Term Recommendation – INS4 (Members States, European Commission)
Member States develop and communicate national investment plans, with a minimum three year time horizon. The European Commission will aggregate individual national investment plans on the basis of agreed sectoral categorisations.

Medium Term Recommendation – INM2 (Members States, European Commission)
The European Commission are well placed to play a lead role in aggregating and publicising individual national infrastructure investment plans. The European Commission should work with Member States on this.

Medium-Term Recommendation – INM3 (Members States)
Governments ensure that the national regulatory environment provides for a stabilisation of tariffs over the life of long-term projects as this reduces investor uncertainty and facilitate long-term investment.

5.5 Adjust Public Procurement Procedures to Attract More Investors

Short-Term Recommendation – INS5 (Member States)
Procuring authorities make greater use of "value for money" analysis when evaluating infrastructure projects delivery method and propose changes to national procurement legislation to disseminate the practice. Continued sharing of best practices via centres of excellence such as EPEC should be leveraged to strengthen skills with the procuring authorities.

Medium-Term Recommendation – INM4 (Member States, Procuring Authorities)
Procuring authorities to limit delays for finalizing planning and permitting post financial close. Procurement policy should also reflect the increasing presence of non-bank solutions in their approach to funding requirements.

Short-Term Recommendation – INS6 (EIB)
The EIB to work with public and private sector representatives to create a "standard set of documents" which will then be used as the basis for tendering projects at all levels. The aim is to achieve a more standardised approach to PPPs across the EU and thereby encourage and facilitate greater interest in the market from investors.

5.6 Channelling Pools of Capital into EU Infrastructure Projects

Medium-Term Recommendation – INM5 (Members States)
Members States working with the appropriate EU level institutions to establish a pan-European institutional vehicle that would provide a European Infrastructure Guarantee Facility for non-investment grade countries or those with no history of PPP. This institution could be funded by a combination of the public sector; EU institutions and private sector investment. This vehicle should have the capability to provide a controlling creditor role and would focus on supporting markets where institutional appetite is more limited or virtually inexistent.

Medium-Term Recommendation – INM6 (Members States)
Member States to consider developing customized pooling vehicles to stimulate capital market financing of smaller infrastructure projects. The UK aggregator funding model offers some recent experience to draw on.

5.7 Strengthen Multilateral Banks Involvement Where Needed

Medium-Term Recommendation – INM7 (EIB)
The EU-EIB Project Bond Mechanism should be extended to other infrastructure sectors reflecting the broader expertise of the EIB.

Table of Contents

1. Introduction

This section sets out the HLEG position with respect to three key dimensions that are considered to be of particular relevance for access to financing for SMEs and infrastructure projects. These are long-term vs. short-term financing, bank vs. non-bank financing as well as the role financial regulation plays in affecting the market for funds in the SME and infrastructure sectors.

Building on the interim report presented by the HLEG to the EFC on 30 August 2013, this report addresses the problems of SME and infrastructure financing.

Many have written very well about the nature of these problems. As a result, this report instead concentrates on presenting a set of recommendations or suggested initiatives, some of which are addressed to policymakers and others to the private sector. The recommendations themselves are, where appropriate, organised in terms of action that could be pursued in either the short term, i.e., for immediate implementation, in the group's assessment – or in the medium term, i.e., requiring more structured and therefore lengthier reform processes.

This report, among many other thoughts, considers some major improvements in the financial infrastructure that could help address the problem of credit assessment as it relates to SMEs, as well as innovations in the management of public infrastructure pipelines that facilitate the process of long-term capital allocation by the private sector.

The task of the HLEG was complicated by the reality that SMEs and infrastructure represent two very different sectors in the economy, with SMEs being a very heterogeneous set of businesses, ranging from distribution to industrial production, services and agriculture. However, both have an important feature in common: they are very good thermometers of the health of the economy and the level of economic activity.

SMEs represent, in all EU Member States, the largest section of the productive sector, uniformly above 50% of value added, and in many countries between 60 and 70%. Infrastructure is important because, when properly selected, it impacts positively the productive capacity of the economy and the construction of infrastructure has significant positive influence on aggregate demand and other sectors in the economy.

Both sectors were confronted with broadly similar experiences during the recent financial crisis, including in terms of access to finance. These experiences are summarized below.

Both our analysis and the recommendations that flow from it take into consideration the macro and micro issues impacting on the functioning of the European financial system and which can therefore affect the financing of both SMEs and infrastructures. Among the macro issues are the role and the likely evolution of the banking system; the impact of extraordinary measures of monetary policy; and the persistent fragmentation of the financial system induced by the sovereign crisis. Regarding the microeconomic issues, the HLEG considers differences in business conditions across Member States, for example, in the fields of taxation, bankruptcy and transparency of information, as well as rules constraining cross border investments in a variety of asset classes.

It is useful at the outset to clarify where the HLEG stands with respect to some key issues that are currently debated on the task of re-orienting Europe's financial system to economic growth:

1.1 Long-term vs. Short-term Financing

Long-term investments tend to be the most productive in the economy; hence it is necessary that they have appropriate access to funds. One of the most dramatic phenomena triggered by the financial crisis has been the collapse of liquidity, reflecting the unwillingness of market participants to commit for the long term – a market failure and fragmentation of the conditions available across different EU Member States. Much of the post-crisis debate has therefore been on the ways to revive channelling of funds to long-term investments.

In several of its recommendations, this report will address the issue of long-term financing, but not exclusively. In the case of SMEs, much of the perceived unfulfilled demand for financing covers short-term needs, including working capital. The general aim of the report is to find ways to unlock financing for SMEs and equity and debt finance for infrastructure, taking into account the special features of long-term finance when necessary.

1.2 Bank vs. non-Bank Financing

It is well known that in Europe financial intermediation is largely bank-based. Around 80% of debt financing to the economy is provided by banks, in contrast to the US where bank-financing is as low as 20%. As a result, the aggregate balance sheet of European banks is about four times European GDP, whereas the corresponding number in the US is 0.8 times. The financial crisis and the subsequent European sovereign crisis have highlighted the vulnerability of the European banking sector and triggered a series of reforms, many of which have yet to be completed or fully implemented. These reforms are aimed at making banks stronger, in part by hindering their ability to take on risk. Such reforms, for example those around higher capital requirements for supporting long term bank lending will inevitably also impact on the volume of financing available to SMEs and infrastructures, to the extent that they rely on bank funding.

These developments have prompted calls to stimulate the role of capital markets in Europe. By complementing and substituting bank intermediation, capital market financing can provide for a more diversified source of funds and more diversified set of financial actors, potentially leading to a more robust financial system. This report supports this view and, in particular, the need to build robust European securitisation platforms, including platforms for SME Collateralised Loan Obligations ("SME CLOs").

However, the solution and its analysis cannot exclusively be about non-bank financing. The HLEG recognises that banks have important functions to perform, both in the financing of SMEs (where they are typically collectors of valuable information relevant for credit evaluation) and in the financing of infrastructure. It is important to recognise that full implementation of Banking Union is a key and critical foundation on which the report's recommendations are built. Many of the recommendations in this report are therefore inspired by the aim to find the proper balance of roles between bank and non-bank financing to these two sectors.

1.3 Financial Regulation

Addressing the potential effects of financial regulations on the financing of SMEs and infrastructure projects is outside the mandate of the HLEG, and therefore outside the scope of this report. While the HLEG refrains from issuing recommendations on changing specific financial regulations, at various points the HLEG notes, and sometimes highlights, the fact that current regulations are significant factors affecting the markets for funds in both sectors. In this context, the aforementioned interim report already set out the main views of its members on selected regulatory issues, including the Solvency II and IORP Directives.

2. SMEs AND INFRASTRUCTURE – CURRENT CONDITIONS

This section describes the specific conditions existing currently in the SME and infrastructure sectors. For the SME sector it differentiates between the specific problems at the level of SMEs and at the level of financial institutions. It also provides an overview of the prevailing financing conditions in the infrastructure sector.

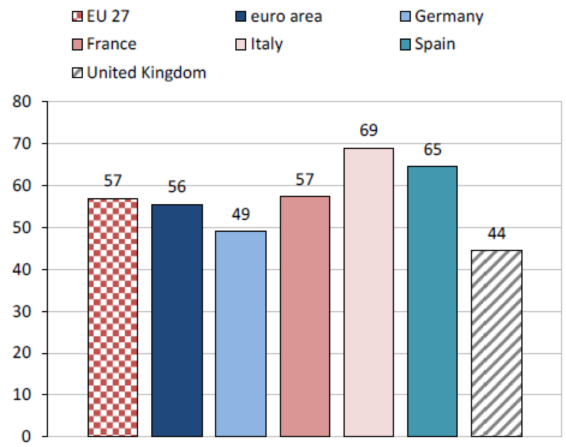
2.1 SMEs

2.1.1 The Sector

SMEs[2] are often referred to as the cornerstone of the European economy (see Chart 1), contributing significantly to GDP growth through their overall importance and their ability to innovate and grow. SMEs represent over 99% of companies across the EU27[3], with only marginal country to country differences. A large proportion of them are micro firms (i.e. firms up to 9 employees).[4] SMEs also account for a large share of employment and value added, representing around two thirds of the European workforce and nearly 60% of value in the EU27 economy; these figures are often higher still in certain euro area Member States. Among SMEs, micro firms make the largest contribution to EU27 employment, whereas for value added micro, small and medium-sized firms each contribute about one-fifth of the total value added of the business economy. However, labour productivity, measured as valued added in nominal terms per employee, is higher – in the euro area – for larger SMEs and large firms. These apparent productivity divergences may reflect differences in labour skills, as well as in capital intensity, as well as effects not related to both inputs, such as technological dynamism. SMEs also play a less dominant role compared to large firms in terms of investment flows per person employed, which are around one-third lower in SMEs than in large firms. SMEs nevertheless make up around 50% of total business investment in the euro area.

Chart 1: Importance of SMEs for the economy

(turnover of SMEs in percentage of the turnover of all non-financial firms)



Source: Eurostat. - Note: Euro area excluding GR, IE, MT and NL due to data unavailability.

[2] SMEs are often simply defined as companies with fewer than 250 employees.

[3] Due to data, this section refers to EU27 rather than EU28.

[4] Where possible the HLEG refers to EU-wide statistics, but note that more granular data relating to the financing of SMEs is only readily available on a harmonised basis at euro area level.

Table 1: Importance of SMEs in the EU27 (as a percentage of total business economy)

Category	*Employees*	*Percentage of firms*	*Employment*	*Value added*	*Productivity*
Large	≥ 250	0.2	32.6	41.9	131
SME	< 250	**99.8**	**67.4**	**58.1**	87
- Medium	50 - 249	1.1	17.2	18.4	110
- Small	10 - 49	6.5	20.6	18.5	91
- Micro	0 - 9	92.2	29.6	21.2	71

Source: European Commission. Note: Figures for 20121-2013 are estimates. Productivity figures refer to the euro area only and are measured as value added in nominal terms per employee and 100% is equal to the total productivity of the business economy

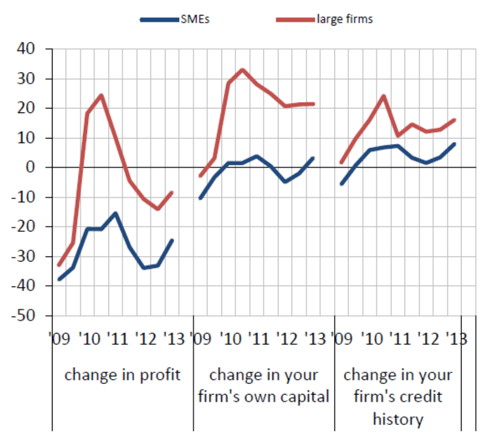
2.1.2 Issues for SME Financing

2.1.2.1 Problems at the Levels of the SMEs

Despite their economic importance in Europe, problems in relation to SMEs' access to finance are frequently highlighted. SMEs, in particular in crisis periods, are prone to experiencing greater difficulties in obtaining funding compared to large firms. This reflects the typically greater opaqueness of their balance sheets and lower visibility of corporate capabilities, which in turn result from less informative financial statements and shorter operating track records, leading to greater asymmetric information problems and transaction costs for SMEs.

In general, young and small companies face larger obstacles to accessing finance and, once they do, they rely heavily on bank debt and pay higher financing costs. Structurally, SMEs also tend to be less profitable than large firms (see Chart 2) and have considerably higher cash holdings, suggesting that they need to build up liquidity buffers more than large firms.

Chart 2: Financial health of euro area SMEs versus large firms
(over the past six months, net percentages of respondents)



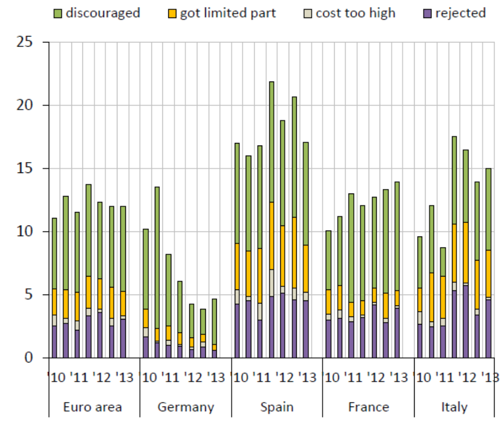
Source: ECB (SAFE).

These factors explain why credit sources tend to dry up more rapidly for small than for large companies during economic downturns, thereby disrupting the business and investment activities as well as the demand for labour of these firms to a greater extent. At the same time, it is difficult to disentangle whether the increase is due to banks' excessive risk aversion, or whether it represents the more traditional pricing of cyclical credit risk, the divergence in firm-specific outlook and default probability.

2.1.2.2 Problems at the Level of the Banks

Given the deterioration in SMEs' financial situation in an environment of weak economic activity, divergent bank funding conditions and banks' adjustments of their balance sheets, banks have generally been taking a more selective approach to supplying loans in order to preserve the quality of the assets side of their own balance sheets. Nearly one-quarter of euro area SMEs that applied for a bank loan during the period from 2009 to March 2013 faced some sort of financing obstacles, mostly through the rejection of a loan application, followed by receipt of a limited portion of the funds requested, whereas only a limited number of SMEs turned down a loan owing to high borrowing costs (see Chart 3).

Chart 3: Financing obstacles of SMEs for receiving a bank loan across euro area countries
(percentages)



Source: ECB (SAFE).
Base: All SMEs

The problems are not restricted to the euro area. For example in the UK, overdraft rejection rates rose from 8 per cent in 2005-07 to 19 per cent in 2012; rejection rates for term loans rose from 6 per cent to 23 per cent over the same period. Although recent Bank of England data show lending volumes were positive in March and June 2013 for the first time in several years, overall lending to SMEs since Q1 and Q2 2013 has dropped and bank lending has been declining continuously from 2010 to date at an average rate of approximately 4 per cent per year.[5]

Within the Euro Area, the level and pattern of financing obstacles have not been homogeneous.[6] SMEs in some countries are also encountering difficulties in accessing finance due to the fragmentation of financial and banking markets. SMEs' businesses in southern European countries are impacted by both the credit crunch of the sectors they belong to and the sovereign crisis. Moreover, in struggling sovereigns, they have also had to bear the higher interest rate spreads reflecting perceived sovereign risks. Thus they are disadvantaged in relation to their peers in the rest of the EU (see Charts 4A and 4B).

Chart 4A: Interest rates for loans up to and including EUR 0.25 million and over EUR 0.25 million and up to EUR 1 million; *with collateral* and/or guarantees; per country in euro area; average in 2013 (Jan-Jul)

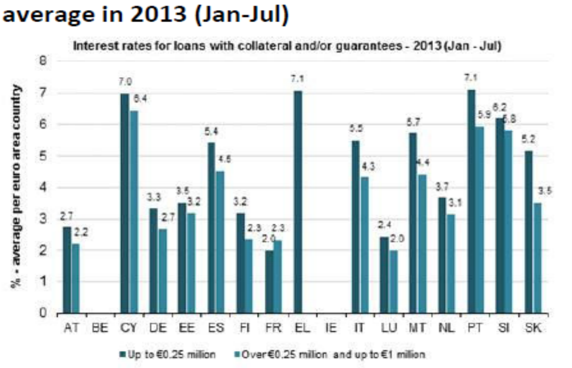
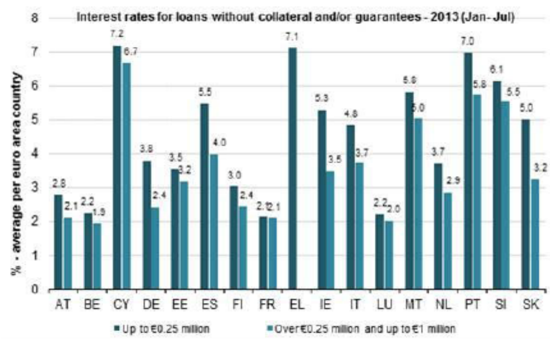


Chart 4B: Interest rates for loans up to and including EUR 0.25 million and over EUR 0.25 million and up to EUR 1 million; *without collateral* and/or guarantees; per country in euro area; average in 2013 (Jan-Jul)



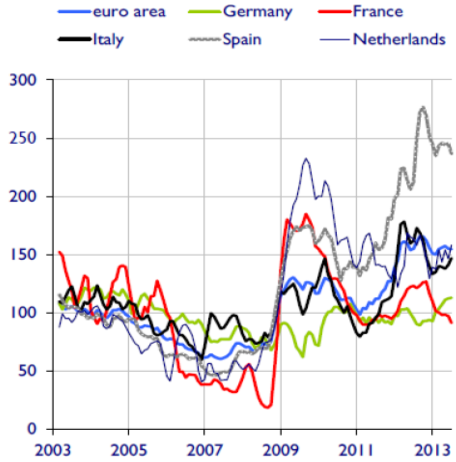
Source: European Commission; MFI Interest Rate Statistics

[5] Source: "Alternative Finance For SMES and Mid-Market Companies", TheCityUK and Ares & Co, October 2013.

[6] For example, in the last ECB survey wave (referring to the period from April 2013 to September 2013) financing obstacles were reported by SMEs to be very high in Greece, Ireland, Spain and the Netherlands (around 20% of participating firms encountering obstacles), more moderate in Belgium and Portugal (around 10%) and lowest in Germany, Finland and Austria (around 4%), reflecting the considerable heterogeneity in borrowing conditions.

This fragmentation can also be evidenced by the positive spread between the cost of bank lending for small-sized loans and large loans (assuming that SMEs are more likely to take up small loans compared with large firms), which increased substantially in Spain and Italy between early-2011 and mid-2012, albeit moderating somewhat since then (see Chart 5). This is not all just about the quality of the sovereign or local bank funding rate. It also reflects the more marked deterioration of SMEs' creditworthiness and firm-specific outlook compared with large euro area firms in less difficult macroeconomic environments.

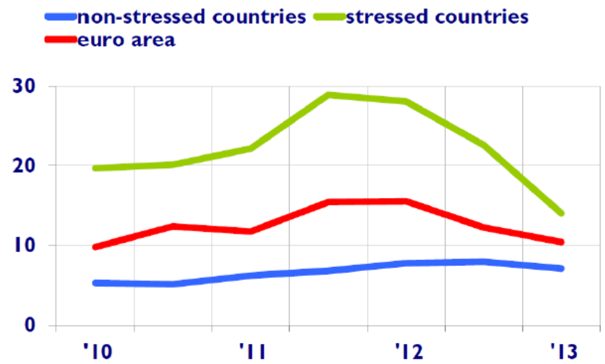
Chart 5: Spread between lending rates on small and large loans (basis points; three month moving averages)



Source ECB (MIR statistics).
Notes: small loans are loans up to €1mn, while large loans are those above €1mn.

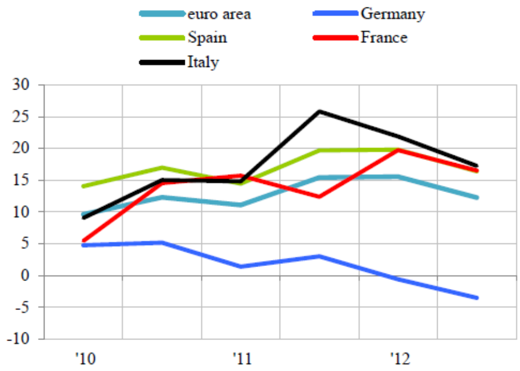
Survey-based evidence confirms a stronger perceived external financing gap of SMEs (i.e. the gap between financing needs and the availability of bank loans, overdrafts, trade credit, debt securities and equity at the firm level, as reported by SMEs) in stressed countries vis-à-vis non-stressed countries and the euro area as a whole, although this has been declining since the second half of 2012 (see Chart 6). The higher increase in the perceived external financing gap for Italian and Spanish SMEs reflects the stronger decline in SMEs' creditworthiness in these countries compared with SMEs in France or Germany (See Chart 7), but also more severe strains in the banking system. In the most recent period, the gap did not grow so much, reflecting some receding financing tensions despite a continued challenging financing situation for SMEs. In addition, the perceived external financing gap is generally higher for SMEs than for large firms (see Chart 8).

Chart 6: Change in the composite financing gap indicator of SMEs across euro area countries
(averages of country results; net percentages of respondents)



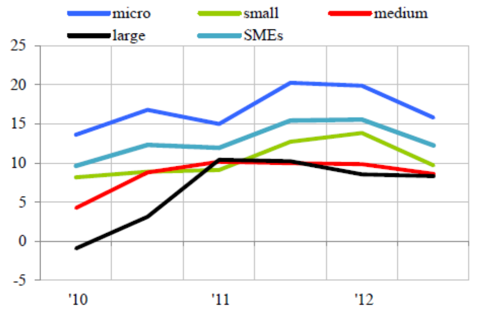
Source: ECB (SAFE).
Note: stressed countries: GR, PT, IE, ES , PT and IT and non-stressed countries: BE, DE, FR, NL, AT, FI.

Chart 7: Perceived change in the external financing gap of SMEs across large euro area countries (over the past six months, net percentages of respondents)



Sources: ECB (SAFE), ECB computations. Indicator from Ferrando, Griesshaber, Köhler-Ulbrich, Perez-Duarte, Schmitt, 2013.
Notes: The perceived financing gap indicator combines financing needs and availability of bank loans, bank overdrafts, trade credit, debt securities and equity at the firm level. A positive value of the indicator suggests an increasing financing gap. - The chart covers the survey period from 2010 Q1 to 2013Q1 (which corresponds to the end of the latest survey period).

Chart 8: Perceived change in the external financing gap of euro area firms across firm size
(over the past six months, net percentages of respondents)



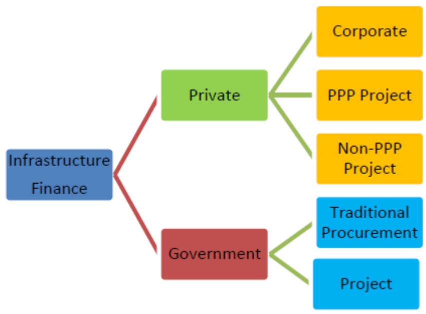
Sources: ECB (SAFE), ECB computations. Indicator from Ferrando, Griesshaber, Köhler-Ulbrich, Perez-Duarte, Schmitt, 2013.
Notes: See Notes for Chart 7.

2.2 Infrastructure

Global infrastructure investment over the next five years is estimated to be some USD 7.5 trn. Climate change, demographics, urbanisation, technology, economic interconnectedness and global shifts in economic trade are some of the key factors increasing the requirement for infrastructure investment. Whilst the majority of this investment is required in the emerging markets, Europe still requires a significant amount of new infrastructure investment in order to maintain its competitiveness, environmental sustainability, social cohesion and security.

Infrastructure investment in the EU is estimated at some EUR 450bn per year on average (3.6% of GDP). This includes investment both in economic infrastructure (transport, energy, telecom, water, sewage) as well as social infrastructure (health, social services, education). The provision of infrastructure finance involves both the public sector and the private sector (see Chart 9).

Chart 9: Composition of infrastructure finance



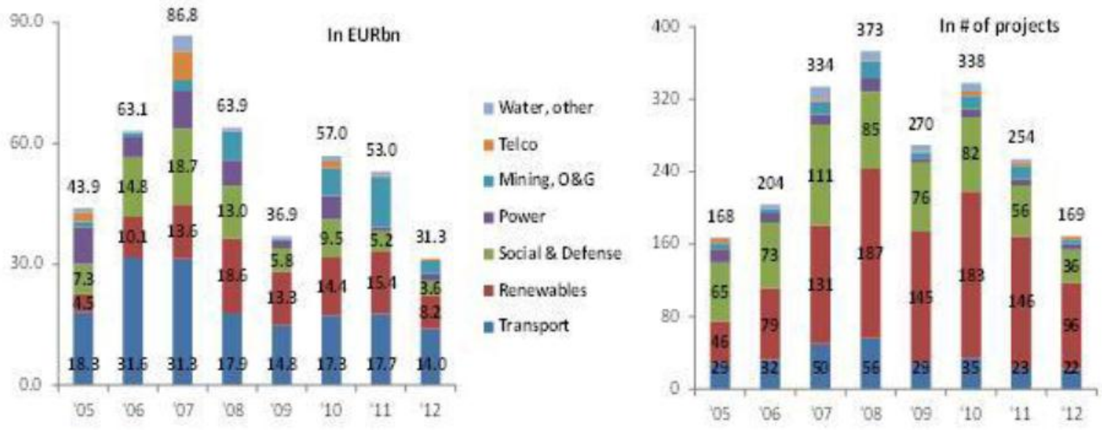
Source: Wagenvoort (2010): "Infrastructure finance in Europe: Composition, evolution and crisis impact"

The public sector provides roughly a third of the infrastructure investment in the EU with an annual volume of some EUR 160bn (1.3% of GDP). The private sector finances the remainder, i.e. some EUR 290bn per annum (2.3% of GDP).

Private sector investment in infrastructure comes mainly in two forms: via corporate finance (operating or service companies) or via project finance (using limited recourse financial structures). The corporate finance involvement in infrastructure is the largest one with circa EUR 250bn p.a. (2.0% of GDP) with only limited aggregate information available. The project finance market represents circa EUR 40bn of investment per annum and is itself divided in two halves: Public Private Partnerships (PPPs) of circa EUR 20bn per year on average (0.15% of GDP) and non-PPP project finance.

In Europe, project-financed infrastructure is funded on average 85% through debt and 15% through equity. Historically, the European project finance debt market has been dominated by banks which represented 90% of the debt funding, with only 10% coming from solutions such as project bonds. Against the back-drop of a sustained decline in bank lending since 2008, project finance volumes in the EU27 took a disproportionately large drop of over 40% from 2008 to 2009, recovered in 2010 and showed signs of stabilising in 2011 before dropping by another 40% in 2012 to reach their lowest level since 2004 (see Chart 10). A similar trend can be observed in the area of

Chart 10: EU 27 project finance volumes by sector, in EUR billion (debt + equity) & number of transactions



Note: scope includes all new transaction i.e. including asset acquisitions, privatisations and refinancing transactions.
Source: Infrastructure Journal database

PPP financing volumes, which are a subset of project finance volumes. This is primarily due to various balance sheet constraints spreading to multiple asset categories: i) the liquidity constraints – banks involved will need to raise long term funding, ii) uncertainties linked to regulatory treatment of the related exposures, iii) the management of the overall size of the balance sheet and iv) the reduction of overall risk exposure in particular in relation with the management of the sovereign risk (directly or indirectly). At the same time, banks are reluctant to divest large amounts of existing infrastructure loan assets in the secondary market at a significant discount to free up capacity for new lending.

Table 2: EU 27 Project Finance Lender League Tables, 2007 vs 2012

Mandated Lead Arranger League Table Evolution ('07 - '12)
EU 27, infrastructure Project Finance (In EURm)

2007 League Table

#	MLA	EURm
1	Royal Bank of Scotland	7,779 *
2	HSBC	5,429
3	Dexia Group	4,019
4	Bank of Scotland	3,915
5	BNP Paribas	3,814
6	Barclays	3,569
7	Crédit Agricole Group	3,311 *
8	Société Générale	3,040 *
9	Grupo Santander	2,310
10	Dresdner Kleinwort	2,137
	TOP 10 - 2007	**39,324**
	Full League Table - 2007	**69,876**

2012 League Table

#	MLA	EURm
1	Bank of Tokyo-Mitsubishi UFJ	1,381
2	SMBC	1,206
3	Lloyds Banking Group	982
4	Société Générale	969 *
5	KfW	951
6	UniCredit	917
7	BBVA	827 *
8	Royal Bank of Scotland	747 *
9	Crédit Agricole Group	731
10	NordLB	696
	TOP 10 - 2012	**9,406**
	Full League Table - 2012	**21,916**

Note: (*) bank included both in 2007 and 2012 Top 10 league tables
Source: Infrastructure Journal database, 12-04-2013

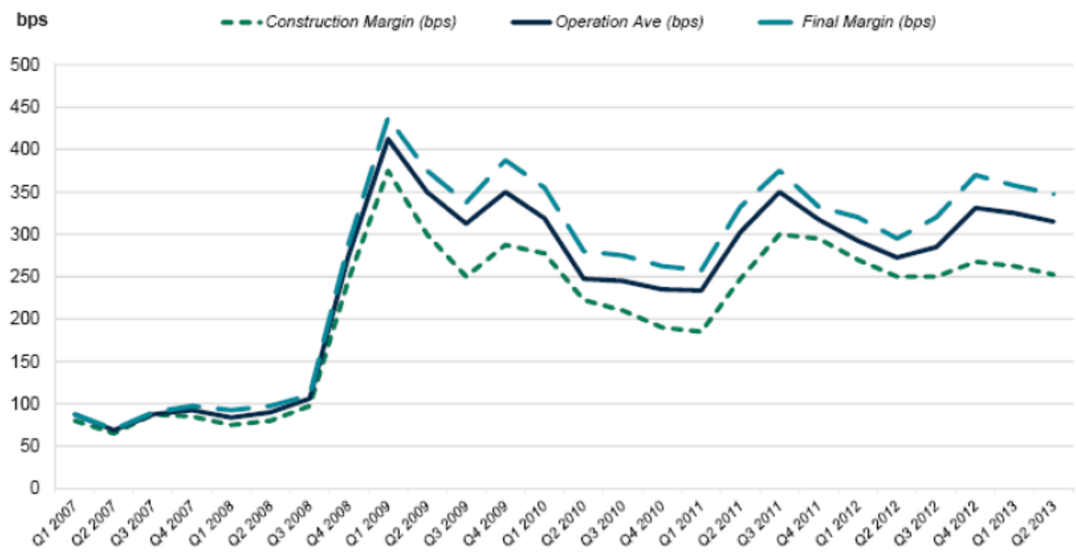
Note: scope includes asset acquisitions, privatisations and refinancing transactions),
Source: Infrastructure Journal database

On the lending side, certain banks exited the market entirely as can be seen from the very different composition of the league tables of lenders (see Table 2). The banking market has become polarised with many global banks now having limited appetite for maturities greater than 10 years. Infrastructure debt lending has become domestic or trade support focused. It is expected that the impact of Basel III will further heighten the instability of this market going forward and increase the importance of diversifying financing sources.

Bond financing, which had played a limited role globally practically vanished from the project finance market in 2008 and 2009. It recovered thereafter in North America and the Middle East but not in Europe where, prior to 2008, the market had been dominated by private sector monoline insurance providers which acted as expert service providers to investors and were able to provide ratings enhancement through a 100% guarantee of the debt of a project at a low cost due to their AAA-ratings.

Obtaining long-dated project finance debt for infrastructure projects has therefore become increasingly difficult since the beginning of the financial crisis. This is further compounded by the tripling of the average project finance loan margin from 2007 levels (see Chart 11); even though the historically low base rates keep the overall cost of interest stable.

Chart 11: European PPP Project Margin Evolution (6m moving average)



Source: DOD Analysis, CA-CIB

The situation can differ considerably depending on the sector or the geography. Sectors differ in the extent to which stable and sufficient revenue streams can be generated from operating the asset alone, and countries differ in their ability and political willingness to go down the PPP road for public infrastructure investment.

3. Cross-cutting framework conditions for long-term and SME financing

Many of the solutions to resolving the financing difficulties facing the very disparate sectors of SMEs and infrastructure are common. Before looking at issues specific to the two sectors, the HLEG analysed those issues which were common to both. In the view of the HLEG factors contributing to fragmentation are either related to the demand side or the supply side. On the demand side, the necessity of a banking union is identified as a key factor to reduce financial fragmentation. In addition we recognise the role of improvements and convergence in the pan EU business environment to minimise its impact on the cost of financing as well as the similar role of bankruptcy rules and their enforcement. In the second part, this section focuses on information asymmetries and how they could be reduced. The third part highlights factors that are related to the supply side, such as the potential role of pooled investment vehicles and of national promotional banks.

3.1 The Financial Environment, Banking Union and the Business Environment

A necessary, although not sufficient condition for ensuring that the financial system in Europe can facilitate the financing of SMEs and infrastructures is stability and confidence in financial institutions and markets; this necessity has been underlined in particular since the financial crisis. Without a safe and sound financial system, the savings of governments, corporates and households cannot be channelled efficiently or effectively to the right users and uses through open and competitive markets.

3.1.1 Banking Union and Fragmentation

In this context, a key priority for Europe is the establishment of a functioning banking union. The necessity of banking union was evident even prior to the financial crisis. Since the introduction of the Single Market and subsequently the euro, while there has been significant integration of financial markets across Europe, there has only been partial integration of regulation and supervision, and the harmful connections between sovereign debt markets and banks have become especially apparent. However, the scale and scope of the financial crisis, has reaffirmed the importance of securing banking union not just for the legacy issues of the deep-seated recession, but also to put in place the foundations for sustainable economic growth and recovery across the entire EU.

In a recent Bruegel paper, Sapir and Wolff[7] stipulate that the euro-area financial system is currently inadequate. The HLEG agrees with this analysis. Most financial intermediation is carried out by banks, and the national banking markets across the EU are largely insulated from each other. Banks are not lending to each other across borders without asking for a significant premium or even not at all. Data from the Bank of International Settlements also suggests continued "geographical segmentation" with cross-border lending declining between Q1 and Q4 2012. Furthermore in the larger euro-area countries, cross-border retail banking plays a negligible role and therefore cannot serve as a meaningful source of credit that could compensate for the dysfunctional interbank market.[8] A recurring theme of the HLEG's discussions was the extent to which the critical problems within the euro area financial system were leading to an increased fragmentation of the Single European Market with corporates in some countries at a competitive disadvantage merely due to their location. Consequently, investment remains constrained and growth sluggish.

The increased fragmentation of European financial markets since 2008 has generated, in particular, a significant problem for the financing of SMEs that is undermining attempts to stimulate economic recovery. The emergence of a considerable divergence in credit conditions for SMEs in different counties creates a strong competitive disadvantage for entrepreneurs and enterprises in the vulnerable countries of the Union – the very countries where Europe needs SMEs to grow and

[7] Andre Sapir and Guntram Wolff (2013) The neglected side of banking union: reshaping Europe's Financial System; note for the Informal ECOFIN 13/14 September 2013, Vilnius.

[8] Ibid.

provide employment. This fragmentation of lending conditions is not only a problem for the corporate in the affected countries, but for Europe as a whole and is therefore not sustainable.

Making progress in building the banking union in its different dimensions is essential to reverse the fragmentation of the Single Market that has occurred since 2008. Furthermore, the application of uniform standards of assessment by a single supervisor will help unlock banks' balance sheets, accelerating the disposal and/or de-risking of non-performing assets and, as a result, facilitating capital raising by banks. It should be kept in mind that the rules which will be enforced by the supervisor are of paramount importance. The result will be a boost in lending, including lending to SMEs and infrastructure projects.

The HLEG recognises that achieving more integrated, robust and deeper capital markets across Europe should be viewed as an integral part of the banking union project, as this would provide European non-financial corporates, including SMEs and Midcaps, with an alternative and/or complementary source of funding to traditional bank borrowing.[9] Achieving the goal of a more robust and stable banking system requires increased direct capital market financing and a greater involvement by institutional investors and alternative financial markets. The establishment of the banking union and the complementary development of more integrated, robust and deeper capital markets are important elements in the wider business environment in which SMEs and infrastructures operate.

3.1.2 Business Environment

SMEs and infrastructure providers are businesses. Their access to finance is determined by the perception that potential investors, the providers of financial resources, have on the riskiness of equity or credit investments in the specific business environments where they are located. Investors form their views on such risks based on objective characteristics of business practices and business rules in the different economies. Among these practices are the standards of accounting disclosure, practices of corporate governance, taxation regimes, legal certainty, rules regarding business resolution and the enforcement of credits, labour market institutions, and so on. Broadly speaking, these represent "transactions costs" which in some instances can become prohibitive, that is, annihilate the viability of a business. To the extent that they induce differentials in the perception of investment risk, significant differences among these business practices and business rules across European countries represent a powerful cause for fragmentation of financial flows and inhibiters against the growth of capital markets in countries within the Single Market.

The evaluation of business rules and practices on a comparative basis has been carried out by a number of entities, most notably the World Bank, with its "Doing Business" project. There are available rich databases of country characteristics, which analyse all costs of starting, running, and winding down a business in different countries, which make it easy to benchmark against best practices. In addition, a number of countries have undertaken reform efforts that actively use the Doing Business inputs.

Short Term Recommendation – CCS1 (Members States)
Finance does not flow in markets where the business environment is sub-standard: Member States to set up regulatory reform committees, coordinating all relevant agencies and authorities, to evaluate their own business environment against best practice, and to coordinate the appropriate reform processes.

3.1.3 Bankruptcy and Enforcement Rules

Ineffective regimes for business resolution and enforcement of credits can adversely impact the pricing or availability of funding.

[9] See also Sapir and Wolf (2013)

Corporate insolvency and bankruptcy legislation across Europe is based on different legal systems that are embedded in individual countries' legal history, culture and procedures. Consequently bankruptcy regimes within Europe are characterised by considerable diversity and complexity.

SME lending is considered to be particularly sensitive to the legal environment and associated bankruptcy regime due to the higher mortality ratio for SMEs; the intricate linkages between both personal and company guarantees and secured and unsecured borrowing; and, the lack of consistent and quality data to assess risk properly and reputational factors.

The World Bank's "Doing business" survey data suggests that insolvency frameworks in parts of Western and Northern Europe function quite well, as demonstrated by the short time span of the process, the low costs and high recovery rates. In contrast, in other countries within Europe the insolvency regimes are considered to be rather weak.

In the wake of the financial crisis which has left many enterprises with excessive legacy debt, many European Member States have been undertaking reforms of their corporate insolvency regimes, particularly focusing on better supporting the early rescue of viable firms and speeding up debt restructurings. At the same time there has also been, in certain jurisdictions, recognition of the need to streamline the liquidation procedure in order to hasten the exit of non-viable firms and thus maximise value for all the interested parties.

IMF research indicates[10] that as a result of the scale of the corporate debt problem since 2008, and the associated pressures on the formal judicial process, there has been an increased attention on the development of alternative non-court based restructuring tools given their potential to provide a speedier, more cost effective and market friendly alternative to formal court-based insolvency procedures. Several Member States have also introduced either fast-track court approval procedures or pre-packaged procedures that allow for expeditious court approval of pre-negotiated restructuring plans that bind minority creditors. Significantly as out of court restructuring takes place in the shadow of the formal insolvency regime, it is critical to have in place effective insolvency law which provides clear benchmarks to incentivise debtors and creditors to reach a restructuring agreement.

The IMF contends that two critical objectives of an effective corporate insolvency law are: firstly, to allocate risk among market participants in a predictable, equitable and transparent manner; and secondly, to maximise the benefit of all interested parties and the economy in general. To achieve these objectives they contend that an insolvency regime should include the following features, in line with international best practice (see Box 1).

[10] Liu and Rosenberg: Dealing with Private Debt Distress in the Wake of the European Financial Crisis: Review of the Economics and Legal Toolbox, IMF Working Paper (Feb. 2013).

Box 1: Corporate Insolvency Law – Key Features

- Clear filing criteria – The law must include clear thresholds such as a missed payment for creditors and debtors to file for insolvency. These thresholds should be designed in a manner that encourages debtors to take appropriate actions sufficiently early on in their financial difficulties, thereby increasing the chances of successful rehabilitation.
- Supporting rehabilitation of viable firms – The law should provide a mechanism that allows a restructuring agreement agreed between the debtor and the majority creditor to become binding on all creditors. At the same time the interest of dissenting creditors should be protected by ensuring they are treated in the same way as similarly situated creditors. Insolvency law should also enforce pre-packaged restructurings negotiated out of court.
- Speedy liquidation of non-viable firms – The law should facilitate the sale of a business as a going concern, afford flexibility in the liquidation process and incentivise speedy exit of non-viable firms so as to maximise value for all parties.
- Stay on enforcement on actions – This will provide breathing room for the parties to negotiate. This would be balanced by the need to adequately protect secured creditors' interests by preserving their rights to enforce against collateral.
- Priority status to fresh money – The insolvency law should accord legal priority (before payment of pre-existing debt) to new financing provided during the insolvency proceedings to ensure a successful restructuring
- Cross border insolvency – To mitigate delays associated with insolvency proceedings of enterprises with assets and liabilities in different countries and to facilitate the reorganisation of multinational entities the insolvency law should incorporate procedural rules on cross-border insolvency in line with the UNCITRAL Model Law on Cross Border Insolvency.

Source: Liu and Rosenberg: Dealing with Private Debt Distress in the Wake of the European Financial Crisis: Review of the Economics and Legal Toolbox, IMF Working Paper (Feb. 2013).

However, overall the comparative effectiveness of an insolvency law is dependent on an adequate institutional framework that implements the law in a transparent, predictable and consistent manner.

At the EU level there has also been a focus on reform of insolvency measures encouraging entrepreneurship and removing barriers to re-engaging in business. A final report from an Expert Group established by the European Commission's Directorate-General for Enterprise and Industry entitled 'A second chance for entrepreneurs: prevention of bankruptcy, simplification of bankruptcy procedures and support for a fresh start' was published in January 2011. This Report reaffirms the benefits of both providing for out of court settlements and also improving court based procedures. The European Commission has also published research, based on a qualitative survey of national experts and stakeholders that assessed the potential impact of different legal systems (common law, civil law and its variations) on bankruptcy efficiency. This study concluded that efficient bankruptcy procedures are not determined by either the type or the orientation (i.e. pro-creditor or pro-debtor) of the legal system, but by the presence of concrete provisions such as the existence of out-of-court settlements; the use of fast track procedures; differential treatment of honest and fraudulent bankrupts; and, the existence of early warning systems.

The HLEG has identified three key issues relating to bankruptcy regimes that exert a considerable influence on SME lending.

- Firstly, what challenges does the bankruptcy process pose to the financing and associated security package? In particular, what is its impact in terms of either potential loss or removal of security or ease of accessing security and/or cash flows?
- Secondly within the bankruptcy regime what is the comparative ranking of the "confirmed claim" when a debtor is declared insolvent and a bankruptcy proceeding is triggered?
- Finally, what is the likely outcome of the bankruptcy proceeding, what are the procedures and stages involved in it and how long does it normally last?

All of these issues, individually and collectively, impact on the cash flows (and therefore the pricing) expected by lenders or an SPV which holds the exposure or indeed by investors who have purchased the securities issued by an SPV.

Although the European Commission has provided guidance in the matter of cross-border bankruptcy proceedings, it is highly unlikely that, however desirable, a common harmonised procedure will be progressed at this level. Given this context, the HLEG concludes that, in the first instance, good practice in terms of bankruptcy regulation from a "finance for growth" perspective should be identified and made available; then and later on, individual countries should be encouraged to tidy or clean up their procedures focusing in particular on the least "lender-friendly" aspects of their legislation.

Short-Term Recommendation – CCS2 (Members States)
Best practice to be identified in terms of bankruptcy regulation from a "finance for growth" perspective, focusing in particular on the following key areas;

- The transparency of the bankruptcy process;
- The tenor of the procedure, including its relative effectiveness and efficiency;
- The consistency of the bankruptcy process and its associated outcomes especially in relation to key elements such as the claw back period and ranking of claims; and
- The provision of out-of court settlement arrangements; early warning systems and fast-track court procedures.

Medium-Term Recommendation – CCM1 (Members States, European Commission)
Member States, working with the European Commission, to make available, on an annual basis, a due diligence review that will allow mapping of existing national bankruptcy regimes against best practice from a "finance for growth" perspective.

3.2 Transparency – Credit Ratings and Data Infrastructure

3.2.1 Credit Ratings & Sovereign Effects

Encouraging greater financing by capital markets and institutional investors requires an objective and credible rating environment in which the evaluation of corporate and project risks are based, as far as possible, on the intrinsic risks of the business or infrastructure project. This necessitates in particular removing inappropriate sovereign biases and ensuring that any correlation between sovereign risk and corporate risk reflected in the rating is fully justified.

European legislation has tackled the subject of the methodologies of credit rating agencies (CRAs), but the HLEG considers that efforts to foster greater transparency must be continued in relation to issue of the "sovereign ceiling". In this context, the aim of structured financial packaging is partly to immunize the cash flow of a real asset or pool of real assets from systemic risk and the originator/sponsor risk. Before the financial crisis, many SME securitisations or infrastructure deals were able to secure higher ratings than the sovereign rating of the location of their assets.

Several CRAs have changed their methodology since the crisis in order to correlate the rating of a SME securitisation or infrastructure deal with the sovereign rating, thereby embedding the impact of financial fragmentation. The fundamental approach of CRAs is not questioned as stress at the sovereign rating may also be reflective of weak micro economic conditions. Nonetheless, the approach reduces the information content of ratings and it is crucial for potential investors to have transparency over the rating of a transaction with and without the impact of the sovereign ceilings.

However, the HLEG considers that CRAs should quantify their credit opinions in terms of both the level of probability and the severity of risks/events associated with the disorderly default of a sovereign (such as the collapse of the banking system, very severe macroeconomic dislocation or, in some instances, an exit from a monetary zone), which may expose structured finance transactions to losses that structural features or credit enhancement cannot fully mitigate. For example, the rating could include a "point rating" and the probability of distribution of a "range of potential ratings" where the CRA believes the credit quality of the transaction differs according to different sovereign scenarios. Within such range, the CRA could highlight the "point rating" it finds the most appropriate according to its own "opinion" as well as the basis of such opinion; and make public its assessment regarding the sovereign factor affecting the overall rating and the weighting it assigns the sovereign factor according to their methodology. Alternatively, or in addition, the CRAs could provide a rating estimate for the securitisation, assuming that the sovereign and all counterparties to the transaction are rated at a specific level, e.g. triple-A. The HLEG considers that such approaches would help reduce the mechanistic way ratings are used in the capital markets, allowing the promotion of a more independent credit culture among market participants and increasing transparency in capital markets.

Medium-Term Recommendation – CCM2 (Credit Rating Agencies)
Credit Rating Agencies to provide greater transparency on their methodology for rating a financing transaction (be it SME or infrastructure) in terms of explaining fully the rating result with and without the impact of the sovereign effect.

3.2.2 Data Infrastructure

A key ingredient to pricing decisions is lender comfort about the credit analysis it has conducted. If there are gaps in information, prudent lenders and Credit Rating Agencies will assume the worst. Gaps are therefore to be avoided where possible.

The HLEG has identified a number of major initiatives that should be pursued to improve the quantity and quality of information available in the market for SME financing and in infrastructure financing. This includes encouraging investors and stakeholders to make use of data and information at their disposal to allow them to apply their own risk analysis and to use their own models as validated with the relevant regulators.

In the case of SMEs, consistent with the predominance of bank financing in the EU, most relevant information is held by banks, or credit insurers which, understandably, have no incentive to give it away for free. Publicly available data is insufficient currently to carry out proper risk assessment of SMEs, which typically do not have a history of disclosure, either individually or even within a portfolio.

In the case of infrastructures, similar issues were noted: absence of comprehensive data on infrastructure financing, no standardized reporting of individual infrastructure finance deals, no information on projected infrastructure supply, and difficulty in estimation of risk weights due to lack of relevant credit history.

These problems are addressed in a number of recommendations—contained in the SME and infrastructure sections— which are tailored to the specifics of each situation.

3.3 Addressing Fragmentation from the Supply Side

So far the HLEG has highlighted factors that produce segmentation—and in some cases distortions—in financing flows in the EU, that are related to the demand side of financing, such as business rules and credit information. The HLEG now turns to cross-cutting factors affecting segmentation on the supply side.

3.3.1 Pooled Investment Vehicles

Facilitating money to be put into SMEs and infrastructure projects in a pooled form operating across the Single Market can encourage investors to channel more financing to investments by offering scale advantages, diversification and risk spreading, as well as the opportunity to leverage expertise or even avail of professional management teams.

To date, the main barriers to the creation of pooled investment vehicles that operate on a cross-border or even pan-European basis are: (i) national differences in relation to tax, legal and regulatory frameworks; and, (ii) a lack of both standardization and visibility.

In this context, the 'passporting' regimes of both the Alternative Investment Fund Managers Directive (AIFMD) and the European Commission's proposed new framework for European Long-Term Investment Funds (ELTIFs) can be considered as positive developments

In particular, the HLEG welcomes the recent ELTIF proposal by the European Commission. The ELTIFs, in particular, if well designed and implemented, could act as an effective mechanism for pooling institutional and retail investment and channelling it to "alternative investment" asset classes that fall outside the traditional definition of listed shares and bonds for example, unlisted companies or infrastructure projects. The HLEG agrees that realising the potential in part requires action at the European level, as currently there is no consistency among the funding vehicles in Member States, where they exist. Furthermore, there is often limited information on the investments that a fund claiming to invest in 'long-term' asset classes pursues.

Although the ELTIF proposal is a positive initiative, it standardises only the conditions for fund raising across the EU. The HLEG believes that standardising also the conditions for the provision of capital by non-bank lenders throughout the EU, perhaps through the development of a European passport for the asset side of the balance sheet of pan-European pooled "direct lending" fund solutions, could further help develop even greater capital market and institutional investor financing sources.

Given that banks are continuing to deleverage, there is value in the establishment of "direct lending" funds targeted at medium-sized enterprises that are not distressed, but which may be bank-lending constrained. Such a long-term investment fund would need to be afforded a pan-EU asset passport allowing it to provide funding across borders on a similar basis to banks. This would include access to both the corporate and SME loan market, as well as infrastructure assets. Such a vehicle could facilitate investment by smaller and medium-sized institutional investors who would not invest directly and would prefer to outsource asset selection and due diligence.

Affording a pan-EU asset passport to specific long-term investment funds could serve to stimulate the enhanced funding of the European economy by further encouraging direct financing by distressed debt firms, private equity and venture capital firms, hedge funds and business development corporations. Indeed there may be an opportunity for such long-term investment funds to function as a means of pooling investor capital in a manner equivalent to Business Development Corporations (BDCs) in the US. Any move to develop this kind of asset passport along these lines would also need to take into account the need to manage any risks related to shadow banking.

Affording funds such as ELTIFs an effective EU-asset passport requires all EU countries to give the fund the same status as approved lenders, in particular banks. This would require action along the following lines:

- Removing barriers to lending (as distinct from deposit taking), such as the need for banking licenses etc., for non bank lenders providing funding to companies using these passported funds;
- Standardising procedures for taking security, enforcement and for creating loans/bonds;
- Equalising treatment of bank loans, non bank loans and bonds in areas such as bankruptcy preferences;
- Managing the related potential regulatory and supervisory shadow banking risks; and
- Aligning tax incentives at national level for different type of lenders in essence to create a level playing field between institutional investors and traditional retail banks.

Short-Term Recommendation – CCS3 (Members States, European Commission)
Member States to work with the European Commission to finalise the new investment fund framework "European Long Term Investment Fund" (ELTIF). The European Commission should take on board industry proposals to ensure that the ELTIF has the broadest possible acceptance among investors and intermediaries.

Medium-Term Recommendation – CCM3 (European Commission, Members States)
The European Commission to investigate how to facilitate the passporting of assets in a manner that would enable investment funds to acquire assets on cross-border basis including allowing them access to both the corporate and SME loan market. This will require the European Commission to work with Member States to ensure that national tax, regulatory and legislative rules do not act as barriers to investments by such vehicles.

3.4 National / Public Development Banks

Fragmentation of funding conditions across national borders has the potential to undermine the achievements of the Single Market and EMU by impeding the proper financing of SMEs and infrastructure. The emergence of significant differences in the costs at which different national public banks across the EU are able to fund themselves and essentially lend to their national clients has also exacerbated this problem

This phenomenon raises the need for a comprehensive policy response to counteract its damaging effects in countries with either no public bank or one with a weak credit rating.

During the most acute phase of fragmentation, the EIB has played a role in reducing the adverse impacts of financial fragmentation.

The EIB's most obvious comparative advantage is its lower cost of funding. A lower cost of funding for a lending bank passed onto clients has an indirect positive impact on SME credit demand (especially in countries more negatively affected by fragmentation). However, national development banks typically hold the comparative advantages of: having better knowledge of their national markets; are linked with a broader range of on-lending banks; and have larger scale operations in their respective markets.

Enhanced strategic cross border cooperation between national development banks, and with the EIB, especially in the area of SMEs, is viewed by the HLEG as being essential and complements the policy goals of Banking Union. An example of how the EIB has developed relationships with individual national development banks is included at Box 2 below. Specific lending by public banks to fund national banks is outside the ambit of the HLEG. How the public banks, especially the EIB with its obvious comparative advantage of lower cost funding, might play a role in further kick-starting securitisation is covered more fully later in this section.

A recent trend has emerged of bilateral partnerships between national development banks. See Box 3 below. This international cooperation among national development banks can also serve to mitigate the impact of market fragmentation and create more normalized lending conditions for SMEs. In order to allow a scaling up of these joint SME initiatives, the HLEG considers that all national development banks should be allowed to operate on a cross-border basis within the EU.

The HLEG also recognizes the role that national development banks and the EIB can play across the EU in advising the national government or the European Commission during both the planning and implementation phases of new programmes or new infrastructure projects. Convergence of practice has been created between the actions of the different NDBs through the relationships they have with the EIB and the EIF. These efforts should be developed further, in particular by prioritising co-investing and co-financing using common documentation and risk parameters.

A better coordination between national development banks and the EIB is a key to improving and promoting access to finance for enterprises. This kind of cooperation and coordination can generate a toolbox of financial instruments aimed at:

- Supporting enterprises financing in Europe. This toolbox could be adapted to the specific needs Member States, banks and enterprises;
- Mutualizing credit risk and articulating industrial policies at an EU level;
- Focusing on supporting NDBs to improve their leveraged ratio; and
- Disseminating best practices.

Box 2: Cooperation between the EIB and National Development Banks

The EIB has a long standing relationship with national development banks, in some cases dating from the early 80s. This cooperation has been particularly intensified in recent years due to the need to counter the effect of the crisis in the economies of some countries. In the last two years the EIB group has signed some €6bn of loans or guarantees with EU national development banks for different sectors of the economy:

In France, the EIB group and Bpifrance recently signed a EUR 750mn loan dedicated to SMEs and small midcaps and a guarantee agreement to support lending of EUR 200mn to innovative, RDI-intensive small and medium-sized enterprises under the Risk Sharing Instrument (RSI), a joint initiative of the European Investment Bank Group and the European Commission.

The EIB and KfW of Germany are working together on financing several off-shore wind projects. It is also envisaged that the EIB will jointly participate in a gas pipeline and in the financing of small scale rail and infrastructure projects.

The Bank has also intensified its relationship with BGK of Poland and CdP of Italy over the same period with signatures of nearly EUR 1.5bn and EUR 1.2bn, respectively, mainly for financing SMEs and midcaps and the promotion of motorway and gas infrastructure.

In Spain, the EIB has provided ICO with EUR 1.7bn of funding to support the joint priority objective of financing SMEs and midcaps, including a dedicated facility for agriculture projects and other private sector initiatives.

Medium-Term Recommendation – CCM4 (Members States)

National and regional development banks to collaborate more actively with the EU/EIB and with each other.

In order to overcome the limitations imposed by the availability of resources in the EIB for SMEs, a recent trend has emerged of bilateral partnerships between national development banks also exploiting the arbitrage conditions created by market and the corresponding relative comparative advantages. This international cooperation among national development banks has served to mitigate the impact of market fragmentation and create more normalized lending conditions for SMEs. In order to allow a scaling up of these joint SME initiatives, the HLEG considers that all national development banks should be allowed to operate on a cross-border basis within the EU.

To accelerate this process, the HLEG considers that national development banks could consider changing their statutes to allow them to operate on a cross-border basis given that:

- Some Member States do not have a national development bank and might be interested by adopting existing IT platforms;
- The sharing of best practice, learnings and sectoral expertise between national development banks could be actively encouraged through existing institutional networks.
- Financial links could also be deepened, either through co-financing or re-financing.

Box 3: Cooperation between the KfW of Germany and ICO of Spain

Germany's KfW and Spain's ICO pioneered a recent agreement to finance SMEs in Spain, worth EUR 1.6 billion. The agreement seeks to tackle the financing and liquidity problems being experienced by SMEs and to improve access to credit for these types of companies. Specifically, the contribution of EUR 800mn from KfW will reach Spanish SMEs through the second-floor facilities offered by the ICO through its partner financial institutions.

Medium-Term Recommendation – CCM5 (Members States)

Governments of Member States that have national development banks to allow these institutions to operate on a cross-border basis. Cross-border operations may require changes to the statutes in some cases.

Medium-Term Recommendation – CCM6 (Members States)

Governments of Member States that have national development banks to proactively encourage cooperation between these institutions.

4. SME

This section 4 analyses the specific challenges SMEs are facing in accessing finance. By looking at a diverse set of options and instruments which could facilitate SME financing this section attempts to identify the necessary conditions and develops recommendations pertaining to SMEs including suggestions to deal with credit analysis, a number of propositions for creating public and private databases on SME finances as well as the efficiency of a range of financing options, such as venture capital, covered bonds, private placements, public equity markets and funds of loans. The HLEG strongly supports the development of capital market options for SME financing, such as securitisation of SME loans, as a complement and alternative to traditional bank financing channels, and offers a number of recommendations to facilitate such a development.

4.1 Introduction

As highlighted above (Section 2.1), SMEs are a main source of growth and employment in Europe. As a consequence of the financial and debt crisis (e.g. deleveraging, greater risk aversion and heightened liquidity sensitivity), financing conditions have become more difficult for SMEs. Tighter financing, in turn, has jeopardized investment and economic activity.

Historically, the financing needs of European SMEs have been dominated by solutions from banks and capital markets and direct funding have played a minor role.

The HLEG does not consider that for SME financing capital markets can replace bank finance in Europe. As a consequence, completion of the implementation of a fully functioning banking union should remain the number one priority.

The HLEG considers, however, that there are a number of under-exploited ways in which alternative funding sources can be developed in Europe, either to (a) provide sources of funding and capital relief for banks who are originating loans to SMEs or (b) more directly connect sources of funding (e.g., retail investors, pension fund assets etc.) with companies, typically larger companies looking for financing.

The role of capital markets must be seen as complementary rather than exclusive. There is a need to take into account a diversity of situations and combine approaches.

There are three main reasons for this:

- Firstly, European countries have attained different levels of capital market development and many require further adaptations or transitional measures before roll out of European wide capital market related solutions.
- Secondly, for SMEs, financing relies on an origination (or underwriting) capability which is most effectively provided for by relationship financial institutions (retail banks mainly).
- Finally, the gap between the smaller entities part of the SME definition and the bigger ones (with 250 employees or €50m turnover) still part of the SME definition is as significant as the gap between the latter and many companies too big to be qualified as SME but qualifying as mid-cap or above. The distribution of each size varies widely between different EU Member States.

4.2 SME Credit Analysis - Analysis on a Portfolio Basis

Loans issued to SMEs are generally for smaller amounts. Capital market intervention usually requires larger amounts before investors will consider getting involved. This therefore requires the bundling of SME loans into portfolios. In addition to scale the investors will require the ability to carry out due diligence on the proposed investment. This therefore requires transparency on the portfolio of SME loans which in order to be effective requires some level of detail on the individual SME loans. Banks can do this for their own customer base as they are already quite familiar to the bank but the capital markets in Europe do not generally have access to the relevant data.

Given the above, advancing any role for capital markets and other non-bank funding in the area of SME backed funding will require an improvement to the link between the capital markets in Europe and the data on SME credit. This can be achieved through greater convergence of approaches to data availability, quality of data, credit scoring, consistency documentation and the underlying legal systems. The sharing of best practice in these areas will also help.

SMEs present particular challenges in relation to the availability of data, the quality of that data and in relation to credit scoring so these are addressed separately below.

SMEs are under stress now and need action now. The HLEG has therefore identified actions which can be initiated at national level in the short term, even if full coordination and convergence across Europe remains the longer term desirable destination.

4.3 Data Infrastructure

Relationship lending remains the dominant model in Europe. As a result, new competing providers of funds have little chance to gain the information required (e.g., about the creditworthiness of a particular SME) to make sound funding decisions. Given the relatively high fragmentation of the European SME finance markets, transparency tends to be low and new market entrants face high investment costs and/or adverse selection problems. The smaller the potential borrower, the more severe these information barriers are.

The HLEG believes that the data infrastructure on SME finances can and must be significantly improved.

Generally there are two different avenues for greater participation of additional bank or non-bank finance providers, these two routes have different data infrastructure aspects and recommendations

4.3.1 Direct Lending in the Local Markets

The HLEG's first set of recommendations aim to break down the information barriers for new direct finance providers, for example institutional funds, insurance companies or banks not represented in the local markets.

Directive 2012/17/EU[11] deals with the interconnection of business registers including central, commercial and companies registers. It has laid the foundation for increased transparency of company information across the EU. A key aspect is the cross-border access to business information on limited liability companies and their branches, and the transmission of information to individual users in a standardised format. It is envisaged that this will lead to an integration of European services, a common interface for services and in time to a European electronic access point which will include unique identifiers for each company on all registers connected by the interface.

Of specific relevance is also Recommendation SMM1. Such a database would combine information from various sources including private sector participants such as banks, leasing companies, credit insurers and national credit bureaus. Given that critical mass is crucial for the viability and appeal of such a database, it should be considered to what extent public sector entities could initiate and spearhead the development of such a database until the private sector could take over. Contributions to such a database should in principle be on a voluntary basis. However given that banks in particular might have reservations about sharing data which has been costly to accumulate and has become a very valuable resource to the bank, an appropriate incentive structure (perhaps regulatory) would need to be developed in order to ensure broad participation of relevant actors. With respect to credit

[11] http://ec.europa.eu/internal_market/company/business_registers/

performance data of individual SMEs, national data protection and bank secrecy rules would likely require any transfer and publishing of data to be on a fully anonymised basis.

A more ambitious and desirable project would give consideration to the combination of both databases and the related technology delivery portals (Recommendation SMM2). This would have the benefit of combining all publicly available information about the SMEs found on the consolidated business registers with anonymised portfolio analysis of SMEs. Additional information given by individual SMEs on a voluntary basis relating to credit histories could also be uploaded and made available to either the general public or on a more restricted basis to interested third parties pre-selected by the SME. This need not necessarily be a government run database. Such a portal could be developed by the private sector in line with similar internet-based social media exchanges about personal information and messaging systems. However, there would be potentially significant synergies to complement business register-based information with voluntary credit relevant SME information. Any approach would require further clarification in terms of legal basis, funding and how to keep the information up to date.

Over time, such a database would give key insights in the behaviour of SME credit performance on a pan-European basis and permit further portfolio analysis to be done.

Another feature that would help to address the problem of credit assessment of SMEs is the development of a common and unique identifier for all corporations in Europe. While identifiers are certainly available on a national level, e.g. VAT- or trade register identifiers, and some data vendors have developed their own proprietary identifiers, there is no official identifier available that covers all companies in Europe consistently. Nevertheless, the development of such an identifier would not only ease the quick identification of companies and ease the linkage between various databases on SME data such as financial statement database but could potentially also help to simplify the comparison of various ratings for a company, which in turn could help to increase the level of trust of the market concerning ratings for SMEs. In order to obtain such common and unique identifier, it could be aimed at a broader application of the Legal Entity Identifier (LEI), sponsored by the Financial Stability Board, including also SMEs, which ever their size, with a view of setting the respective fees low enough to facilitate the participation also for very small SMEs.

Short-Term Recommendation – SMS1 (European Commission, Members States)
A study be initiated immediately by the European Commission and/or interested Members States to assess how a privately run database might be implemented to collect both SME credit risk performance on a portfolio basis, as well as credit performance of individual SMEs on an anonymised basis. This should investigate overlaps with existing European Commission work on pan European availability of business register information. The study might also investigate the feasibility of allowing companies to self-elect to have their information made available with their consent on a named basis to identified third parties.

Medium-Term Recommendation – SMM1 (Private Sector, European Commission)
Implementation of a fully robust easily accessible SME credit risk database permitting greater pan European analysis of the SME sector to be promulgated on a portfolio basis to complement the surveys in recommendations SMS2 below.

Medium-Term Recommendation – SMM2 (Private Sector, European Commission)
Build on the European Commission's work on business registers by creating a voluntary unified corporate SME information portal. If feasible, the database should be developed to deliver a single portal fully integrated with the European Commission's work on business registers, the database outlined in SMM1 and voluntary information submitted by individual SMEs.

Medium-Term Recommendation – SMM3 (European Commission)
Consider the conditions under which the Legal Entity Identifier, sponsored by the Financial Stability Board, could be used for the unique identification of SMEs, whichever their size, with a view to setting the fees low enough especially for very small ones.

4.3.2 Indirect Lending through Securitisation (see more fully Section 4.6 below):

By contrast, SME portfolios in securitisations originated by banks tend to be granular and well diversified. Accordingly, a lack of detailed SME specific information can be somewhat counter balanced by portfolio diversification, though CRAs have reasonably detailed SME data and historical performance data requirements in order to rate an SME CLO. The more robust the public information about SMEs and their funding even as a group in a particular country, the more likely bank lenders will secure funding by way of securitisations at an economically acceptable rate.

While there is substantial statistical information available on the economic output and employment significance of SMEs in Europe, statistical information on SME lending, lending conditions and access to finance is relatively underdeveloped. What is needed is the ability to identify relevant market gaps as well as trends on, e.g., lending volumes, regional dispersion, lending costs, collateralisation requirements, term structure of SME finance and finance supplier analysis

A step in overcoming these challenges is the European Data Warehouse initiative, through which banks have been required since January 2013 to provide loan level information on SME securitisations, in accordance with a standardised template, in order to be eligible as collateral for Eurosystem credit operations. Loan-level data is important for investors to assess SME portfolio risks but the SME data is anonymised so that there is no link to a particular SME.

In the short run, for many SME finance markets, generating bank funding by securitisations will be the more realistic route to increased system capacity for SME lending until information barriers for SME individual finance are lowered.

Short-Term Recommendation – SMS2 (National Central Banks, European Central Bank)
Develop and improve statistical surveys to better capture the SME finance markets in Europe. These should be commenced immediately by National Central Banks (NCBs) lacking such information for their own countries, perhaps responding to common sets of criteria promulgated by the ECB.

Medium-Term Recommendation – SMM4 (Eurostat)
To ensure maximum utility and pan European comparison, the organisation of SME finance surveys and the dissemination of information over the medium term will be turned over to a pan-European institution such as Eurostat in cooperation with the European System of Central Banks (in order to avoid duplication of tasks and the overburdening of SMEs) and with the help of national statistical institutions and national or European associations relevant for the SME finance markets.

4.4 Credit Ratings and Credit Scoring of SMEs

Most SMEs are not rated by international Credit Rating Agencies (CRAs), implying a need to resort to alternative credit assessment methods both for direct lending and also in computing the credit quality of a portfolio of SME loans.

Credit assessment by CRAs is determined on the basis of an expert assessment and it takes into account any qualitative elements and forecasts that the company manager may have communicated to the analyst. The cost of such a rating by a CRA on an SME may vary between €10,000 and €100,000. It is therefore disproportionate to the average financing amount that would be sought by an SME and is consequently rarely sought.

Scoring systems, by contrast, are purely statistical tools based on accounting and financial data, data relating to trade bill payment incidents and to loans reported by credit institutions. They typically compute factors such as balance sheet topics (tangible assets/total assets, short-term debt/total debt, equity/total assets), liquidity topics (liquid assets, current liabilities, EBITDA/debt service), return topics (cash flow/turnover, net profit/total assets), size and growth topics, and efficiency and velocity factors (sales/inventory and sales/total assets).

National central banks have a natural interest in accurately measuring and managing credit risk of corporates. Some national central banks carry out in-house credit assessment of non-financial companies in order to decide which of them can be considered as eligible debtors/issuers of eligible collateral for Eurosystem credit operations. See example in Box 4 describing the in-house credit assessment system of the Banque de France.

Euro area national central banks who decide to develop their own in-house credit assessment systems are subject to an ECB validation procedure and a performance monitoring process.

The credit assessment systems of national central banks are robust, having been precisely calibrated and validated. They also have the benefit of having no dependence on external providers and may be potentially relatively cost efficient sources of credit assessment for investors. However, an important pre-requisite for the development a credit assessment system is the existence of a national credit register and in several euro area countries, credit registers do not exist.

Box 4: The In-House Credit Assessment Systems of the Banque de France

The HLEG understands that the Banque de France ratings consist of a synoptic assessment comprising two elements:

- the turnover rating, represented by a letter from A (for companies whose turnover is more than EUR 750 million) to M (with a turnover below EUR 0.10 million). A non-significant turnover rating N is also given to other companies that do not directly carry out an industrial or commercial activity. These companies' volume of business cannot be measured in terms of turnover (e.g. holding companies). The turnover rating X corresponds to companies whose turnover is not known or is too old (the last financial year dating back to over 21 months ago);
- the credit rating has a range of 13 different levels (0, 3++, 3+, 3, 4+,4, 5+, 5, 6, 7, 8, 9, P). The rating 0 is given to companies for which the Banque de France has collected no unfavourable information. In descending order, the most favourable ratings are 3++, 3+, 3 and 4+. The credit rating 8 represents irregular payments and 9 very irregular payments (severe cash flow problems). Rating P is given when the company is the subject of insolvency proceedings (court-ordered turnaround procedure or judicial liquidation).
- However, the economic model used by the Banque de France is based on characteristics that differ significantly from those of rating agencies, specifically in the two following respects:
- the ratings are not made available to the public: the service is exclusively provided to the banking and credit insurance companies community whose members are subject to banking secrecy. In order to access the information, banks must subscribe to FIBEN;
- above all, the rating service is not paid for by the borrower (no "issuer pays model"), but billed to the banks and credit insurance companies that consult FIBEN, which considerably reduces the potential risks of conflicts of interest between the rated entity and its appraiser's opinion (in this instance, the Banque de France).
- Although French banks have the choice between several sources of credit risk assessment, they almost unanimously prefer the system used to assess their credit claims which are based on Banque de France ratings because of its wide scope. This rating system may also facilitate the financing of companies, out of which more numerous SMEs: indeed, the banks have a deep pool of eligible collateral available for monetary refinancing.
- This system (the accuracy of the system is tested against historical defaults) has not led to a decrease in the number of credit analysts for SMEs in French banks. No bank has perceived

the system as a reason for not conducting its own credit analysis, but rather as a benchmarking tool for its own internal system.

For a foreign investor, accessing a rating and its default probability on a foreign SME will not be sufficient to lend; the investor may choose to add a relevant margin of safety but it helps the investment decision making process.

A question to be addressed is how freely available such information from national central bank in house credit assessment systems should be made. For instance, as noted in Box 4, the Banque de France service is exclusively provided, for a fee, to the banking and credit insurance companies community whose members are subject to banking secrecy. Furthermore, unlike Banque de France, it should be noted that most other national central bank credit assessment systems do not make the actual credit score of companies available to banks but rather just a list of eligible companies. Wider disclosure of SME credit scores information would also go beyond the original objective and remit of credit assessment systems which was for assessing eligibility of the central bank's collateral for its monetary policy operations.

In the USA, the National Association of Insurer's Commissioners (NAIC) has created such a common database. It is only available for insurers, allowing them to have an indication on the probability of defaults of a debtor.

The NAIC's Securities Valuations Office, is responsible for the day-to-day credit quality assessment and valuation of securities owned by state regulated insurance companies. It conducts credit analysis on these securities for the purpose of assigning an NAIC designation and/or unit price. The scoring database provides an anchor to a variety of regulatory mechanisms such as statutory accounting and risk based capital.

Medium-Term Recommendation – SMM5 (Member States)
Member States where the national central banks are not already doing so are encouraged to assess the feasibility and business case for developing an internal credit assessment system for SMEs for their own jurisdiction. As a pre-requisite for the development of a credit assessment system, Member States should consider the establishment of a national credit register if it does not already exist.

Medium-Term Recommendation – SMM6 (European Commission, ECB)
The European Commission in cooperation with the ECB and national central banks to consider whether and how SME credit scores computed by national central banks or other authorities could be made widely available.

4.5 Start-Up, Venture Capital and Private Equity

Companies at different stage of their lives require different forms of finance. Small start-ups require micro-finance or seed capital initiatives. The HLEG supports the EIB group and national Governments with their initiatives in this area.

However, for companies to grow other forms of equity need to be available. This is also particularly important where recent years of low growth or recession bound economies have depleted working capital of businesses. Venture capital firms solve many of these issues.

Aside from the fact that the broader European economic and financial environment is challenging, the further development of the European Venture Capital industry faces a number of longer standing barriers including:

- continued fragmentation along national borders with only very few pan-European VC funds;
- the small size of VC funds in Europe; and,
- the relatively low returns compared to other forms of private equity.

The HLEG welcomes the new EU frameworks for investment in venture capital and in social entrepreneurship funds. Public funds invested over the last 10 years on a market-oriented basis have helped to prevent further shrinkage of EU VC activity, as a result of private investors quitting the sector for reasons of poor returns and limited perspectives of improvement.

The HLEG is of the view that there is scope to increase equity financing of start-up, small and growing SMEs via targeted pan-European venture capital funds in which public money is used as a catalyst to develop more robust funding structures and deeper pools of finance. These could operate as pan-European funds that serve to increase the depth and liquidity of the market and promote cross-border activity in the funds being supported. These funds would employ a sectoral focus and would be targeted at those sectors with high growth potential across Europe.

These funds could build on national venture capital operators for their management either individually or gathered in a pool, and benefit from their knowledge of the markets to select the best venture capital funds. In view of the disappointing performance of European risk capital over the last ten years, it is unlikely that private investors will be attracted to these funds of funds at the inception and as such public investment/equity would be required to demonstrate that these vehicles can produce a worthwhile return, with the intention of attracting additional private capital subsequently.

This will necessitate the adoption of a targeted market approach focused on supporting carefully selected teams with the capacity to both provide sustainable returns to investors, and also eventually the ability to raise a successor fund. This it is suggested represents the most viable mechanism to attract private sector investors back to the EU VC market (Box 5 illustrates Spain's approach to tackling this issue). Ultimately, it is not just the size of the funds which matter but also their ability to connect a company with those other businesses who might be key to open doors or partnering with the company through its growth phase.

Box 5: Spain: ICO's FOND-ICO Global

FOND-ICO Global is the first public venture capital "fund of funds" to be established in Spain. It has €1.2bn in committed resources, and is managed by AXIS, ICO's venture capital arm[12]. The size of the Private Equity market in Spain (measured by annual gross investments) was €2.5bn in 2012, of which Venture Capital amounted to just slightly more than €100m.

FOND-ICO Global is seeking to invest across the entire investment life cycle which includes seed capital, venture capital, growth capital, buyouts, and turnarounds / distressed, amongst others.

The main features are as follows:

- The program amounts to €1.2bn with an investment period of 4 years. The investment pace will depend on investors' appetite and on the available market opportunities at any given time.
- This fund will invest in projects that combine innovation and entrepreneurship via investments in companies in both the initial and more advanced stages of development. Indirectly, FOND-ICO Global will seek to promote employment creation, attract international investors and enhance the internationalisation of Spanish companies, among other benefits.
- In addition, the investment strategy will focus on those funds with a significant percentage of investments in Spain.

The investment program will be implemented through systematic "tender processes", accessible for all those funds that meet the qualification requirements, which will be defined and communicated before each tender. FOND-ICO Global will invest in qualifying funds in proportion to their relative scoring obtained during the selection phase.

[12] http://www.axispart.com/fond-ico-global-announces-its-first-call-for-the-selection-of-venture-capital-funds/?lang=en

The HLEG is of the view that the EIF, given its experience and expertise in the development of entrepreneurship and innovation, is ideally placed to take a lead role in stimulating the development of pan-European structures through a combination of its traditional Fund-of-Fund investing and the roll out of products such as Tech Transfer and business angels investment.

The HLEG recognises that national tax systems generally perpetuate a debt bias as the tax treatment of debt and equity differs and equity is less favoured. This can clearly create a disincentive for companies in seeking to attract non-bank investment via venture capital and as such it would be important that national regimes consider how best to accommodate private sector equity investment.

Medium-Term Recommendation – SMM7 (European Investment Fund)
The EIF to further strengthen its strategy to support the development of more robust Venture Capital funding structures based on public sector cornerstone investment and leveraging private sector funding.

Medium-Term Recommendation – SMM8 (European Investment Fund)
The EIF to continue and further strengthen its investments in funds directed towards young technology companies and to further its attempts to incentivise additional investor classes (like Business Angels and Corporates) to invest in this segment.

4.6 Securitisation – Supporting Bank Funding

4.6.1 Background

The problem of inadequate SME finance on a non-fragmented basis in Europe is an immediate one. Realistically, in the short run, for most EU Member States, generating additional direct funding to SMEs is a medium term objective. Therefore, for these countries, the priority should be using tools like securitisation to generate greater capital market funding, and capital relief, for the national bank sector. This in turn generates consequential capacity for new SME loans by such banks and will be the more realistic short-term route to increased system capacity for SME lending until information barriers for individual direct finance are lowered.

Development of acceptance of securitisations involving SME loans in a wider range of European countries will also assist in the eventual disintermediation of SME credit in those countries reducing the risk to SME credit flows of banking sector failures.

Even in the short term while banks remain the main source of direct SME loans, securitisation markets provide an additional source of funding for banks, potentially making bank lending less sensitive to abrupt changes to the cost of funds and ultimately affecting positively the availability of finance to economic growth. Indeed, the SME population is particularly sensitive to changes in bank lending terms and conditions, since many SMEs cannot access the capital markets directly.

Securitisations backed by European receivables have performed well during the crisis, from both a credit and price perspective. From an investor's standpoint, high quality securitisations can provide a high-performing asset class for European and global institutional investors with potentially large size. For example, in 2011, European insurers held €7.7trn of assets and had a new premium income of €1.1trn for investment in all types of instruments. However, only a small share of insurers' total assets was invested in securitisation.

The potential for additional funding provided by securitisation is significant; if the current barriers to revival of the securitisation market are removed, AFME estimates that approximately €200-300bn or more of funding could be provided through securitisations sold to third party investors, including insurance companies, pension funds, banks and others.

4.6.2 Best Industry Practice

Asset encumbrance reduces the ability of the financial system to absorb shocks. Given policymakers' understandable growing concerns about increasing levels of asset encumbrance, securitisations provide a collateral-efficient means of raising cash as compared to other long-term secured funding techniques such as covered bonds.

Significant regulatory changes in Europe have already addressed pre-crisis concerns of policymakers and investors in relation to securitised instruments. Specifically, the Capital Requirements package, which has already been implemented, requires originators to retain at least 5% economic risk in order to better align interests between the bank originator and the third party securitisation investors. In addition, bank investors are also required to undertake significant due diligence prior to investment under CRR. Similar regulations will take effect for EU insurers under Solvency II.

Considering the very limited default rates of investment grade European tranches, there is scope for considering the possibility to offer such instruments, **preferably indirectly via funds**, to retail investors. This, when accompanied by enhanced transparency and standardisation, would achieve a better distribution of risks across the economy.

It should be mentioned that some initiatives supported by the public and private sectors are already tackling such issues. For instance, the Eurosystem's loan level data initiative has contributed to increase transparency and standardisation in the European ABS market. In fact, in order to be eligible as Eurosystem collateral, ABS transactions must be backed by homogeneous asset pools and detailed loan-by-loan information should be available in a privately-managed information portal (European Datawarehouse).

In addition, the industry has developed initiatives with a view to help reviving the securitisations market. One example is the Prime Collateralised Security (PCS) initiative which has developed a label that can be awarded to securitisation issuances meeting a set of criteria defined by the industry in respect to quality, transparency, simplicity and liquidity.

In order to encourage the use of a quality label (this one or others) and to acknowledge the actual quality of the structure and its underlying assets, the regulatory treatment could be adapted (i.e. comparable for the same risk/quality to other products such as covered bonds) from a capital as well as liquidity point of view provided that the labelled deals are proven superior than non-labelled ones (e.g. in terms of market liquidity, performance metrics).

In the course of its work, a number of other points were made to the HLEG about which some of its members felt strongly indicating how current regulatory rules inhibit the development of desirable SME securitisations. Consideration of the validity of such assertions is beyond the mandate of the HLEG. Given the desirability of seeing additional high quality simple and transparent securitisations, it was decided that these assertions should be added as an Annex A for consideration as to their merit or otherwise by the relevant authorities.

Short-term Recommendation – SMS3 (European Commission, Member States)
National and European policy makers to issue clear supporting statements about the important role securitisation has to play in financing the European economy's growth.

Short-term Recommendation – SMS4 (National Financial Regulators)
Regulators are invited to monitor labelling initiatives established by the financial industry to increase transparency and standardisation in order to determine whether the labelled deals are proven superior to non-labelled ones (e.g. in terms of market liquidity, performance metrics) with a view to supporting the use of such labels.

Short-term Recommendation – SMS5 (National Financial Regulators, European Commission)

Regulators are invited to consider how best to identify high-quality, simple and transparent securitisations and how this could subsequently be reflected in regulatory treatment.

4.6.3 Supporting EU Wide Securitisations

Greater involvement by EU institutions in supporting EU securitisations should help kick-start these markets to generate funding sources for banks particularly in countries where banks and/or sovereigns are credit-rating challenged at present. In that way, the EU institutions can help break down fragmentation of SME funding markets.

While ideally, these securitisations might involve SME loans, it is important that the role securitisations in other asset classes which might be more easily transacted in current market conditions (mortgages, credit cards etc.) might also play to free up bank capacity for new lending should not be overlooked. Given the experience and expertise of the EIF in the development of the SME securitisation markets, the EIB Group is well placed to play a vital role in stimulating the revival of this important market segment and reduce market fragmentation.

For the longer term, participation by EU institutions can help encourage or require convergence of structure and standards of securitisation vehicles/securities in all European countries thereby generating a more acceptable and therefore less expensive new European SME securitisation asset class for global investors which in turn will help reduce the pricing of associated loans for European SMEs.

With this second objective in mind, particularly, it is important that support for the generation of a new European wide securitisation structures not be confined only to those done by banks' lending to SME loans in struggling countries but that banks with SME loans in "strong" countries also participate so as to more quickly develop the European gold standard for this new asset class.

4.6.3.1 Credit Guarantee Support

In many European Member States credit guarantee schemes represent a key policy tool to address SME financing gaps, as guarantee instruments enable the spreading and mitigation of risk and therefore allow financial institutions to extend loans and other forms of financing that they would have otherwise found difficult to grant.

Depending on their structure and status, guarantee schemes may also enable banking institutions to free up economic and regulatory capital and therefore enhance a bank's lending capacity to the SME sector. The higher the rating of the guarantor, the more efficient such a scheme is likely to be. As a result, a guarantee scheme operating at European AAA level by addressing financial market fragmentation, encouraging further harmonisation and at the same time complementing existing national schemes could bring additional benefits for the support of the lending by banks across all EU Member States, especially those with sovereigns rated less than AAA. A fuller consideration of same is outside the remit of the HLEG. What the HLEG has considered is how such a scheme could be applied to support development of securitisation for SME loan portfolios in a broader range of countries than is currently the case.

Firstly, a guarantee scheme could be utilised during the ramp-up phase of an SME loan portfolio, i.e. providing support to originators during the loan warehousing phase, thus supporting the efficient creation of a portfolio which can be securitised and that can after suitable aging (typically 1 to 2 years) be placed with institutional investors through a term ABS issuance, while maintaining at all times appropriate alignment of interest between the originator and third parties.

Secondly, a pan-European guarantee scheme might be used to provide credit enhancement either directly for securities issued by the securitisation vehicle or indirectly by guaranteeing SME loans in the securitisation as a portfolio especially those which by reason of sovereign ceilings are unable to reach a high enough quality rating to be purchased by investors.

4.6.3.2 Purchase of Securities

It is also desirable that during the formative years for this new asset class or during periods of stress at a particular sovereign level, EU institutions (EIB, National Public Banks) might be allowed to purchase or at least underwrite tranches of the securities issued by the securitisation vehicles. For example, a purchase by the European Investment Fund of lower tranche securities might enable the creation of higher tranche quality securities suitable for investors and perhaps also for Eurosystem refinancing operations.

This would generate less costly funding sources for banks operating in countries where highly rated public bank support is not available.

4.6.3.3 The EU-EIB SME Financing Initiative

The recent EU-EIB SME Financing Initiative was one example of such a move to support SME securitisation.

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

Given these objectives, the HLEG noted that while Option 1 added some value by generating bank capital relief for new loan generation, it did not advance objectives (c) and (d). As a result the HLEG concluded that Option 2, or better still Option 3, presented more optimum use of any available structural funds. It was noted that from the point of view of the markets, option 2 and 3 differ only in the quantum of securities being created for investor funding. Furthermore there was a view that if only Option 1 (guarantees) of the joint EIB – European Commission initiative is finally adopted there will also be a need for a scaling up of the role of the EIB in providing funding for SMEs through its traditional SME Global Loan Schemes. Otherwise the additional "firepower" proposed by the EIB under option 2 (by buying senior SME tranches) will not be used at all for the benefit of SMEs. Option 3 allows for more EIB participation in more trades and therefore more securities for investors.

The HLEG further noted that the well-established AAA credit enhancement activities carried out by the EIF in SME securitisation are a good match for the operational and strategic objectives of the SME Financing Initiative.

Short-Term Recommendation – SMS6 (European Commission, Member States)
The High Level Expert Group endorses initiatives like the EU-EIB SME Financing initiative but is of the view that the harnessing of the full potential of this measure requires a clear political commitment not just for pursuing a guarantee option but also those which encourage securitisations.

Medium-Term Recommendation – SMM9 (Member States)
Member States should consider the appropriateness of establishing/supporting a AAA guarantee scheme for securitisation in their market aimed at the ramp-up phase of a SME loan portfolios, thus encouraging development of securitisation for SME loans and reducing fragmentation within the EU.

Medium-Term Recommendation – SMM10 (Member States)
Member States should consider the appropriateness of establishing/supporting a AAA guarantee scheme for securitisation in their market aimed at SME loans that are affected by economic stress, thus reducing fragmentation within the EU.

4.7 Covered Bonds

There is a strong causal relation between banks' SME lending (volumes and prices) and the cost of financing SME loan portfolios[13].

Owing to their preferential regulatory treatment, covered bonds offer cost effective funding for banks. Loans to SMEs are already eligible and significantly used in legislative covered bonds in Germany and Spain. However, to be eligible, the loans need to be collateralised by real estate with an LTV below 60% (in order to comply with the articles of the CRR for preferential risk weights). Allowing the greater use of unsecured or non-real estate collateralised SME loans as eligible collateral for covered bonds could potentially unleash credit demand from SMEs that may currently be suppressed due to the elevated costs of SME lending. Analysis by the IMF seems to support this[14].

Increasing the amounts of secured borrowing always raises the issue of the impact on asset encumbrance in banks' balance sheet. However, in this regard, asset encumbrance should focus on the total level of encumbrance in the balance sheet and be more agnostic on what type of specific collateral is pledged to secure the borrowing. It is unfortunate that a potentially large portion of SME loan portfolios cannot be effectively used for secured borrowing (total SME loan portfolios in 2010 in the EU27 are estimated at €1.7trillion, of which a large proportion is not secured with sufficient real estate collateral 15), thus implicitly penalizing, via higher refinancing rates, SME lending vis-à-vis other banking activities.

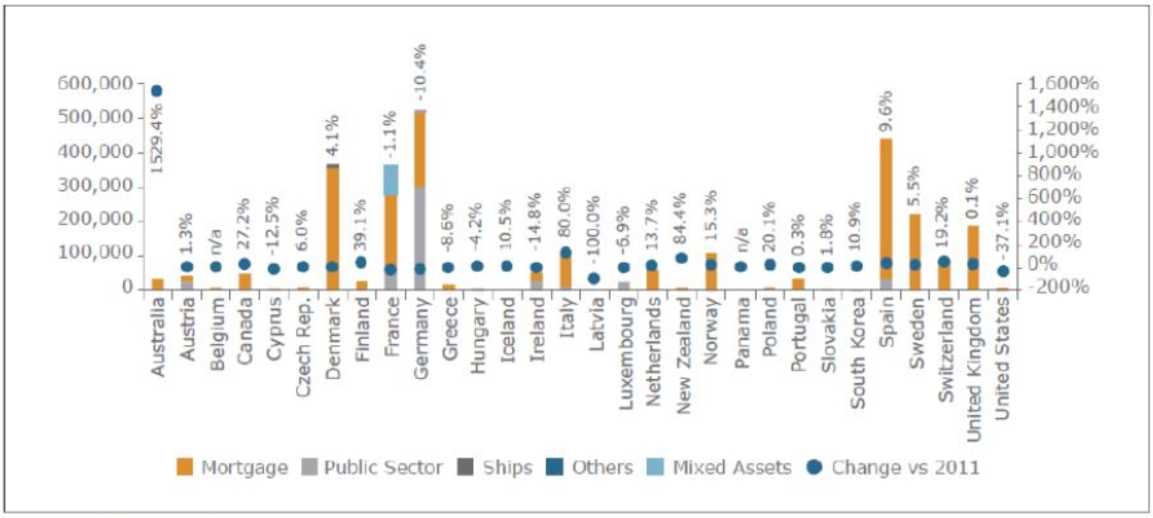
Given the underlying differences across SME financing, the creation of a well-accepted asset class of SME covered bonds will require strict EU regulation on eligibility criteria and adequate overcollateralization rules for ensuring a high quality of the posted collateral. It is worth exploring with industry and regulators of what the eligible pool of SME collateral may be comprised. Some initial thoughts in this area are included below:

- Exposures to SMEs guaranteed by sovereigns, public sector entities and multilateral financial institutions.
- Exposures to SMEs guaranteed by any credit risk coverage arrangement backed by sovereigns, public sector entities and multilateral financial institutions (this will include amongst other things; loans guaranteed by mutual guarantee schemes (see section 4.6.3.3 above)).
- Exposures to SMEs guaranteed by financial institutions in the form of credit insurance or guarantees.
- In order to ensure minimum credit quality of the collateral pool, the Expected Loss of the SME pool should be measured according to standard risk assessment methodologies similar to those used when assessing Residential Mortgage collateral, i.e. based on reliable estimates of the Probability of Default (PD) and loss severity (LGD).

The maximum weight of any individual component to the total covering pool may be limited to ensure the maximum quality of the overall collateral.

[13] IMF, Global Financial Stability Report, October 2013, Chapter 2, pp 8-9
[14] IMF, Global Financial Stability Report, October 2013, Chapter 2, pp 11-16
[15] Zsolt Darvas, Bruegel Policy Contribution, July 2013, pp 6

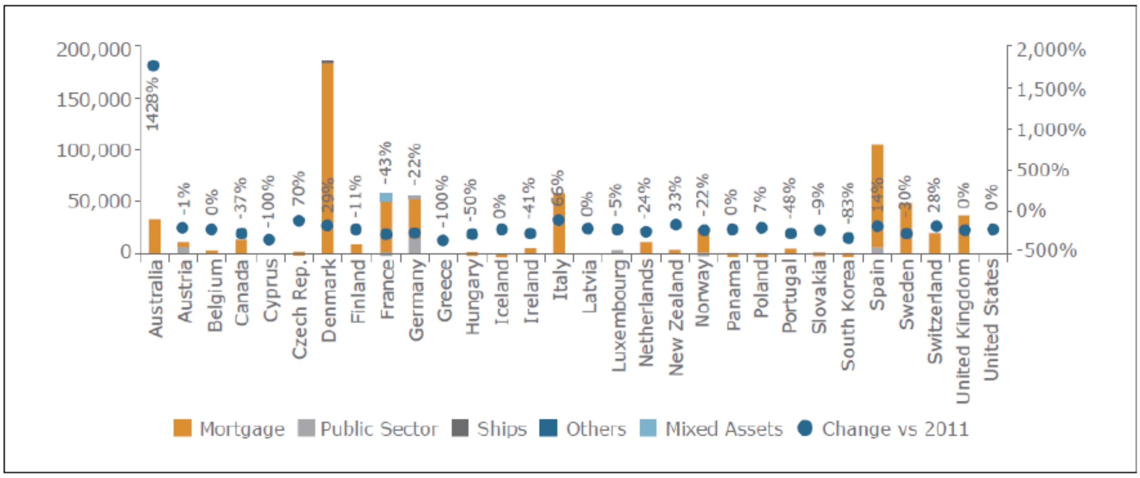
Chart 12: 2012 Outstanding Covered Bonds by country and collateral type (EURm) incl. change vs. 2011 (%)



Source: ECBC, Crédit Agricole CIB

The experiences in several EU national covered bonds markets show that market players perfectly discriminate between the different types of covered bond depending on the perceived quality of the posted collateral. This factor helps to explain the asymmetric and independent development across and within EU Member States of public sector loans covered bonds alongside the more traditional mortgage covered bonds. In addition, ensuring that a new class of SME covered bonds has similar prudential and collateral (i.e. for central bank repo operations) treatments than other forms of covered bonds will be essential for the appetite of the potential investor base.

Chart 13: 2012 Covered Bond New issuance by country and collateral type (EURm) incl. change vs. 2011 (%)



Source: ECBC, Crédit Agricole CIB

EU regulated SME covered bonds could be an efficient tool for reducing SME cost of funding. They imply several advantages vis-à-vis the "contractual synthetic SME covered bonds" which are currently emerging and are not subject to specific regulation[16].

Firstly, an EU wide general framework would reduce issuance costs, allows for a better control of the minimum quality of the posted collateral, reduce the overreliance on ratings by credit rating agencies

[16] Commerzbank announced a €5bn program for contractual SME covered bonds that combines bonds issued directly by the bank with the guarantee of an ABS structure with underlying SME loans, thus creating a synthetic SME covered bond.

and finally would not mix the relative simplicity of covered bonds with the complexities of securitization structures. However, the recent emergence of contractual synthetic SME covered bonds programs is a sign of the genuine market appetite for this type of products underlying their potential for increasing SME funding at more favourable rates, both in the short and long term even in markets with relatively favourable bank funding conditions, and especially in more challenging environments.

Medium-Term Recommendation – SMM11 (Commission, Members States, Central Banks)
The European Commission, Member States and Central Banks review the existing regulatory framework to ensure that it is supportive of SME loans forming part of the collateral for covered bonds.

4.8 Private Placements

The development of a private placement loan market for European SMEs has been largely restricted to German Schuldschein issuances that operate quite successfully: the aggregate value of transactions amounted to EUR 8.6bn in 2011[17]. Few other European markets have developed in scale. Instead, European SMEs wishing to tap into these sources of funding often issue in the US where an even more developed market exists: In 2011 the value of traditional Private Placements issued amounted to nearly 45bn of which only 35% were US issuers[18].

A successful private placement market requires a number of aspects which are not yet present in Europe, especially on a pan European basis.

- Private placement loans are not particularly liquid nor is information about issuers readily available. However, private placement loans may represent useful forms of diversification of credit risk from larger bond issuers. The HLEG believes that it is important that progress be achieved quickly on the data and credit scoring recommendations above (see SMM6).
- There is a lack of visibility on new transactions and perhaps some of the portals to ease data availability might be used for this purpose too.
- There would need to be greater standardisation of loan documentation and covenants moving closer to an off the shelf product and governing law consequences well understood by borrowers and lenders alike.
- There may be less favourable withholding tax or other tax treatment for non-quoted securities.
- Some EU Member States and also the US have methodologies for determination of regulatory impact for investments by insurance companies. These would need to be more widespread.
- Accounting treatment of private placement loans would need to be standardised to ensure a level playing field amount borrowers and lenders. In this respect it is worth noting that German Schuldschein certificate of indebtedness are not marked to market in the hands of investors.

Short-Term Recommendation – SMS7 (Members States)
Drawing on successful bespoke private placement markets, e.g. the German Schuldscheindarlehen market, Members States in the EU to take action to establish a national private placement regime in order to further develop direct funding sources for SMEs paying particular attention to the items discussed above.

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[17] Ernst & Young – CFO INSIGHT issue 1 -2012 - Anne-Kathrin Meves - page 36 (http://performance.ey.com/wp-content/uploads/downloads/2012/07/CFO-Insight-01-2012-Schuldschein.pdf)

[18] PP15+ working group on developing a UK Private Placement market – Association of Corporate Treasurers, December 2012 – Section 2.5.1 (http://ec.europa.eu/internal_market/consultations/2013/long-term-financing/docs/contributions/registered-organisations/association-of-corporate-treasurers-annex_en.pdf)

Medium-Term Recommendation – SMM12 (EU, Members States, National Regulators)
The EU working with Members States to undertake joint initiatives to standardise documentation and regulatory and accounting treatment across all EU countries and establish best practice for other areas like taxation and data availability.

4.9 Funds of Loans

In addition to more traditional venture capital and mezzanine funds (funds combining debt and equity or hybrid instruments) there is a recent and growing market interest for direct financing to SMEs by the setting up of specialized debt funds, particularly in EU jurisdictions with banking sectors under stress where a bottoming out of the business cycle has paved the way for business opportunities by newly created debt funds to engage in SME risk.

In playing an immediate role in providing new funding sources for European SMEs, these funds may have the major advantage of not having to deal with impaired legacy assets stemming from previous boom and bust cycle. In addition, the liability structure of these funds with no deposits and only qualified investors on their equity and debt may allow them to enjoy a less stringent regulatory framework vis-a-vis banks in the areas of liquidity and solvency.

However, there are challenges.

- The typical leaner structures of funds and their management limit their ability to obtain efficiently the level of grass root information required from being a significant player in originating new loans other than those targeted to the bigger end of the medium sized enterprises and mid-caps corporates. As a result, progress on the data and credit scoring recommendations cited above will be key (Recommendations SMM4 and SMM5).
- In addition, non-bank financial institutions may face a myriad of differing regulatory rules in extending credit in different countries across the EU. There is no ability to passport this activity from one country to another. Indeed, in some, it may even be necessary to have a banking license before extending credit in that jurisdiction.
- In some instances, credit provided by banks benefits from preferential treatment on the insolvency of the debtor.
- Some regulatory structures for loan funds do not accept funds which plan to include as assets loans originated by the manager as favourably as loans simply purchased in the secondary market by the manager.

Notwithstanding these limitations, the HLEG believes specialized debt funds may well play a role in creating new non-bank links between the supply of funding and the SMEs who require it. In the short term, the funds have a particular role in increasing the efficiency and liquidity of the secondary market for loans to small and medium sized enterprises originated by banks and willing to transfer them to third parties thus providing incentives ex ante for more SME loan origination primarily by the banking sector.

Medium-Term Recommendation – SMM13 (EU Commission)
The EU introduce a single market "passport" of EU loan funds to enable such vehicles to acquire assets and advance credit freely on a cross border basis and not just be able to use (as is currently the case) their passport to generate investment into the fund on the liability side of the fund's balance sheet.

4.10 Public Equity Markets

Lack of equity or lack of ambition on the part of founders mean that many European SMEs do not grow to their full potential or sell out in a trade sale perhaps at the end of their VC investment period. It is key that Europe develop channels for companies to IPO their business to continue to grow creating an exit option for venture capitalists (roughly half the IPOs at the Neuer Markt had a venture capital market background). Such a move can also create a heightened public profile, stemming from increased press coverage and analysts' reports, helping to maintain liquidity in the company's shares, enhance the company's status with customers and suppliers and help diversify and reduce the cost of borrowings.

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

Smaller Equity exchanges and markets are currently most beneficial to the largest SMEs. There is scope for the exchanges to reach many more SMEs including all but the smallest categories but it is acknowledged that direct benefit is likely to accrue to medium sized enterprises or larger small enterprises that are expanding. There is of course the potential for indirect benefits to accrue across all SMEs as other funding sources are freed up.

4.10.1 Experience of Other Exchanges Aimed at Smaller Companies

4.10.1.1 UK

Since its launch in 1995, more than 3,100 companies have joined the Alternative Investment Market[19] (AIM) of the London Stock Exchange in the UK. AIM has a market capitalisation of GBP 69.4bn in equities, with 1,090 companies currently listed, 239 of which are international. This year alone has seen 66 admissions to the market and turnover to September 2013 was GBP 21.3bn. A number of factors have contributed to this success including:

- a balanced approach to regulation which facilitates a smooth transition to becoming a public company
- a network of advisers that is experienced in supporting companies from the time they first consider a flotation, through to helping them raise capital
- a knowledgeable international investor base

4.10.1.2 Germany

The MDAX and the SDAX in Germany, offer access to the stock exchange for middle and small-sized companies. Together, these exchanges cover roughly 100 companies but many of these are larger than the European Commission definition of an SME definition. They represent the equivalent of 17 % of the market capitalization of the DAX 30. A previous attempt in Germany to cater for SMEs was known as the Neuer Markt. It was targeted at young companies in tech and "new economy" industries. On average companies that used this market were much smaller in size. The Neuer Markt was active between 1997 and 2002 peaking in 2000, when the "New Economy" boom reached its top. In those years the number of IPOs in Germany had been rising from 36 of which 10 involved the Neuer Markt to 159 with 120 of those relating the Neuer Markt. Over the same period nominal proceeds of IPOs in Germany had risen from EUR 2.5bn to EUR 25.6bn. At its peak the market included more than 300 companies yet its market capitalization was equivalent to 25 % of the DAX 30. The successor market, known as TecDAX, is the equivalent of 3% of the capitalization of the DAX 30.

4.10.1.3 Ireland

The Irish Stock Exchange's (ISE) is an example of an exchange with a smaller domestic investor base innovating to reach broader markets. While much recognised as a pan-European exchange for listings of debt securities, it has recently announced a co-operation with NASDAQ OMX that now affords dual ISE / US market access to Irish companies enabling them to raise capital more easily on both sides of the Atlantic. The ISE already has dual listing regimes in place with the UK.

4.10.1.4 Non-EU Examples Tel Aviv / Toronto

The Stock Exchanges of Tel Aviv and Toronto are unusual in that they are both profitable; most SME markets are loss leaders for exchanges. Both Exchanges attribute their success to their ability to

[19] http://www.londonstockexchange.com/companies-and-advisors/aim/publications/documents/a-guide-to-aim.pdf

create and incentivise a supportive ecosystem for the types of companies they seek to attract. In the case of Tel Aviv - medical tech and software Israeli companies and in the case of Toronto, the Canadian resource sector dominates. In both cases, the ecosystem is very localised, sector specific and interconnected, therefore analysis, due diligence and ability to promote and distribute to a defined investor base, is very efficient and therefore cost effective. Credible cross sectoral comparisons which are important for any market are also easier to achieve and deliver to investors. Both markets are focussed on local companies. The Toronto Stock Exchange (TSX) and the TSX Venture Exchange (TSXV) have a combined market capitalisation of CAD 2,193bn with 3,731 issuers listed including 1,638 mining sector companies and 378 oil and gas companies. It has attracted 173 new listings in the first 8 months of 2013 14 which were international listings. Tel Aviv has a market capitalisation of USD 184bn in equities; USD 222bn in corporate bonds, with 514 companies listed and 49 cross listed, mainly on US markets.

4.10.1.5 Lessons Learned

Although there are a number of potential financial and economic benefits associated with the development of a deeper and more liquid SME stock market segment across Europe, to date many of the European regulated trading venues that have launched specific SME markets or segments to address the funding needs of SMEs, are struggling to attract companies for a variety of reasons.

- Equity investment remains risk averse, and very concentrated on blue chips. There are few clearly identifiable SME capital pools, dedicated collective investment vehicles and risk diversification opportunities.
- Outside of certain specific sectors, the size at which it is possible for a company to IPO has increased significantly when viewed historically. IPO is therefore less likely to offer an exit option for providers of early stage funding. As the availability of bank and mezzanine debt has decreased, a funding gap has emerged with the only remaining option being a sale process.
- The ecosystem that traditionally supported SMEs on public markets has been significantly eroded (particularly in the last decade), as markets (and players) have become more focussed on blue chips and non-equity. Decreasing numbers of smaller banks, brokerages and trading venues has significantly reduced the incentive alignment to support SMEs whose scale is unattractive to larger players.
- Many SMEs remain nationally, or narrowly geographically, dependent for investment and brokerage support. Differences in investment culture, accounting, language, company law, shareholder protections, and corporate governance norms present significant challenges to cross border investment.
- For some SMEs the regulation and transparency of communication required by the market and the cost, both direct and in terms of management time, continue to represent significant hurdles. Although many EU exchanges have established enterprise markets which seek to reduce the burden associated with public listing, this negative perception continues to be a barrier.
- The minimum equity or issuing market price minima may be in excess of the requirement of the SME. For example, the admission to the Neuer Markt companies had to have equity of at least EUR1.5mn, and the minimum issuing market price had to amount to EUR5mn.

The proposals under MiFID II to create a new subcategory of markets known as SME growth markets are a positive initial step that should support growing companies to access capital markets by raising the profile and visibility of these markets within the investor community. However, this initiative needs to be built upon through a co-ordinated and focused set of ancillary policies at the national and EU levels e.g. the provision of working capital support for exporters, that are designed to incentivise dynamic companies, both SMEs and larger corporations, to continue to grow and scale using the IPO route to raise development finance as opposed to a trade sale exit.

Short-Term Recommendation – SMS8 (Members States)
Member States review the experience of other countries to benchmark best practice in addressing the specific needs of mid-sized SMEs and mid-caps when accessing equity capital markets. Member States should then take action to import applicable best practices.

Short-Term Recommendation – SMS10 (Members States)
Member States investigate (and report on) as a matter of urgency what is required in their market to (re)build an ecosystem comprised of dedicated analysts, brokers, market makers, ratings etc., that can both advise and support issuers and investors, and foster the liquidity of equity growth markets. This will aid in the development of small and mid-cap financing through equity growth markets and will also support the private placement mechanism which relies on the same ecosystem.

Medium-Term Recommendation – SMM14 (National Stock Exchanges)
National Exchanges explore ways to provide dual listings with other EU exchanges with a view to approximating a European platform for stocks.

Medium-Term Recommendation – SMM15 (National Stock Exchanges, Members States)
In seeking to build an ecosystem around SME markets, Member States consider the development of sector specific markets which should not necessarily be limited by geography. This could lead to pan European SME markets in certain sectors.

4.11 Mini-Bonds

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

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

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

Level playing field: a high degree of level playing field for mini-bond issuers across Europe would be achieved if the mini-bonds were to benefit from credit risk mitigation provided by a supranational entity.

Risk diversification: a risk pooling mechanism, e.g. at European level, would have the benefit of providing a much wider risk diversification for the credit risk mitigation provider, therefore cheaper protection cost.

Source of capital: the information disclosure required for the issuance of mini-bonds would make mid-sized SMEs and smaller mid-caps more visible to potential investors. As mini-bonds could be 'convertible', they could attract external capital-sourcing opportunities.

Liquidity: in the long-term coordinate national markets with a view to create a European platform for mini-bonds.

Medium-Term Recommendation – SMM16 (Members States)
To address the specific needs of mid-sized SMEs and smaller mid-caps to have access to debt capital markets Member States to review the experience of other countries for example Germany and Italy in order to benchmark best practice. In the long-term, coordinate national markets with a view to create a European platform for mini-bonds. To address the needs of smaller SME the HLEG encourages the development of mutual issuance platforms that would allow sufficient aggregation for mini bond issuance.

4.12 Supply Chain Finance

It is a fact that purchasers of goods and services in business prefer to pay later rather than sooner. The European Commission approach has been to mandate that all payments should be made on time or as close to on time as is possible. Otherwise penalty interest will be applied. The ground truths in business, however, is that small suppliers will accept any terms to get a contract and that larger customers will exert their influence to suit their own cash flow needs and in some cases exploit that power. Supply Chain Finance gives the opportunity for SMEs to bridge that gap by using credit or indeed true sales of invoices to maintain adequate cash flow. Increasingly Supply Chain Finance providers look at the creditworthiness of the stronger customer rather than that of the recipient SME to assess the pricing of the credit facility involved. This is beneficial to the SME and reflects more accurately the true situation.

Box 6: UK Supply Chain Finance Scheme
The UK Prime Minister met with a number of large UK companies in October 2012 and obtained agreement that they would actively evaluate the implementation of, or continue to offer Supply Chain Finance[20]. The UK Government in conjunction with Citi is putting Supply Chain Finance in place for community pharmacies which claim payments from the NHS for services and goods they provide.

4.13 Other Financing Sources

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

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

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

Short-Term Recommendation – SMS11 (Members States and National Central Banks)
Member States and National Central Banks support peer-to-peer financing and crowd-funding to the greatest extent possible.

[20] https://www.gov.uk/government/news/prime-minister-announces-supply-chain-finance-scheme

5. INFRASTRUCTURE

The recommendations pertaining to infrastructure contain a number of practical suggestions to address information failures and minimize unnecessary uncertainty over the life of infrastructure projects which hinder the participation of long term investors in this market. There are also proposals aimed at minimizing diversity among Member States practices so as to promote an EU-wide infrastructure finance market, and suggestions to develop pooling vehicles for smaller infrastructure projects. As in the case of SMEs, the HLEG views favourably the development of capital market financing options alongside bank financing.

5.1 Introduction

Institutional investors have been increasing their asset allocation to specialist infrastructure funds and direct investments especially since the mid-2000s. Infrastructure funds currently raise about USD 20bn per annum globally, around 90% of which is equity. In recent years, some 250-300 deals have been registered per year by these funds. Half of the global deal volume of USD 100-120bn involves European assets. The main preference of most institutional investors is for lower risk, operating infrastructure assets with predictable, often inflation-linked, cash flows ('coupon clipping'). Some pension funds, especially very large and well-funded ones, are also able to take on construction risks, or should consider so.[21]

The interest is growing in infrastructure debt funds although volumes are still low. These funds currently have a strong focus on Europe, potentially contributing some USD 2bn to infrastructure debt finance there. This is in line with the ratios mentioned above of 10% of the funds being in debt and half of the global deals being centred in Europe.

The institutional investor appetite for infrastructure debt has evolved over the past year with over €35bn equivalent of investment capacity for primarily investment grade, long-dated senior debt being announced and/or available as of 2013. The immediate readiness to invest is primarily led by large insurance companies (e.g. Allianz, AG Insurance, Aviva, Axa, CNP, Legal and General) and larger pension platforms. At the same time, a number of asset managers and banks are offering access to expertise through a combination of infrastructure debt funds, separately managed accounts and bi-lateral lending agreements (e.g. Allianz Global Investors, Aviva Investment Management Blackrock, Hastings Management, JP Morgan, and Natixis).

Taken as a whole, it appears that the institutional market is evolving to provide funding for infrastructure debt with an increasing number of mid-size insurance and pension funds in the process of developing solutions and choosing managers. As a result, the role of the European Commission in further facilitating this market is also changing as the question is no longer one of kick-starting institutional appetite, but rather facilitating the continued growth of the market while recognizing that as these are real assets. Their financial structuring and monitoring are complex by necessity to ensure the stability of long term cash flows.

By definition, infrastructure will always be circumscribed by specific national differences, related not only to legal systems, funding approaches and balance sheet considerations, but also to the regulatory and other bodies responsible for infrastructure oversight. The HLEG has therefore tried to focus on those elements where the European Commission can better facilitate a greater consistency and treatment of infrastructure across national boundaries.

5.2 Facilitating Access to Information on Infrastructure Projects

There is very little consistent pan-European data available with respect to transaction opportunities and progress or to the performance of those transactions once complete. By nature, infrastructure

[21] Blanc-Brude and Ismail 2013
http://cib.natixis.com/flushdoc.aspx?filename=IPE_defining_Infrastructure_under_Solvency_II.pdf

assets are large and sample sizes are therefore smaller than for SME loans. Moreover, most data on infrastructure project finance are proprietary information and often subject to strict confidentiality, hence any movement to create greater transparency is likely to need to be on a voluntary basis from equity sponsors who control legal rights to performance information and governmental agencies who may be able to collect data and render it anonymous.

As mentioned below, specific risk weights for infrastructure are only feasible if regulators receive the necessary information on credit history (e.g. on probability of default, loss given default etc.). Similarly, there are no comprehensive data sets on the asset allocation of investors to infrastructure. One difficulty for data collection is that investors use different routes to invest in infrastructure such as private equity funds, direct equity participation, bonds (Inderst 2010, p.76). However, it is estimated that between 2% to 3% of the USD 91.4trn of global assets managed by institutional investors are allocated to infrastructure, representing between USD 1.8trn and USD 2.7trn.[22]

To increase institutional investor participation in infrastructure financing, global data on infrastructure financing (by sector, type of financing, terms and asset performance) should be shared more widely with regulators, statistical agencies and investor communities in order to build trust and allow for the calculation of realistic risk weights for regulatory purposes. In this context there is an opportunity to build on the work that is being undertaken by the OECD as part of their Institutional Investors and Long Term Investment Project.

Short-Term Recommendation – INS1 (Members States, European Commission)
Member States to collate information on State backed infrastructure projects for the previous 10-15 years and publicise this in a Data Warehouse. A list of the minimum data requirements should be agreed across the EU without delay but Member States can record further details.

Medium-Term Recommendation – INM1 (Members States, EU Commission)
The Commission to work with Member States to establish a pan-European Infrastructure Data Warehouse whose functions would include tracking a pre-set list of covenant performance, collating available information from various EU debt providers and defining the criteria for assessing risk.

5.3 Transaction Pipeline Information

Expanding institutional investor involvement in infrastructure requires accessible timely information regarding everything from the initial requests for bids by procuring authorities to the results of final bidding and awarded transactions. Not only is there no readily available source of information related to all transactions, but also some national governments are unaware of the bidding at a local or regional level. Availability of this information is identified as critical not only to market confidence in future transaction flow, but also the ability of capital market players to derive solutions for creating the critical mass necessary for institutional involvement (currently estimated to be above €100m).

The HLEG notes that the European Commission has historically provided some information and coordinating services primarily to the public sector through the European PPP Expertise Centre (EPEC). EPEC provides a meeting point for governmental authorities to discuss best practices and maintain general statistics on Private Finance Initiatives (PFIs). An expanded role should be created for EPEC or a similar organisation to aggregate, coordinate and disseminate information to lenders/institutional investors providing timely information on bid results as individual PFIs move through the procurement process.

Countries differ in their public-sector and/or private-sector "PPP readiness". Some have an established PPP market in some EU Member States, while in others, undertaking PPPs is difficult in

[22] TheCityUK estimates total assets managed by pension funds, insurers and mutual funds at USD 91.4bn as of June 2013. Global allocation percentage as per expert group estimates.

others. As a rule, governments should prioritise projects according to their highest economic rate of return and separate the decision whether to invest from how to finance and procure.

Also, governments should focus on gaining more information from institutional investors about their needs in relation to long-term financing; for example: in relation to the Dutch PPP market, the Dutch government has been in dialogue with pension funds and insurers in order to get informed on their specific needs. Such initiatives will make policy tools more effective, which in turn will contribute to an effective long-term investment framework.

Short-Term Recommendation – INS2 (EPEC)
EPEC or a similar appropriate body develop and manage a pan-European real-time database of infrastructure projects in planning and procurement phases.

Short-Term Recommendation – INS3 (Members States, Industry Associations)
Organise an annual forum where governments and institutional investors can engage in a dialogue and find solutions for the long-term financing of infrastructure projects. The first of these should take place in Q1-2014 at the latest.

5.4 Developing a Strong PPP Market across Europe

Governments across Europe have an important role to play in committing to unlock new infrastructure investment and in addressing uncertainty over the future supply or pipeline of infrastructure projects. Without a proper pipeline of (suitable) deals, long term investment cannot be enhanced. Representatives of both institutional investors and the capital markets sector highlighted that building investor confidence in transaction flow, so that they are both willing to commit their savings pool and invest in building the new capabilities required to provide finance for infrastructure projects necessitates a greater degree of transparency in the pipeline of projects at the national and supranational levels.

Consequently individual Member States should develop aggregated national investment plans at as long a time horizon as they can commit, and at a minimum a three year time horizon. In preparing these plans those individual Member States could also give some consideration to how those projects could, in theory at least, be funded in order to highlight project finance, project bond and government-guaranteed financing opportunities. These national plans would also involve central administrations undertaking a co-ordination role in terms of aggregating the investment plans of local and regional governments, in order to provide institutional investors with a cumulative assessment of the potential future demand for project financing over a set time period. Ideally, such plans should have a continuous character and not be changed from time to time, for political or other reasons. Also, coordination of such plans between the various Member States is desirable and may well improve the investment opportunities of international investors. A similar aggregating role could be played by the European Commission in aggregating individual national plans on the basis of an agreed sectoral categorisation. Additionally the European Semester could be useful in assisting Member States to stick with their national investment priorities against competing short-term demands arising from national politics.

Short-Term Recommendation – INS4 (Members States, European Commission)
Member States develop and communicate national investment plans, with a minimum three year time horizon. The European Commission will aggregate individual national investment plans on the basis of agreed sectoral categorisations.

Medium Term Recommendation – INM2 (Members States, European Commission)
The European Commission are well placed to play a lead role in aggregating and publicising individual national infrastructure investment plans. The European Commission should work with Member States on this.

Sudden changes in policy with regard to the regulatory approach for a specific sector driven by short-term political and/or fiscal considerations, for example changes to the financial incentives regime for new renewable energy projects, will reduce investor appetite in relation to such projects beyond the borders of the specific Member State making those changes. Termination compensation in case of sudden/interim regulatory changes is an important aspect that needs to be considered. Additionally given the relatively small size of the infrastructure investor community the creation of uncertainty in relation to a specific sector in one jurisdiction can relatively quickly exert a negative influence on confidence in other jurisdictions (particularly Member States facing similar economic and fiscal pressures).

Medium-Term Recommendation – INM3 (Members States)
Governments ensure that the national regulatory environment provides for a stabilisation of tariffs over the life of long-term projects as this reduces investor uncertainty and facilitate long-term investment.

5.5 Adjust Public Procurement Procedures to Attract More Investors

Many procurement systems seem to be biased towards preferring the cheapest bid rather than the one that offers highest value for money, which makes it more difficult for public infrastructure projects to be procured as PPPs. National PPP units should identify opportunities to strengthen the concept of "value for money" (appropriately defined and seen from the perspective of the off-taker) and propose changes to national procurement legislation accordingly.

Without any doubt, capital market financing of an infrastructure project is a highly specialised and technical activity consisting of a web of complex and interdependent contracts. Successfully initiating and executing a market-funded infrastructure project requires a high level of expert skills, planning capacity and project management capability within both the public and private sectors. For the public sector this further increases the importance of ensuring that national procurement authorities are well staffed with the appropriate expertise to structured and conduct project specific transactions. A commitment to working with the relevant national and European centres of excellence, such as EPEC and increased exchange of information and good practice between networks of officials across EU Member States would certainly assist in building the institutional capacity of public organisations in this key policy area.

Short-Term Recommendation – INS5 (Member States)
Procuring authorities make greater use of "value for money" analysis when evaluating infrastructure projects delivery method and propose changes to national procurement legislation to disseminate the practice. Continued sharing of best practices via centres of excellence such as EPEC should be leveraged to strengthen skills with the procuring authorities.

Over and above prudential and other financial regulation matters and tax matters, the expected average return on investment and its variance depend on the legal and regulatory environment for infrastructure, both in terms of land planning and licensing and in terms of sector-specific regulations that shape the cash flows generated by infrastructure assets.

Legislation should be such that the risk of delays is kept at a reasonable minimum. Also, procuring authorities should ensure that equity investors do not get penalized for delays in permitting or challenges to existing permits caused by the procuring authorities.

Given the scarcity of bank lending to infrastructure projects, governments need to take action to ensure that there is a level playing field between bank financing and bond financing options. In particular, procurement processes should allow for both dual bank/bond routes in the tender process and split financing arrangements. To bring more bidders forward in a difficult market, it might also be necessary to allow for variable credit spread pricing.

Box 7: Canadian PPP market
Although there are variations in applicability across the various provinces, the Canadian PPP market has adopted a risk sharing approach to bond spread risk i.e. where bond spreads 'unexpectedly' balloon at financial close. Under the Canadian model, the private and public sector stakeholders agree a basket of comparable projects prior to financial close. This basket then serves as a reference point for bond spreads at financial close. If the movement between forecast and actual spread of the project's bond is broadly reflected in movement of the spreads of the bonds in the basket, the public sector bears the cost impact. However, if the movement in the project's bond spread is not reflected by the spreads of the bonds in the basket, the cost impact is passed on to the private sector.

Medium-Term Recommendation – INM4 (Member States, Procuring Authorities)
Procuring authorities to limit delays for finalizing planning and permitting post financial close. Procurement policy should also reflect the increasing presence of non-bank solutions in their approach to funding requirements.

A problem that Market participants regularly encounter is the degree of inconsistency in the implementation of EU procurement rules at the national level. The HLEG urges the European Union to ensure that information and knowledge on best practice in procurement and project execution are spread easily across countries and sectors, for example through the European PPP Expertise Centre (EPEC) or a similar organisation. Over and above formal advice, some of the EIB's accumulated specialist *infrastructure* knowledge spills over via the EIB's participation in infrastructure deals.

By developing a "standard" set of documents with the advice of different market participants, the EU will increase the likelihood of creating a "financeable approach" within the standards. The EIB are well placed to lead this effort and take a more proactive role in providing both legal and technical expertise and guidance on good practice in the public procurement process and in project execution. This could include promoting the adoption of standard forms for tender documents or guidance on how to run procurement competitions. This could also serve to demonstrate to national authorities the potential advantages associated with the adoption of EIB (EPEC) endorsed best practice in public procurement.

Examples of areas which might be more readily standardized are the Termination Provisions and the Timing of procurement and closing.

Short-Term Recommendation – INS6 (EIB)
The EIB to work with public and private sector representatives to create a "standard set of documents" which will then be used as the basis for tendering projects at all levels. The aim is to achieve a more standardised approach to PPPs across the EU and thereby encourage and facilitate greater interest in the market from investors.

5.6 Channelling Pools of Capital into EU Infrastructure Projects

Credit quality of infrastructure projects is an important aspect for the supply of finance, especially from institutional investors. On the one hand, the investors would like to increase their asset allocation in infrastructure in search of higher yields given the current environment of very low interest rates. But on the other hand, many pension funds and other institutional investors are bound by their investment strategy and risk-return profiles or even by their statutes to invest only in selected infrastructure projects (or infrastructure funds) meeting strict minimum credit quality standard e.g. corresponding to investment grade rating at least.

For projects that do not match these requirements there is a role for governments, the European Commission and the EIB to design credit enhancement vehicles to allow institutional investor participation in senior tranches of debt which would not otherwise achieve investment grade equivalent ratings. While national government initiatives could in principle achieve that goal in highly-rated countries, national solutions are not available in countries with badly hit sovereigns.

Such credit enhancement could take the form of insurance of the availability payments, or alternatively direct guarantees or first loss protection on the senior debt.

The group therefore recommends considering a pan-European institutional vehicle that would provide a European Infrastructure Guarantee Facility. This institution could be funded by a combination of the public sector; EU institutions and private sector investment. The vehicle would need to have the capability to provide a controlling creditor role to manage its exposure to the project's risk where it is directly guaranteeing the debt. Furthermore, the vehicle would need to demonstrate sufficient autonomy from individual governments so as to address potential conflict of interest concerns. Finally, the vehicle should focus on supporting markets where institutional investor appetite is more limited while taking care not to crowd-out developing appetite in other markets where there is already an excess of demand.

Such a vehicle would benefit from taking stock of insights held by similar national initiatives developed in the past or that are currently being developed. An example is the UK Guarantee Scheme for Infrastructure Projects, which proves that significant credit enhancement can be achieved with partial guarantees as long as the conditions for triggering the guarantee are not overly restrictive (see box 7). However, a number of market participants will prefer taking certain projects without the guarantee in order to access the higher yields available hence the UK like other member states will need to manage the careful balance between inciting appetite and crowding it out.

Box 8: The UK Guarantee Scheme for Infrastructure Projects

In April, the U.K. government guaranteed a GBP 75m loan for a U.K.-based power generator. The loan is intended to co-finance a GBP 700mn project to convert some of the units at the 4,000 megawatt plant to burn biomass. This project is the first to be guaranteed by the U.K. government through its UK Guarantee Scheme, which was launched by HM Treasury in July 2012. The UK Guarantee Scheme has been introduced to avoid delays in UK infrastructure projects that may have stalled because of adverse credit conditions. Up to GBP 40bn of guarantees can be offered under the scheme. Projects can be considered from a wide range of infrastructure sectors including transport, utilities, energy, and communications. A major rating agency has indicated that the scheme effectively assigns the UK sovereign rating to infrastructure project guaranteed debt instruments.

Medium-Term Recommendation – INM5 (Members States)

Members States working with the appropriate EU level institutions to establish a pan-European institutional vehicle that would provide a European Infrastructure Guarantee Facility for non-investment grade countries or those with no history of PPP. This institution could be funded by a combination of the public sector; EU institutions and private sector investment. This vehicle should have the capability to provide a controlling creditor role and would focus on supporting markets where institutional appetite is more limited or virtually inexistent.

The traditional banking route is thought to offer execution cost advantages over capital market financing. However, developing active capital markets (public or private placement market, rated or unrated) requires diversification of the investor base. In the medium term, once this distribution route is more developed, pooling a sufficiently large number of smaller projects could open securitisation opportunities. Bonds should then be distributed as widely as possible in order to safeguard liquidity. It is understood that the cumulative value of such a pool should exceed a critical mass to make aggregation financially attractive to capital market investors. It could be considered to start with homogeneous, mono-sector (high-quality) assets to make the analysis simpler. At a later stage, more diversified pools may then be used.

Optimal properties of projects in the pool would include:

- Single sector to minimise complexity of credit assessment and loan portfolio administration;
- Single jurisdiction to minimise complexity through regional variability in enforcement law, tax and accounting practices; and

- Diversification being achieved through variability in the subcontractor / supply chain supporting each project.

Ideally, investor interest in the bonds issued by these pooling vehicles would be broad in order to achieve pricing tension and associated efficiency. Striving for relative simplicity through consistency in the sector and jurisdiction of the underlying projects is therefore an important consideration.

The UK is currently looking to test some innovative cases of pooling that use aggregator funding vehicles as a pooling option to enable capital market funding of smaller infrastructure projects in the area of school accommodation. Other European countries should consider learning from the UK experience and possibly replicate it nationally. Key features of such an approach could include:

- A single procuring authority, a shorter procurement process and standardized documentation;
- Standardised loan arrangements;
- Credit enhancement at the aggregator level (with underlying projects required to reach investment grade as a minimum); and
- Protection to ensure aggregator is exposed to project risk and insulated from market movements / refinancing risk at the point when it converts all of the aggregated short-term debt facilities into a single long term debt obligation.

Giving aggregators access to funding from the EIB, bank debt and debt capital markets would be helpful. Access to the capital markets would be most effective by concentrating on public bond issues with robust BBB range / single-A range rating and of benchmark size GBP 250m. The ultimate decision on whether to credit enhance and, if so, how, would belong to the aggregator.

Medium-Term Recommendation – INM6 (Members States)
Member States to consider developing customized pooling vehicles to stimulate capital market financing of smaller infrastructure projects. The UK aggregator funding model offers some recent experience to draw on.

5.7 Strengthen Multilateral Banks Involvement Where Needed

The Project Bond Credit Enhancement (PBCE) facility at the EIB is in the process of demonstrating its value in attracting a broad range of institutional investors to transactions which might otherwise have difficulty being financed. The recent success of Watercraft Capital (Castor gas storage in Spain) is a prime example. That transaction was further facilitated by the EIB simultaneously investing in a pari-passu piece of senior debt in turn reinforcing the absolute alignment of interest between the EIB and third party investors. However, the PBCE facility is currently restricted to Trans-European transport networks (TEN-T), Trans-European energy networks (TEN-E) and telecom projects (excluding power generating renewable projects), whereas the EIB has a much wider breadth of transactions in which they can participate. Given the number of national projects potentially struggling for funding, the HLEG would suggest that an expansion of the PBCE availability would be a positive catalyst to developing investor appetite beyond TEN-T, TEN-E and telecom projects in sectors such as social infrastructure.

Medium-Term Recommendation – INM7 (EIB)
The EU-EIB Project Bond Mechanism should be extended to other infrastructure sectors reflecting the broader expertise of the EIB.

Annex A – REGULATORY ASPECTS RELATED TO SECURITISATION

In the course of its work, a number of other points were made to the HLEG about which some of its members felt strongly indicating how current regulatory rules inhibit the development of desirable SME securitisations. Consideration of the validity of such assertions is beyond the mandate of the HLEG. Given the desirability of seeing additional high quality simple and transparent securitisations, it was decided that these assertions should be added as an Annex A for consideration as to their merit or otherwise by the relevant authorities.

- CRD IV and CRR do require increased burden for SME securitisation vs direct SME lending for the same or even a greater risk [23]. Also and for example, the requirement to have loan by loan data for SME securitisation is difficult to implement technically (by the sheer size of information required, the timing of collection, the regional diversity, etc.).
- LCR: the definition of high quality assets to cover short term funding needs is very narrow. For securitisation, only RMBS rated AA and above and with LTV below 80% are included as high quality assets. Whilst the evidence for the discrimination against securitisation papers is not clearly established, the regulation forgets its "self-fulfilling" dimension. Excluding SME or Infrastructure related securitisation from the liquidity bucket can only perpetuate a vicious circle and overly penalize the related transactions impacting negatively the funding of SME. In the same vein, the treatment of back-up liquidity lines provided to ABCP vehicles is at best unclear and at worst heavily penalising transactions that have provided over time and successfully an effective answer to corporate in search of working capital funding solutions (among other objectives) to corporates.
- BCBS 236: for SMEs, regardless of the level of risk weight, the rating agencies in Europe are extremely conservative. They require very high attachment points for good ratings (AAA) and also impose country caps on ratings. As a result, the capital implied by all the tranches, whether one uses the existing RBA or the RRBA is a multiple of the underlying risk weight. As long as capital in securitisation tranches is linked to rating agencies view of the risk, there will be no appetite from banks to buy securitisation of SMEs. In addition, under the proposed SSFA and MSFA formulas, the capital will be multiplied compared to the current SFA formula. For senior tranches, given the high attachment points and the resilience of SME pool performance during the crisis, the proposed new risk weights are not justified. See Appendix for details.
- CRA3: Obligation to have a second rating provided by a rating agency with a specific maximum market share for structured transactions will have a detrimental impact as it reinforces the reliance on rating agencies (instead of relying on investors own analysis) whilst at the same time making the compliance with the rule difficult to fulfill. It would be better to favor disclosure of information made easily available to investors and market participant be it line by line or by stratifications, emulating the model developed by EDW, than maintaining the request for RA involvement under conditions that seem to contravene the need for less reliance on RA. To be noted: this is not anymore an option in some market.

So be it under the angle of the regulatory capital consumption (including Solvency II known approach), the increased operational constraints or the over penalising liquidity treatment, Securitisation in general and SME Securitisation included is discouraged.

The proposals above fail to recognise that the vast majority of European securitisations have demonstrated incredible credit resilience and strong price performance.

Additionally, the proposals don't take into account the efforts carried out since the onset of the crisis. For instance, the public and private entities have developed initiatives that aimed at encouraging best practice, fostering transparency and on that basis, at reviving market dynamism. The Eurosystem loan-level initiative should be mentioned as a good example. But as long as the message or the

[23] "Capital charges for exposures to SMEs should be reduced through the application of a supporting factor equal to 0,7619 to allow credit institutions to increase lending to SMEs"

perception emanating from the regulators or policymakers is not more decisively positive many investors will remain on the side-line.

As for industry-led initiatives, a reference to PCS could be made.. The heart of the PCS initiative is the PCS Label which can be awarded to securitisation issuance meeting the criteria set by PCS. The Label criteria focus on issues of quality, transparency, simplicity and liquidity.

For more information about the eligibility criteria or the governance of the label, please refer to http://pcsmarket.org/home/ .