




supporting investors and growth firms

A BOTTOM-UP APPROACH TO A
CAPITAL MARKETS UNION

THOMAS AUBREY,
RENAUD THILLAYE
AND ALASTAIR REED



**SUPPORTING INVESTORS
AND GROWTH FIRMS**

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EXECUTIVE SUMMARY

The European commission has made its top priority jobs and growth. And for good reason. Growth remains sluggish across most parts of Europe, with a growth forecast of 1.7% for the EU and 1.3% for the eurozone for 2015. Unemployment is expected to remain at stubbornly high levels of around 10%, and investment remains subdued.

To break out of the cycle of economic underperformance, the commission has undertaken two major initiatives: Jean-Claude Juncker's Investment Plan for Europe and the Capital Markets Union (CMU). While the former is expected to have an impact in the short term, the CMU is a more ambitious and longer-term project. To work, the CMU needs to place the emphasis on improving the connections between savers, investors and companies. EU policymakers should focus on firms that have ambitions to innovate and expand since it is this particular group that drives up the rate of job creation and growth. The CMU's goal should therefore be to do whatever it takes to support firms in their growth ambitions.

This project analysed the challenges faced by high-growth and innovative firms in France, Germany, Italy, Poland, Sweden and the UK. Together these economies account for nearly 70% of the

EU's GDP. The research was based on detailed data analysis of access to finance challenges faced by high-growth and innovative firms, as well as interviews with a wide range of public- and private-sector stakeholders.

Despite the diverse cultures, institutions and conditions of the six reviewed member states, a number of common concerns emerged for growth firms, investors and banks:

- Europe is severely lacking equity financing. Poorly developed tax and insolvency regimes for investors remain critical drivers behind this shortfall. Although national governments are aware of these issues, some raised legitimate concerns on the difficulties of funding this type of structural reform. Furthermore, public policy to try and increase funding levels for venture capital do not appear to be working.
- There is too little focus on the things that work well and a lack of mutual learning between member states to take advantage of this. Examples of best practice ranged from business support schemes, to the development of local ecosystems, the value of credit mediation schemes for firms rejected for finance and more business-oriented education systems. Concerns also remain that some existing rules of the single market are not being enforced effectively and that financial services regulation has been excessive and sometimes contradictory since the financial crisis.
- Concerns were raised that banks may have less access to the capital market to diversify their sources of funding and help transfer risk due to punitive charges for high-quality securitisations.
- There was little appetite that Europe should abandon its traditional banking model, but there was strong support for a complementary system of financing focussed on specific areas of the capital market.

In order to address these major concerns, the European commission should focus on the following key areas and recommendations.

Improve the Environment for Investors in Growth and Innovative Firms

This is widely considered to be the most important priority to promote investment and jobs across Europe. Although many of the powers to unlock this remain under member states, the EU needs to play a central role in supporting these changes.

- ***Recommendation 1: Encourage the introduction of tax incentives for business angel and venture capital investors.*** Promoting a much wider equity culture in all member states should feature highly in the European Semester. Country-specific recommendations should push forward tax incentives for business angel and venture capital investors. These measures should qualify as structural reform and therefore not constitute a breach of the Stability and Growth Pact's fiscal rules. In order to ensure that the implied extra borrowing would not lead to rising interest rates and the cost of servicing debt, EU leaders should consider again some form of bond guarantee programme. Furthermore, clearer guidance on state aid rules for tax incentives would provide certainty for investors in riskier firms, and a reduction in the minimum requirement for retail investors to invest in riskier firms would also help to promote a deeper equity culture.
- ***Recommendation 2: Expand the role of the European Investment Fund (EIF) to provide long-term loans to newly-established small business investment companies (SBICs).*** The European commission should work with the European Investment Fund to set up a new SBIC scheme to provide low-cost, fixed-term loans to registered investment funds. As has been demonstrated in the US, such a scheme would be self-financing and not require extra public resources in the medium term. These loans would allow investors to provide a combination of debt and equity to firms. This mixed mode of financing will increase the profitability of returns from riskier investment due to earnings from interest. Restrictions on the EIF investing in business angel syndicates should also be

removed, as many business angel investments are being increasingly made through syndicates which help spread risk.

Raise Insolvency Standards and Permit a Culture of Failure

Insolvency standards across the EU have not kept up with developments in the knowledge economy. Many jurisdictions still do not permit debt restructurings, out-of-court settlements and the use of fast-track procedures, which are crucial if businesses are to survive. Furthermore, in many European jurisdictions the discharge period for paying back debt is too long which stigmatises failure and discourages entrepreneurship. Without minimum standards, it is highly unlikely that cross-border investment levels will increase, particularly in knowledge-intensive industries, which are central to the growth of investment and jobs.

- *Recommendation 3: Ensure that the European commission's minimum standards on business rescue and giving entrepreneurs a second chance are a key priority for the Capital Markets Union (CMU).* The recommendations set out by the commission in March 2014, requesting that member states put in place appropriate measures, need to become a key priority for the CMU. The commission should prioritise further action, including a directive, if minimum standards are not in place within a reasonable period and should also consider reducing the discharge period to two years.

Ensure Best Practice Is Implemented Across the EU, and Enforce Existing Rules More Effectively

The European commission should encourage member states to adopt best practice with regards to competitiveness and facilitate the learning process across member states. The commission needs to integrate policy across departments more effectively, ensuring that existing rules are enforced, and that existing rules are of benefit.

- ***Recommendation 4: The commission should actively support implementation of best practice through the European Semester, and enforce existing rules that are of benefit.*** As part of the remit to improve competitiveness, the commission needs to improve the process by which it identifies policies that successfully support growth and innovative firms. In particular, it should make greater use of the European Semester to advance the Capital Markets Union's objectives and think more creatively about reform incentives for member states. REFIT should also become central to the CMU initiative. Its remit should be strengthened to reduce unnecessary rules, and this should be accompanied by an improved impact-assessment procedure for each stage of the legislative process.

Promote High-Quality Securitisation to Provide More Flexibility for Banks to Lend to Firms and Households

The work that the commission has started on high-quality securitisation was well received and should remain a key priority for the CMU initiative.

- ***Recommendation 5: Reduce risk-weights for high-quality securitisation and apply these rules to synthetic transactions.*** Risk-weights for high-quality securitisations should be reduced to be more in line with on-balance-sheet assets. This should provide banks with greater flexibility in the medium term to lend to households and firms. Applying these rules to synthetic securitisations would also support greater risk transfer.

In summary, the CMU initiative needs to focus more on the broader business environment for high-growth and innovative firms rather than on individual financial instruments. Whilst improvements in the Prospectus Directive, promoting a pan-European private placements market and building an SME credit database (as suggested in the commission's Green Paper) might help, their

impact on supporting high-growth and innovative firms is expected to be more limited. The success of the CMU will be measured by the increase in the rate of investment, job creation, and the number of globally successful firms. Policies therefore ought to prioritise how this can be achieved.

UNDERSTANDING THE NATURE OF THE CHALLENGE

The European commission has made it clear that its priority is jobs and growth. Investment remains sluggish across the EU, as does underlying trend growth. Two particular initiatives have emerged to symbolise this direction: the Investment Plan for Europe and the Capitals Market Union (CMU). The Investment Plan is meant to be rolled out over the period 2015 to 2017 while the CMU is a longer project that will span the commission's mandate.

The thrust of the CMU was expressed in Jean-Claude Juncker's inaugural speech in the European parliament on 15 July 2014:

Over time, I believe we should complement the new European rules for banks with a Capital Markets Union. To improve the financing of our economy, we should further develop and integrate capital markets. This would cut the cost of raising capital, notably for SMEs, and help reduce our very high dependence on bank funding. This would also increase the attractiveness of Europe as a place to invest.¹

As reflected by the Green Paper published in February 2015 on CMU the commission is concerned that small and medium sized enterprises (SMEs) across Europe, which provide the bulk of new jobs and growth firms of the future, are not able to access sufficient capital. The commission also referenced the fact that SMEs in Europe are over-reliant on bank financing for capital.

The financial crisis demonstrated the vulnerability of banking led finance as credit became severely constrained. Banks in Europe provide around 80% of the funding for SMEs whereas in the US it is around 50%.² Concerns were also raised that insufficient capital was being channelled into long-term projects, particularly infrastructure. In response to these issues, the commission argues that a deeper and more liquid European capital market is required and has proposed a number of policy responses to address this. These include policies on high-quality securitisation, improvements in the Prospectus Directive, pan-European private placements markets as well as an SME credit database and arrangements for long-term investment funds.

This study is a contribution to the CMU debate from the specific angle of growth and innovative firms. It does not look at the current infrastructure deficit and how this might be overcome through new financial products and regulatory changes. Although a dramatic increase in infrastructure investment could indirectly support SMEs, through driving demand, our analysis has concentrated on the challenges faced by high-growth and innovative firms given their role in job creation and in driving up productivity growth.

THE CASE FOR SUPPORTING HIGH-GROWTH FIRMS

Understanding the challenges faced by innovative and high-growth firms ought to be a much higher priority from a policy perspective. Across the EU, SMEs employ two in every three people and produce 58 cents in every euro of value-added.³ However what matters more for future economic growth are those businesses that innovate, grow and export. These are the businesses that will create the jobs of the future and drive productivity growth, which is central to improving living standards across the EU. In terms of access to finance, growth firms tend to be less profitable in the short term and therefore are generally more dependent on external finance. But if these innovative and high-growth businesses are unable to finance

their expansion plans, then underlying productivity growth and job creation is likely to be stunted.

Taken as a whole, SMEs have lost jobs in recent years across the EU, whilst seeing modest gains in value-added. Between 2008 and 2013, SMEs across the EU lost 1.96 million jobs (2.1%), despite the number of SMEs rising by around 350,000 (1.7%) and value-added increasing by €44bn (1.2%).⁴ However, when the overall set of SMEs are dissected in more detail, it is clear that younger firms are net job creators overall. An OECD study comparing the contribution of firms to employment growth across 18 (mostly EU) countries over a 10-year period found that in aggregate firms that are younger than five years old were net job creators, whereas firms older than five years old lost more jobs than they created (see Figure 1.1).

Even the aggregate figures of young firms mask the importance of a small cohort of high-growth and innovative businesses for

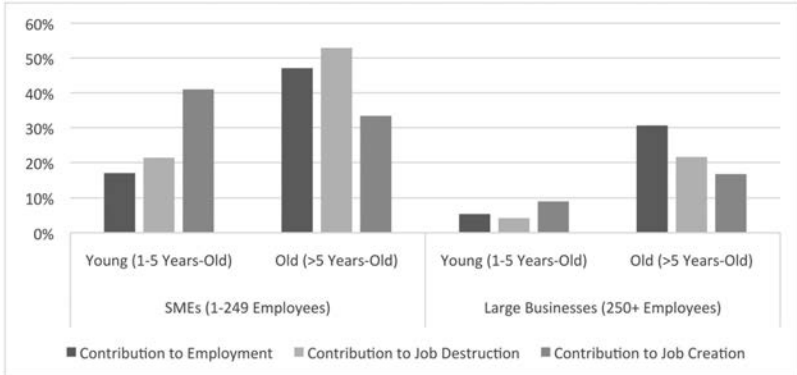


Figure 1.1 Share of Total Employment, Job Creation and Job Destruction by Firm Age and Size Across 18 (Mostly EU) Countries, 2001–11. The period covered is 2001–2011 for Belgium, Finland, Hungary, the Netherlands, the UK and the US; 2001–2010 for Austria, Brazil, Spain, Italy, Luxembourg, Norway and Sweden; 2001–2009 for Canada, Japan and New Zealand; 2001–2007 for France; and 2006–2011 for Portugal. Sectors covered are: manufacturing, construction, and non-financial business services. *Source:* Criscuolo, C., P. N. Gal and C. Menon (2014), “The Dynamics of Employment Growth: New Evidence from 18 Countries”, OECD Science, Technology and Industry Policy Papers, No. 14, Figure 15, p. 38, available at: <http://dx.doi.org/10.1787/5jz417hj6hg6-en>.

economic growth. Most SMEs and start-up businesses have a limited impact on employment and GDP. Fewer than 4% of all UK start-ups have 10 or more employees 10 years later.⁵ Furthermore, the median annual sales of a six-year-old firm in the UK is less than £23,000, while just 1% of UK businesses have sales of more than £1m six years after formation.⁶

It is a small cohort of high-growth businesses that are responsible for a large proportion of employment growth. An OECD study of 11 countries found that high-growth firms – defined as those with average annualised employment growth greater than 20% over a three-year period – accounted for fewer than 10% of firms in all 11 countries but created up to two-thirds of all new jobs (see Figure 1.2). In the UK, high-growth firms accounted for 6% of firms that survived over the period and had 10 or more employees, yet they accounted for 64% of all jobs created by surviving firms (see Figure 1.2). These findings are supported by a recent study by the Enterprise Research Centre that tracked start-up firms in the UK from 1998 to 2013. The report found that around 6% of the firms that survived the 15-year period yielded 40% of all the jobs.⁷

Economies with a more dynamic population of businesses, with both a higher proportion of businesses growing and shrinking, also tend to support faster productivity growth. A cross-country analysis by Nesta, which explored the relationship between total factor productivity growth (TFP) by industry in each country and the share of firms that do not grow, found that industries with a 5% higher share of non-growing firms are associated with 1% lower annual TFP growth.⁸ The importance of a more dynamic population of businesses is attributed to three factors: evidence of a more competitive environment; increasing the rate at which resources are reallocated to more efficient uses; and evidence of a higher level of experimentation and innovation.⁹

To ascertain whether new EU initiatives will help support high-growth and innovative firms, it is necessary to understand to what extent high-growth and innovative firms are impacted by any underlying structural issues where they operate.

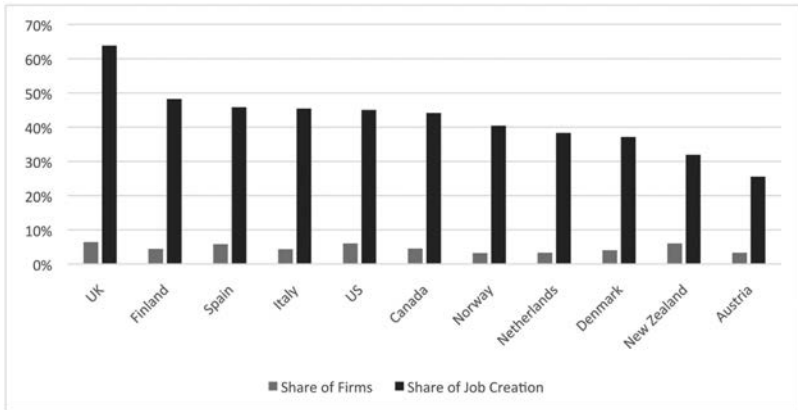


Figure 1.2 Share of High-Growth Firms and Contribution to Job Creation by Country, 2002–05 (%). High growth firms (HGFs) are enterprises with 10 or more employees in the beginning of the observation period with average annualised employment growth greater than 20% over a three-year period (2002–2005). Share of firms corresponds to the share of HGFs in the total number of surviving firms in the country with ten or more employees at the beginning of the period; share of employment corresponds to the share of employment of HGFs in the aggregate employment of surviving firms with 10 employees or more at the beginning of the period; share of job creation corresponds to the share of jobs created by high-growth firms relative to all jobs created by surviving firms with ten or more employees during the three-year period 2002–2005. *Source:* Bravo-Biosca, A (2010), Firm Growth Dynamics Across Countries: Evidence from a New Database: Data Appendix: Supplementary Tables and Figures, Tables N. 6 and N. 7, p. 108.

STRUCTURAL ISSUES ACROSS THE EU

The complexity of the European institutional landscape – with certain powers delegated to the EU and others retained by member states – creates a number of challenges for firms and policymakers. Policymakers need to seek the right balance between growth and consumer protection, and between enforcing the single market’s rules and allowing diversity.

More specifically to high-growth and innovative firms, the environment within which they operate differs across the EU which has implications for their ability to scale up and become global leaders. These factors include:

- Impact of financial regulation on growth
- Enforcing the existing rules of the single market
- Insolvency law
- Allocation of capital

Impact of Financial Regulation on Growth

Since the 2007–2008 financial crisis nearly 40 legislative and non-legislative measures have been initiated at EU-level, in line with international commitments, to strengthen the stability of the financial system. There are now concerns that the emphasis on financial stability has impacted the ability of financial institutions to finance the real economy.

The EU's post-crisis legislation on financial services has affected both bank and non-bank finance actors, with the intention of stabilising financial markets in the event of a future crisis. In particular, the wave of regulation with regards to securitisation may have had a negative impact on growth by preventing banks from accessing the capital market to diversify their sources of funding and for risk transfer. As the European commission has recognised, implementing a high-quality securitisation framework will help diversify funding sources and unlock capital, making it easier for banks to lend to households and businesses. Crucially the commission has agreed to look at whether the capital requirements for banks and investment firms adequately reflects the actual risks attached to high-quality securitised instruments.¹⁰

Given that capital charges should be risk-based in accordance with the current regulatory approach this is an important step. The current premium for investing in the senior tranche of a securitisation structure compared to a similarly rated corporate bond does not correspond to the actual underlying risk. There is therefore an argument that current charges for senior high-quality assets that have been securitised are set at a level well-beyond what is needed to absorb the worst-case loss experience.¹¹

Paradoxically, the recent wave of new legislation has taken place while the EU has become increasingly concerned about the

Table 1.3 EU Legislation in Financial Services Since the 2007–08 Financial Crisis

Supervision	<ul style="list-style-type: none"> • Establishment of supervisory authorities such as ESMA, EBA and EIOPA and the European Systemic Risk Board • A single supervisory and resolution framework for banks referred to as “Banking Union” • Tighter rules for credit rating agencies
Transparency, Prevention and Resolution	<ul style="list-style-type: none"> • Prudential requirements for banks (CRDIV/CRR) • Resolution of banking crises and deposit guarantee schemes (BRRD/DGS) • Tighter regulatory frameworks for: hedge funds and private equity managers (AIFMD); derivatives (EMIR); short selling and credit default swaps; and trading platforms (MIFiD II) • Insurers: Solvency II (prudential requirements) and Omnibus II (supervisory framework) • Revised rules for occupational pension funds (IOAPS, pending) • Transparency of shadow banking and prudential requirements for money market funds (pending)
New Investment Instruments	<ul style="list-style-type: none"> • European Venture Capital Funds • European Social Entrepreneurship Funds • European Long Term Investment Funds (ELTIFs, pending)

Sources: AFME (2014), *An Agenda for Capital Markets Union*, available at: <http://www.afme.eu/Documents/Discussion-papers.aspx>; European Commission (2015), *Progress of Financial Reforms*, available at: http://ec.europa.eu/finance/general-policy/policy/map_reform_en.htm.

regulatory burden. Following similar initiatives for “better regulation,” the European commission launched the Regulatory Fitness and Performance, or REFIT, programme in 2013. Under REFIT, the commission is screening the entire stock of EU legislation on an ongoing and systematic basis to identify burdens, inconsistencies and ineffective measures, and to initiate corrective actions.

In the field of financial services, there is consensus for a pause in EU legislative initiatives as many technical standards have yet to be developed on the back of the 2009–2014 legislation. To date there has been limited focus on the impact of these reforms on jobs and growth.¹²

Enforcing the Existing Rules of the Single Market

Concerns remain with respect to sections of the single market that have not been effectively implemented. For a single market to

function effectively, enforcing existing rules remains paramount. However, in certain areas of financial services, national bodies continue to introduce extra requirements above and beyond those which have already been deemed acceptable at the EU-level. A more robust enforcement of existing rules would therefore improve the competitiveness of the European economy.

Examples that were raised in the course of this study included incremental fees imposed by some member states on investment products sold cross-border despite already having an EU passport in place. This would appear to be contrary to the aim of the single market, discouraging rather than encouraging cross-border investment.¹³ Of potential greater magnitude is the ongoing discrimination of withholding tax on cross-border dividends, despite the European Court of Justice ruling that levying different rates on domestic and foreign funds breached the EU principle of free movement of capital.¹⁴ This still remains the position in a number of jurisdictions across the EU.

In other areas of financial services, creating a pan-European infrastructure is also a major challenge particularly in the field of payments and securities settlement. A cross-border securities transaction in Europe has been estimated to cost at least 10-times as much in the US. In two reports, published in 2001 and 2003, Alberto Giovannini identified 15 barriers to cross-border clearing and settlement in the EU. One crucial development in this area will be the launch of the T2S platform, scheduled for June 2015, which will provide a single pan-European platform for securities settlement in central bank money.¹⁵ Progress has been made on many of the 15 barriers, but a number of issues identified by Giovannini remain outstanding, such as the harmonisation of securities law.¹⁶

For all the benefits of harmonised enforcement, member states can also benefit from their diversity. But in those areas left to their responsibility, there has been an insufficient focus on mutual learning from best practice, and ensuring that the wider EU economy benefits from different centres of excellence. Examples of best practice relating to supporting growth and innovative firms are in abundance

across member states such as in fiscal policy, business support and insolvency arrangements.

Insolvency Law

Insolvency regimes vary widely across member states and have a significant impact both on domestic as well as cross-border investment in innovative and high-growth firms. According to the World Bank's global ranking for resolving insolvency, half of EU member states are ranked below 25 (see Table 1.4). This is also closely correlated to a much longer work-through period, which can only increase investor uncertainty. Furthermore, many countries actively dis-incentivise a culture of failure and make it difficult for entrepreneurs to have the opportunity to make a fresh start. In many European jurisdictions the discharge period for paying back debt is over three years.

The European commission has recognised the importance of this issue and published new guidelines that follow the more business-friendly principles applied in the UK insolvency regime.¹⁷ As the commission has highlighted: “Long discharge periods are counter-productive as they stigmatise failure, discourage entrepreneurship, with negative effects of employment rates, growth and innovation.”¹⁸

Another significant issue with regards to insolvency law is the fact that efficient bankruptcy regimes are better for knowledge-based firms. As the OECD has shown in Figure 1.5, the level of investment into knowledge-based capital is partially dependent on the efficiency and relative cost of bankruptcy proceedings. Efficient bankruptcy procedures can be defined by their ability to proceed with out-of-court settlements, the use of fast-track procedures and the differential treatment of honest and fraudulent bankrupts. The timeliness of the process and likely outcome are central to financing decisions, and therefore are highly relevant in encouraging investment.

The diverse nature of insolvency laws across the EU is also a limiting factor for cross-border investment. The legal uncertainty where there are defaults in certain jurisdictions act as a constraint. A quarter of all insolvencies in Europe have a cross-border dimension,

Table 1.4 World Bank Global Ranking for Resolving Insolvency, 2014

<i>Country</i>	<i>Global Ranking</i>	<i>Time Taken to Resolve Insolvency (years)</i>
Finland	1	0.9
Germany	3	1.2
US	4	1.5
Denmark	9	1
Portugal	10	2
Belgium	11	0.9
Netherlands	12	1.1
UK	13	1
Austria	16	1.1
Sweden	17	2
Czech Republic	20	2.1
Ireland	21	0.4
France	22	1.9
Spain	23	1.5
Italy	29	1.8
Slovak Republic	31	4
Poland	32	3
Estonia	37	3
Bulgaria	38	3.3
Latvia	40	1.5
Slovenia	42	2
Romania	46	3.3
Cyprus	51	1.5
Greece	52	3.5
Croatia	56	3.1
Luxembourg	62	2
Hungary	64	2
Lithuania	67	2.3
Malta	86	3

Source: World Bank (2014), *Doing Business*, available at: <http://www.doingbusiness.org/data/exploretopics/resolving-insolvency>.

but the financial difficulties of a domestic firm can also have cross-border implications with suppliers and customers being affected. To tackle uncertainty and encourage cross-border investment, the EU is currently working on improving the 2000 Insolvency Regulation, which established a European framework for cross-border insolvency proceedings (i.e. when the debtor has assets in more than one member state). The regulation established the “centre of main interest” (COMI) as the main criteria to decide which jurisdiction

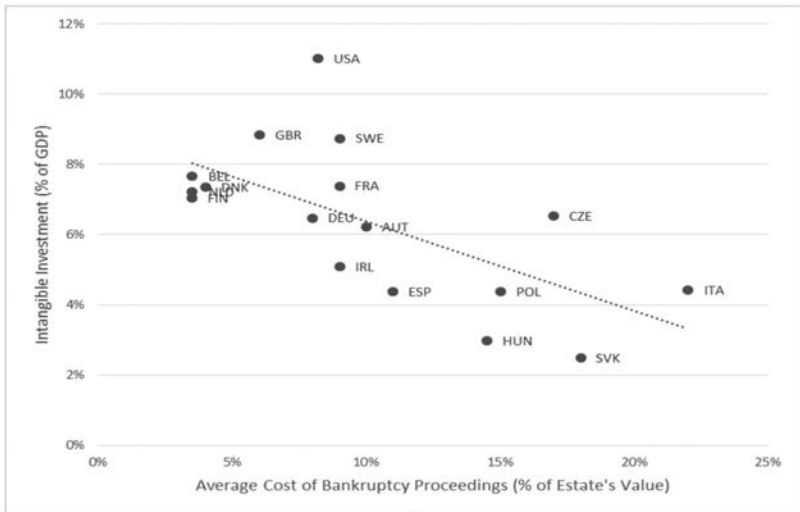


Figure 1.5 Investment in Knowledge-Based Capital and Cost of Bankruptcy Proceedings, 2000–10. Sources: Corrado, Carol et al (2012), *Intangible Capital and Growth in Advanced Economies*; World Bank (2014), ‘Resolving Insolvency’, *Doing Business Project*. Based on a similar chart in: OECD (2014), *OECD Economic Surveys: European Union*: April 2014, Figure 17, p. 23.

can open insolvency proceedings. It specified under which conditions secondary proceedings can be opened. The revision extends the regulation to “pre-insolvency” and “hybrid” proceedings (in order to facilitate debt restructuring before insolvency), clarifies the concept of COMI, and limits secondary proceedings. This progress is positive but further reform in this area is still required.

Allocation of Capital

The Money Is There, Just Not Where It Is Needed

Although the US economy relies more heavily on capital market funding than bank funding, it is not necessarily the case that one is better than the other. The financial crisis highlighted the flaws in off-balance-sheet financing prevalent in the US including the use of opaque and complex securitisations. This, in turn, undermined the US banking system.

One reason why European SMEs are more dependent on bank financing than SMEs in the US is due to size differences. Half of all workers in Europe are employed by firms with less than 50 employees as opposed to only a quarter in the US.¹⁹ Given it is less economical for smaller firms to access the capital market, one would expect banks to play a more important role in Europe than in the US. One study has estimated that only 11,000 firms out of 23 million SMEs in Europe tap into the capital market.²⁰

Hence, a greater driver to shift funding away from banks in Europe would be to introduce policies that lead to a greater number of larger SMEs. Some factors hindering such a shift have been structural including labour market regulations that impede flexibility. For example, the French Labour Code requires firms with more than 49 employees to create three worker councils, introduce profit sharing, and submit restructuring plans to the councils if the company decides to fire workers for economic reasons.

European SMEs have access to a bigger pool of capital than their US counterparts. Both the outstanding stock and flow of financing for firms in the EU is nearly two-thirds larger than in the US (see Table 1.7). In essence, Europe has the capital it needs to invest, but for a variety of reasons this investment is not being directed to where it is needed most.²¹

The financing of SMEs generally requires knowledge of the management team and local market dynamics. This makes the funding of SMEs a fundamentally local phenomena, although providers of finance should still be able to tap into larger pools of capital to support financing when supply is lower than demand. Some investors are able to leverage their expertise in certain sectors across borders. For example, UK private equity investors have become major investors in certain sectors across Europe. UK-based private equity funds accounted for more than a fifth of the total private equity investment into businesses in Germany, Italy and Sweden between 2007 and 2013, as well as 11% for France and 8% for Poland (see Table 1.6).

The major deficit in capital between the US and the EU is in business angel and venture capital funding which are three and five

Table 1.6 Investment By UK-Based Private Equity Firms into Businesses in Other Countries, 2007–13

<i>Country</i>	<i>Share of Total Private Equity Investment Made By UK-Based Private Equity Firms</i>
Italy	22%
Sweden	22%
Germany	21%
France	11%
Poland	8%

Source: EVCA (2014), European Private Equity Activity Data 2007-2013, available at: <http://www.evca.eu/research/activity-data/annual-activity-statistics/>.

Table 1.7 Source of Financing for SMEs in the US and EU, 2013 (€bn)

<i>Source</i>		<i>Stock (of Outstanding Financing)</i>		<i>Flow (of New Financing in 2013)</i>	
		<i>US</i>	<i>EU</i>	<i>US</i>	<i>EU</i>
Banks	Loans	464	1,425	281	712
	Securitised loans	30	118	5	36
	Bonds/Equity	AFME/Boston Consulting Group desk research and investor interviews indicated only marginal investments			
	Subtotal	494	1,543	286	748
Non-Banks	Mutual Funds	107	88	10	7
	Segregated Mandates	5	10	1	0
	Pension Funds	AFME/Boston Consulting Group desk research and investor interviews indicated only marginal investments			
	Insurance	via funds, mandates or securitisation			
	SWF				
	Private Equity Funds	59	32	14	9
	Venture Capital Funds	104	22	26	5
	Family and Friends	371	168	186	84
	Crowdfunding	3	1	20	6
Angel Investing	39	11	20	6	
	Subtotal	688	332	258	112
Government	Government guarantees and sponsored loans	54	132	27	66
	Subtotal	54	132	27	66
Total		1,236	2,007	571	926

Source: AFME (2015), Bridging the Growth Gap, p. 9, available at: <http://www.afme.eu/funding-economy/>

times higher in the US respectively, as shown in Table 1.7. This is a crucial difference as this is the kind of capital that is needed to transform firms into larger and more successful enterprises. In essence, Europe needs to expand its risk-bearing capability.

The European Investment Bank (EIB), commenting on the Juncker investment plan, has rightly stated that “the investment gap comes from a lack of risk-bearing capacity in Europe.”²² With its focus on maintaining its AAA rating and very low rates of non-performing loans, the EIB exemplifies this lack of risk taking. An analysis of the EIB’s loan portfolio for the six jurisdictions covered shows that SME lending accounted for on average 17% of lending. Of the total loans extended to the UK and Germany, 22% were for blue-chip firms.²³

To a certain extent national development banks have stepped in to try and increase the level of risk-bearing capability, with significant support provided by the European Investment Fund particularly for member states who do not have the scale to set up their own funding programmes. How best to support risk-bearing capacity, particularly when it comes to financing high-growth and innovative firms, remains a key challenge for public policy.

Analysis by the World Bank estimated that the average rate of SME non-performing loans in developed markets in 2007 was 6.93%, more than twice that of large business loans at 2.54%.²⁴ Non-performing loans increased dramatically during the crisis in Portugal, Spain, Italy and Ireland to between 10% and 25%.²⁵ Banking sectors with high levels of non-performing loans increase financial instability and cause credit contraction for firms that would normally be able to access finance.

Some evidence collected during this project suggested that the level of non-performing loans on early-stage firms was approximately 39%. Data from business angel portfolios implies that around 44% of investments are likely to lose money.²⁶ The central question for policymakers is therefore which financial institutions are best equipped to manage these higher levels of risk?

Policies that encourage banks to extend loans to riskier firms, particularly early-stage companies with limited collateral, will most

likely create a set of risky banks, credit contraction and increasing financial instability. Given the substantial dislocation of the European economy due to banking failure, encouraging banks to lend down the risk curve does not appear to be a sensible solution. Hence public policy clearly needs to orient itself toward trying to stimulate far greater equity investment.

Limiting Factors on Cross-Border Investment

During the crisis, the lack of a banking union meant that the policy response to bank failures was uncoordinated and piecemeal compared to the US bank bailout, which received \$250bn within a month of the Lehman default. With measures now in place to increase capital levels and to develop a banking union, the European banking system is now much more resilient than it was before the crisis. However, it remains unclear to what extent the proposed banking union will lead to similar levels of cross-border lending as seen in the US given the ongoing cultural and institutional differences.

An analysis of the cross-border claims on banks within five jurisdictions in Europe between 1999 and 2014 highlights the slump in cross-border lending, which has yet to recover (see Figure 1.8). In contrast, cross-border private equity and venture capital investment saw a small rise between 2007 and 2013, albeit the absolute levels of cross-border claims are around 2% of those for cross-border debt.²⁷ For Europe, the challenge therefore is how to scale up the supply of business angel and venture capital funding.

The lack of growth capital and lower levels of dynamic firms can be more clearly observed in Europe when one compares the difference in average annual company growth rates to the US. The US has a much larger cohort of high-growth firms as well as a larger cohort of firms that can be said to be failing. Conversely the EU has a much larger cohort of stable firms, implying a less risky outlook (see Figure 1.9).

There are also significant differences between the birth and death rates of firms in the US and the EU. The data in Table 1.10 show

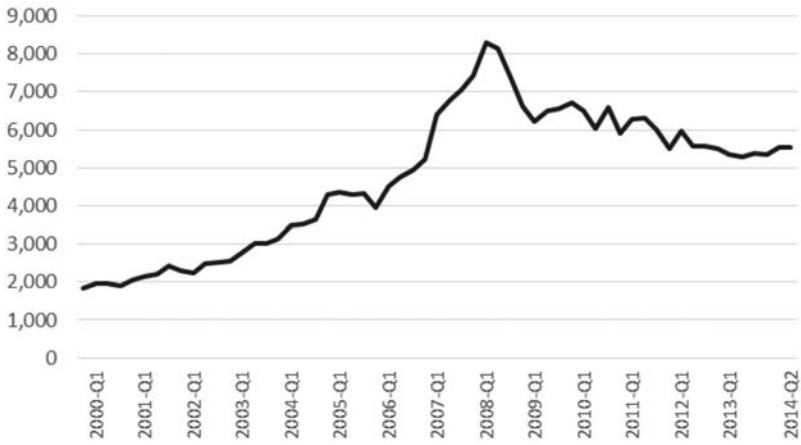


Figure 1.8 Aggregate Value of Foreign Claims Across Europe of Banks in Germany, France, Italy, Sweden and the UK, 2000–14 (\$bn). *Source:* Bank for International Settlements (2015), International Bank Claims: Consolidated Immediate Borrower Basis, available at: <http://www.bis.org/statistics/consstats.htm>.

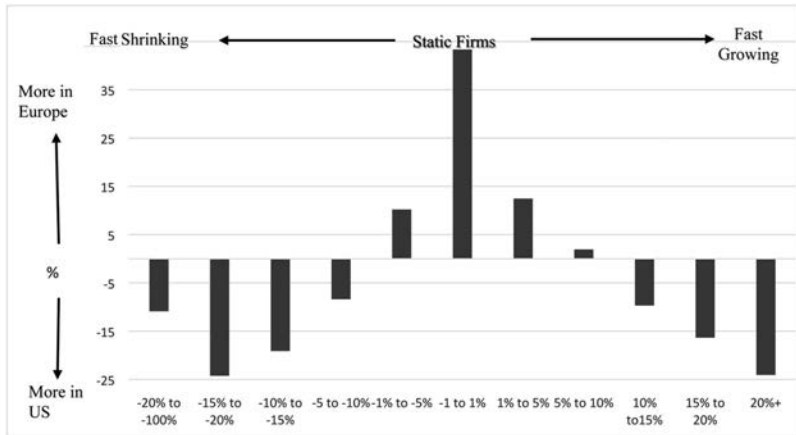


Figure 1.9 Share of Firms By Average Annual Employment Growth Rate: Europe vs the US, 2002–05 (%). *Source:* Raw data provided by the author of the following: Bravo-Biosca, A. (2013), A Look at Business Growth and Contraction in Europe, see chart on p. 9, available at: http://www.nesta.org.uk/sites/default/files/a_look_at_business_growth_and_contraction_in_europe.pdf.

Table 1.10 Births and Deaths of Employer Enterprises in the US and EU as a Share of All Active Employer Enterprises, 2010–12 (%)

Country	Births			Deaths			Net		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
US	13%	14%	14%	13%	13%	13%	-0.2%	1%	1%
EU countries (DE, FR, IT, SE, UK)	6%	6%	6%	5%	5%	5%	1%	1%	1%

Sources: US Department of Labor (2015), Private Sector Establishment Births and Deaths: Seasonally Adjusted, available at: http://www.bls.gov/web/cewbd/table9_1.txt; Eurostat (2015), Business Demography by Size Class, available at: <http://ec.europa.eu/eurostat/web/structural-business-statistics/entrepreneurship/business-demography>.

that although the net growth is roughly the same, the much higher rate of start-ups in the US increases the probability of faster growing companies. However, this process is inherently risky which is why the death rate is so high in the US.

Why Equity Investment Is Low

As well as pan-European venture capital investment being only a fifth of US levels (as shown in Table 1.7), investment is particularly low outside of Sweden, the UK and France, with investment in Italy and Poland a seventh of the comparable level in Sweden (see Table 1.11).

There are a number of reasons why there is far less capital flowing to business angel investing and venture capital in Europe. First, tax incentives across most of the EU are not supportive of this type of financing.

Second, most European countries' pensions systems are financed through general taxation. Besides the unsustainability of such an approach, this also means there is far less patient capital willing to take these kind of investment risks, something that capital market funded pension schemes in other countries are willing to invest in. This has been exacerbated by stringent requirements for retail investors to invest directly in this asset class. The European Venture Capital Fund Regulation (EuVECA) states that retail investors must

Table 1.11 Venture Capital Investment By Country, 2007–13

Country	Average Annual Investment 2007–13 (% of GDP)
Sweden	0.07%
UK	0.05%
France	0.04%
Germany	0.03%
Italy	0.01%
Poland	0.01%

Source: EVCA (2014), European Private Equity Activity Data 2007–2013, available at: <http://www.evca.eu/research/activity-data/annual-activity-statistics/>.

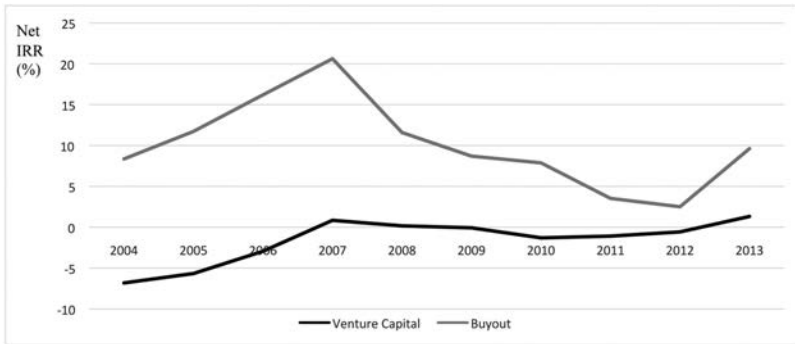


Figure 1.12 Performance of Venture Capital Funds vs Buyout Funds, Measured By Five Year Rolling Internal Rate of Returns (IRR), 2004–13 (%). Source: Raw data provided by EVCA from the following: EVCA (2014), 2013 Pan-European Private Equity Performance Benchmarks Study, see figure 3, p. 16, available at: <http://www.evca.eu/media/199202/2013-pan-european-private-equity-performance-benchmarks-study-evca-thomson-reuters-final-version.pdf>.

invest a minimum of €100,000.²⁸ This in effect restricts investment to those individuals with around €2m of investable assets, assuming a 5% asset allocation is given to this asset class.

Third, the return on venture capital over the last few years has been approximately zero. In Europe, the internal rate of return on venture capital over five years was negative for seven out of the 10 years over the period from 2004 to 2013 (see Figure 1.12). It is difficult to encourage investment into a risky asset class when the performance of the asset class is lower than far less risky assets.

Table 1.13 Share of the Total Value of Venture Capital Raised in Europe By Source, 2007–13

Source	2007	2008	2009	2010	2011	2012	2013
Government agencies	14%	15%	29%	32%	33%	38%	38%
Private individuals	15%	16%	14%	18%	14%	8%	18%
Fund of funds	13%	10%	13%	4%	10%	9%	10%
Pension funds	12%	5%	9%	10%	8%	5%	9%
Corporate investors	11%	20%	8%	14%	14%	15%	7%
Family offices	3%	15%	4%	6%	3%	7%	5%
Insurance companies	6%	4%	1%	2%	2%	7%	4%
Endowments and foundations	2%	2%	6%	4%	1%	1%	3%
Banks	14%	10%	13%	4%	9%	4%	3%
Sovereign wealth funds	0%	0%	0%	1%	0%	0%	2%
Other asset managers (including PE houses other than fund of funds)	5%	2%	2%	5%	1%	5%	2%
Academic institutions	0%	0%	0%	0%	0%	0%	0%
Capital markets	5%	1%	1%	1%	4%	1%	0%

Source: EVCA (2014), European Private Equity Activity Data 2007–2013, available at: <http://www.evca.eu/research/activity-data/annual-activity-statistics/>.

Member states are aware of these issues and have intervened substantially in the market in order to try and stimulate investment. As Table 1.13 shows, government funding for venture capital comprised 38% of the total venture capital raised in Europe in 2013, having increased from 14% in 2007. There are two reasons behind this shift. First, the total annual value of venture capital raised in Europe fell by 50% from around €8bn to €4bn between 2007 and 2013.²⁹ Second, the actual value of government funds going into venture capital has roughly doubled from €650m to €1.4bn over this period.³⁰

Venture Capital: A Public Sector Industry?

The European Investment Fund (EIF) provided funding for around 15% of all venture capital investment in Europe in 2013. The EIF estimates that it invested in more than two-thirds of all venture capital funds launched in 2013. Its average stake in a venture capital fund is estimated to be between 25% and 30%. The EIF also

estimates that almost 60% of the funds that it has invested in would not have reached a viable fund size without EIF's support.³¹

National and regional governments also invest significantly into venture capital funds. Some of these funds are operated by the EIF on behalf of member states, with the EIF as a co-investor. In Germany, for example, the EIF leads the German Federal Ministry of Economics and Technology's €1bn "ERP-EIF Dachfonds" fund of funds.³² EIF also co-invests with the Italian government's Fondo Italiano di Investimento (FII), and manages four regional JEREMIE funds in Italy.³³ The EIF co-invests with Poland's development bank, Bank Gospodarstwa Krajowego, in a fund of funds;³⁴ and it manages a €200m technology-focused fund of funds in the UK, into which it co-invests alongside the UK government.³⁵

To what extent these interventions have worked remains an unanswered question. There is a lack of publicly available information on the performance of government venture capital schemes. The EIF does not publish data on the return of its investments, nor do most national governments. A recent review of the performance of the UK government's venture capital schemes though has shown that these have performed significantly below private sector trends, incurring significant losses. The UK's independent financial watchdog, the National Audit Office, found that the UK's Regional Venture Capital Funds had an internal rate of return of -15.7% compared to a -0.4% return for comparable private funds (albeit ones operating with fewer investment restrictions). All nine of the funds, which covered the nine English regions, had negative returns.³⁶

Government venture capital schemes in Europe have typically amended their models in recent years to protect taxpayers' money and to maximise economic outcomes. This reflects the emerging consensus gathered from many reviews of the venture capital industry. These have highlighted the importance of larger fund sizes, the ability to make follow-on investments, and the need for a broad geographic coverage to enhance deal-flow.

Schemes have also been redesigned to provide greater protection for public funding. Some previous schemes, such as the Regional

Venture Capital Funds in the UK, offered downside protections to private investors to encourage them to invest. Most schemes now, however, are either on a *pari passu* basis, whereby public and private investors are on equal terms, or private investors gain a disproportionate share of profits but pay back the state's investment first.³⁷ With the Enterprise Capital Funds, for example, which were launched in the UK in 2006, the state is the preferential investor receiving its investment back first. Private investors are though given greater opportunity to benefit from success.³⁸ Differences in the size of the public share of venture capital funds remain though. For the UK's Enterprise Capital Funds, around two-thirds of each fund is made up of public funding. This is compared to around 35% in Sweden for the government's regional venture capital funds, which imposes a cap of 50%.

Business Angels: Growing in Importance

Business angel investment is becoming increasingly important but levels remain particularly low outside of the UK and Sweden. On a comparative basis, levels of investment in France and Germany are less than half those in the UK and Sweden, while those in Italy and Poland are even lower.

Germany and the UK have specific co-investment funds for business angels. In Germany, this operates under the European

Table 1.14 Business Angel Investment By Country, 2013 (% of GDP)

<i>Country</i>	<i>Investment in 2013</i>
Sweden	0.0046%
UK	0.0044%
Germany	0.0020%
France	0.0017%
Italy	0.0013%
Poland	0.0006%

Note: Given the challenges measuring business angel investment, the data is unlikely to be indicative of absolute levels of investment.

Source: European Commission (2015), *Business Angels and Access to Finance*, Figure 5, available at: http://ec.europa.eu/enterprise/policies/finance/data/enterprise-finance-index/business-angels/index_en.htm.

Investment Fund's European Angels Fund scheme, which is also used in Spain and Austria. This scheme invests EU funds into equity stakes alongside individual business angels and family offices that are able to invest at least €250,000 over 10 years. All investment decisions are taken by the private investors, with the EIF granting a capital allowance upfront.³⁹ The UK government's Angel Co-Fund invests via business angel syndicates rather than individual business angels. Each investment decision also has to be approved by an independent investment committee.

There are encouraging signs that the business angel co-investment funds are beginning to generate positive investments. This may well be linked to the fact that business angels invest themselves and do not charge for due diligence. The overheads of venture capital firms are high and therefore require high charges, which in turn dilutes returns. Another factor that is also supporting the growth of angel investing has been through using crowdfunding technology.⁴⁰ It is being increasingly used to support lead investors or business angel syndicates to close deals. It is worth noting though that passive investments made using such platforms where there is no lead investor may find returns are much lower. This is because the value of equity participation also comes from the experience of the lead investor or angel, as well as the needed financial injection.

Summary

This overview has shown that the CMU project should prioritise the needs of innovative and high-growth firms given their contribution to future jobs and growth. It has also highlighted a number of underlying challenges that hamper these firms' ability to scale up and become world-leading firms.

The following section looks more specifically at the financing needs of high-growth and innovative firms in six EU member states. It aims to provide a more accurate picture, both of the specific challenges of each country and of common issues that need to be addressed at EU-level.

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FINDINGS ACROSS SIX COUNTRIES

The core of the data in this section is focused on our analysis of individual responses to the European commission's and European Central Bank's joint *Survey on the Access to Finance of Enterprises (SAFE)*. This survey is the largest and most comprehensive comparative survey of businesses across the EU. It has been conducted annually across all EU member states since 2013, and was first conducted in 2009. More than 17,000 businesses in total responded to the survey in 2014. For the six countries focused on in this report, with the exception of Sweden, between 1,200 and 1,500 businesses in each country responded to the survey in 2014.

For the purpose of this project, Policy Network has been given access to the anonymised individual responses from SMEs. This has permitted analysis to be conducted by innovative and high-growth firms by country. The focus of the analysis is the 2014 survey, which was conducted between September and October 2014. These findings have in some cases been combined with the findings from the 2013 survey, which was conducted between August and October 2013, to support the reliability of the data, particularly where there are questions on past finance applications.

From a methodological standpoint, there will always be challenges in relying on survey data. One component of this research

project has been to share the analysis with public and private sector experts in each jurisdiction. The feedback received on the survey data was in line with stakeholders' perceptions.

The analysis of the SAFE survey data has focussed on the issues impacting high-growth and innovative businesses in six EU member states: France, Germany, Italy, Poland, Sweden and the UK. High-growth businesses are defined as those that had increased turnover by an average of at least 20% per year over the previous three years. Innovative businesses are those that had introduced a new product or service in the previous 12 months. This cohort of firms more than any other has a far greater impact on job creation and growth.

KEY FINDINGS

A number of key themes emerged during the analysis that were subsequently validated by interviews within the six jurisdictions visited:

- ***There was general support for the spirit of the commission's Capital Markets Union initiative, but there was also scepticism that a top-down approach was likely to succeed.*** For many, the initiative should not be seen as a quick-fix to resolve under-performing banks, and above all should be complementary to Europe's banking system. The specific policy proposals were generally welcomed, but there were concerns that the commission was not focusing sufficiently on the critical priorities, complicated by the fact that many of these challenges remain in the remit of member states.
- ***Accessing debt finance is more challenging for high-growth and innovative businesses, which could be better-served with equity.*** There was a strong correlation between countries with an under-performing banking sector and higher levels of rejection rates for high-growth and innovative firms. In countries with solvent banking systems and excess funds to invest, the main obstacle was

that innovative and high-growth firms are less well suited to bank financing due to higher risk levels. These firms tend to be young with few tangible assets. In those instances where banks had rejected credit-worthy firms, there was interest in whether national compulsory referral or credit mediation systems might provide the opportunity for other financial institutions to step in.

- ***Significant under supply of equity financing.*** The major barrier for growth firms is the under supply of equity. Levels of business angel activity and venture capital investment remain low or extremely low across the countries analysed. Many jurisdictions had few high-net-worth individuals and undercapitalised pension systems to provide sufficient equity capital. The lack of incentives for investors given the underlying risk remains a significant challenge, as does the lack of equity culture. Bankruptcy regimes and their punitive approach to failure has done little to encourage risk-taking. The issue of business education and being aware of the different financing options also arose as being central to changing the perception of equity.
- ***Stronger business support is crucial, alongside local financing institutions that are able to access deeper pools of savings.*** There was strong agreement that the financing of high-growth and innovative firms required local institutions to be the initial source of financing, given the need to understand management and local market dynamics. But there was strong support for these institutions to be able access a deeper pool of savings. Many jurisdictions considered their own business support systems inadequate, and there was a great deal of awareness of the need to support innovation ecosystems in city regions.
- ***Member states have a key role to play in addressing these issues, but the commission can provide substantial support.*** Ideas such as providing improved tax incentives for equity investors were universally agreed upon as the right approach but given the upfront costs these were not being pushed due to both political and fiscal constraints. Some longer term harmonisation themes did arise

with a general consensus that accounting and insolvency standards would dramatically improve cross-border flows. Although this was recognised as politically challenging, this was seen by many as a 20-year project that needs to start now.

- ***Enforcing the existing rules of the single market and promoting best practice across countries were seen as crucial.*** Jurisdictions with more advanced financial services institutions felt that there remained too many restrictions in place to support greater cross-border investment. However, some felt that if the commission could successfully enforce existing rules, the economy would receive a boost from improved competitiveness. Many commenters emphasised the importance of learning from what works well in members states rather than just focusing on what needs to be fixed.

HOW HIGH-GROWTH AND INNOVATIVE BUSINESSES DIFFER ACROSS COUNTRIES

Before exploring how the challenges for high-growth and innovative businesses accessing finance differ across countries, it is important to understand how the profile and characteristics of these firms are different. Appreciating these dynamics is not only helpful for understanding the analysis in this report but it is also vital for policy interventions, whether designed or delivered locally, nationally, or at the EU-level. The key trends are that:

- ***Businesses in Italy and Poland are more likely to be innovative.*** 37% of all businesses in Italy and Poland are innovative. This compared to 27% in Germany and 26% in France, the lowest of the six countries. At least a fifth of businesses are high-growth in Poland, the UK and Sweden compared to 13% in Germany, 11% in France and 9% in Italy. Just 17% of businesses in Italy have seen increasing profits over the past six months compared to an EU average of 27%.¹

- ***Start-up rates are much higher in the UK and Sweden, resulting in a higher proportion of young firms.*** 11% of the total number of active employer enterprises were started in the UK in 2012, and 6% in Sweden. This is compared to a rate of 4% of business births in both Italy and Germany, and just 2% in France.² Around a quarter of businesses are under 10 years old in the UK, Sweden and Poland compared to around a fifth of businesses in Germany, Italy and France.³
- ***High-growth and innovative businesses are typically smaller in Italy and Poland, and more likely to be seeking smaller amounts of financing.*** For both high-growth and innovative businesses in Italy and Poland, around six out of 10 of these businesses have turnovers below €2m, the EU's threshold for defining micro businesses. In contrast, in Sweden, the UK and France, the majority of both high-growth and innovative businesses have turnovers above €2m.⁴ In Poland and Italy, 39% and 32% respectively of innovative businesses are seeking financing of less than €100,000 to realise their growth ambitions, compared to 18% in Sweden.⁵
- ***Innovative and high-growth businesses in Sweden and the UK are more likely to be in the services sector; whereas in Italy and Germany they are more likely to be in industry and exporters.*** Half of high-growth businesses in Sweden and the UK are in services compared to an EU average of 38%.⁶ Furthermore, 44% and 42% of all services businesses in Sweden and the UK are in knowledge-intensive services compared to around a quarter in the other four countries.⁷ A third of all high-growth businesses in Italy are in industry compared to an EU average of 23%.⁸ But just 1% of Italy's industry businesses are classed as high-tech compared to 5% in the UK and 4% in Germany,⁹ where 37% of all innovative businesses are in industry. Almost two-thirds of innovative businesses in Italy and three-quarters in Germany are exporters compared to 55% in France and 56% in Sweden.¹⁰

UNMET DEMAND FOR FINANCE

Most Businesses with Growth Ambitions Cite Issues Accessing Finance, Particularly for Equity

In all of the six countries, businesses were more likely to cite obstacles to securing equity to finance their growth ambitions than loans. At least four out of five businesses seeking equity finance cited obstacles in all six countries except Sweden, where only three out of five businesses cited obstacles (see Table 2.1).

Three quarters of businesses in Italy and Poland seeking bank loans to finance their growth ambitions cited obstacles in securing finance (see Table 2.1). In contrast, only four out of 10 businesses seeking loans from banks in Germany and half in Sweden cited obstacles. In Italy, these obstacles resulted in significantly lower success rates and high rejection rates in securing a bank loan. However, Polish firms had very high success rates in securing loans and very low rejection rates; only second to Germany (see Table 2.2). This divergence is mostly explained by the high levels of bureaucracy associated with loan applications in Poland, which firms felt were extremely onerous. Other data in Table 2.4 highlights that loans for many high-growth and innovative firms are not suitable

Table 2.1 Share of Businesses With Growth Ambitions Citing Obstacles to Financing Growth By Type of Finance Being Sought, 2014 (%)

Country	Bank Loan		Loan from Other Sources (e.g. Trade Credit)		Equity	
	No		No		No	
	Obstacles	Obstacles	Obstacles	Obstacles	Obstacles	Obstacles
Poland	77%	23%	84%	16%	80%	20%
Italy	75%	25%	83%	17%	82%	18%
UK	70%	30%	73%	27%	79%	21%
France	64%	36%	77%	23%	90%	10%
Sweden	51%	49%	41%	59%	60%	40%
Germany	41%	59%	49%	51%	81%	19%

Source: Policy Network's analysis of the individual responses to: European Commission/European Central Bank (2014), Survey on the Access to Finance of Enterprises.

for this cohort of firms. Hence, the constraint in equity remains a far greater problem for this set of firms.

Overall Rejection Rates for Bank Loan Applications Are Relatively Low in Most Countries

Of the six countries focused on in this report, Italy was the only country to have rejection rates for bank loans that were above the EU average, at 14%. As Table 2.2 shows, the UK, Sweden and France all had similar levels of rejections, at 12%, 12% and 11% respectively. Rejection rates for bank loans were around half this level in Germany, where just 6% were rejected and 82% secured the full amount that they had applied for. In Poland, 9% of businesses that applied were rejected for bank loans.

One of the major drivers of Italy's much higher level of rejection is the higher rate of non-performing loans. The proportion of non-performing loans in Italy, at 13.7%, is more than twice the EU average of 6.7% (see Table 2.3). Furthermore, the recent European Central Bank (ECB) review found that four banks in Italy, including its third largest lender, had net capital shortfalls. Nine Italian banks also failed the ECB's stress tests, out of a total of 25 euro-area banks that failed the tests, underlining the challenges faced by Italy's

Table 2.2 Outcomes of Applications for Bank Loan Finance in the Previous Six Months for All Types of Business, 2013 and 2014 (%)

Country	Successful	Received	Received	Rejected	Business Refused Because Cost too High
		75% to 99% of Amount Applied for	1% to 74% of Amount Applied for		
Germany	82%	6%	5%	6%	2%
Poland	75%	4%	6%	9%	6%
France	77%	5%	6%	11%	2%
Sweden	75%	5%	6%	12%	3%
UK	74%	7%	4%	12%	4%
Italy	59%	11%	14%	14%	3%
EU (2014)	66%	7%	10%	13%	4%

Source: Policy Network's analysis of the individual responses to: European Commission/European Central Bank (2014), Survey on the Access to Finance of Enterprises.

Table 2.3 Non-Performing Bank Loans By Country, 2012 (%)

Country	<i>Non-Performing Loans as a Percentage of Total Gross Bank Loans (%)</i>
Italy	13.7
Poland	5.2
France	4.3
UK	3.7
Germany	2.9
Sweden	0.7
EU	6.7

Note: This is a measure of the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue.

Source: World Bank (2014), Bank Nonperforming Loans to Total Gross Loans, available at: <http://data.worldbank.org/indicator/FB.AST.NPER.ZS/countries?display=default>.

banking system.¹¹ This is inhibiting Italian banks from lending to businesses, as seen in the higher rejection rates in Italy for bank loans. In the other five countries focused on in this study, bank balance sheets are relatively healthy.

High-Growth and Innovative Businesses Have Greater Difficulties Securing Bank Loans in Most Countries, Typically Due to Insufficient Collateral or Guarantee

In all six countries except Poland, the rejection rates for bank loan application were higher for high-growth businesses than low- to medium-growth businesses (see Table 2.4). In the UK and France, high-growth businesses were around three times more likely to be rejected for bank loans than low- to medium-growth businesses. Similarly, the rejection rates for innovative businesses were higher than those for non-innovative businesses in the UK, France, Sweden and Germany. In Sweden, innovative businesses were more than three times more likely to be rejected than non-innovative businesses.

High-growth and innovative businesses are often more likely to be rejected for bank loan finance because they lack physical capital, which forms a key part of banks' credit assessments. These businesses also tend to be younger, and therefore have shorter credit

Table 2.4 Percentage of Bank Loan Finance Applications Rejected in the Past Six Months By Growth Rate and Level of Innovation, 2013 and 2014 (%)

Country	High-Growth Businesses	Low/Medium Growth Businesses	Non-Growing Businesses	Innovative Businesses	Non-Innovative Businesses
UK	16%	6%	13%	13%	10%
France	14%	5%	15%	16%	8%
Italy	12%	9%	17%	13%	15%
Sweden	10%	9%	13%	18%	5%
Germany	4%	2%	7%	5%	4%
Poland	4%	5%	14%	8%	9%

Note: Growth rates are defined by average annual turnover growth over the previous three years: 'high-growth' is more than 20% annual turnover growth; 'low/medium' growth is more than 0% up to 20% annual turnover growth; 'non-growth' 0% or below. 'Innovative' businesses are defined as those that had introduced a new product or service in the past 12 months; 'non-innovative' businesses are defined as those that had not introduced a new product or service in the past 12 months.

Source: Policy Network's analysis of the individual responses to: European Commission/European Central Bank (2014), Survey on the Access to Finance of Enterprises.

histories. This is evident when businesses were asked about the key barrier to securing finance. In France, Sweden, the UK and Germany, high-growth and innovative businesses were most likely to cite insufficient collateral or guarantee (ignoring the option "other") as the main limiting factor to obtaining external financing to realise their growth ambitions (see Table 2.5a and 2.5b). In Poland and Italy, insufficient collateral or guarantee was the second most cited barrier after paperwork and interest rates respectively. Given that interest rates are currently at historically low levels, it seems likely that the issue of interest rates in Italy is more of an issue of affordability for businesses with low levels of profitability.

The Level of Demand for Equity Finance Differs Significantly Between Countries

In countries where businesses have traditionally been more reliant on bank financing, such as Germany and Poland, just 9% and 6% respectively of high-growth businesses would prefer equity finance most to realise their growth ambitions (see Table 2.6a). This is compared to 38% of high-growth businesses in Sweden, the country

Table 2.5a Most Important Limiting Factor to Obtaining External Financing to Realise Growth Ambitions for High-Growth Businesses, 2014 (%)

<i>High-Growth Businesses</i>							
<i>Country</i>	<i>Insufficient Collateral/ Guarantee</i>	<i>Financing</i>					<i>No Obstacles</i>
		<i>Interest Rates/Price</i>	<i>not Available</i>	<i>Too Much Paperwork</i>	<i>Reduced Control</i>	<i>Other</i>	
Poland	26%	11%	2%	30%	3%	5%	22%
Italy	21%	25%	13%	8%	0%	8%	25%
Germany	21%	8%	2%	8%	3%	9%	50%
UK	18%	16%	7%	6%	10%	22%	20%
Sweden	16%	6%	8%	5%	8%	19%	39%
France	13%	5%	9%	12%	4%	20%	36%

Table 2.5b Most Important Limiting Factor to Obtaining External Financing to Realise Growth Ambitions for Innovative Businesses, 2014 (%)

<i>Innovative Businesses</i>							
<i>Country</i>	<i>Insufficient Collateral/ Guarantee</i>	<i>Financing</i>					<i>No Obstacles</i>
		<i>Interest Rates/Price</i>	<i>not Available</i>	<i>Too Much Paperwork</i>	<i>Reduced Control</i>	<i>Other</i>	
Poland	21%	18%	4%	23%	4%	6%	25%
Germany	19%	6%	4%	9%	3%	9%	50%
France	19%	10%	11%	7%	5%	21%	28%
Italy	16%	28%	14%	6%	2%	9%	25%
UK	16%	14%	9%	8%	8%	17%	27%
Sweden	15%	7%	11%	3%	4%	12%	48%

Note: Growth rates are defined by average annual turnover growth over the previous three years: 'high-growth' is more than 20% annual turnover growth. 'Innovative' businesses are defined as those that had introduced a new product or service in the past 12 months.

Source: Policy Network's analysis of the individual responses to: European Commission/European Central Bank (2014), Survey on the Access to Finance of Enterprises.

with by far the highest level of demand for equity finance. In the UK and France, the next highest countries, 16% and 15% respectively of high-growth businesses would prefer equity financing most.

There is a similar picture for innovative businesses, although overall demand levels are slightly lower as this cohort can include firms that are not growing. In Sweden, 30% of innovative businesses would prefer equity finance most to realise their growth ambitions (see Table 2.6b). This is around three times the rate seen in the UK (11%) and France (10%), the next highest countries.

Table 2.6a Type of Finance That High-Growth Businesses Would Prefer Most to Realise Their Growth Ambitions, 2014 (%)

<i>High-Growth Businesses</i>				
<i>Country</i>	<i>Bank Loan</i>	<i>Loan from Other Sources</i>		
		<i>(e.g. Trade Credit)</i>	<i>Equity</i>	<i>Other</i>
Sweden	48%	8%	38%	5%
UK	63%	10%	16%	11%
France	72%	5%	15%	8%
Italy	61%	17%	10%	12%
Poland	54%	19%	9%	18%
Germany	69%	19%	6%	6%

Table 2.6b Type of Finance That Innovative Businesses Would Prefer Most to Realise Their Growth Ambitions, 2014 (%)

<i>Innovative Businesses</i>				
<i>Country</i>	<i>Bank Loan</i>	<i>Loan from Other Sources</i>		
		<i>(e.g. Trade Credit)</i>	<i>Equity</i>	<i>Other</i>
Sweden	49%	12%	30%	9%
UK	54%	15%	11%	20%
France	69%	11%	10%	10%
Italy	62%	19%	8%	11%
Poland	55%	19%	8%	18%
Germany	69%	16%	7%	7%

Note: Growth rates are defined by average annual turnover growth over the previous three years: 'high-growth' is more than 20% annual turnover growth. 'Innovative' businesses are defined as those that had introduced a new product or service in the past 12 months.

Source: Policy Network's analysis of the individual responses to: European Commission/European Central Bank (2014), Survey on the Access to Finance of Enterprises.

The low levels of demand for equity financing in Italy appear to be in part due to a lack of investment-readiness. As Table 2.7 shows, only 25% of high-growth businesses and 23% of innovative businesses in Italy are confident talking about financing with equity investors. This is the lowest level of confidence of the six countries, and less than half the level seen in all but France.

In Poland and Germany, however, financial readiness is less of an issue and the low levels of demand for equity are more likely due to the lack of an equity culture. 70% of high-growth businesses in Poland say that they are confident talking to equity investors about

Table 2.7 Confidence Talking About Financing with Equity Investors Among High Growth and Innovative Businesses, 2014 (%)

Country	<i>High-Growth Businesses</i>		<i>Innovative Businesses</i>	
	<i>Confident</i>	<i>Not Confident</i>	<i>Confident</i>	<i>Not Confident</i>
Poland	70%	30%	64%	36%
UK	62%	38%	65%	35%
Germany	55%	45%	59%	41%
Sweden	54%	46%	60%	40%
France	40%	60%	34%	66%
Italy	25%	75%	23%	77%

Note: Growth rates are defined by average annual turnover growth over the previous three years: ‘high-growth’ is more than 20% annual turnover growth. ‘Innovative’ businesses are defined as those that had introduced a new product or service in the past 12 months.

Source: Policy Network’s analysis of the individual responses to: European Commission/European Central Bank (2014), Survey on the Access to Finance of Enterprises.

financing, the highest level of the six countries. In Germany, 55% of high-growth businesses and 59% of innovative businesses are confident talking to equity investors – similar levels to Sweden (see Table 2.7). This may reflect the strong provision of business support, such as the chambers of commerce in Germany, which help businesses to be investment-ready and to understand the range of financing options that are available.

SUPPLY OF FINANCE

Low Levels of Business Angel and Venture Capital Investment in Most Countries

As Table 1.14 showed, business angel investment is far higher in Sweden and the UK than the other four countries. Investment levels in 2013, measured as a share of GDP, were more than twice the level in Germany, the next highest country, and seven times the level seen in Italy, the lowest country.

Venture capital investment is also highest in Sweden and the UK, as shown by Table 1.11. As a proportion of GDP, average annual investment between 2007 and 2013 in Sweden was seven times

the level seen in Poland and Italy, the countries where investment was lowest, and around twice the levels of France and Germany. The UK had the largest absolute level of venture capital investment, averaging €43m between 2007 and 2013.¹² Venture capital investment in the UK is, however, significantly below pre-crisis levels, at €60m in 2013 compared to €1.5bn in 2008.¹³ The other five countries also continue to see levels of venture capital investment that are significantly below pre-crisis levels.

The Supply of Equity Finance Is Impacted By Cross-Country Differences in Pension Fund Structures and Retail Investors' Risk Appetite

The UK and Sweden have the highest level of household financial assets held in pension fund and life insurance reserves, at 160% and 91% respectively of national GDP compared to an EU average of 78% (see Table 2.8). This provides a larger pool of institutional capital for equity financing. The other four countries all have levels below the EU average, with Italy (42%) and Poland (24%) the lowest, thereby reducing the pool of capital available. Table 2.8 also shows that Sweden has the highest levels of household financial assets held in shares and other equity, totalling almost 100% of GDP, which is more than twice the EU average.

The value of household financial assets held in pension funds is higher in the UK and Sweden due to the greater reliance on funded personal and company-led private pension schemes. This is evident from the Allianz Pension Sustainability Index, which combines a number of indicators to measure the overall sustainability of a country's pension system. Sweden and the UK had the highest scores of the six countries focused on in this report, and Sweden had the second highest score of the 50 countries included in Allianz's index (see Table 2.9). The other four countries in this study have pension systems with a stronger public, pay-as-you-go pillar, particularly Italy and France which have the lowest sustainability scores.

Table 2.8 Value of Household Financial Assets By Asset Class and Country, 2012 (% of GDP)

Country	Currency and Deposits	Pension Fund	Shares and Other Equity	Securities	Other	Total
		Reserves and Life Insurance Reserves		Other than Shares		
Germany	76	67	33	9	1	185
France	63	77	49	3	16	208
Italy	75	42	66	44	2	229
Poland	39	24	21	1	2	86
Sweden	39	91	99	3	3	235
UK	84	160	34	2	10	290
EU	72	78	46	11	6	212

Note: Data for consolidated balance sheets.

Source: Eurostat (2015), Financial Balance Sheets, available at: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nasa_f_bs&lang=en.

Table 2.9 Pension Sustainability By Country, 2014

Country	Allianz Pension Sustainability Index (Scale 1–10: 10 minor need for reforms; 1 high need for reforms)
Sweden	7.8
UK	7.2
Poland	6.6
Germany	6.4
France	5.9
Italy	5.9

Source: Allianz (2014), 2014 Pension Sustainability Index, Figure 3, p. 10, available at: https://www.allianz.com/v_1396002521000/media/press/document/2014_PSI_ES_final.pdf.

Beyond the UK There Is Very Little Business Financing Available via Online Alternative Platforms

Peer-to-peer (p2p) lending to businesses amounted to €98m in the UK in 2014, compared to €3m across the rest of the EU where the p2p market for businesses is not growing particularly fast.¹⁴ This data is skewed by the growth in p2p lending in the UK which was catalysed by the failure of a number of high-profile UK banks.

Equity-based crowdfunding for businesses amounted to €11m in the UK in 2014, compared to €3m across the rest of the EU.¹⁵ This market is growing in a number of countries but the success of these platforms remains to be seen, particularly given the model of

passive investment which lacks the mentoring process and corporate governance associated with business angel syndicates.

GOVERNMENT SUPPORT

Government Loan Guarantee Schemes Are More Prevalent in Italy, Poland and France; Whereas State Co-Financing Is the Dominant Model in Germany and Sweden

The value of government guaranteed loans for businesses granted in 2013 amounted to more than €9bn in Italy and €2bn in Poland (see Table 2.10). Bpifrance provided guarantees amounting to around €6bn in 2013. German and UK government guarantee schemes support fewer businesses in relation to GDP, amounting to €1.1bn and €469m respectively. Sweden does not provide public guarantees, instead opting for a direct lending model.

Germany's national development bank, KfW, provided more than €10bn of co-financing via private banks in 2013 (see Table 2.10). In France, Bpifrance provided €5bn of co-financing. For both

Table 2.10 Value of Government Guaranteed Loans and Co-Financed Loans Granted in 2013 By Country

Country	Government Guaranteed Loans		Government Co-Financed loans	
	€m	% of GDP	€m	% of GDP
Italy	9384	0.60%	252	0.02%
Poland	1981	0.51%	48	0.01%
France	5916	0.29%	5073	0.25%
Germany	1117	0.04%	10581	0.39%
UK	469	0.02%	N/A	N/A
Sweden	0	0.00%	242	0.06%

Note: Government guaranteed loans data for Sweden is for 2011 and government co-financed loans data for Poland and Italy are for 2012.

Sources: Government guaranteed loans data for all countries except the UK and Sweden from: European Commission (2014), Value/Volume of Guarantees Granted per Year; UK and Sweden data from: OECD (2014), Financing SMEs and Entrepreneurs 2014. Government co-financed loans: Bpifrance (2014), 2013 Bpifrance Financement Annual Report, p. 20; KfW (2014), KfW Annual Report, p. 82; OECD (2014), Financing SMEs and Entrepreneurs: An OECD Scoreboard, p. 214; Bank Gospodarstwa Krajowego (2013), Report on the Activities of Bank Gospodarstwa Krajowego in 2012, p. 28.

countries, the value of government co-financed loans was significantly more as a share of GDP than Italy and Poland, which instead have large government loan guarantee schemes, as stated above. Sweden, which does not provide government guarantees for loans, provided around €250m of co-financed loans in 2013 via Almi Företagspartner AB.

Public Funds Make up a Significant Share of Venture Capital Investment in All Six Countries

In all six countries, at least a fifth of venture capital investment over the period from 2007 to 2013 was raised from government agencies (see Table 2.11). Government interventions primarily consist of investments into privately-run venture capital funds, with investment decisions made by the private funds. In both France and Sweden, around 40% of the venture capital raised was from government, amounting to an average of €266m per year in France and €65m per year in Sweden (see Table 2.11). As a share of GDP, in the UK and Germany government fundraising was around a third of the levels seen in France and Sweden, amounting to an average of €12m and €149m per year. This accounted for around a fifth of the total venture capital raised in both countries. In Poland and Italy,

Table 2.11 Venture Capital Raised from Government Agencies By Country, 2007–13

<i>Country</i>	<i>Average Annual Value of Venture Capital Raised from Government (€m)</i>	<i>Average Annual Value of Venture Capital Raised from Government (% of GDP)</i>	<i>Share of Total Venture Capital Raised</i>
France	366	0.018%	40%
Sweden	65	0.016%	39%
UK	112	0.006%	18%
Germany	149	0.005%	20%
Poland	3	0.001%	32%
Italy	11	0.001%	24%

Source: EVCA (2014), European Private Equity Activity Data 2007–2013, available at: <http://www.evca.eu/research/activity-data/annual-activity-statistics/>; 2013 GDP figures from Eurostat.

the amount of venture capital raised from government was just €3m and €1m per year respectively. This comprised almost a third of total venture capital in Poland and a quarter in Italy, reflecting the low overall levels of venture capital.

NOTES

1. Policy Network's analysis of the individual responses to: European Commission/European Central Bank (2014), *Survey on the Access to Finance of Enterprises*.

2. Policy Network's analysis of: Eurostat (2015), *Business Demography by Size Class*, available at: <http://ec.europa.eu/eurostat/web/structural-business-statistics/entrepreneurship/business-demography>.

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COUNTRY FINDINGS

FRANCE

France Needs More Equity Capital to Help High-Growth and Innovative Firms

The key issue identified from interviews in France was the need for more equity capital for high-growth and innovative businesses. For debt financing, Bpifrance's loan guarantee scheme and other support programmes help to keep credit flowing. In particular, the credit mediation scheme supports firms whose loan applications have been rejected to find other sources of finance.

“There are no major issues for SMEs gaining debt finance in France, and there was no credit crunch after the 2008 financial crash. There is, however, a structural issue for high-growth and innovative SMEs gaining finance.”

“Government schemes have helped address cash flow problems for SMEs, particularly the Médiateur du Crédit scheme, but there remains a structural issue for high-growth businesses trying to obtain finance.”

“The equity gap for France is for financing between €5m and €15m. Seed funding is adequate.”

“There is a lack of equity finance in France. Government funding has to take an ever growing share of private equity investment, as the returns on venture capital are so poor.”

A Lot Can Be Done at National Level to Improve Access to Finance for High-Growth and Innovative Firms

In general, most of those interviewed felt that many of the barriers to financing high-growth and innovative firms were national and cultural rather than European. The lack of fiscal incentives for investors given the higher risk, for example, were seen as a major barrier, as was the insolvency regime.

“There is a lack of investment-readiness and financial culture in French SMEs.”

“There are lots of national, regional and sectoral networks of business support but they do not link together – there is no one-stop-shop for fast-growing SMEs.”

“The tax incentives for business angel investors need to be strengthened even further but this is politically impossible given France’s fiscal deficit.”

“French insolvency law makes it very difficult for investors to predict what will happen if the company gets into trouble. For years, French governments have been trying to improve the regime but have only added extra layers of complexity. A radical shake-up is needed, and the prospect of a European insolvency regime could help.”

The CMU Project Is Welcome But There Is Scepticism Regarding the Effectiveness of EU Initiatives

The overall aims of the CMU project are generally viewed positively, but there are mixed views on whether EU institutions should be trying to help SMEs directly. Interviewees supported lower risk-weights on high-quality securitisations but did not expect this to lead to a rapid increase in lending to SMEs in the short term. Private placements are seen as important for mid-cap companies but new legislation is not necessary.

“The Capital Markets Union should aim to promote risk sharing. If there had been more cross-border ownership in banking the financial crisis would have been much smaller than it was.”

“Reforms to encourage the securitisation of SME loans are unlikely to lead to increased take-up but securitisation of high-quality mortgage portfolios could help free up bank balance sheets for SME lending in the future.”

“The European commission cannot really help SMEs. They have tried things in the past, but they have all failed. These are mostly national challenges.”

“The European Investment Bank does not take enough risk, due to its rating constraint, so by definition it cannot help drive SME funding that much. National business banks generally take far more risk.”

GERMANY

Debt Financing Is Not an Issue as the Mix of Government Debt Financing Institutions’ Interventions Have Been Effective

The mix of banks and government financing institutions and schemes, along with strong business support networks, mean that very few German businesses have issues accessing bank finance. Interviewees did, however, stress the challenges for growth businesses seeking equity finance. Securitisation of SME loans is not viewed as being something that German banks would want to take up but may help countries with less-well-capitalised banks.

“The picture for debt financing has been good for a while. There are a few problems, but none that are likely to be solved with new policies.”

“It is harder for SMEs without collateral but Germany’s system of regional state guarantees helps significantly.”

“Securitisation could help poorly capitalised banks in Europe but German banks have sufficient funds to lend to the market – there just is not enough demand from businesses.”

“Securitisation could be useful as a general funding instrument in the future once the European Central Bank’s liquidity begins to be withdrawn, but at the moment there is no need for banks to take assets off their balance sheets.”

There Is a Lack of Equity Capital for High-Growth Firms, In Part Due to National Tax Rules and the Pensions System

The lack of incentive schemes for investors remains a central issue, as does the absence of a capitalised pension system. Demand for equity is generally low, partly due to the many well-established, family-owned enterprises that remain cash rich.

“Equity financing is a major issue in Germany, particularly for young tech companies.”

“Germany’s many established family enterprises are well capitalised, and many do not have aspirations for high growth. There is very little demand for equity finance in this part of the German economy.”

“There is a problem in Germany for equity finance but there is no political impetus to introduce tax incentives for investors. The system is not clear if foreign investors will be taxed twice.”

“The German pension system is still mainly a pay-as-you-go system which not only raises concerns about the ability to fund future pensions given the demographic shift in Germany but also means that the capital market is less developed.”

Germany Has Distinct Institutions for Supporting Finance That Should Be Reflected in the CMU Project

Interviewees were keen to stress that many issues are national ones, and that Germany has distinct institutions and systems of financing. There was general support for long-term EU harmonisation strategies and a role for the commission in pushing structural reform. Some interviewees also felt that the European Investment Bank is crowding out the European banking sector rather than focussing on lending down the risk curve.

“The European commission’s role should be to push and support member states on structural reform. Everything else is just window dressing. It shouldn’t be trying to take pan-European ownership of specific issues which are best resolved by member states.”

“The European Investment Bank does provide funding for guarantee programmes and loans to firms in Germany but this is crowding out the market by providing cheaper loans to firms that the banks would offer finance to anyway.”

“Germany has developed effective institutions to help SMEs access finance. These are different to other countries, particularly the anglo-saxon model, but any reforms as part of the Capital Markets Union should work with existing institutions.”

“Capital markets can dry up too as well as bank lending. The assumption that everything the US does is the right way of doing it is not well founded.”

ITALY

The Main Issue for Italian Banks Is the Level of Non-Performing Loans But Securitisation Could Help Regional Banks

The challenges in the Italian banking sector, which are affecting the ability of SMEs to secure loans, were attributed by interviewees to the high level of non-performing loans rather than issues with liquidity or capital. However, a number of Italy’s regional banks have major funding issues which could be helped by securitising SME loan portfolios.

“The main issue for Italian banks is not capital or liquidity, as the ECB has flooded the market, but non-performing loans due to the state of the economy. This is acting as a major drag on the availability of new credit.”

“Private guarantees for SME loans are having ever increasing levels of defaults, so the public guarantee scheme should be expanded.”

“Lending to SMEs is often not profitable for Italian banks, it is more of a ‘loss leader’ to sell other more profitable products.”

“Reforms to encourage securitisation could primarily help Italy’s regional banks, which have large SME portfolios and funding challenges.”

There Is a Severe Lack of Private Equity Investment, Particularly Venture Capital and Business Angels

Interviewees cited a dearth of equity financing, due to the lack of a culture of equity investment and the absence of a well-capitalised pension system. Building strong, local industrial networks to support businesses to be finance-ready and to connect with investors is seen as crucial. The need for fiscal incentives for investors was also cited, although recent reforms in this area are beginning to help. The Italian government’s decision to introduce entry requirements for retail investors investing in venture capital funds that are above the EU’s minimum level was also seen as damaging for investment.

“There is a growing understanding that equity is the way to go for funding growth and innovative companies but the numbers are still very small. The problem of equity is undermining the future of the country.”

“If Italy had pension funds that invested in the capital market, we would expect a lot more investment to flow into venture capital. At the moment the sector is just too small to be investing much in venture capital.”

“Italy is 10 years behind France and many other EU countries on public policy support for venture capital and business angel investment but at least things are moving in the right direction.”

“Regional business angel networks are beginning to develop in Italy but in most places there is a lack of businesses or limited finance. In Turin, it has developed well because of a concerted effort from local partners including the university, local government and investors. Beyond that, most investors are in Milan.”

A Need for a Targeted CMU Project and Continued Structural Reform By the Italian Government

There is not a desire for lots of new EU regulation but there is support for targeted initiatives from the European commission.

Beyond securitisation, schemes that help kick-start private placements would be beneficial. Interviewees also emphasised the need for national reforms, particularly to the legal system related to insolvency procedures.

“We do not want lots of new initiatives or regulations from the European commission but some targeted legislation to create pan-European investment instruments, such as for private placements, would help.”

“In reality the EU cannot do all that much to address the issues for SME financing – it is too far away. Investors want to see less bureaucracy in Italy, more flexible labour laws and a more efficient justice system.”

“The issue with insolvency law in Italy is due to implementation, particularly the legal system, not the legislation itself. Navigating the legal system for SMEs facing insolvency is impossible.”

POLAND

There Are No Major Credit Constraints But Application Rates Are Low Among SMEs

Poland has not seen a major contraction in SME lending in recent years. According to interviewees, this was because national banking regulations were already robust before the Basel III rules came into force. Rejection rates are also low because SMEs have built up an understanding of the lending criteria of Poland's banks.

“The rules for approving bank finance application in Poland have been very strict since before the crisis. Businesses understand these rules and do not apply unless they think they have a realistic chance of success.”

“Polish businesses are less leveraged than those in other countries, which explains the relatively low application rate for bank finance.”

“Poland has long had one of the most conservative banking systems in Europe. This meant that our banks were better prepared for the financial crisis and that the Basel rules have not hit lending.”

Attracting Foreign Capital and Tax Reform Are Seen as Key to Increasing Equity Financing

As a relatively new economy, interviewees highlighted the underdeveloped pool of equity capital for growing businesses. There is very little equity financing available in Poland. Foreign capital, including EU funding, is seen as crucial for increasing the flow of equity capital. Interviewees cited a number of issues with the design and administrative burden of some EU initiatives. Pension and tax reforms were also discussed but considered politically challenging.

“There is a lack of equity capital in Poland which is a major problem. There are only two Polish-domiciled private equity funds. We need European institutional investors to increase assets to allow funds to close and investment to start.”

“Private pension funds are still too small given the collapse of the Polish pension system and there are barriers preventing them for investing in illiquid assets. Private equity funds have stopped trying to get pension assets to invest.”

“The major issue for tax reform is that constitutionally Poland is not allowed to have a debt to GDP ratio greater than 60%. Any short-term increase in costs from structural reform would therefore impact this, so tax incentives are not even being discussed.”

“The EU’s hard criteria for its investment schemes are often not appropriate and prevents certain deals going ahead. EU funds are also expensive to administer as there are lots of layers and institutions involved.”

There Are Concerns That CMU Might Introduce Greater Risk to Poland’s Financial Markets, and National Reforms Are Seen As the Key Priority

Although the CMU project is viewed positively, there are fears it could undermine Poland’s strong national system of financial supervision. Reforms to encourage the securitisation of SME loans are not expected to help Polish banks significantly, as Poland’s mainly foreign-owned banks are generally well funded. On a national level,

it was also felt that the Polish government should do more to support growth SMEs and improve competitiveness, and to evaluate its policies. The insolvency process is also a barrier to investment, but this is as much an issue of culture.

“We are concerned that a Capital Markets Union might weaken our financial stability as Poland has stronger financial regulation and supervision than most other European countries.”

“All the major Polish banks are foreign-owned by large international banks so are well funded. Securitisations of SME loans is unlikely to make a difference.”

“The Polish government is too focused on supporting start-ups. We need a more balanced approach across different types of firms, including later-stage businesses.”

“Allowing a second chance for entrepreneurs is critical. The stigma of being insolvent is a major issue in Poland, and Poland also has a very complicated insolvency process.”

SWEDEN

There Are No Major Credit Constraints and the Swedish Government’s Direct Lending Approach Has Widespread Support

Businesses are generally well-served by the Swedish banking sector although innovative and high-growth businesses have more issues accessing loans. The Swedish government’s direct lending approach, as opposed to the loan guarantee schemes prevalent in many other countries, is seen as an effective model particularly in economic downturns. Sweden notably has a thriving market for the private placement of corporate bonds, which is providing levels of finance as low as €m.

“There is a big funding gap for Sweden’s tech sector but in general most businesses get bank financing.”

“The Swedish government’s direct lending model was a quicker way to lend than a guarantee system, which helped Sweden respond to the

crisis. It makes no sense to have both a direct lending model and a guarantee – for historical reasons Sweden has direct lending and it works.”

“The last few years has seen a boom in high yield bonds in Sweden for amounts as low as €5m. The firms issuing private placements often have very little assets or collateral. Investors have a high risk appetite for private investment, partly incentivised by low interest rates.”

Despite Sweden Having Comparably Strong Equity Markets There Remains a Lack of Business Angel and Venture Capital Investment

Sweden has a strong equity culture but there is evidence of a significant gap for equity investment for early-stage and scale-up businesses. Interviewees were concerned to find that Swedish start-ups increasingly go to the US for equity investment. Both the Swedish government’s and the EU’s equity investment schemes were also considered to be too rigid, which undermines their impact.

“There is a huge gap in Sweden for funding businesses with amounts between €500k and €3m, and this funding gap between business angels and venture capitalists is widening.”

“Business angels are primarily concentrated in Stockholm, and they are typically focused on tech and life sciences. Gothenburg has only a handful of angels.”

“Business angel investment has gone up in Sweden recently partly due to the introduction of the Investment Reduction Tax Scheme two years ago, but it is predominantly due to successful entrepreneurs reinvesting.”

The CMU Project Is Viewed Positively But Not Expected to Have a Major Impact on Sweden

There was a general view that the commission should be trying to eliminate the plethora of national rules that still impede the single market, but that this should not be a substitute for structural reform. It was felt that there are no major issues with regulation, tax or

insolvency regimes for the Swedish government to address but Sweden does have only limited forms of company types, which can act as a barrier for investors. The securitisation of SME loans is not considered to be of interest to Swedish banks.

“Most Swedish start-ups head to the US, not Europe. And venture capital funds tend to come to Sweden from the US and the oil-rich regions more than they do from Europe.”

“SME lending is typically done nationally not cross-border. There may be a case for a Nordic cross-border investment platform rather than a pan-European one.”

“There is very little interest in securitisation in Sweden and no history of it. 15 years ago the Swedish government tried to help promote securitisation but no one took this up.”

“The insolvency regime is not too much of an issue for investors, but folding a company is more challenging than in the UK – you either have to sell it, often to a holding company, or get an independent adviser to approve.”

UK

Bank Financing Is Not Seen as a Major Issue, But Business Support – Particularly for Firms Whose Loan Applications Are Rejected By Banks – Remains a Concern

There is not a major issue financing businesses via banks in general, but high-growth businesses find it much harder to secure bank loans than other businesses. The UK’s comparatively more targeted loan guarantee scheme was considered by interviewees to be a broadly effective intervention to help such firms. Improved business support, including the UK’s proposed credit referrals scheme, was seen as crucial to supporting firms’ access to finance. Reducing risk-weights for high-quality securitisation was seen as a positive step to diversify sources but was not expected to increase SME lending in the UK given that banks are well-funded.

“Most banks want to lend to SMEs but there is a lack of demand. The bank deposits of SMEs are still increasing, implying continued deleveraging. But riskier firms will continue to struggle to get debt financing, unless we want to try to increase risk within the banking sector.”

“There is a huge need for business support services to help firms approach the right financial providers for the right type of finance.”

“The proposed UK referrals system could go a long way to resolving the financing issues in the UK to help those SMEs that are rejected to find finance elsewhere. This is a more important reform than the SME credit database that is proposed as part of the CMU Green Paper.”

“UK banks are super-liquid therefore they do not need more funding, and securitisation of SMEs is not currently cost effective for them. It could be helpful at some point though, as finance has changed radically in the past five years.”

EU Equity-Based Schemes Should Be Redesigned and Focused on Riskier Businesses

Despite the comparatively strong equity culture and pool of equity capital, interviewees cited significant levels of unmet demand for equity investment. Government tax incentives have helped to increase levels of investment, but the returns on government venture capital funds have been poor. Interviewees also cited the lack of scale among the plethora of UK pension funds as a barrier to investing in private equity. Interviewees thought that the European Investment Fund’s role should be shifted to better support business angel investing. The entry requirements for retail investors to invest in venture capital funds were also thought to be too high.

“EU initiatives, such as the European Investment Fund and the Investment Plan, need to be careful not to crowd out the private sector. They should focus on the riskier end that the market will not fund.”

“The European Investment Fund (EIF) invests with individual business angels but the evidence shows that business angel syndicates are far more effective. EIF’s venture capital funds have gone for easy

wins – and fund managers have to invest a lot themselves, which is a major barrier.”

The CMU Project Has Strong Support and a Range of Reforms Are Suggested for Inclusion

Support for the European commission’s CMU project was positive among interviewees in the UK. There was less support though for harmonisation, with a greater focus on member states improving the business environment and greater certainty in national legal systems. Cross-border securities legislation was widely cited as needing to be improved.

“The positive sentiment and approach from the commission with regard to the Capital Markets Union is as important as specific reforms. It is clear that Europe is open for business.”

“The EU’s passport for investment products is not working. Too many national regulators stipulate extra measures for these investment products to be sold across-borders.”

“Post-trade costs are a third higher in Europe than in the US. A drive to improve the efficiency of clearing and settlement would have a substantial impact on improving this cost disadvantage.”

CASE STUDIES ON SUPPORTING GROWTH FIRMS

During the course of this project, numerous examples of best practice of policies supporting fast growing innovative firms were observed. They included:

- Ensuring that those rejected by banks have access to other sources of finance: *Médiateur du Credit* (France)
- Tax incentive schemes to increase the flow of funds into riskier assets: EIS, SEIS and VCT schemes (UK)
- Increasing the flow of funds into venture capital and the sustainability of pension systems: pensions reform and AP6 (Sweden)
- Improving education systems to better prepare workers for the knowledge economy: education reforms (Poland)
- Developing local ecosystems bringing together firms, universities and local government: Turin's innovation ecosystem (Italy)
- Preparing firms to be finance-ready and providing widespread business support programmes: Chambers of Commerce and Industry (Germany)

Ensuring That Those Rejected By Banks Have Access to Other Sources of Finance: Médiateur du Credit (France)

The *Médiateur du Credit* scheme was created in 2008 in France to offer a free and confidential mediation service to any company encountering difficulty in accessing finance with its bank(s) or with Bpifrance. The body was initially set up as a response to the financial crisis. Since then, 45,000 mediation requests were filed, and 36,000 of them were considered as valid. Solutions were found in two-thirds of the cases, which helped save an estimated 20,000 companies and 360,000 jobs.¹ In 2013, the scheme helped to unlock €1.3bn of financing and preserve 47,000 jobs.²

There are 100 local credit mediators (one in each *département*, the French sub-regional local authority), with the cost of running the scheme met by the French finance ministry and the Banque de France. Banks have also appointed 500 advisers across the country. Volunteers from business networks such as chambers of commerce are consulted to give an opinion on each request.

A review by the OECD found that over time the complexity of the cases submitted to mediation has increased and the scope of mediation broadened, from short-term loans to credit insurance and equity finance.³

Tax Incentive Schemes to Increase the Flow of Funds into Riskier Assets: EIS, SEIS and VCT Schemes (UK)

The Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS) have been central in catalysing business angel activity across the UK, which in turn is leading to a higher rate of investment in firms that are more likely to become the engines of growth for the future. Since the EIS was launched in 1994, over 22,700 companies have received investment through the scheme and over £12.2bn of funds have been raised. In 2013–14 the amount of investment raised was £1.3bn, a 36% year-on-year increase.⁴ The SEIS was introduced in 2012 to encourage investment in higher risk, earlier-stage companies.

Companies with fewer than 25 employees that have been trading for less than two years can raise up to £150,000 under SEIS. Under EIS, firms with fewer than 250 employees can raise up to £5m each year, with a lifetime limit of £15m pending EU state aid approval. Growth achieved by investment made under both schemes is exempt from capital gains tax. The SEIS's income tax relief, at 50%, is much higher than the EIS's 30% relief, reflecting the higher risk of investing at an even earlier stage of a company's development. An individual investor can invest up to £100,000 in SEIS and £1m in EIS per annum. In addition the UK has a Venture Capital Trust (VCT) scheme which was introduced in 1995. Under the scheme, investments in firms are made by fund managers rather than business angels. To date, this scheme has raised £5.5bn to invest with just under 100 VCTs.⁵ This scheme has a maximum investment limit of £200,000 per year.

Research has indicated that between 52% and 87% of the funding provided through the EIS and VCT schemes would not have been invested in small unquoted companies in the absence of the schemes. Analysis of firms listed on the UK's AIM market, which can take advantage of EIS, shows that AIM firms in 2009 created 250,000 jobs, generated £12bn of GDP and paid £1.8bn in tax revenues.⁶ In general the EIS scheme appears to have been more successful than the VCT scheme. On top of raising almost double the amount, the EIS scheme has raised over four-times the tax liability compared to just over two for VCTs.⁷

80% of business angel investment in the UK utilises the EIS and SEIS schemes, and private investors account for up to £1bn of early-stage investment per year.⁸ The median expected return for business angel investments made since January 2012 is between one- to five-times initial investments. The second largest segment of investments is expected to return between six- to 10-times initial investments.⁹ Moreover, 64% of business angels reported reasonable growth across their portfolio.¹⁰ There do remain concerns related to the impact of high charges levied by VCTs and EIS fund managers on performance. The challenge for these fund managers

remains the high cost of undertaking due diligence of investing in small firms.

Increasing the Flow of Funds into Venture Capital and the Sustainability of Pension Systems: Pensions Reform and AP6 (Sweden)

Governments that do not reform pay-as-you-go (PAYG) pension systems will eventually face a pension crisis. According to Allianz's Pension Sustainability index, many EU member states still have to undergo significant reform to ensure that their pension systems are put on a sustainable footing. Sweden has the most sustainable pension system in the EU with an index score of 7.8, and the second most sustainable system in the world behind Australia. Only six other EU countries have scores above seven including the Netherlands, Denmark, Latvia, UK, Estonia and Finland.¹¹

One major benefit of using the capital market for pension provision is that pension investments are by definition patient: they have long-dated liabilities that need to be met with appropriate long-dated returns. Investment in innovative and growth firms can therefore play a role as part of the asset allocation of a pension fund.

A comparison of the share of total venture capital funds raised from pension funds across six jurisdictions shows that Sweden has the highest percentage of assets coming from the pension sector (see Table 4.1). Sweden also has the most developed market for venture capital investment as a percentage of GDP across Europe.

Prior to the 1994 reform, Sweden was in the position that many EU countries find themselves in now with an unsustainable PAYG system. The reforms not only made the pension system more sustainable, but by using the capital market Sweden has also been able to channel some of this capital back into the real economy to help finance growth and innovative firms.

As part of the pension reform, a government buffer fund known as AP6 was created, which is a long-term, active investor in unlisted companies. AP6 invests around two thirds directly into firms with

Table 4.1 Venture Capital Raised from Pension Funds By Country, 2007–13

Country	Share of Total Venture Capital		% of GDP
	2012	2013	2007–13
Sweden	50%	37%	0.07%
UK	11%	15%	0.05%
France	3%	1%	0.04%
Germany	0%	0%	0.03%
Poland	0%	0%	0.01%
Italy	0%	0%	0.01%

Source: EVCA (2014), European Private Equity Activity Data 2007–2013, available at: <http://www.evca.eu/research/activity-data/annual-activity-statistics/>; 2013 GDP figures.

the rest via private equity funds. The fund has generated returns averaging 5.4% over 10 years,¹² outperforming both US bonds and equities over the period which saw returns of 5.1% and 3.3% per annum respectively.¹³ The need to maintain a sufficient level of return from investing has meant that the emphasis has shifted away from early-stage investment to later-stage investment, which has shown to have been more profitable. As a result pension funds on their own are unlikely to resolve the finance gap for early-stage investments. However, they are well positioned to focus on growth and late-stage investments, whilst being part of the solution for early-stage investing.

Improving Education Systems to Better Prepare Workers for the Knowledge Economy: Education Reforms (Poland)

Education reforms implemented since the fall of the Berlin Wall have helped to radically improve educational performance and participation in Poland. This has helped to develop a stronger base of human capital for entrepreneurship and for businesses to recruit.

One of the key reforms was to abolish the twin-track system that primarily aimed to prepare people for life-long employment in a specific job. This system saw only 20% of pupils going onto general secondary education that would prepare them for the university entrance

exam, the *matura*. Half of pupils would study at basic vocational schools run by individual sector industries and around 30% would prepare to be technicians at technical secondary schools. In 1993, a new type of secondary vocational school was introduced that provided students with a general secondary education as well as technical training, and gave pupils the option to take the university entrance exam. A common curriculum was also introduced, including courses in reading, mathematics, and science. This gave pupils an extra year before having to choose their study route from the age of 15.

Poland is now ranked 14th in the OECD's 2012 PISA rankings, above the other five countries focused on in this report and the US.¹⁴ Between 1990 and 2005, the total annual number of Polish university students increased from around 400,000 to 1.9 million. Business related courses also increased by a factor of 15 and the number of business schools increased from five to 93.¹⁵

Poland now has high levels of entrepreneurship. Nearly half (47%) of citizens in Poland say that they would prefer to be self-employed rather than be employed by a company compared to 37% across the EU.¹⁶ This has been helped by initiatives to promote entrepreneurship, with three out of 10 respondents (30%) in Poland saying that they have taken part in a course or activity about entrepreneurship compared to 23% across the EU.¹⁷

Developing Local Ecosystems Bringing Together Firms, Universities and Local Government: Turin's Innovation Ecosystem (Italy)

Turin has a strong history of innovation and design. Car manufacturer, Fiat, started in Turin over a hundred years ago, as did the ICT firm, Olivetti. Other major companies such as Alenia Aeronautica (aerospace), Lavazza and Ferrero (agro-food), and innovative SMEs such as Mondo and Novamont in materials and chemicals, also have strong bases in the area.

The *Piemonte* regional government has been an active player in supporting the innovation ecosystem around clusters since

it was given responsibility for innovation in 2001. According to the OECD's 2014 regional innovation scoreboard, the *Piemonte* region is now ranked first out of 21 regions in Italy for R&D expenditure in the business sector. It is also ranked second in Italy for employment in knowledge-intensive industries, innovation among SMEs, and collaboration between innovative SMEs.¹⁸ According to a report that benchmarks university incubators, the *Politecnico di Torino* ranks fifth in Europe.¹⁹

Key to the success of the *Piemonte* region has been the regional government's focus on developing networks in 12 industry clusters in specific parts of the region. These networks, which cover 1,400 businesses and research centres in total, have been awarded private sector contracts to help foster each cluster, with the aim of supporting knowledge-exchange and the sharing of infrastructure.²⁰

There are four clusters in Turin: digital creativity and multimedia; ICT; sustainable building and hydrogen technology; and mechatronics and advanced production systems.²¹ The mechatronics and advanced production systems cluster, for example, brings together two universities and nine research centres with more than 200 businesses, which are mostly SMEs.²²

Each cluster is provided with a small budget of around €3m euros per year. The clusters have also helped to secure funding for more than 330 R&D and innovation cooperation projects.²³ Clusters' responsibilities include identifying the technological needs of companies, encouraging the sharing of laboratories and other infrastructure, and helping the flow of skilled employees between private companies and public research centres.

Preparing Firms to Be Finance-Ready and Providing Widespread Business Support Programmes: Chambers of Commerce and Industry (Germany)

Across Germany there are 80 chambers of commerce and industry (*Industrie- und Handelskammern*, or *IHKs*), which provide support and advice to three million businesses. These employ 7,000

specialist advisers and draw on the support of 400,000 business volunteers.

All German companies registered in Germany, with the exception of handicraft businesses, the free professions and farms, are required by law to join an *IHK*. *IHKs* are entirely private-sector funded, although in many regions newly formed businesses are typically not required to pay fees.

The support provided by *IHKs* for finance-readiness aims to make sure that businesses are well-prepared before they approach financial providers or investors. *IHKs*' role is to transmit basic knowledge about the funding process and to challenge thinking, with specialist advice in technical areas typically left to professional services firms. The support provided by *IHKs* starts with regular outreach events that inform a wider audience of entrepreneurs about different financing options, but typically continues with one-to-one meetings that establish ongoing relationships. This support can include writing business plans, considering the most appropriate finance option and offering feedback on prospective applications for finance.

Each *IHK* tailors its services to the needs of local businesses, many of which are locally devised initiatives. The Hamburg *IHK*, for example, offers its own two-day seminar to entrepreneurs looking to start a business before asking them to submit a draft business plan which they then provide feedback on at personal consultations. There is also a "point of single contact" where businesses can register and apply for any necessary licences. The Berlin *IHK* offers its BBB-Start! Programme, which provides financial checks for new businesses at intervals during their first year. The programme is linked to the provision of guarantees by the regional guarantee bank, *BBB Bürgschaftsbanken zu Berlin-Brandenburg*. All businesses that are provided with loan guarantees by the bank are given free access to the programme.

IHKs also work in close partnership with national government departments and agencies to help deliver nationally-recognised schemes in a way that is most suited to the local economy. *IHK*'s

are the main partner for the “Start-Up Coaching in Germany” programme, for example, which is led by Germany’s national state development bank, KfW. The scheme offers subsidised consultancy on economic, financial and organisational issues to businesses that are less than two years old.

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POLICY PROPOSALS

The analysis on the structural challenges across the EU found a number of obstacles that are constraining the growth of high-growth innovative firms:

- Europe is severely lacking equity financing. Poorly developed tax and insolvency regimes for investors remain critical drivers behind the shortfall. Although national governments are aware of these issues, some raised legitimate concerns on the difficulties of funding this kind of structural reform. Furthermore, public policies to try and increase funding levels for venture capital do not appear to be working.
- There is too little focus on the things that work well and a lack of mutual learning between member states to take advantage of this. Examples of best practice ranged from business support schemes, to the development of local ecosystems, the value of credit mediation schemes for firms rejected for finance and a more business-oriented education. Concerns also remain that existing rules of the single market are not being enforced effectively and that financial services regulation has been excessive and sometimes contradictory since the financial crisis.

- Concerns were raised that banks may have less access to the capital market to diversify their sources of funding and help transfer risk, due to punitive charges for high-quality securitisations.
- There was little appetite that Europe should abandon its traditional banking model, but there was strong support for a complementary system of financing focussed on specific areas of the capital market.

KEY PRIORITIES FOR A CAPITAL MARKETS UNION

During the course of the study, four key policy priorities emerged as being central to a successful Capital Markets Union that will help resolve much of the current underlying economic underperformance.

Priority 1: Improve the Environment for Investors in Growth and Innovative Firms

This was widely considered to be the most important priority to promote investment and jobs across Europe. Although many of the powers to unlock this remain under member states, the European commission needs to play a central role in supporting these changes.

Tax Incentives

Tax incentives for investors in riskier assets was seen as the main priority to stimulate investment and growth. Stakeholders in member states generally saw the UK tax incentives as a good benchmark. However, there were numerous political objections raised to such a proposal given that these tax incentives would lead to a shortfall in revenue which would then need to be clawed back in some way through either higher taxes or higher borrowing. Raising taxes from the community to pay for tax incentives for wealthy investors was not considered a potential election winner for many political parties across Europe. This leaves higher borrowing as the only potential solution.

There was a general recognition that such tax reforms ought to be seen by the commission as structural reforms and therefore should not constitute a breach of the Stability and Growth Pact's fiscal rules. There was also interest in establishing some form of mutual guarantee of member state bonds used to finance structural reform. These could be similar to the "Stability Bonds" proposed by the commission in 2011 and in the spirit of the "contractual arrangements" discussed by EU leaders in 2012–2013. This would alleviate any concerns that interest rates might increase in the short run causing the cost of debt servicing to rise, thus acting as a barrier to any member state trying to implement structural reform.

There were also strong views that the commission should be clearer with regards to state aid rules to ensure the longevity of schemes that provide tax incentives to investors in riskier firms given the overriding market failure. Lowering the financial threshold for retail investors into this risky asset class would also help drive up the size of funds. The European Venture Capital Fund Regulation (EuVECA) states that retail investors must invest a minimum of €100,000. This in effect restricts investment to those with around €2m of investable assets, assuming a 5% asset allocation is given to this asset class.

- ***Recommendation 1: Encourage the introduction of tax incentives for business angel and venture capital investors.*** Promoting a much wider equity culture in all member states should feature highly in the European Semester. Country-specific recommendations should push forward tax incentives for business angel and venture capital investors. These measures should qualify as structural reform and therefore not constitute a breach of the Stability and Growth Pact's fiscal rules. In order to ensure that the implied extra borrowing would not lead to rising interest rates and the cost of servicing debt, EU leaders should consider again some form of bond guarantee programme. Clearer guidance on state aid rules for such tax incentives would provide certainty for investors in riskier firms, and a reduction in the minimum requirement for

retail investors to invest in riskier firms would also help promote a deeper equity culture.

Supporting Venture Capital

Since the crisis, public sector support for venture capital funds has largely kept the industry alive. However, there has not been the flood of funds back into the asset class from the private sector. Policy needs to shift towards supporting new kinds of investor business models that can help generate positive returns. Whilst the returns on venture capital remain close to zero, it will remain very challenging to increase the flow of funds into the industry in any substantial way. The challenge for venture funds is that they have high fixed costs given the challenges of investing in riskier firms, which impacts the profitability of investing in this asset class.

A scheme run by the Small Business Administration (SBA) in the US provides low-cost, fixed-term loans to small business investment companies (SBICs) without any cost to the taxpayer. These funds are raised from the capital market through bond issuance. These SBICs tend to provide a mixed mode of financing to growth companies with part equity and part debt with relatively higher interest rates. The interest margin allows the SBICs to cover some of their costs, thus making the asset class more viable. Conversely high-growth firms are happier to accept a lower equity stake and are more likely to be able to pay back the higher interest payments.

The Business Growth Fund (BGF), which was set up in the UK in 2011, operates in a similar way. It provides long-term capital to growing companies with investments between £2m and £10m. These investments are comprised of both equity and loan notes in roughly equal measure. This mixed mode of financing generates an ongoing yield of approximately 4% from interest that contributes to the costs of running its 110-person operation. The BGF is in a rather unique situation in that it was funded by the main UK high street banks, and therefore is not capital constrained. But if other investment funds had access to low-cost, 10-year fixed loans they could compete in this market as well. The European Investment Fund (EIF) already

has a great deal of this kind of experience and would be able to step into this role and provide low-cost, fixed-term loans to registered investment funds.

The EIF should also use its business angel fund to invest in syndicates as there is an increasing trend across the business angel market for investments to be pooled from several investors.

- ***Recommendation 2: Expand the role of the European Investment Fund (EIF) to provide long-term loans to newly-established small business investment companies (SBICs).*** The European commission should work with the EIF to set up a new SBIC scheme to provide low-cost, fixed-term loans to registered investment funds. As has been demonstrated in the US, such a scheme would be self-financing and not require extra public resources in the medium term. These loans would allow investors to provide a combination of debt and equity to firms. This mixed mode of financing will increase the profitability of returns from riskier investment due to earnings from interest. Restrictions on the EIF investing in business angel syndicates should also be removed, as many business angel investments are being increasingly made through syndicates, which help spread risk.

Priority 2: Raise Insolvency Standards and Permit a Culture of Failure

Insolvency standards across the EU have not kept up with developments in the knowledge economy. Many jurisdictions still do not permit debt restructurings, out-of-court settlements and the use of fast-track procedures, which are crucial if businesses are to survive. Furthermore, in many European jurisdictions the discharge period for paying back debt is too long which stigmatises failure and discourages entrepreneurship.

In March 2014, the European commission issued a recommendation on a new approach to business failure and insolvency. Its aim was to encourage member states to put in place a framework that enables the efficient restructuring of viable enterprises in financial

difficulty and give honest entrepreneurs a second chance. The recommendation puts forward guidelines for establishing preventive restructuring frameworks and for limiting the negative impact of bankruptcy on entrepreneurs.¹

Without having in place these minimum standards, it is highly unlikely that investment levels will increase, particularly in knowledge-intensive industries, which are central to the growth of investment and jobs. The European commission should promote its guidelines more proactively especially by using all the leverage available during the European Semester, and consider further action if states fail to comply.

- ***Recommendation 3: Ensure that the European commission's minimum standards on business rescue and giving entrepreneurs a second chance are a key priority for the Capital Markets Union.***

The recommendations set out by the commission in March 2014, requesting that member states put in place appropriate measures needs to become a key priority for the CMU. The commission should prioritise further action, including a directive, if minimum standards are not in place within a reasonable period and should also consider reducing the discharge period to two years.

Priority 3: Ensure Best Practice Is Implemented Across the EU, and Enforce Existing Rules More Effectively

The European commission should encourage member states to adopt best practice with regards to competitiveness and facilitate the learning process across member states. The commission needs to integrate policy across departments more effectively, ensuring that existing rules are enforced, and that existing rules are of benefit.

- ***Recommendation 4: The commission should actively support implementation of best practice in the European Semester, and enforce existing rules that are of benefit.*** As part of the remit to improve competitiveness, the commission needs to improve the

process by which it identifies policies that successfully support growth and innovative firms. In particular, it should make greater use of the European Semester to advance the Capital Markets Union's objectives and think more creatively about reform incentives for member states. REFIT should also become central to the CMU initiative. Its remit should be strengthened to reduce unnecessary rules, and go hand-in-hand with an improved impact-assessment procedure all along the legislative process.

Priority 4: Promote High-Quality Securitisation to Provide More Flexibility for Banks to Lend to Firms and Households

This core plank of the CMU as set out in the Green Paper was seen to be a key reform to provide banks with greater flexibility to lend money to the real economy. There are potential short-term benefits from being able to remove assets from the balance sheet and provide greater levels of capital in less well funded banking systems. This was particularly the case in Southern Europe. For most banks in Northern Europe, there was an expectation that once the ECB liquidity support dries up and interest rates rise, securitisation would be an extremely useful funding tool.

There was very little expected demand for SME securitisation per se, with most banks expected to securitise other assets such as mortgages and credit card receivables. However, there was general support that high-quality securitisation should also be applied to risk transfer and therefore synthetic securitisations. The expectation from the market was that any plan for high-quality securitisations would reduce risk-weights to make them more comparable with on-balance-sheet assets.

- ***Recommendation 5: Reduce risk-weights for high-quality securitisation and apply these rules to synthetic transactions.*** Risk-weights for high-quality securitisations should be reduced to be more in line with on-balance-sheet assets. This should provide

banks with greater flexibility in the medium term to lend to households and firms. Applying these rules to synthetic securitisations would also support greater risk transfer.

In summary, the CMU initiative needs to focus more on the broader business environment for high-growth and innovative firms rather than on individual financial instruments. Whilst improvements in the Prospectus Directive, promoting a pan-European private placements market and building an SME credit database suggested in the commission's Green Paper might be of assistance, their impact on supporting high-growth and innovative firms is expected to be more limited.

Lesser Priorities

There was very little support that changes in the Prospectus Directive would have a significant effect on channelling growth capital to where it is needed. Most commenters were supportive of removing unnecessary rules, but there was a wide range of views on what specifically needed to be changed. For example, some argued that there should be exemptions for secondary issuances under certain conditions, but others felt this would undermine the position of existing shareholders. The general view was that firms who list, will list anyway. Improvements to the Prospectus Directive to make listing easier and cheaper is positive, but it will not help resolve the lack of supply of growth capital.

There was a lot of support that a pan-European private placements market would be beneficial for mid-market firms, leading to banks reducing their loan exposure to these kinds of firms. However, there was not much expectation that this would direct growth capital to SMEs. Market participants felt that the provision of certain guidelines would be helpful in jurisdictions where the market for private placements is not currently functioning. In general there was no desire to have the European commission involved in regulating this market. The kind of government intervention that was perceived as

helpful to kick start the market was mainly fiscal. Many stakeholders remarked on the decision by the UK government to exempt withholding tax on interest payments on private placements.

The increase in transparency of credit information was widely supported as a positive step. In particular, it was seen as providing more transparency in concentrated banking markets, or in markets where the banking sector was not able to meet the demand for loans. Such a database would therefore be able to provide more options for those firms who are currently able to access capital, as well as strengthening the resilience of the banking system through increased competition. However, the general view was that such a database was unlikely to do much for those firms who were unable to get capital. Firms unable to access credit would benefit more through the implementation of credit mediation services such as in France, or compulsory referral schemes for rejected loans. The impact of such a database was not deemed to be significant with regards to increasing cross-border lending due to differing national accounting standards. Until national accounting standards are harmonised, using something like an “IFRS Lite” scheme, the benefits of such a database were expected to be limited. There was however some support for an “IFRS Lite” scheme for SMEs to be started now, but there was a realisation that such an initiative would take a long time to be completed. The commission should therefore seek to set up an “IFRS Lite” scheme now given the long lead time before this can have an impact.

NOTE

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APPENDIX

LIST OF CONTRIBUTORS

- Angel Co-Fund, UK
- Association for Financial Markets in Europe
- Association of British Insurers
- Association of German Banks
- Association of German Chambers of Commerce and Industry
- Association of German Public Banks
- Bank of England
- Barclays Bank
- BNP Paribas, France
- Bpifrance
- British Bankers Association
- British Business Bank
- British Venture Capital Association
- Bruegel
- Business Angel France
- Business Angels Europe
- Business Angels Network Germany
- Business Growth Fund, UK
- Calculus Capital, UK

- Commerzbank, Germany
- Confartigianato, Italy
- Confederation of Swedish Enterprise
- DE Capital, Sweden
- Deutsche Börse, Germany
- Droit et Croissance, France
- Enterprise Investment Scheme Association, UK
- European Association of Craft, Small and Medium-sized Enterprises
- European Association of Mutual Guarantee Societies
- European Banking Federation
- European Central Bank
- European Commission – Cabinet of Jyrki Katainen
- European Commission – Directorate-General for Financial Stability, Financial Services and Capital Markets Union
- European Commission – Directorate-General for Internal Market, Industry, Entrepreneurship and SMEs
- European Commission – Directorate-General for the Internal Market and Services
- European Commission, team of commissioner for Economic and Financial Affairs, Taxation and Customs
- European Financial Congress, Poland
- European Investment Fund
- European Venture Capital Association
- Federal Ministry for Economic Affairs and Energy, Germany
- Federal Ministry of Finance, Germany
- Federation of European Securities Exchanges
- Federation of Small Businesses, UK
- France Angels
- Frankfurt am Main Chamber of Commerce and Industry
- German Private Equity and Venture Capital Association
- German Savings Banks Association
- Grant Thornton, UK
- HM Treasury, UK
- Impact Invest, Sweden

- Intelligent Partnership, UK
- International Capital Markets Association
- Intesa SanPaulo, Italy
- Italian Angels for Growth
- Italian Banking Association
- Italian Private Equity and Venture Capital Association
- KPMG
- Legal and General
- Lewiatan Business Angels, Poland
- London Stock Exchange
- Mannheimer Swartling, Sweden
- mBank, Poland
- Minister of Economy, Industry and the Digital Affairs, France
- Ministry of Economy & Finance, Italy
- Ministry of Enterprise, Energy and Communications, Sweden
- Ministry of Finance, Poland
- Ministry of Finance, Sweden
- Ministry of Foreign Affairs, Poland
- Moodys Investors
- Nesta, UK
- Nordic Capital Markets Association, Sweden
- Office of the Prime Minister, Italy
- Old Mutual
- PKO Bank Polski, Poland
- Poland Business Angels
- Polish Bank Association
- Polish Craft Association
- Polish Financial Supervision Authority
- Polish Private Equity and Venture Capital Association
- Prudential
- Royal Bank of Scotland
- Santander
- Société Générale, France
- Swedbank, Sweden
- Swedish Private Equity and Venture Capital Association

- Swedish Securities Dealers Association
- The German Association for Small and Medium-sized Businesses
- The Investment Association
- UK Business Angels
- Vienna Stock Exchange