COMMISSION OF THE EUROPEAN COMMUNITIES

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ANNEX II to the

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Implementing the Community Lisbon Programme:

Financing SME Growth – Adding European Value

{COM(2006) 349 final}

IMPACT ASSESSMENT

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1. SUMMARY

Financing innovative SMEs is considered by many finance providers as a risky activity due to high transaction costs and low average expected returns especially for investments in early stage firms. This leads to gaps of finance provision in the marketplace.

The purpose of the Communication is to contribute to reducing the barrier to access to finance that SMEs currently face and thus to contribute to the goals of the Lisbon Agenda of higher growth. The target groups of this Communication are SMEs, public authorities and the financial sector.

The Communication aims at three goals, more bank financing for innovation, more risk capital for growth financing, and better performing financial systems.

The first port of call for most SMEs requiring finance is their bank. The risk orientation of banks requires that SMEs need to familiarise themselves with bank requirements, and need to be prepared to provide the necessary information to the banks. Guarantees and other risk sharing mechanisms can be used to facilitate access to bank lending. Improved policies on the provision of guarantees and microcredits will allow more people to become entrepreneurs.

Early growth is most often financed with risk capital. However, there is no effective way for venture capital funds to invest and raise funds across borders in Europe with up to 25 sets of operating conditions and action is needed to remove obstacles. This would increase efficiency and lead to more firms surviving the crucial early stage.

On developing financial system, the Commission is committed to helping all Member States, to adopt global best practices. For example, increasing cooperation between advice providers can lead to easier access to support services that enable SMEs to better access finance.

The options available to the Commission are do nothing, legislate or enhance cooperation between the Member States. Of these, the "zero option" would squander an opportunity to increase the speed of policy reform in SME finance and would prevent many SMEs to fully utilise their growth potential, harming economic growth and employment in Europe.

A legislative package could only address some of the issues at stake (eg. a cross-border fund structure) and would leave all policy-related questions unanswered.

The option of using enhanced cooperation requires cooperation between the Commission the Member States and various stakeholders to influence policy making by increasing awareness about the necessity to improve the supply and demand of finance for SMEs, and for implementing good practices in policy-making. Reformed policies on SME finance would improve growth and productivity of the whole Europe.

If the Commission were to propose further action in areas covered by the Communication, a detailed impact assessment would be carried out for these.

2. INTRODUCTION

Businesses across the EU are faced with increasing international competition. The continued prosperity of the EU-countries depends to a large extent on how successful its businesses are in staying competitive. The Lisbon Agenda (2000) highlighted the need to raise productivity growth rates and the important role innovation has to play.

SMEs account for over 99% of all EU enterprises and are responsible for two-thirds of private employment. Their success is therefore inextricably linked with that of the EU.

However, financing innovations is not risk free as not every idea develops into a commercially successful innovation, nor does every start-up firm survive. While bigger enterprises are not held back by a lack of finance, many SMEs find it difficult to obtain adequate levels of it. This limits their economic growth and thus that of the EU.

The communication, which this impact assessment (IA) accompanies, highlights the problems that SMEs often face when trying to access finance and makes broad suggestions for how these barriers can be reduced. The communication points to areas in which more concrete policy proposals should be developed and while it makes some suggestions, their broad nature does not allow for an extensive and detailed IA at this point in time. The analysis provided in this IA is, however, proportionate and suffice to say that any follow-up concrete policy proposals will of course be accompanied by more in-depth impact assessment work.

3. PROBLEM IDENTIFICATION

The overall problem of access to finance can be subdivided into problems with financing the life-cycle of an SME, those arising from the financial environment and matching offer and demand.

Problems in financing the whole life cycle of an SME

Financing innovative SMEs is considered by many finance providers as a risky activity due to high transaction costs and low returns especially in the early stages. However, finance is a strategic resource for enterprises because investments are needed for new ideas to become marketable products and services. One of the main functions of financial markets and financial institutions is to provide the finance for such investments to take place in the most efficient way.

However, there is strong evidence to suggest that markets are not fulfilling this role and that they provide insufficient capital to SMEs in particular when they are at their early growth stages. The lack of an equity investment culture, informational problems and market volatility are amongst the main reasons for this market failure. Due to the important negative implication for the growth of SMEs which directly translates into lower overall economic growth, there is a need for the public sector to act in cooperation with private investors to overcome this market failure.

Fragmentation in the venture capital market lowers its efficiency. Because of limited options to invest across borders, many funds are cannot become sufficiently specialised and their management teams cannot develop the special sectoral expertise required for successful investments. The result is a venture capital market that is far less efficient than in the US.

In a functioning single market, professional venture capital managers should be able to raise capital and invest across borders without incurring punitive unfavourable tax treatment or extensive legal documentation. This is not yet the case in Europe.

The banking sector continues to be the most important source of business finance for SMEs [1]. Banks require collateral against their lending, but SMEs often lack access to collateral or guarantees, which reduces their chances of getting a loan. This affects especially new and minority entrepreneurs looking for finance.

In addition lack of finance providers on one hand and unpreparedness and financial knowledge on the other hand make economically sound businesses disappear every year because they fail to overcome the difficulties involved in the transfer of ownership. This problem is likely to increase as many entrepreneurs will retire in the coming years. The lack of appropriate matching of the demand and supply of finance for business transfers[2] also holds back growth and employment in the European Union.

Problems arising from financial environment

The revision of capital requirements for banks, the Basel II process[3], will gradually align capital requirements more closely with risks and lead banks to increasingly use rating systems to evaluate risks. This means that many SMEs need to increase their financial literacy, need to familiarise themselves with bank requirements, and need to be prepared to provide the necessary information to the banks.

The European Union will continue to build an integrated, open, and more competitive European financial market[4] that also covers venture capital. This is an essential precondition for improved flow of finance to innovative SMEs. Moreover, the Commission is reviewing the recommendation on state aid for risk capital[5] with the view of increasing flexibility of its application.

Problems on matching offer and demand

There is a fundamental information asymmetry between the financial community and SMEs, as the entrepreneur knows always more about the state of his firm than the investor. This increases, in particular, the riskiness of early-stage investments where no track record is available. There is also a knowledge gap to the other direction: in order to successfully find finance, whether equity, loans or other forms, the entrepreneurs need knowledge about the available options, and need to demonstrate their management capability. The lack of demonstrable track record can be overcome with guarantees or other risk sharing mechanisms, often involving the public sector.

Resource and knowledge constraints in SMEs mean that they are at a considerable disadvantage vis-à-vis bigger firms by often not possessing the capabilities to present investment projects that would address the concerns of investors, which results in a high failure rate when trying to obtain finance, particularly in accessing risk capital. Many business plans have inherent merit, but are either insufficiently developed or are inappropriately

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1 See the results of the Flash Eurobarometre survey http://europa.eu.int/comm/enterprise/entrepreneurship/financing/surveys.htm

2 See http://europa.eu.int/comm/enterprise/entrepreneurship/action_plan/ap_03.htm.

3 See studies and documentation on the Basel II capital requirements at http://europa.eu.int/comm/internal_market/bank/regcapital/index_en.htm.

4 White paper: Financial Services Policy 2005-2010, 5.12.2005.

5 http://europa.eu.int/eur-lex/pri/en/oj/dat/2001/c_235/c_23520010821en00030011.pdf

structured, which reflects badly on the entrepreneur's ability to take investor concerns onboard.

4. OBJECTIVE OF THE PROPOSAL

The purpose of the Communication is to contribute to reducing the barrier to access to finance that SMEs currently face and thus to contribute to the goals of the Lisbon Agenda of higher growth, increasing competitiveness and employment creation. The Communication has three different objectives:

To improve the environment for investing in risky innovative SMEs

There is no effective way for investing and raising funds across borders in Europe with 25 sets of operating conditions. The European venture capital industry remains fragmented and suffers from obstacles when investing across borders. These factors lead to a lack of a genuine single market for venture capital and private equity. Apart from a few exceptions, European venture capital markets do not provide enough growth capital to small companies, in particular in comparison with that in the US, which is one of the biggest barriers to growth of innovative European SMEs.

Improving the environment for investing in risky and innovative firms will stimulate entrepreneurship and allow larger and more efficient venture capital industry to emerge, which will improve the prospects of innovative SMEs.

To stimulate the convergence of financial systems

The European Commission is committed to helping all Member States, but in particular the new ones that face large challenges, to adopt global best practices. The Commission's long-term effort to build lending capacity in the ten new member states is starting to bring results but further efforts are needed to develop a venture capital market based on best practices and public-private partnerships.

To strengthen local and regional finance for innovation

Bank lending continues to be the main source for innovation finance and the strengths of European banks in financing innovation should be leveraged to encourage further lending. Increasing the availability of instruments like guarantees, microcredits and subordinated loans is a way to achieve this.

5. POLICY OPTIONS OF THE PROPOSAL:

Option 1 – No change approach

This scenario would entail continuing to rely entirely on existing Community action programmes aimed at facilitating access to finance for SMEs. Continuing with the baseline scenario is very likely to have the following consequences:

- It would preserve the weaknesses in financing with risk capital (in particular for start-ups and young innovative companies)

- The gap between the financing systems of the old and new Member States would persist longer.

- The achievements in the access to finance area over the last few years (identified good practices, networks, momentum in addressing common challenges) would be underutilised.

- Opportunities to highlight the challenges and opportunities facing SMEs in their banking relationships in the rating-oriented environment would not be fully used

- Europe risks losing more and more investment to competitors because of the attractiveness of investment opportunities in these countries.

The "zero option" would thus squander an opportunity to increase the speed of policy reform in SME finance and would prevent many SMEs to fully utilise their growth potential, harming economic growth and employment in Europe. The European Union is committed to achieving the Lisbon goals and the only way of doing this is to speed up reform, also in the access to finance area.

Option 2 – Legislative approach

A legislative approach is the second option that would be possible. A legislative approach could, however, only address some of the issues at stake (eg. cross-border investments) and would leave all policy-related questions unanswered.

Policy issues are paramount when addressing the complexity of access to finance. Policies at European, national and regional level have an effect on access to finance, for example the extent to which Member States are able to orientate the structural funds towards venture capital and guarantee instruments. Further policy issues not addressed by any legislation are the identification and dissemination of best practice, and the need to reduce the differences in the financial systems between old and new member states. EU legislation only could therefore not address the problems facing SMEs when accessing finance.

However, although legislation only is currently not a suitable option, the Commission continues to review the functioning of the single market and will propose improvements when necessary.

Option 3 – Using strengthened partnerships in access to finance

This alternative allows the all parts of the issue to be tackled and the Commission considers that in the current circumstances it is the best way to address the problems identified.

This option requires partnerships between the Commission the Member States and various stakeholders, and is consequently slower, but at the same time it is more likely to have significant political impact at national, regional and local level in stimulating an open debate and dialogue on policy issues on financing business growth in Europe.

Spreading good public sector practices, and enhancing the knowledge of various stakeholders, including regional authorities, SMEs and advisory networks, are all policy elements that can be achieved at Member State level with Community support.

Option 3 is the most appropriate choice to influence policy making by increasing awareness about the necessity to improve the supply and demand of finance for SMEs, and for implementing good practices in policy-making.

It also allows highlighting synergies available from European policies and instruments, highlighting their capacity to provide leverage for national, regional and local efforts to improve access to finance.

Option 3 is therefore an efficient, effective and consistent alternative.

The strengthened partnerships allow stakeholders and policymakers to discuss the possibilities of a recognised European fund structure that would allow venture capital funds to more easily to invest across borders.

Investing in innovative and high-growth SMEs could be increased through having more large venture capital funds. Such funds can make larger deals and absorb the overhead costs of seed investments, and policies should favour the emergence of such funds.

The availability of bank finance for innovation should be increased through the use of guarantees and advisory networks, in particular through the efficient use of the financial instruments of the Competitiveness and Innovation Framework Programme (CIP)[6] and using the structural funds to this end. The Joint European Resources for Micro to Medium Enterprises (JEREMIE)[7] is one new element joint initiative of the structural funds of the EU with the EIF/EIB, which will provide the Member States and their regions an opportunity to improve considerably expertise and performance and enhance available resources in the field of access to finance for SMEs. However, this requires that the Member States take an explicit decision to use this instrument to improve SMEs' access to finance, and with that, to improve their competitiveness, growth and employment.

Reinforcing partnerships between advisory networks and the financial community is essential to improve SMEs' financial literacy. In particular, investment readiness programmes will improve the quality of projects presented to investors and it is important to identify and spread good practices concerning these programmes and encourage, for example, regional authorities to run similar initiatives.

At European level, Gate2Growth, PAXIS, EUROPE INNOVA and PRO INNO Europe are initiatives that include networks of actors active in innovation, finance and industry. These networks are developing a number of coaching tools for start-ups investor readiness like the Gate2Growth Self Assessment Tool and hands-on coaching schemes. The networks are also developing new sector specific risk and debt capital investment schemes. Both the coaching tools and the investment schemes will improve the rate of return of investors in the early stages of young innovative companies thus increasing the amount of funds allocated by private investors. The PRO INNO EUROPE initiative[8] will implement the results through joint programmes and actions at European, Member State and sub-national level.

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6 Proposal for a decision of the European parliament and of the Council establishing a Competitiveness and Innovation Framework Programme (2007-2013), COM(2005) 121 final, 6.4.2005.

7 See http://europa.eu.int/comm/regional_policy/events/ifi/documentation.cfm?deploy=0

8 See http://www.cordis.lu/innovation/en/policy/home.html

The Commission and the Member States should improve the environment for venture capital investment so that it allows tripling the investment by venture capital funds in seed and early stage (on average) in Europe (in relation to GDP) by 2013.

Principles of subsidiarity and proportionality have been taken into consideration when proposing these measures).

6. IMPACT

Impact on the actors involved in SME finance

SMEs make a major contribution to the growth and employment of the EU and are at the heart of the Lisbon Strategy. However, the prospects of growth of SMEs depend on their ability to invest in restructuring, innovation and production. All these investments need proper access to finance and SMEs are the major beneficiaries if the Commission and the Member States succeed in considerably improving the environment for finance.

The second group that is affected by the Communication is the financial sector (banks, pension funds, venture capital funds, guarantee institutions, business angels) that would benefit from the efficiency gains that a more complete single financial market would bring. Financial market participants would be able to benefit from the economies of scale and scope, would be able to effectively gather and use focused expertise, would be able to offer specialised services to SMEs, and would be able to raise funds and invest more easily across borders.

Better access to finance for SMEs will also fuel new ideas, support entrepreneurial culture and promote access to, and use of new technologies. Integration can help the development and modernisation of financial markets, institutions and infrastructures, thereby increasing economic activity and raising growth.

The third group affected by the Communication are public authorities (Member States, regional and local authorities). Improved policies and new partnerships between authorities and the private sector are necessary to achieve improved access to finance for SMEs – and the Lisbon goals. Furthermore, governments can act as important catalysts in bringing together actors in research, innovation and finance to improve the commercialisation of research. Dissemination of good practices can also support entrepreneurship, job creation and economic development.

Economic, social and environment impact

Reforming policies as suggested in the Communication will support business creation, growth and jobs by improving access to finance.

- Developing ways for venture capital funds to invest more efficiently across borders would raise fund profits, increase investment in venture capital, and lead to more efficient allocation of capital.

- If the Member States adopt good practices when investing in cooperation with the private sector using national and European resources, this will lead to more firms surviving the crucial early stage.

- If the Member States can increase cooperation between various networks that are active in research, innovation and finance, this can lead to easier access to support services that enable SMEs to better access finance.

Reformed policies that promote growth will help addressing the challenges affecting Europe.

- First, participation in the labour force declines as populations age and to counteract this, improved access to risk capital leads to higher investment that improves productivity and allows maintaining growth.

- Second, smaller cohorts of young people mean that all avenues of promoting entrepreneurship must be used, in particular among women and minorities. Improved policies on the provision of guarantees and microcredits will allow more people to become entrepreneurs.

- Third, to ensure the continuity of existing firms, instruments adapted for the transfer of businesses allows a new generation to take over. As entrepreneurs retire, about 30% of European firms will have to change ownership over the next 10 years.

- Policies that lead to a better supply of microcredits will help social inclusion when it allows less privileged groups to move to self-employment. This is of particular importance in the new Member States and the new JEREMIE initiative is also focusing on developing microcredit and supporting specialised microcredit providers.

The policy reforms proposed in the Communication will have no direct impact on environment. However, the financial instruments of the CIP will have an instrument supporting the implementation of the Environmental Technologies Action Plan[9].

Consultation of stakeholders

This Communication builds on an ongoing dialogue with stakeholder groups. Views expressed in the different stakeholder consultation have been taken into account in the development of the Communication.

More precisely, the policy approaches of the Communication were developed on the basis of

- Consultations in the context of the drafting the Competitiveness and Innovation Framework Programme (CIP), and the evaluation of the Multiannual Programme for Enterprises and Entrepreneurship (MAP).

- **Expert group on best practices in early-stage equity finance** identifying criteria for best practices in public policy supporting early-stage equity finance.

- **Expert group on improving opportunities for initial public offerings** on growth stock markets in Europe. The group discussed the fragmentation of growth-oriented stock markets in Europe.

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9 http://europa.eu.int/comm/environment/etap/

- **Expert group on the merits and possibilities of a European fund structure** for venture capital funds. The group discussed the difficulties venture capital funds face when investing across borders and the ways to enhance the single market in this respect.

- **EU-US working group** on venture capital reviewing the state of venture capital investment in Europe and in the US and making recommendations about global policy learning.

- **EUROMED expert group** on SME access to finance exploring the market gaps, identifying best practice, exploring possible public-private partnerships in areas such as guarantee, microcredit and equity.

- **Study on asset backed securities,** examining the role that banks, SME associations, trade groups, governments and regulatory authorities might play in encouraging the development of the market for securitisation.

- **Guide on how to deal with the new rating culture** focusing on advice for small businesses on basic rules when applying for a loan and on how to manage their relationship with the bank.

- **Seminars on how to deal with the rating-oriented bank environment.**

- **Microcredit conference** organised in Brussels in September 2004 by the European Commission in partnership with the European Microfinance Network, the Microfinance Centre for CEEC & CIS and the Network of European Financial Institutions. The overall objective was to disseminate the lessons learned and the good practices in providing access to microfinance for small enterprises.

- **Risk capital conference** organised in cooperation with the British Presidency in October 2005. The goal was to debate and make recommendations on how risk capital should support the innovation, growth and competitiveness of European SMEs. The conference arrived at a broad consensus on the obstacles and solutions for improved provision of risk capital in Europe.

The dialogue with the stakeholders provided a solid basis on which to build the analysis and the conclusions of the Communication.

7. CONCLUSIONS, MONITORING, EVALUATION AND FOLLOW-UP

The Commission intends to continue efforts to reform policies affecting SMEs access to finance, working together with a wide range of stakeholders to coordinate efforts, to raise awareness and to leverage expertise. As an integral part of the actions outlined in the communication, the Commission will monitor market developments and effects of Member State policies in the marketplace. The Communication includes also an invitation for Member States to regularly evaluate the impact of their policies and programmes.

The Communication and this impact assessment propose policy reforms based on enhanced cooperation, where the European Union acts to develop and safeguard the single market and to support the development of good policies at the Member State and regional levels. The proposed actions are essential to support the Lisbon goals and respect the requirements for subsidiarity to achieve the goals set in the Communication.

The Communication presents a framework for action on access to finance with a set of actions following from the problem descriptions and recommendations. The goal is to reform policies at European, national and regional levels in order to build an efficient financing environment that will boost competitiveness, wealth creation and jobs in the EU.

The Communication and this impact assessment are complemented by a Commission Staff Working Document which provides further detailed arguments for the measures proposed.

If the Commission were to propose further action in areas covered by the Communication, a detailed impact assessment would be carried out for these.