AECM Position regarding the European Commission's Green Paper on Innovation – "From Challenges to Opportunities: Towards a Common Strategic Framework for EU Research and Innovation Funding (COM(2011)48)

Brussels, 19th May 2011

The European Association of Mutual Guarantee Societies (AECM, see annex II) is pleased to provide the European Commission with its views on its Green Paper, entitled "From Challenges to Opportunities: Towards a Common Strategic Framework for EU Research and Innovation Funding", which will also have implications for the future EU programmes in the field of Competitiveness and Innovation, i.e. the CIP successor programme. In addition to the comments in this paper, we also refer to our Position Paper to the Commission's consultation on the CIP successor programme, which ended in February this year: http://www.aecm.be/en/aecm-position-on-cip-successor-programme.html?IDC=30&IDD=748

I. General Comments

AECM welcomes the general objective of the Commission to streamline EU funding to support Competitiveness and Innovation. We agree that it is in the best interest of the Commission, tax payers and beneficiaries, that the use of the resources available should be optimized as much as possible.

9 of AECM's member organizations are currently acting as financial intermediaries under the Competitiveness and Innovation Programme (CIP). The CIP and its predecessor Framework programmes have proven to be of particular added value for our members, which are non-profit SME guarantee institutions, and their beneficiary clients.

Indeed, both before as during the financial crisis, the CIP financial instruments have allowed a great number of SMEs get access to finance and contribute to the global European economy in terms of employment and GDP growth.

The EIF-managed counterguarantee programme has allowed our members to remedy specific market gaps regarding SME access to loan finance. Loan operations with high risk profiles, such as e.g. business transfers, which are of crucial importance and which would under normal conditions not have been undertaken by credit institutions, could be realized thanks to the risk sharing agreement between guarantee institutions and the CIP funds. Among others due to the leverage factor obtained through the use of CIP funds AECM considers the current CIP to be highly relevant in terms of European Added Value.

AECM calls on the Commission to maintain an unwavering commitment to guarantee instruments for SME access to loan finance under the successor programme. Indeed, now more than ever, these will have to count on loan guarantees in a future context of rising interest rates and stricter prudential supervisory rules, which will all put SME lending under pressure. In this context, there should be a strong CIP successor programme, closely linked with European Enterprise and SME policy objectives, accessible to a reasonably broad spectrum of SMEs, which are not only a few high-tech, high-growth

SMEs, but a wider constituency of technology adopters and SMEs that have to increasingly compete on their local markets with international competitors.

When it comes to the financial instruments in general, the successor programme should strike a proper balance of support for all available sources of funding (guarantees vs. Venture capital) as well as for all classes of beneficiaries according to their respective weight in the European economy (smaller companies vs. High tech and medium-sized companies).

II. <u>Specific Comments</u>

<u>A/ The future Common Strategic Framework for Research and Innovation Funding</u>

The Green Paper (GP) raises the general question, how funding for research and innovation could be coordinated in the future to optimize the use of community financial resources. In this context, the GP examines among others the FP7, the CIP and Cohesion Policy. AECM has the following comments:

<u>Broad definition for competitiveness and innovation focus</u>

- As stated in the general comments, even small local SMEs are exposed to competition pressures by foreign companies on their domestic markets. These companies clearly need to be supported to ensure high levels of competitiveness of these smaller companies. These companies may also not be high-tech companies in terms of drivers of innovation. However, they may be innovative in the broader term, i.e. by innovating processes in traditional industries, etc. This in our view is consistent with section 4.3 of the GP, which highlights that "innovation requires many competences and activities other than research, which are non-technological in nature...". This should also include the aspect of innovation adoption, in other words, investments to introduce latest technologies to remain competitive or to lower CO^2 emissions.

- Therefore, for the purpose of a future Common Strategic Framework (CSF), there is a need to recognise that there are distinct SME constituencies, with very different projects, activities and financing needs, i.e. fast growing high-tech SMEs on one side, more focused on research and in need for venture capital and on the other side a larger group of SME that are less or not focused at all on research, that rely mainly on loan finance, and for which guarantee support instruments are highly relevant. For this later group, we advise to keep a **<u>broad definition</u>** of the scope of beneficiary SMEs.

<u>The use of Structural Funds under a CSF for guarantee instruments</u>

- The GP raises the issue of using cohesion funds for innovation funding. Many AECM member organizations make use of structural funds for their guarantee operations, mainly in the new Member states. While the funding is useful and appreciated, there are however a few question marks, regarding the potential use of structural funds alongside other EU Financial Instruments:
    - Severe market gaps in SME finance can occur in all Member States economies, regardless of their relative economic development. Even in economically more well off Member States, viable start-ups or business transfers projects may not receive adequate access to loan finance, due to lack of collateral. Structural funds in turn can only target specific regions, thus in essence, it would be impossible to obtain a full geographical coverage of the EU.
    - Most of our member organizations are active at national level. The use of structural funds supposes a negotiation at regional level. This may result both in a partial geographical coverage in the respective Member States as well as in a variety of different guarantee instruments. As a consequence, there is a risk of ending up with

a myriad of small and different regional agreements, which stand in the way of building critical mass, economies of scale and hence cost efficiency.
    - The use of structural funds for guarantees entails far more administrative burden than the use of the relatively simple and straight-forward CIP (although even for the latter, there is room for improvement, see comments further below).
- As a consequence AECM clearly advocates the use of a European post-CIP programme alongside the use of Structural funds for guarantees. It would be ideal, if Structural Funds regulations could be amended with a view of providing a full geographical coverage for the instrument.

The use of the Framework Programme under a CSF for guarantee instruments

- AECM sees no obvious added value to run guarantee facilities under the Framework. As stated above, most high-growth, high-tech SMEs will not be in need for loan guarantees. These are more likely to be financed via Venture Capital. Therefore, guarantee support measures should remain in the purview of the CIP and Structural Funds.

Reduction of complexity and synergy effects between financial instruments

- The Green Paper states the need for a simplification of the complexity of the existing financial instruments and a reduction of over-bureaucratic rules. This would provide both the European Institutions and the financial intermediaries with direct benefits. AECM would welcome the following:
    - In general, a good balance should be struck between the need for accountability and control of resources on one side and avoidance for overly burdensome application and reporting requirements. Guarantee institutions are typically small to medium sized operations and the current administrative burden has a disproportionate impact on the financial intermediaries' activities.
    - It would be interesting to look at possible simplified procedures with regard to application, reporting, etc, across a spectrum of different support programmes. This would enable a financial intermediary to use the same procedures and requirements when applying for different support measures e.g. CIP resources and Structural Funds, resulting in a clear gain of time and efficiency.
    - Of course, the challenge will be to design a set of criteria which can accommodate all types of programmes, all the while providing sufficient flexibility. AECM member organisations would be available to provide input for such a process.

B/ The rationale for guarantee support via the successor programme to the CIP

In addition to our comments above, we would like to highlight the rationale for continued guarantee support via the guarantee facilities of the CIP. The CIP and its predecessor programmes has proven to be highly successful over the past decade, in particular, CIP instruments have also been used efficiently to support anti-crisis guarantee measures during the financial crisis and recovery phase (See annex I).

On the other hand, a certain number of international institutions and think-tanks have underlined the positive performance of guarantee schemes during the financial crisis and are considering the role for guarantee institutions in the post-crisis environment. The **World Economic Outlook by the IMF**, published in January 2010[1], the IMF sees guarantee programmes more important than ever in the future, as financing conditions will remain more difficult than before the crisis. Also, the **OECD Working Party on SMEs and Entrepreneurship** has analysed the impact of guarantees on SME

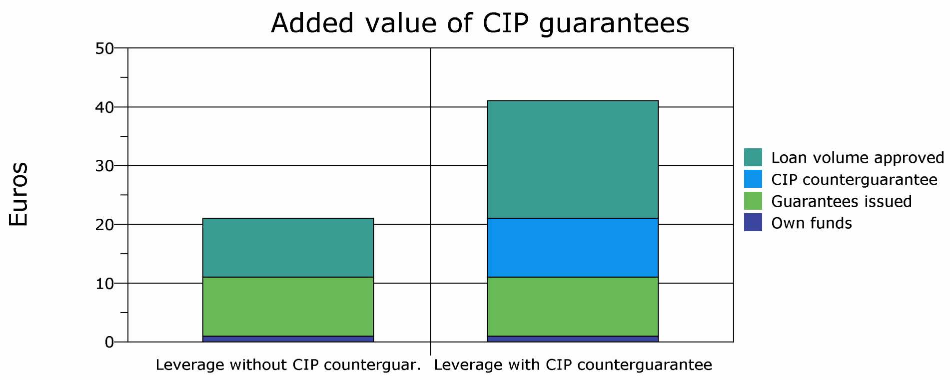
[1] International Monetary Fund : World Economic Outlook, 26 January 2010, page 3 ; http://imf.org/external/pubs/ft/weo/2010/update/01/pdf/0110.pdf

access to finance and is in the process of investigating the usefulness of guarantees for SME access to finance.

In addition, AECM underlines that there are a number of compelling rationales to increase funding for the guarantee facilities under the successor programme to ensure SME access to finance in a changed post-crisis environment:

<u>Cost efficiency of the CIP guarantee instruments</u>

- Guarantee instrument are a particularly interesting financing and policy instrument due to their **<u>leverage factor</u>** and the **<u>revolving nature</u>** of the guarantee. Since guarantees are only paid out in case of insolvency of the SME customer, depending on the risk profile of the product only a fraction of the funds are actually paid out. This allows financial intermediaries to issue a much higher amount of guarantees for a given regulatory capital level, leading to an average leverage factor of 10 times guarantee volume in portfolio over own funds for the normal guarantee operations of AECM member organisations. To illustrate, for a guarantee coverage ratio of 50% of the loan amount, € 1 of own funds allows issuing € 10 in guarantees and € 20 in approved loans.



- The presence of a European CIP-Counterguarantee **<u>dramatically improves this impact (see graph)</u>**. Indeed, given a coverage rate of 50% by the CIP-Counterguarantee instrument, the amount of loans issued to SMEs can be doubled to € 40 for every € 1 of own funds of the guarantee institution. **<u>Clearly, this is an efficient and cost-non-intensive support instrument and should therefore get appropriate funding under the new framework programme</u>**. Similar results cannot be reached with other financial support instruments, such as grants or equity.

Additionality provided by Financial Intermediaries

- Additionality is a key requirement to justify the presence of a European support instrument. In practice this has meant that guarantee institutions wanting to act as a financial intermediary under the CIP had to demonstrate in what sense their product would provide value in addition to the existing support instruments at national level.

- AECM members have been able to design new guarantee instruments addressing market niches and financing needs that were not properly served by the banking sector, often due to a higher risk profile. As an example, French AECM members have supported loans for SME business transfers, which contain both a higher default risk and a greater financing need. For these riskier operations, smaller companies usually have difficulties in finding bank lending. The presence of a guarantee with a CIP counterguarantee reduces the risk profile of the loan for the lender and allows him to engage these clients. **Without the presence of a CIP counterguarantee, these products could not have been created to address these specific market gaps**.

Added value of a European counterguarantee

- There is a clear need for a European guarantee support policy in the framework of the CIP successor programme, rather than just setting this policy at a national level:
    - As mentioned above, the presence of a CIP counterguarantee doubles the volume of guarantees available for the SME customers through an additional risk sharing of 50% (see above). This **allows targeting specific areas**, which are of European policy concern (e.g. ecological investments, business transfers, start-ups, etc.) and **multiply the impact at national level considerably**.
    - European guarantee support programmes have acted in the past as **a transmission chain for know-how** with regards to financial engineering. Some guarantee institutions have been able to benefit from the EIF's knowledge in the design of new guarantee products, which otherwise would not have been created.
    - The European counterguarantee is also crucial for newer guarantee institutions, which are still building up their portfolios. The presence of a European guarantee gives them the possibility to boost their volumes in the early stage, making thus a considerable contribution to "**institution building**".
    - Ensuring similar levels of guarantee support measures for SMEs within the Internal Market also provides a more **level playing field** across the different Member States with regard to equal terms of competition between SMEs.
    - The CIP instruments have lead to a certain **benchmark for guarantee industry standards**, e.g. for reporting, risk management, etc. and thus provides a certain level of discipline. While the level of requirements can be discussed (see below), in general, this is seen as a beneficial aspect from an operational point of view.
    - There also is a rationale for a strong EU industry policy in favour of guarantees from the point of view of **international competition**. AECM considers that the availability of guarantees will become more and more crucial in the future in a context of ever increasing competition not within the EU but with regards to other trading blocks. Indeed, both the US and Japan have sharply increased their funding for new guarantee instruments, which cover far higher loan amounts and provide higher coverage rates than is the case in the EU. Contrary to the EU Internal Market, these trading blocks **do not apply state aid restrictions**. Hence, SMEs in the EU will come under increasing pressure in the future. This concerns not only exporting, relatively internationalised mid-sized export companies but also smaller businesses exposed to international competition on their home markets. Consequently, even in at the local level a strong EU SME guarantee support is key to ensure competitiveness of smaller companies.

- Finally, last but not least, the mid-term report by the **Special Committee on the Financial, economic and social crisis (CRIS)** of the European Parliament[2] expressly "*calls on the Union to promote its web of SMEs – which are at the forefront of job creation – by facilitating their access to credit, notably through support for guarantee schemes and the creation of new standard products to combine loans and equity for smaller companies; calls on the Union to create an EU Guarantee Fund for SMEs; also calls for an evaluation of existing funding schemes, especially the CIP programme, and for dedicated efforts to make EU-backed loans accessible to businesses in all Member States*", **a clear endorsement for a strong industrial SME guarantee policy at EU level**.

C/ Elements - Improvements suggested by AECM for the successor programme to the CIP

Many AECM members have acted as financial intermediaries for EU support programmes over the last decade. While the quality of the support instruments and the cooperation with the European Institutions have improved all the time, AECM suggests that there is still room for modifications when designing the CIP successor programme. The following aspects are key for the new Framework programme:

Adequate balance between support instruments and beneficiaries

- AECM underlines that an adequate balance needs to be struck in the design of the new Framework programme. There is a need and justification for all types of financial instruments, such as guarantees, subordinated loans, venture capital, etc.
- However, these instruments address different classes of beneficiaries and life-cycle situations. Venture capital is most suited for high-tech start-up, medium-sized companies and companies with high growth potential. This however is not the case of the majority of European SMEs, who also provide the bulk of employment and GDP. Being rather small and not necessary with high growth perspectives, they are not naturally the target of profit oriented venture capital funds. These businesses mainly rely on loan finance and therefore are in need of a proper guarantee support.
- **As a consequence, venture capital should not become the exclusive focus of the successor programme, instead it has to be ensured that the funding made available under the new framework programme is balanced with regard to the financing needs on the market and the respective size of the beneficiary populations**.

Financial envelope for guarantee facilities under successor programme

- The financial envelope for guarantee facilities under the new framework programme should be significantly higher than at present. Indeed, this programming period has shown that funding did not keep pace with market demand. At the same time, the guarantee has proven to be a highly performing and affordable support instrument (see above). In this perspective, we suggest **multiplying the funding for guarantee instruments by three times under the new framework programme**.

[2] CRIS, mid-term report on the financial, economic and social crisis: recommendations concerning measures and initiatives to be taken, Para. 199, published 5 October 2010 http://www.europarl.europa.eu/activities/committees/reportsCom.do?language=EN&body=CRIS

Cap ratio for portfolio losses

- The EIF handles a cap ratio for portfolio losses of financial intermediaries participating in the CIP. While AECM understands the rationale behind the cap ratio, we flag the problem that due to the conditionality of reimbursement underlying such a cap, the loan amounts counterguaranteed via the CIP **cannot benefit from a zero-weighting under the CRD**, otherwise possible in presence of a public guarantee representing sovereign risk. While the cap is a central element of the design of the guarantee facility, in turn we suggest that in many cases, the **cap level could at least be increased further**.

Additionality

- AECM agrees that additionality has to be proven for the use of public funding. However, we have observed that the additionality criteria under this programming period have been handled and interpreted in a particularly strict way, making it difficult for some of our public members for instance to participate in the programme. **For the successor programme to the CIP, we therefore suggest a reasonable relaxation of the interpretation of the additionality criteria**.

Flexibility in times of crisis / economic downturn

- AECM welcomes the flexibility of the Commission in adjusting terms and conditions of the CIP-contracts in the context of the financial crisis, i.e. the lowering of the target guarantee volumes and the raising of the cap levels. **We encourage the Commission to foresee an explicit provision for such flexibility in the successor programme of the CIP**.

Coverage rates and Working capital

- For **specific higher risk guarantee operations, the coverage rate of the future CIP guarantee instruments could be increased** to take a larger part of the risk. This could e.g. be foreseen for start-ups or business transfers. Also, AECM highlights the need to **continue the eligibility of Working capital under the on-going programming period**, as in some Member States, it is still crucially needed to allow SMEs manage the recovery.

Institution building

- AECM points out the fact, that in many Member States, guarantee societies do not exist. Here we see a field of activity under the CIP successor programme to **facilitate the creation of such schemes** where desirable. AECM of course is ready to provide its technical expertise to such an initiative.

Transition between CIP and successor programme

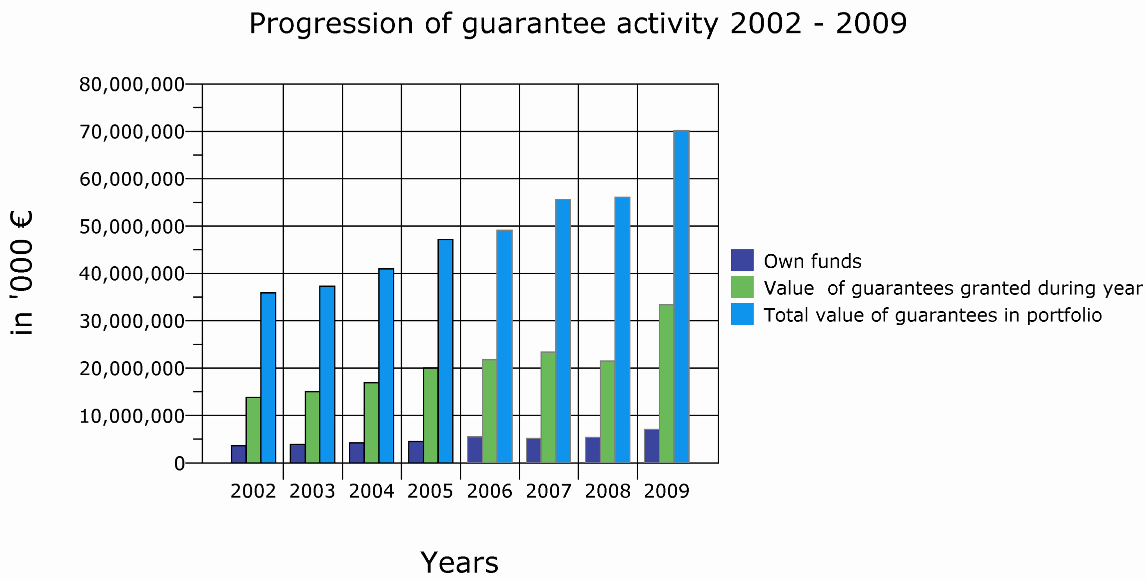
- AECM calls for a seamless transition between the CIP and the successor framework programme. Any interruption of coverage between the two programming periods should be avoided, as interrupting the distribution of a guarantee product in a decentralised network is both difficult to handle and communicate to the beneficiary SMEs. Any such situation would have negative consequences for the prestige of both for the financial intermediary and the European Institutions. **We therefore appeal to all actors involved to ensure that there is no gap between the two programming periods**.

AECM remains at the Commission's disposal for any further information which might be needed.

Annex I /

Positive contribution by SME guarantee schemes during the financial crisis and recovery

Overall, in 2009, AECM members issued over 855.000 guarantees with a value of over € 34 billion. On 31st December 2009, AECM members held in their portfolios more than 2 million guarantees for a value of € 70,4 billion to over 1,8 million customers, which represent about 8% of all SMEs in the European Union. The vast majority of the beneficiaries are small companies.



This extraordinary increase in guarantee activity also reflects in part **the impact of the specific crisis instruments**, which have been launched by AECM member organisations towards the end of 2008 and the beginning of 2009 as new products or modified existing products.

Indeed, with a total volume of € 11,2 billion, guarantees issued under the specific crisis programmes make up about a third of the total guarantee activity in 2009. 90 % of the total volume of these specific crisis guarantees has been dedicated to short term, working capital loans.

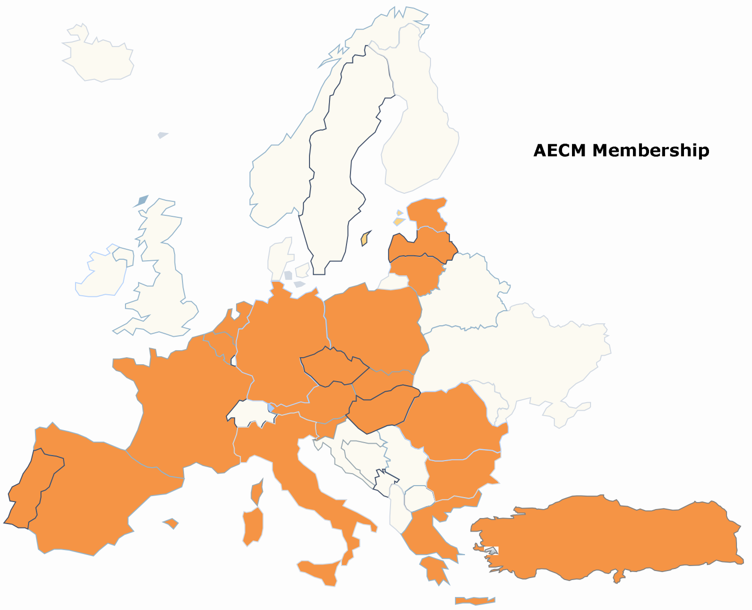
The specific crisis guarantee instruments have provided over **120.000 SMEs** with crucial access to finance and thus contributed to maintaining more than **851.000 jobs.**

Annex II /

About AECM

AECM represents the political interest of its member organisations both towards the European Institutions, such as the European Commission, the European Parliament and Council, as well as towards other, multilateral bodies, among which the European Investment Bank (EIB), the European Investment Fund (EIF), the Bank for International Settlement (BIS), the World Bank, etc. It deals primarily with issues related to state aid regulation relevant for guarantee schemes within the internal market, to European support programmes and to prudential supervision.

AECM has 34 member organisations operating in 19 EU countries and Turkey. Its members are mutual, private sector guarantee schemes as well as public institutions, which are either guarantee funds or Development banks with a guarantee division. They all have in common the mission of providing loan guarantees for SME who have an economically sound project but cannot provide sufficient bankable collateral. In 2009, AECM member organisations had a total guarantee volume in portfolio of € 70,4 billion and issued a total of € 34 billion in new guarantees.



The member organisations of AECM, the European Association of Mutual Guarantee Societies, have made a particular contribution to shoring up SME access to loan financing during the crisis. Overall, the **total volume of new guarantees issued in 2009** by AECM members has risen by 58 % as compared to 2008. (see graph previous page).

More information is available on the AECM web-site at: www.aecm.eu