

# Financing facilities to boost entrepreneurial activity



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Promoting the evaluation of public programmes and policies, developing transparency and improving the use of resources and quality of services to citizens are government priorities. Every year, the Council of Ministers approves a number of programmes and public policies to be evaluated by the National Agency for the Evaluation of Public Policies and the Quality of Services, within the scope of the functions outlined in its action plan.

On the proposal of the Minister of Public Administrations, the Council of Ministers, in its meeting of 30 March 2007, decided on the public programmes and policies to be evaluated in 2007. These included: The National Reform Programme of Spain; the administrative procedures for the creation of enterprises; the national register of greenhouse gas emission rights and the quality of services in state museums.

The evaluation of The National Reform Programme of Spain was to focus on: the effect of measures adopted for the rationalisation of pharmaceutical expenditure, the effectiveness of energy security policies, programmes to foster research, development and innovation, and the financial facilities to boost entrepreneurial activity.

**Please note that the English-language version of this text is a translation of the original Spanish-language document and is for informative purposes only. The Spanish text shall be regarded as official in all cases.**

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## FINANCING FACILITIES TO BOOST ENTREPRENEURIAL ACTIVITY

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## GLOSSARY OF ACRONYMS

CERSA	Compañía Española de Reafianzamiento S.A.
CES	Consejo Económico y Social
CESGAR	Confederación Española de Sociedades de Garantía Recíproca
CDTI	Centro para el Desarrollo Tecnológico Industrial
DG	NSA Directorate General
DGPYME	Dirección general de Política de la Pequeña y Mediana Empresa
ENISA	Empresa Nacional de Innovación S.A.
EOI	Escuela de Organización Industrial
GEM	Global Entrepreneurship Monitor
ICO	Instituto de Crédito Oficial
IDEA	Instituto para la Diversificación y el Ahorro de la Energía
MGS	Mutual Guarantee Society/Societies
NSA	National State Administration
NRP	Spanish National Reform Programme
OECD	Organisation for Economic Cooperation and Development
R&D&I	Research, Development and Innovation
SME	Small and Medium-sized Enterprises



## 1. Main conclusions and recommendations

There is a risk of identifying entrepreneurs with up-and-running small or medium-sized enterprises but these are not relevant to this assessment. Up-and-running enterprises, regardless of their size, may be entrepreneurial but for the purpose of this report, entrepreneurs are people with business ideas and projects who wish to set up a company as a vehicle for such projects but whose limited capital or resources make it difficult for them to obtain finance from financial institutions in the market.

For the purposes of this report, there is an important relationship between entrepreneur and enterprise but they are two separate concepts. It is important to be aware of this distinction in order to analyse the lines of finance specifically aimed at entrepreneurs as opposed to the financing of up-and-running enterprises.

It can be confirmed that National State Administration aid, initiatives and subsidies are mainly aimed at enterprises already in existence. These companies, be they small or medium-sized would not seem to require such aid in order to have adequate financing and therefore the subsidies they receive do not appear to be justified, despite the fact that this is common practice in Europe<sup>1</sup>.

In contrast, many entrepreneurs have limited access to loans unless they can provide guarantees and security. To overcome this market failure, the mutual guarantee system for enterprises, the Official Credit Institute's (*Instituto de Crédito Oficial - ICO*) specific lines of finance to entrepreneurs and aid to technology-based companies would currently seem to be the most efficient initiatives. However, these initiatives receive considerably less attention from the National State Administration and have much lower subsidies than those available to up-and-running enterprises.

Therefore, some of the measures contained in the seventh pillar of the Spanish National Reform Programme to boost the financing of entrepreneurs and accelerate the rate at which companies are set up should be re-examined. This is because the market failure does not seem to lie in the access of up-and-running companies to loans but rather in the availability of loans to the start-up business of entrepreneurs. In any case, the market failure should be studied in greater depth to enable adjustment of intervention policies.

Existing specific lines of finance to entrepreneurs suffer from lack of direct contact with clients in some cases and scarce resources and large spread of initiatives in others. These failings could be overcome by the creation of a public-private consortium, which would have direct contact with entrepreneurs for the granting of

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<sup>1</sup> Small and Medium-sized Enterprises (SMEs) create jobs and are the biggest contributors to the economy's added value. They also give large companies flexibility in their adjustment processes. Nonetheless, this evaluation sets out to analyse lines of finance to entrepreneurs rather than to SMEs.



loans or aid, through extensive use of new technologies and a small network of offices. This body should have the capacity both to analyse the financial viability of the projects and to monitor them using private management criteria. It should have sufficient financial support from the National State Administration to assume the higher risk of such projects and it should be responsible for coordinating and managing all public initiatives to finance entrepreneurs.

In the specific area of the mutual guarantee societies, the autonomous regional governments have a very relevant role to play. Greater coordination in the intervention policies of the National State Administration and the autonomous regions would be welcome, despite the fact that a certain degree of competition between them acts as a stimulus to improve the financing of entrepreneurs.

#### First recommendation

Carry out more specific studies to clearly identify the market failure with respect to the financing of enterprises in order to justify public intervention and subsidies and facilitate the optimum use of resources.

#### Second Recommendation

Until there is change in current criteria with respect to the market failure, National State Administration subsidies should be aimed at those initiatives which best enable entrepreneurs to have access to necessary finance. At the moment, these would seem to be the activities of the mutual guarantee societies, the Official Credit Institute's specific lines of finance to entrepreneurs and aid for the creation of technology-driven companies.

#### Third recommendation

Study the setting up a public-private consortium that would have direct contact with entrepreneurs, thereby overcoming the failings of existing lines of finance to entrepreneurs and coordinating these lines of finance within a general National State Administration policy. Potentially, there seems to be high demand for such a public-private consortium.



#### Fourth recommendation

As the resources outlined in the second recommendation are redirected, the National State Administration units with current and future responsibility for the financing of entrepreneurs should be strengthened.

#### Fifth recommendation

Finally, it would be beneficial to increase coordination with the autonomous regions with respect to the objectives, tools and subsidies related to this policy, whilst retaining the stimulus of competition between the different regions.

#### TURBULENCE IN THE INTERNATIONAL CREDIT SYSTEM

The evaluation of the financing facilities to boost entrepreneurship has been mainly carried out prior to the current turbulence in the international credit system, i.e. at a time when there was liquidity in the markets and the upward trends of the growth stage of the cycle seemed set to continue. Nonetheless, if there were a change from a situation of liquidity to one of credit tightening and uncertain economic perspectives, the main conclusions of this report would not differ and indeed might well be reinforced. The first to suffer from tighter credit conditions would be entrepreneurs incapable of offering guarantees or security.



## **2. The National Reform Programme, the financing of entrepreneurs and the market failure**

### **2.1. The National Reform Programme and the financing of entrepreneurs**

The seventh pillar of the National Reform Programme (NRP) has the main objective of strengthening entrepreneurial initiative throughout society. To achieve this, the NRP outlines a series of legal-administrative, financial, labour, educational and innovation-boosting measures.

NRP financial measures include:

- Broadening of the Official Credit Institute (ICO in its Spanish initials) ICO-PYME line, which finances projects of up to 1.5 million euro with better-than-market conditions (lower interest rates, longer repayment periods). This is probably the most popular SME financing tool.

This measure was implemented in 2006 and its budget has been increased from 4, 000 to 7, 000 million euro annually. In summer 2007, in response to international credit system turbulence, the annual budget for the line was increased by 2,000 million euro giving total 2007 resources of 9,000 euros. 114,596 companies availed of this line in 2006.

- Even more favourable ICO-PYME loan conditions for companies with an MGS guarantee.

This measure has not been developed.

- Creation of a new ICO line for medium-sized enterprises and investment projects of between 1.5 and 4 million euro, with better-than-market conditions.

This measure has been implemented, with the creation of the ICO-Crecimiento empresarial 2007 (ICO business growth 2007) line, with a 2006 budget of 500 million euro. 120 companies availed of this line in 2006 receiving 77 million euros of the 500 million total.

- Substantial improvement of the ICO internationalisation line, designed to finance Spanish companies wishing to set up foreign sales networks or initiate export activities.
- Improvement of the ICO micro-credit line with loans of up to 25,000 euro. These are attractive loans for the small entrepreneur as they do not require guarantees and there is positive discrimination in favour of certain groups (youth, women, unemployed and immigrants).



- Implementation of the ICO entrepreneur line, similar to the previous line but without positive discrimination.

This measure has been implemented. In 2006 the ICO micro-credit and entrepreneur lines had a budget of around 70 million euro. 212 companies availed of the micro-credit line, receiving 4 million euro of the total amount available. 1, 229 companies benefited from the entrepreneur line, receiving 44 million euros of the total budget.

- Development of a nationwide Business Angels network, enabling contact and cooperation between networks already existing in the autonomous regions.

This measure has hardly been developed at all.

## **2.2. Entrepreneurs and the market failure**

To assess NRP entrepreneur financing measures, it is first necessary to define the term entrepreneur. It is also necessary to identify the market failure that makes public sector intervention necessary.

The term entrepreneur is currently fashionable in Spain. However, the interpretation is often ambiguous and needs defining. For the purposes of this assessment, the entrepreneur is a person with limited capital or resources, who wishes to set up a business as a vehicle for business ideas and projects.

The market failure would appear to lie in the difficulties the entrepreneur has in access to finance, due to the limited guarantees or security that can be offered to potential lenders<sup>2</sup>. Without public intervention, many entrepreneurial projects would not have access to funding.

This definition excludes up-and-running enterprises, be they small, medium-sized or large. It is true that a small or large company may be entrepreneurial in the broader sense of the term, but such enterprises are excluded from this assessment because they can provide guarantees for loans. Neither would the maximum amount of the

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<sup>2</sup> All those interviewed in this assessment agreed with these definitions of entrepreneur and the market failure. Empirical analysis is hindered by the fact that many data bases exist with respect to companies and persons receiving loans but very little, and often distorted, information is available regarding those who are refused loans and why. In 2005, the Economic and Social Council (CES in its Spanish initials) described the typical Spanish entrepreneur as a 38-year-old male, with second-level education, in the mid-to-high income range who wants to work for himself and achieve earnings in line with his efforts. This typical profile is not relevant to the matter of obtaining finance for projects.



loans be relevant. It is unlikely that an entrepreneur, as defined herein, would aspire to a very large amount in his first loan applications.

Therefore the market failure does not lie with the SME's lack of access to credit. In the interviews for this assessment, nobody has suggested that up-and-running small and medium-sized companies have difficulty in getting finance. Undoubtedly, they would prefer to have lower interest rates and longer repayment periods. But the market can provide this finance, especially in the recent period of high liquidity and generally favourable monetary conditions. There does not appear to be a market failure with respect to the financing of SMEs in Spain.

This coincides with the conclusions of the 2006 OECD study, "The SME Financing Gap". This concludes cautiously, pending a more comprehensive study and peculiar circumstances in some countries, that there is no significant market failure with respect to SME access to credit in OECD countries.

It also coincides with the results of a Euro-barometer survey on SME access to finance published in October 2005. The results show that 85% of Spanish SMEs felt they had sufficient financing at their disposal. The average for the EU 15 was 77%.

Experts in company finance believe that only between 7.5% and 10% of companies registered in Spain have difficulties in access to finance and this figure includes those nearing the end of their business lifecycle. The entrepreneurs with their new companies also fall into this group and this is where there does seem to be a significant market failure.



### **3. NRP financing measures and the market failure**

NRP financing measures have little impact with respect to the market failure. The main lines of finance proposed, ICO-PYME, ICO medium-sized enterprise and ICO internationalisation are aimed at up-and-running companies. Specific lines for entrepreneurs, such as the ICO micro-credit and ICO entrepreneur lines, have far fewer resources. More favourable treatment for companies with MSG guarantees applying for an ICO-PYME loan is a worthwhile approach but has yet to be developed. In addition, the national Business Angels network has not yet taken off.

This is not to say that these financing measures are not successful. The ICO-PYME line is the favourite finance tool of the vast majority of SMEs seeking loans.

The ICO-PYME, the ICO medium-sized companies and the ICO internationalisation lines are simply not designed to finance entrepreneurs. They are aimed at up-and-running SMEs and are very successful in this respect.

#### **3.1. The ICO-PYME line**

This line puts resources at the disposal of credit institutions so that they can offer loans under favourable conditions to SMEs for capital goods investment.

About seventy credit institutions grant loans of up to 1.5 million euro to SMEs to finance new capital goods investment at half a point lower than the market interest rate. The average repayment period of seven years is considerably longer than in the normal market. Therefore, it is hardly surprising that every year, the 7,000 million euro available annually is allocated in full by September or even earlier.

The credit institutions, who assume the risk for these loans, do not see this line as a competitor to their own products but rather as a broadening of their lending capacity. These loans, considered quality loans by agents, are normally granted first to preferential credit institution clients and the rest goes to other clients. That demand exceeds supply is hardly surprising given the implicit subsidy. The longer repayment periods are more important to borrowers than the lower interest rates. In 2006, over 80,000 companies received 7,000 million euro.

Better-than-market conditions are made possible by the combination of the ICO's excellent credit rating, which allows it to obtain finance in the market, and an annual state subsidy. This subsidy is included in the annual national budget prepared by the Ministry of the Economy and Taxation (MEH in its Spanish initials). The state subsidy for the line amounted to around 58 million euro per annum for the years 2005 and 2006. The provision for 2007 is 66 million euro, assuming a full take-up of loans available.



The default rate is very low, well under 1%. However, it will have to be controlled in the light of the cyclical boom of recent years. In any case, the low default rate is not surprising since priority is given to preferential clients<sup>3</sup> in the granting of these loans.

Due to the low default rate, credit institutions do not have real incentives to monitor compliance with loan requirements. This may explain the existence of some failure to meet requirements. The ICO has discovered in some monitoring samples that failure to comply with requisites could exceed 6%, though this figure is not reliable as the samples are not statistically valid. Using the loans to finance investments other than new capital goods investment is the main form of non-compliance<sup>4</sup>. When failure to comply is discovered, the company must return the subsidy.

Therefore, this line of credit provides subsidised financing to SMEs who would be able to obtain the necessary finance in the market, albeit under less favourable conditions. It does not tackle the market failure. The subsidy for this line could be devoted wholly or partly to programmes which address the market failure. However, this is difficult to implement, given the widespread practice of financing SMEs in the European Union<sup>5</sup>. Joint action is needed to avoid discrimination and should be seriously considered.

The excess demand for loans under this credit line might lead one to suspect a delay in new investment as companies, on observing that the annual budget has been exhausted by September, delay their loan applications until the following year when resources are once again available. No evidence of this possible delay has been observed. In fact, it seems to encourage investment planning in the light of the effective schedule of loan availability.

Excess demand results in pressure to increase the resources available to the line. All agents involved believe this to be advisable. It is easy to see the advantages to the

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<sup>3</sup> This opinion is shared by all those interviewed for this assessment. It is even considered logical by the Spanish Banking Association (*Asociación Española de Banca*, AEB in its Spanish initials). Such opinions should, however, be accompanied by empirical analysis. The ICO has an important data base of enterprises receiving loans under this credit line and plans to improve it in 2008 by increasing and enhancing company data. Data available for 2004 to 2007 show that only 9% of ICO-PYME loans were for the creation of companies, which in principle, is the activity most associated with entrepreneurs. 90% of loans were for consolidation (about 65%) and expansion (about 25%). In contrast, 70% of ICO entrepreneur loans were for the setting up of enterprises, though this data only refers to 2006 and 2007.

<sup>4</sup> Real non-compliance may be lower, as in some cases, failure to present requested documentation on time is considered non-compliance, which does not necessarily mean a real failure to comply. The ICO aims to carry out much more systematic monitoring of these loans and this will enable more exact information with respect to the degree of non-compliance.

<sup>5</sup> In the past the European Investment Bank provided most of this financing in Spain. Now, it is provided by the ICO and the MEH in the form of state subsidies.



companies and the credit institutions. However, the government should direct the resources to the lines of finance aimed specifically at entrepreneurs<sup>6</sup>.

### **3.2. The ICO-Crecimiento empresarial line 2007**

This line is aimed to an even greater extent at up-and-running companies. The same points made about the ICO-PYME line apply. Demand for loans in this case was 500 million euro in 2006, just over 15% of the total available. It is practically irrelevant as a line of finance to entrepreneurs.

### **3.3. The ICO internationalisation line**

This is aimed at up-and-running companies seeking expansion into international markets. Its objective makes it irrelevant in terms of tackling the market failure.

### **3.4. Favourable treatment for ICO-PYME applicants with MGS guarantees**

Mutual guarantee societies, attempt to address the market failure by providing guarantees and security for loans that entrepreneurs and their companies could not offer themselves. Favourable treatment for companies with MGS guarantees applying for an ICO-PYME loan is an excellent approach but its volume depends solely on the MGS. In any case, this measure has not been implemented.

### **3.5. The ICO micro-credit line**

This line is also aimed at addressing the market failure as it does not demand the guarantees normally required by credit institutions. Unsecured loans of up to 25,000 euro are available and there is positive discrimination in favour of women, the unemployed, young people and immigrants. Total resources for this line amount to less than 20 million euro per annum. This also reflects a desire to limit risk because default rates and non-compliance are high. The result is a relatively ineffective line of a testimonial nature in terms of financing entrepreneurs. In 2006, 212 companies received loans of 4.12 million euro<sup>7</sup>.

Even so, there is not a full take-up of the funds available. Commercial banks are not interested because the small amount involved means processing costs are relatively high. Savings banks show greater interest.

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<sup>6</sup> The same can be said of other initiatives such as asset securitisation. This successful initiative, under the DGPYME (Directorate General of SMEs) and the *DG del Tesoro y Política Financiera* (Directorate General of the Treasury and Financial Policy), increases the finance that credit institutions can offer to SMEs by means of a state guarantee. This guarantee has decreased greatly in recent years. The explicit state subsidy is not estimated. A state guarantee has never had to be called in.

<sup>7</sup> This line has a social component not found in lines whose sole objective is to finance investment.



The micro-credits are much more successful when processed and granted by institutions providing basic advice with respect to the management of the business or idea. Borrowers do not feel alone when faced by problems they consider to be major. A contact telephone number or a personal visit makes them feel more secure. This explains the greater demand for micro-credits applied for through mutual guarantee societies, such as the Women's Institute (*Instituto de la Mujer*), etc., i.e., bodies which provide advisory services, however limited.

### **3.6. The ICO for entrepreneurs line**

Like the micro-credits, this new line of finance is aimed at tackling the market failure in the financing of entrepreneurs. Unlike the micro-credits it has the advantage of not being aimed at specific groups, but at entrepreneurs in general.

Though its budget is limited to 50 million euro per annum, there is not a 100% take-up. This line is still very new and therefore, less well known. In addition, the lack of incentives for commercial banks is similar to the case of the micro-credits. There is also a high application rejection rate.

This line needs to be better advertised and offer a better support structure to entrepreneurs. With some changes to its design and support structure it could become popular quickly and enjoy more resources. In 2006, loans of 44.34 million euro were granted to 1,229 enterprises<sup>8</sup>.

The extending of state subsidies to the micro-credit and ICO for entrepreneurs lines would not necessarily mean a net increase in public spending, as this money could be redirected from resources currently allocated to up-and-running enterprises. This redirecting of funds would boost the creation of enterprises and entrepreneurship.

Although the micro-credit and entrepreneur lines are testimonial due to the relatively small amounts involved, their value lies in the example they set. The ICO is the market leader in designing packages for company finance. Other financial and credit institutions tend to follow suit. The reference represented by the ICO should be maintained, regardless of whether the financing is done through other institutions. The ICO for entrepreneurs line could be successful with more resources and if a public-private consortium were set up, as will be discussed in section 5.

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<sup>8</sup> The total cost of this line was 1.3 million euro in 2006, with a provision of 1.50 million euro for 2007, assuming that the budget is fully taken up. These figures are revealing when compared to those for the ICO-PYME line.



### **3.7. The national Business Angels network**

This network has hardly been developed and there are no figures available regarding its penetration. However, the existing regional and national associations are now within the framework of the European association.

Current efforts are geared towards publicity in the form of events and seminars etc. There have also been preparatory studies, with proposals for a Business Angels regulatory framework, which include possible tax reliefs.

There are doubts as to whether such regulation is a good idea. Apart from public intervention, similar practices are already in place, with the support of some credit institutions. Different entrepreneurial projects are assessed by experienced private investors who decide whether to become involved by financing them and acting in an advisory capacity, depending on expected future profits. The failure of some projects can be more than offset by the success of others. Furthermore, tax relief on losses reduces risk.

Possible regulation of this activity should take into account that a public register of investors might discourage those who do not wish such publicity. Care should also be taken to ensure that tax incentives do not make this activity similar to risk capital, which is not really aimed at entrepreneurs but at businesses that would obtain financing in the market in any case. Finally, there is a risk that poorly conceived regulation might result in a vehicle for money laundering.



#### 4. Mutual guarantee societies and the market failure

Not every project rejected by a credit institution ends up with an MGS. However, most companies that approach an MGS have failed to obtain finance through a credit institution. If the project is considered viable, the enterprise becomes a member of the MGS and pays a 1% commission fee. The MGS provides the necessary guarantees to enable finance to be obtained from a credit institution. In this way, it addresses the market failure. The MGS not only obtain financing for their members with longer-than-usual repayment periods but also provide technical guarantees and other advantages<sup>9</sup>.

The credit risk shifts from the credit institution to the MGS. In turn, the MGS has the support of the state-funded Spanish Re-guarantee Organisation (*Compañía Española de Reafianzamiento*, CERSA in its Spanish initials). This assumes up to 75% of the risk entered into by the MGS, free of charge. CERSA, in turn, is supported by the European Investment Fund (EIF), which assumes 35% of its risk. The default rate borne by the MGS is higher than the market average, as might be expected. On 31 December 2006, the default rate stood at 1.22%, between two and three times higher than for the credit system as a whole.

The mutual guarantee system comprising the MGS, the CERSA and the EIF makes a considerable contribution to tackling the market failure. However, only 25,000 enterprises, barely 2% of companies registered in Spain, have MGS guarantees. The relatively low figure is reflected in few transactions. These barely exceeded 2,400 million euro in long-term financial guarantees in 2006.

The Autonomous Regions participate in most of the 23 MGS. MGS management, risk assumption and transaction volumes vary greatly according to the Autonomous Regions<sup>10</sup>. Average MGS results must be examined with care as there is great variation in the way they function. In some cases, management skills and business practices could be improved and some MGS are more inclined to assume risk, i.e., take on entrepreneurial projects, than others<sup>11</sup>.

Through its guarantee contracts with the MGS, the CERSA seeks to boost entrepreneurship. In the 2007 guarantee contract, it assumes a greater percentage

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<sup>9</sup> The 1% contribution, though recoverable at the end of the guarantee period, is expensive and indicative of the problems of finding finance where sufficient guarantees cannot be provided.

<sup>10</sup> In some cases, the transaction growth rate and the amount of loans granted is extremely high in recent years, almost reaching 100% annually. However, in the most successful cases, what has grown most is the amount of funding available for these transactions that savings banks have agreed with the autonomous regions.

<sup>11</sup> Default rates, though notably higher than the market average, seem low. A greater default rate is expected from entrepreneurial projects. Favourable cyclical aspects must also be controlled.



of risk in transactions involving new companies or those with fewer than 100 employees. Unfortunately, such incentives have generally met with a weak response in terms of MGS policies.

The main limit on MGS expansion lies in the limited resources of the CERSA, which imposes the Q ratio on MGR. Q-ratio modifications, would allow for an expansion of MGS credit activity. Whether this increase would be channelled into entrepreneurs would depend on the incentives built into the Q-ratio modifications and benefit to entrepreneurs would not necessarily be in direct proportion, given that the MGS are completely independent.

#### The Q-ratio concept

This is the relationship between the annual increase in provisions plus the increase in defaults and amortized risk. Under the terms of the guarantee contract, it cannot exceed 6%. In practice it has never exceeded 2.7%, perhaps due to favourable economic conditions in recent years and an excessively conservative MGS policy.

Recently, it was decided that the Q ratio would not be applied to innovation project finance, a clear incentive for MGS to favour such transactions. The possibility of exempting transactions to finance the setting up of new companies from the Q ratio is being looked into. This would be very positive for entrepreneurs.

By taking on credit risk, MGS interests are more similar to those of credit institutions than those wishing to foster entrepreneurship. However, MGS make a greater contribution in terms of addressing the market failure. According to the Spanish Confederation of Mutual Guarantee Societies (*Confederación Española de Sociedades de Garantía Recíproca* –CESGAR in its Spanish initials), about 20% of all MGS guaranteed loans go to the creation of new companies<sup>12</sup>. The total percentage of enterprise creation transactions re-guaranteed by the CERSA is higher. This serves as a stimulus, but the really relevant figure is that of 20%.

The CERSA's prudence is understandable and like all the MGS, it is subject to the financial criteria and supervision of the Bank of Spain<sup>13</sup>. In 2006, CERSA assumed

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<sup>12</sup> Compared to 9% of the ICO-PYME line though the objectives are not the same. In any case, the comparison is illustrative, though the CESGAR figure has to be examined cautiously as there seems to be non-compliance in that some projects are falsely presented as enterprise creation projects.

<sup>13</sup> The solvency coefficient measured by resources owned to outstanding risk must be above 8%.



risk of 549 million euro, while the direct state subsidy, which largely determines the Q-ratio value, amounted to 10.7 million euro<sup>14</sup>, less than 2% of assumed risk.

The CERSA has considerable reserves due to favourable economic conditions in recent years. However, the state subsidy is very low<sup>15</sup>. There does not appear to be any justification for this and its calculation, 2% of assumed risk, lacks any element of the anti-cyclical policy essential for all financial institutions.

An increased state subsidy for the MGS system would not necessarily mean a net increase in public spending, as the money could come from that currently used to finance up-and-running enterprises. Such an increase in the state contribution should be used to ensure that the CERSA incentives result in the MGS increasing their guarantees for enterprise creation.

State subsidisation of the CERSA does not end with the aid received by the MGS, without which they would possibly be unable to survive. Regional government contributions, through their participation in the MGS as active partners, increases MGS solvency and perhaps their volume of activity. Such contributions are made in different ways and are difficult to quantify. There is also considerable variation between different MGS and regional governments<sup>16</sup>.

Before pushing for a significant increase in the volume of MGS transactions, it is important to take account of the need for greater monitoring of loans guaranteed. At present, this seems to be weak and may mean a high degree of non-compliance with conditions. Because of its limited resources, the CERSA only reviews the files of bad loans and there are no guarantees that the MGS will be stricter. This must change because greater compliance with loan conditions will not only reduce fraud but also increase funds available to entrepreneurs.<sup>17</sup>

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<sup>14</sup> The subsidy is part of the Ministry of Industry, Trade and Tourism budget forming part of the national state budget. It is channelled through the DGPYME.

<sup>15</sup> Borne out by a simple comparison with the state subsidy for the ICO-PYME line.

<sup>16</sup> For example, the Andalusian regional government makes an annual contribution of around one million euro to MGS funds. The Valencia regional government complements the CERSA guarantee service with the *Instituto Valenciano de Finanzas* (Valencia Finance Institute). The Basque regional government does likewise and in this results in MGS commission being reduced from 1% to 0.5%. The Madrid regional government and the Corporación Financiera Caja Madrid (Caja Madrid Finance Corporation – Caja Madrid is a savings bank) make variable contributions to the capital of Avalmadrid (Madrid Guarantee Scheme and the prevision funds). In 2006 such contributions amounted to 12 million euro.

<sup>17</sup> This is particularly important in respect of the requirement that loans are for newly created enterprises. There are up-and-running companies or subsidiaries that set up new companies to enable access to these loans.



## **5. Other initiatives to finance entrepreneurs. A return to frontline loans?**

New NSA initiatives to finance entrepreneurs are being developed. One characteristic of these initiatives is direct contact with the entrepreneur, a return to the frontline approach to granting credit. This is largely because direct contact in the form of project analysis, advisory services and monitoring is now considered a key element in boosting entrepreneurial activity.

Support programmes for the creation of technology-driven enterprises and the fostering of risk capital is perhaps the best example of this. Many initiatives are coming out of these areas, though resources and experience are limited and there is a wide diversity of strategies. The fostering of innovation is behind most of these programmes, and innovation is but a part of entrepreneurial activity.

### **5.1. *La Empresa Nacional de Innovación S.A.* (National Innovation Enterprise) ENISA**

Set up in 1982, the ENISA offers participatory loans under favourable conditions to SMEs. The only guarantees required are the business project itself and the professional expertise of the management teams. The ENISA has three basic lines of finance. The first is for any type of business project (general line). The second is for projects offering technological advances in the production process and/or the product (EBT line). The third is for SMEs with non-technological modernisation and innovation projects (SME line).

This approach seems appropriate for the financing of entrepreneurs. However, it is limited by scarce resources. The ENISA's working capital, with the participation of The Centre for Industrial Technology Development (CDTI in its Spanish initials) and The Institute for the Diversification and Saving of Energy (IDEA in its Spanish initials), barely exceeds 36 million euro. Between 1995 and 2006, loan operations amounted to less than 50 million euro for the general line, 36 million for EBT and 11 million for the SME line.

Although companies in existence for less than three years receive most loans, those in existence for more than 7 years obtain more funds. The ENISA also provides micro-credits and invests in risk capital funds.

### **5.2. CDTI initiatives and the CEIPAR programme**

The CDTI Neotec initiative to support new Spanish technology-driven companies has been in existence since 2002. The CDTI gives seed loans to new companies (less than 2 years old) needing finance to demonstrate the commercial viability of their innovations. The maximum loan is 400,000 euro. It is interest free and no guarantees are required. The budget for 2007 is 15 million euro, to be shared among



approximately forty projects. Repayments are in annual amounts of up to 20% of cash flow, where this is positive.

The CEIPAR programme, a result of cooperation between the Ministry of Industry Trade and Tourism, The School of Industrial Organisation (*la Escuela de Organización Industrial* - EOI in its Spanish initials) and the ENISA gives grants for the creation and development of innovative technology companies in scientific and technological parks. The programme seeks to transform R&D&I activities into business projects.

Aid takes the form of capital grants to selected projects. Total 2007 aid (state subsidies approved in the national budget) is 5 million euro and the maximum grant is 0.5 million euro.

These are new initiatives to address the market failure in the financing of entrepreneurs and as such it is early to draw conclusions, though some have already been reformed.

### **5.3. Risk capital funds**

After many changes to regulations and incentives, risk capital is becoming more important. However, there are relatively very few risk capital seed transactions. The corresponding take-off rate of entrepreneurial initiatives is also very low. In 2005, most risk capital transactions registered with *Comisión Nacional del Mercado de Valores* (Spanish SEC) were real estate projects, the majority of which would have obtained finance in the market. Some state agencies are investing in risk capital funds and in the capital of some companies in order to foster seed and start-up transactions.

Since 1986, the ICO has had a 100% shareholding in Axis, a long-standing operator in the risk capital market. Throughout its more than 20 years in existence, Axis has invested 200 million euro for the launch and development of more than 100 companies, most of them innovative in nature.

In 2005, within the framework of the INGENIO 2010 R&D&I support strategy, the CDTI launched the Neotec risk capital fund, whose function is to support Spanish risk capital companies. One of its objectives is to support new technology-driven companies.<sup>18</sup>

### **5.4. Back to frontline loans?**

Common features of the initiatives outlined include: the lack of resources, overcoming the problem of guarantees, direct contact with the entrepreneur and a

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<sup>18</sup> A more detailed analysis can be seen in the assessment report on the NRP's strategy to boost R&D&I.



large spread of initiatives. These four characteristics serve to show what a coherent and solid public programme to finance entrepreneurs might achieve.

Without going into cases where aid is given in the form of capital grants, the question of guarantees in the granting of loans requires direct knowledge of the projects and a capacity to assess their financial viability. The large spread of initiatives stems from the low state contribution for the funding of each one.

Setting up a single organisation to deal with these four characteristics would be an alternative option for public intervention in the financing of entrepreneurs. This should take the form of a public private partnership, managed along the lines of a private company. It should take advantage of new technologies and have a small network of offices open to the public. The PPP should be capable of analysing and monitoring project viability and could grant loans directly and/or participate in the capital of new companies with the necessary financial support of the NSA. Such support would enable it to assume the much higher default rate arising from the inherent risk of the projects and the lack of guarantees.

This new body would not necessarily replace existing credit initiatives or new pipeline initiatives. However, it should coordinate all these initiatives and house them in a single policy to foster entrepreneurship. It would also serve to increase transparency in the implementation of policies to finance entrepreneurs and the control of such policies. This new PPP would serve as an example and a stimulus to the transactions of risk capital funds and private institutions in general.

Private credit institutions, their representative organisations and employer unions agree that such a PPP would be a positive step to meet a demand which private institutions are currently unwilling to satisfy.

Is there sufficient potential demand in Spain for the financing of entrepreneurial projects to justify such a PPP consortium? How many companies of this type are there in Spain?

There are no easy answers to these questions. The few studies available do not coincide in terms of approach, action or results<sup>19</sup>. Nor have international organisations carried out much research in this area. International comparisons are hindered by the fact that the relationship between economic and business development is not linear. According to the Global Entrepreneurship Monitor (GEM)

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<sup>19</sup> Bank of Spain studies by Núñez, Gordo, Jareño and Urtasun on the entrance, exit and size of Spanish companies and some structural features of the service sector in Spain point to a relatively low rate. This does not coincide with DGPYME studies carried out using a different approach. A new Bank of Spain data base of companies operating in all sectors, compiled using data from *Central de Balances* (Bank of Spain register of non-financial companies), the Company Register and *Directorio Central de Empresas* (Central Directory of Companies (compiled by the Spanish Central Statistics Office) may help to provide the answers.



programme, designed to compare entrepreneurial activity in different countries, in 2005 the percentage of adult population involved in recent entrepreneurial activities in Spain was similar to that of Germany and France. It was well below that of Ireland, Norway, The United States, Australia and particularly New Zealand<sup>20</sup>. A quick look at the figures suggests that there is a potential demand for entrepreneurial finance, though this potential demand needs to be studied in more depth.

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<sup>20</sup> In its 2006 study, the GEM observed a significant increase in Spain, from 5.7% in 2005 to 7.3%. Such a change in just one year is surprising.



## 6. Conclusions and recommendations

If the figures quoted above are correct, there seems to be a problem in the financing of between 2.5% and 8% of Spanish SMEs. Some of these would seem to be entrepreneurs and their new companies.

There is a dearth of literature on the financing of Spanish entrepreneurs. There are hardly any empirical studies and there is no definition or even practical concept of what an entrepreneur is. However, the cumulative experience of many companies in the business of financing entrepreneurs is wide and extensive. This is also true of sector analysts. The following recommendations, rather than being new and original ideas, are simply a compilation of the most relevant aspects of this experience.

- First. There should be more specific studies to identify the market failure in the financing of entrepreneurs. Everyone agrees that entrepreneurs and SMEs are not the same thing, despite the fact that many entrepreneurial activities are carried out in the guise of small, new companies and many up-and-running SMEs are entrepreneurial.
- Second. Many current subsidies to SME financing do little to address the market failure. In addition, the concept of SME can be stretched to include more than 90% of companies. This is especially true of Spain. Subsidising the financing of the majority of companies is hard to justify. However, this needs to be tackled on a Europe-wide basis.
- Third. The increase in resources proposed in the NRP for the ICO-PYME and ICO-Crecimiento empresarial 2007 lines cannot be justified. However, given the logical excess demand for these lines, discrimination between subsidised loans and unsubsidised loans does not have any apparent justification either. This seems to suggest that more funding should be provided for the two lines. All in all, it would be best to reconsider these subsidies and other initiatives such as SME asset securitisation, at European level.
- Fourth. Assuming that market failure criteria does not change, NSA subsidies should be redirected towards initiatives designed to provide necessary finance to entrepreneurs. Currently, these are the MGS, the ICO lines aimed specifically at entrepreneurs and aid to new technology-driven companies.
- Fifth. State subsidy of the mutual guarantee system is very low and should be increased substantially. This increase should be in proportion to the number of small companies having difficulties in raising finance. This would have two main effects. Firstly, there would be an increase in the number of MGS financial guarantees. Secondly, there would be a greater than proportional increase in the financing of entrepreneurs if appropriate incentives were written into the guarantee contract entered into by the CERSA and the MGR.



- Sixth. There should be greater monitoring of transactions funded with this increased state subsidy. ICO-PYME loan advantages could also be developed for MGS processed loan applications.
- Seventh. To support the redirecting of state subsidies towards entrepreneurs, NSA units responsible or to be responsible for their financing should be strengthened. This does not necessarily mean a net increase in financial or human resources but rather a re-deployment thereof or a new balance in the objectives and functions of units currently dealing with SMEs.
- Eighth. Policies, objectives, tools and subsidies should be better coordinated with the Autonomous Regions, whilst maintaining and even encouraging beneficial competition between MGS. MGS should be encouraged to operate nation-wide and not be limited to the Autonomous Region providing their main subsidy. This would help to reduce the large spread of MGS policies and results.
- Ninth. Great care should be exercised in the fostering of the Business Angels so that their function is optimum. State regulation, previously agreed with the Autonomous Regions should not deter potential participants. Neither should it redirect Business Angel activities towards up-and-running medium and large companies. The Business Angels should promote the financing of entrepreneurs.
- Tenth. Specific NSA lines of finance to entrepreneurs, such as the ICO-Entrepreneurs and ICO-Micro-credit lines and support for the creation of technology-driven companies are flawed. Despite being well designed in terms of addressing the market failure, they suffer either from a lack of direct contact with clients, a lack of resources or lack of expertise to analyse and monitor applicant projects. In addition, these initiatives are too widely spread.
- Eleventh. A Public Private Partnership should be set up to deal with these shortcomings. It should use new technologies and have a small network of offices to deal with potential entrepreneurs. It should be run on the lines of a private company and provide loans or participate directly in projects considered to be viable. It should have the capacity to analyse and monitor the financial feasibility of projects and enjoy the financial support of the NSA to assume the greater risk inherent in projects of this nature.
- Twelfth. This PPP should coordinate the objectives and resources of existing initiatives. This would enable the implementation of a general support policy for entrepreneurial financing with greater transparency and control, whilst retaining the specific approaches and objectives of the individual initiatives.
- Thirteenth. The creation of new companies is always difficult. It is important to adapt to an ever-changing environment by putting the necessary structures in place to meet challenges and obtain optimum results. The NSA response to the need to



provide finance to entrepreneurs should be improved in order to obtain better results.

- Fourteenth. There is a great potential demand for entrepreneurial financing. If this demand is met, it would produce positive knock-on effects for the economy as a whole. The value of such effects has yet to be quantified but there is unanimous agreement that it would be considerable.
- Fifteenth. NSA resources to meet this objective are too low and not in line with the extent of the challenge or the potential benefits of an increased budget and a proper strategy. There appears to be no general policy, just disperse initiatives. Therefore, a lot of work remains to be done with potentially very good results to be obtained.