

The Equity-Financed Enterprise

Sharing Uncertainty to Support Investment

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Abstract

This essay takes a non-mainstream approach to small business finance and investment, with a particular focus on Europe. We advocate for greater use of external equity finance to support investment in uncertain environments. Equity, differently from debt, is designed to absorb the downside and to profit from the upside of future events. *Ceteris paribus*, external equity finance should reduce the risk for the entrepreneur, as it shares the uncertainty in a way that is not possible with debt instruments.

Venture capital already demonstrates a success story in this respect, though by design it invests in a very select portion of firms with the highest growth potential. A broader scale of intervention is required to sustain small business investment, centered on mature firms with sound prospects, and to be articulated along three mutually reinforcing pillars:

- 1) Banks to provide (quasi-)equity finance to entrepreneurs, subject to the restriction that firms receiving equity finance from banks are not allowed to borrow;
- 2) In exchange for not being able to borrow, equity-financed enterprises benefit from a lower corporate tax rate;
- 3) Investors should be able to access the returns from the (quasi-)equity thus provided by the banking system via securitization.

Enacted together, these three pillars hold potential to trigger positive incentives on both the demand and the supply side of entrepreneurial equity and investment, while still being compatible with the pursuit of financial stability.

The proposal builds on the momentum of policy initiatives that are well under way, particularly in Europe, and is consistent with the overall banking reform agenda. We see a possibility to enhance the role and profitability of the banking system, while at the same time launching a novel and potentially attractive asset class for investors.

Introduction

In his influential 1921 book *Risk, Uncertainty and Profit*, Frank H. Knight articulates entrepreneurship as a response to uncertainty.

Uncertainty thus exerts a fourfold tendency to select [wo]men and specialize functions: (1) an adaptation of [wo]men to occupations on the basis of kind of knowledge and judgment; (2) a similar selection on the basis of degree of foresight, for some lines of activity call for this endowment in a very different degree from others; (3) a specialization within productive groups, the individuals with superior managerial ability (foresight and capacity of ruling others) being placed in control of the group and the others working under their direction; and (4) those with confidence in their judgment and disposition to "back it up" in action specialize in risk-taking.

Because entrepreneurs accept an uncertain remuneration, they are entitled to the residual income that comes in the form of profits. In Knight's own words:

The function of making these estimates and of "guaranteeing" their value to the other participating members of the group falls to the responsible entrepreneur in each establishment, producing a new type of activity and a new type of income [profit] entirely unknown in a society where uncertainty is absent.

While there is no lack of uncertainty in Europe today, entrepreneurs struggle to perform the function of *making these estimates and of "guaranteeing" their value*. One telling indicator is the limited demand for bank loans, despite record low interest rates. Nearly half of the small and medium-sized enterprises (SMEs) surveyed by the European Central Bank (ECB) do not consider bank loans to be relevant and another thirty percent did not use loans in the past six months, despite very low and often still falling interest rates (ECB 2016).

The core thesis of this essay is that lack of risk-taking capital contributes to explain low appetite for investment, and that unwillingness to borrow comes as a consequence. Setting up, expanding or restructuring an enterprise are inherently risky activities. The bulk of the uncertainty rests on the shoulders of the entrepreneur, their partners and coworkers. This

remains true even if debt finance is available, since debt is a poor instrument to share risks. Debt is not designed to cope with uncertainty. It comes with a repayment schedule that is fixed in amounts and dates, so that it cannot absorb the unexpected events faced by the entrepreneur. Just as importantly, debt does not reward those lenders that are prepared to accept a higher level of risk, as the upside in debt contracts is fixed, irrespectively of how successful the borrower is in the end.

To think of an alternative, suppose external equity investors were ready to finance the SME's investment plans. Equity shares both the upside and the downside of entrepreneurship and it is a more attractive source of finance in the face of uncertain prospects. Unlike debt, which is foregoing the upside in exchange for the promise of a fixed payment at a given date, equity enables flexible payments in schedule and amounts. As entrepreneurs willing to invest face uncertainty both in terms of extent and timing of future cash flows, equity provides a natural hedge. Under this reasoning, the question for Europe becomes how to best channel equity investment into SMEs. For those entrepreneurs with high-risk, high-return prospects there is venture capital, and public institutions throughout Europe are already contributing to support and develop this instrument (Kraemer-Eis et al. 2016). Given their business model, focusing on high-growth prospects, venture funds can only serve a portion of businesses.

Banks, on the other hand, have a universal reach in Europe when it comes to SMEs; no firm can operate effectively without a bank account and a broader relationship involving employees, customers and suppliers. Banks serve all SMEs, including those that do not borrow. Suppose banks were able and willing to share into the risk of growing these companies. Could this help revive entrepreneurial animal spirits?

This essay takes a three pronged approach to the question. In the first section, we illustrate why banks are a natural intermediary for providing equity to the bulk of SMEs. In the second section, we explain the rationale for our core policy proposal: companies receiving equity from a bank ("equity-financed enterprises") cannot be allowed to also receive debt finance. This constraint should justify a lower tax rate, to level the playing field,

as these companies will not be able to take advantage of the tax deductions that benefit debt instruments. In the third section, recognizing that bank capital remains scarce, we call for the establishment of a secondary market for enterprise equity in the form of securitization. If all three measures are enacted, the economy should begin to see the gradual establishment of a new form of corporate finance, better adapted to the needs of those entrepreneurs, who have the potential to support renewed investment in the European economy. The fourth section addresses the likely skeptical initial reactions to our proposal, including attendant questions about financial stability; the final section concludes.

Why should banks invest in SME equity?

Commercial lending activities and equity investment have long been separated; the Great Depression having shown the perils of the negative spiral taking place when banks own companies during a downturn. Even without strict prohibition against owning equity in non-financial corporations, banks continue to be discouraged by punitive capital requirements. Under current regulations, they need more capital to convert a bad loan into equity than to write it off. Thus, deposit taking institutions are either *de iure* or *de facto* discouraged from equity investment, even if it would benefit companies that they know well. While not necessarily arguing for a change in capital requirements, this essay offers an alternative in the last section. Let us focus for a moment on why commercial lenders possess an advantage in providing equity to SMEs.

Banks intermediate all of the cash-flows that SMEs generate, paying for supplies and wages, receiving payments for invoices and so forth. This information puts them in a privileged position to evaluate and monitor the operating soundness of their clients. Local branches often manage the finances of the entrepreneurs, their families and their employees. They are best placed, not only to make informed investment decisions, but also to provide ongoing monitoring and support, especially when relationships are for the long

term. All of this is particularly true in Europe, where deposit taking institutions, rather than capital markets, dominate finance.

Community-focused branches are natural partners of local firms, since they possess the required information. Cooperative banks may be particularly suitable because their purpose is to do business with their own members, and members have an incentive to maintain the solidity of the cooperative. They are based on a partnership concept that should be more conducive to informed investment and monitoring, both of which could enhance portfolio performance. The next section will describe how branches can build the required set of skills and mitigate the potential conflicts of interest inherent in these relationships, but let's continue to focus for the moment on their best interest.

Equity investments should provide banks with superior returns compared to lending. First of all, equity returns are higher on average than credit returns in reward for the higher risk taken. Second, returns from equity come with a significant upside potential, whereas the upside from credit returns is typically limited; therefore, it takes fewer individual investments to achieve diversification in an equity portfolio than in a credit portfolio. Third, because equity finance shares the risk with the entrepreneurs, it strengthens the overall relationship and makes entrepreneurs less likely to go to competitors for fee-generating services.

The small businesses we have in mind in this essay are established concerns with sound operations and growth opportunities, coupled with limited appetite to borrow (Maziak et al. 2017). We are looking at firms that are well placed to benefit from the informational advantages and close proximity of a bank relationship, and ready to give up some control in exchange for sharing of risks. We should like to call such businesses "Equity-Financed Enterprises".

A rationale for the Equity-Financed Enterprise

Prior to the Great Depression and the reforms it triggered, lenders to a company could also invest in its equity. The stock market crash and associated banking crisis of the late 1920s and early 1930s brought to the fore the conflicts of interest inherent in these arrangements. In particular, financial institutions and other companies might share the same group of directors, creating incentives for excessive lending, insider trading, ever-greening of debt and so forth. How can one prevent a repeat of this experience if commercial banks are to be able to engage extensively in equity provision to SMEs?

Incentives can be balanced if enterprises receiving equity are either not allowed to borrow at all, or are restricted to borrowing for working capital and trade finance needs only. Such an arrangement is simpler and less drastic than separating commercial and investment banking, and it may no longer require a regulation that penalizes banks for owning equity. On the other hand, a restriction would now be shifted to the entrepreneurs: those enterprises whose equity is owned by banks will no longer be able to borrow. Would such limitation represent a binding constraint?

As already mentioned, the European Central Bank surveys reveal that half of the companies do not consider bank loans to be relevant. In a similar venue, the OECD (2016) finds that only half of bank lending goes to SMEs, and furthermore, a full half of such loans are secured by collateral. The statistical pattern emerging is that non-financial corporations may not borrow very much overall, and those companies that do tend to be the larger ones. European SMEs already rely primarily on internal cash-flows; that is, internally generated equity as opposed to external funds.

Let us now focus on the fifty percent of the companies, which are not interested in receiving loans from banks. Why would they seek external equity investors with the attendant loss of autonomy and higher degree of transparency required? Personal finances will have to be tightly separated from the company and accounts subject to a higher degree of scrutiny. Skepticism about external equity finance is an often-invoked justification for the

lesser development of the European venture capital market compared to the US. And, indeed, ECB (2016) finds that ninety percent of SMEs it surveys declare equity to not be relevant as a source of finance.

This situation could represent more of a consequence than a cause of current practices. It is well possible that entrepreneurs would welcome an equity-based partnership with the right bank. One could also imagine that a number of banks would be ready to embrace the challenge, provided one can match the right entrepreneurs with the right credit officers. Making the argument requires a short digression.

Progress in information technology and credit portfolio management, coupled with stricter regulation and supervision, has transformed credit into a data-driven business, which relies on measurable inputs for a centralized decision. This is especially true in the case of the SMEs which are the main protagonists of this essay. Loan officers with credit expertise and judgment tend to serve larger corporate clients from regional headquarters, while local branch managers enjoy limited delegated powers on credit matters.

This is possibly the most daring aspect of our proposal, a call to give back to the local networks the skills and the autonomy that are required to invest alongside entrepreneurs as partners. Centralized credit risk management emerged from the belief that taking credit authority away from the branches would remove conflicts of interest and result in arm-length decisions. In a similar venue, the recommendation that SMEs receiving equity from a bank should not be allowed to borrow is intended to align the interest of the entrepreneur and the local branch managers, while still taking advantage of local relationships. It goes without saying that such a decentralization will require appropriate planning, monitoring and supervision.

Another obstacle is the tax-deductibility of interest rates. European governments should level the playing field when it comes to fiscal treatment, by applying lower corporate tax rates to the “equity-financed enterprise”. Such a lower rate can be calibrated to compensate the foregone benefit from tax deductibility of interest rates, which is available to companies that utilize external finance in the form of debt instead of equity. There have been

several calls for elimination of the tax shield and implicit subsidy for corporate debt across the board, cited in our sources. This essay takes a less ambitious approach, that is, to ensure non-discrimination when it comes to entrepreneurial equity. Two identical entrepreneurs should pay the same amount of taxes, regardless of whether bank finance comes in the form of debt or equity. Implementation should thus not present major difficulties, as the definition of SMEs is well established and understood, the restriction to borrow can be established contractually and, finally, voters rarely object to lower taxes.

A final word on the contractual form, for those entrepreneurs that may perceive bank-provided equity as constraining autonomy and prefer to keep the status quo rather than grow. Finance may come in the form of preferred shares or quasi-equity that leaves control in the hands of the entrepreneur. An advantage of the latter instruments is that contracts include a maturity date. Suppose the investment financed by quasi-equity is successful and the SME reaches a size for which it makes sense to start borrowing. At that point the entrepreneur may refinance with debt. In case of downside, the quasi-equity stays in place and the enterprise remains a going concern. The equity-financed enterprise is thus not a special legal form, and retains the opportunity to evolve in line with its requirements. The use of quasi-equity may also be more attractive to some banks, as it would not entail director's liabilities arising from participating in the corporate governance of the enterprises.

The opportunity for equity securitization

Banks engaging in (quasi-)equity investment will need more capital under current regulations, *ceteris paribus*. Where would this capital come from? We believe a solution is at hand, in the form of securitization, and furthermore it is fully consistent with banking reforms under way.

European policy makers have been continually calling for the development of a securitization market to support small business credit. There are at least three potential benefits associated with this effort: increased business lending, lower capital requirements

and establishment of an asset class for investors. We believe, however, that SME loans face structural disadvantages compared to other assets on the balance sheets of the banks, residential mortgages in particular, when it comes to securitization. Residential mortgages are easier to securitize because they typically involve only one loan, one lender and one asset. Credit analysis is therefore simpler and the same applies to legal documentation. In the case of small business loans, multiple lines of credit and lenders are often involved, as well as different forms of security. If one adds the lower spreads that are typical of corporate loans, it becomes easy to understand why securitization markets remain dominated by mortgages (Kraemer-Eis et al. 2016).

(Quasi-)equity investments in small business should be more conducive to securitization than it is the case for loans. There will be only one bank investing, one investment and one SME. Higher prospective returns and diversification should make this asset class attractive to investors. The legal form of the underlying instrument should also be simpler.

Structuring and retention of interest by the originating bank should be straightforward. While credit securitization entails a complex waterfall of cash-flows and the issuance of multiple classes of liabilities, equity securitization could take a mutual fund structure. Originating banks either retain a portion of each investment in the pool, or a share in the overall fund. This would preserve alignment of interest and ensures incentives for continued monitoring.

There is additional social value in promoting the (quasi-)equity securitization market as a new asset class. Not only will it contribute to channeling financial savings into real investment, it will also provide European pension plans and insurers with potentially higher yielding instruments. Within a Capital Market Union, it could lead to deeper equity markets, while continuing to build on Europe's capillary banking network, which has served our enterprises well for many years prior to the crisis.

The approach is also consistent with the spirit of banking reforms aiming at separating deposit-taking from riskier and illiquid activities, launched by the Liikanen (2012) report and

currently under examination. The reforms call for riskier activities, including private equity, to be carried out by a separate legal entity that cannot take deposits. They, however, specify a threshold below which the bank can continue to carry such activities on its balance sheet. Our proposal for securitizing equity investment in a separate mutual fund and for the originating bank to retain a small quota for alignment of interest appears to be consistent with the requirements.

Debunking mainstream counter arguments

To some readers the storyline of this essay must evoke financial heresy. Banks investing in risky equity: was this not a factor in the 1929 stock market crash? Lower corporate taxes: why this proposal at the height of global income inequality? Securitization: was it not at the root of the 2007 credit market meltdown? We believe reform across all three dimensions of our proposal is needed to make equity finance work, and equity finance to be a credible option to deleverage the financial system and stimulate investment. So, let's see if one can debunk each of these arguments in turn, as a different way to restate the main thesis of this essay.

First, is equity investment always riskier than lending? Common experience and theory both appear to say yes. Since debt claims are fixed, equity remuneration comes as a residual after debt service. The value of equity fluctuates therefore more than the value of debt with the business fortunes of the firm. In exchange for taking higher risk, compared with lenders *to the same firm*, equity holders are better able to observe and direct the business of a company as they are represented on its board, something that is not available to debt holders. The former see business results in real time, the latter have to content themselves with financial statements. Their protection lays in covenants and collateral, which can only be activated in case of downside. Debt holders have therefore limited prevention power or influence in the running of a firm. They only get to take over a firm after it is already

bankrupt. For all these reasons, lenders require fixed payments, set contractually and as a consequence face a lower risk than equity holders do.

The above narrative, however, only applies in the case of claims on firms that are financed by both debt and equity. Consider, instead, the case of an entrepreneur starting a business without any funds of their own. If s/he manages to borrow the amounts required to launch the enterprise, operating cash-flows will be used for debt service, with the residual going towards profit. The same will apply in case outside investors provide equity finance. The contracts will be different, in the case of debt requiring fixed payments set in advance, or, alternatively, with equity enabling flexible payments; as already argued, the risk for the entrepreneur will be different. But from the point of view of the providers of finance, either the lenders in a purely debt-financed firm or the investors in an exclusively equity-financed firm, the risks of investing should be the same. In conclusion, equity is riskier than debt only when both are used concurrently to finance the same firm. If equity is considered as an alternative to debt for financing a firm without leverage, equity is not necessarily riskier for the investors. As a matter of fact, it could be less risky. An equity-financed entrepreneur is less likely to go bankrupt and can recover from a downturn more easily as they do not need to continue making payments to debt holders when times are difficult. Thus, long term prospects are better, as is the ability to generate fundamental value for the shareholders.

Second: lower corporate tax rates will *necessarily* increase inequality and fiscal deficits. Let us start with inequality. Take two entrepreneurs running businesses that generate the same profit before interest and taxes, say ten euros; one is however entirely equity financed, the other one leveraged, with half of the finance in the form of equity and the other half debt. For simplicity let us assume that the second entrepreneur remunerates debt and equity equally, five euros each, and that both equity and debt come from the same investor. With corporate taxes at 35%, the investor in the equity financed firm will be left with 6.5 euros after corporate taxes, while the investor that provided half of the finance in the form of debt, will enjoy an after-tax return of 8.25 euros (that is 5 euros for the debt service, which is not taxed at the level of the company, plus another 3.25 euros from its equity

investment). The additional return of 1.75 euros is a cost to the taxpayer and if the taxpayer and the investor are not one and the same person, the investor gains while the taxpayer loses. In this case, a lower corporate tax rate will reduce inequality, rather than increasing it.

What about the budgetary consequences of lower corporate tax rates? In this example, total corporate tax income amounts to 5.25 euros (3.50 from the first company and 1.75 from the second). If corporate rates were lowered to 25%, but applied to income before interest, total corporate tax revenues of 5.0 euros (2.50 from each firm) would be only five percent lower (25 cents less), however the subsidy granted from the taxpayer to the investor would disappear, leading to lower inequality. The insight is that if one were to lower corporate tax rate and concurrently eliminate tax deductibility of interest, the tax base would increase. This way, the total tax revenues could be maintained at the same time that inequality is reduced. A less radical alternative would be to apply a higher corporate tax rate to more leveraged firms and lower rates to less leveraged firms, so that overall tax revenue is maintained, but the taxpayer subsidy to corporate borrowing is reduced. In conclusion, lower tax rates for equity financed firms do not necessarily represent fiscal heresy.

Third, is there a possibility of igniting a bubble in small business finance, leading to a repeat of the large savings and loans crisis seen in the 1980s in the US and more recently in Denmark? Political mismanagement of local banking can lead to excessive risk taking for weak projects, especially if banks do not retain the risk, as was the case for subprime mortgages. Just as they do not always lend to the best companies, banks will not always invest in the best prospects. One can never rule out bubbles, yet, a number of institutional developments already initiated in response to the crisis should be conducive to a healthy securitization market for small business equity.

There is an emerging momentum towards simple, transparent and standardized securitization (STS), which is being promoted jointly by the European Commission and industry associations. This new framework aims at mitigating the complexities that characterized securitization leading up to the financial crisis. Also, the Single Supervisory Mechanism (SSM) and the reinforcement of bank supervision that it entails provide further

reassurance to investors. Local regulatory capture and forbearance are less likely to be possible under the SSM, as national supervisors operate within a European network. Finally, the increased availability of comparable data at the European DataWarehouse (ED) enables benchmarking and oversight directly by the investors in the new securities.

The proposed equity instrument, more likely to be pooled into portfolios and sold to investors, thus complements and reinforces the institutional efforts under way for STS, while benefitting from the SSM and the ED. These are being designed specifically to avoid the repeat of pernicious bubbles, and hold the promise to deliver.

Conclusion

It is harder to face uncertainty on one's own, either in life or in business. Whether setting out in open seas, climbing a mountain, or steering a company in difficult economic times, uncertainty is easier to tackle in partnership. When it comes to entrepreneurship and investment, having the long-term support of a financial institution that shares into the risks can make a difference.

While banks may not be popular at the moment, they continue to perform an essential and irreplaceable function for the economy. And, to be fair, not being able to invest in companies has historically restricted the bank's ability to achieve higher returns on their assets. A low interest rate environment further limits bank profitability and it may lead to systemic consequences if banks are not able to restore revenues.

Against such background, this essay calls for a reinterpretation of the role of European banks when it comes to financing entrepreneurs. We contend that, as long as the firms that receive equity finance are not allowed to borrow, banks can provide equity. There is nothing inherent to banking that restricts it to the exclusive provision of credit instruments, as long as moral hazard, adverse selection and other conflicts of interest can be effectively mitigated. And there are several advantages in channeling equity finance to SMEs through banks, provided banks have adequate capital to support this activity.

The reinterpretation we propose would not require major policy intervention in either the legal or the fiscal domain. Our proposal builds on existing and ongoing reforms that have followed the crisis, though it is bolder in questioning long-held beliefs that banks can only originate credit. We are well aware that while banks are best placed to provide equity to entrepreneurs, this may conflict with their traditional function as deposit takers. Thus, enabling banks to invest in equity should go hand-in-hand with their ability to securitize such exposures.

We are also aware that many entrepreneurs are not inclined to welcome third party equity investors, as equity is more expensive than debt, dividends are not tax-deductible and partnership comes with strings attached. These entrepreneurs may prefer to forgo growth opportunities that cannot be financed directly out of their companies' cash-flows. To provide an incentive, we recommend a tax treatment that rewards, rather than penalizes, the equity-financed corporation. Finally, for those entrepreneurs eager to retain full control of their companies, quasi-equity instruments will deliver similar advantages; likewise for banks that are wary of the corporate governance responsibilities that come with ownership.

The key to European opportunity is to recognize that restoring growth requires risk taking and that risks are best shared in partnership. This essay ultimately urges to re-establish a partnership between the European banking sector and the real economy that would be beneficial to both.

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