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Task 1: Financial engineering

Cyprus

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Lena Tsipouri and Sophia Athanassopoulou

National and Kapodistrian University of Athens

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Contents

List of abbreviations

- EEN Expert Evaluation Network
- ERDF European Regional Development Fund
- FEI Financial Engineering Instrument
- OP Operational Programme
- EIB European Investment Bank
- EIF European Investment Fund
- BoC Bank of Cyprus
- CCCB Cyprus Central Cooperative Bank
- UDF Urban Development Fund

Executive summary

The use of ERDF FEIs in Cyprus is composed of only two schemes supported by the JEREMIE initiative, a Funded Risk Sharing Scheme (EUR 20 million, 50% of which will be provided by the Bank of Cyprus (BoC) and 50% by the ERDF and national funds) and a First Loss Portfolio Guarantee scheme addressed to all SMEs seeking to collateralise part of their loan portfolio (EIF aims to provide for the EUR 8 million collateral for the programme and generate about 6 times the amount in loans). There is higher demand for the former. The only non-ERDF FEI is similar to the Funded Risk Sharing Scheme initiative implemented by CCCB. All other incentives are grants and there is no venture capital at all in the country.

FEIs were for the first time introduced in the current programming period, taking advantage of the opportunities offered by the Structural Funds. FEIs are recognised as having higher multiplication effects for the economy, application procedures are faster and payments are easier to be disbursed. FEIs are more appropriate for more mature investments, which can rapidly generate income, and would be less appropriate for R&D and innovation initiatives that are risk-loaded and take long time to commercialise.

These first incentives need to be considered as pilots. Although not yet formally evaluated, it is assumed that their contribution to the national economy will be positive, allowing a better policy mix for business development. However, at the micro level, improvements in the management cost structure are needed, as well as procedural clarifications and softer rules, related more to content than form.

1. Use of financial engineering instruments

The use of ERDF FEIs in Cyprus is rather limited; it is composed of two schemes supported by the JEREMIE initiative:

- the Funded Risk Sharing Scheme addressed to micro and small companies aiming to fund their expansion. The programme started in 2010 and will run until September 2012. The total fund allocation is EUR 20 million, 50% out of which is covered by BoC and 50% is the JEREMIE Fund (of which 85% is ERDF and 15% national public investment budget);
- the First Loss Portfolio Guarantee scheme, is addressed to micro and small start ups as well as to medium-sized companies, seeking to collateralise part of their loan portfolio. The programme started in 2011 and is expected to run until April 2013. EIF aims to provide for EUR 8 million collateral for the programme, which is expected to generate about 6 times the amount in loans, granted by BoC. 73% of total loans will be channelled to start ups.

The government launched a call for intermediaries for the JEREMIE initiative and BoC was the only one applying for the job. BoC is the selected intermediary for both programmes, and the EIF is the designated Managing Authority of the Holding Fund created for this purpose. The Fund is co-financed by the Cypriot ERDF funds and the EIF.

Another initiative introduced by Cyprus Central Cooperative Bank (CCCB) is similar to the Funded Risk Sharing Scheme, but not supported by the ERDF. It is addressed to micro companies and individuals. The programme started in 2011 and will run until September 2012. EUR 16 million of funds are expected to be allocated through this programme, 50% of which will be provided by CCCB and 50% by EIF.

Cyprus continues to refrain from the JESSICA Initiative[1]; national policies do not see it as a priority. In addition, it is unlikely that there is sufficient experience for the development of Urban Development Funds (UDFs) and the support of the single Holding Fund option.

There has been no venture capital development at all. While this is a weakness addressed by both policy documents (ERAWATCH Network, 2011) and the business sector, there is a lack of private initiative because of the small overall size of the market and the scale of the manufacturing sector in particular. The lack of private VC has also discouraged the government to invest in public VC in the form of Fund of Funds, as it is unlikely that there would be any demand for it.

All other programmes implemented in Cyprus refer to traditional grant schemes, as presented in the Appendix. Although, as explained there, it is not possible to know precisely what the amount of ERDF support received by companies is, a rough estimate indicates an amount significantly larger than EUR 100 million. ERDF funds for the Funded Risk Sharing Scheme are EUR 8.5 million; hence less than 5% of all are other forms than grants.

[1] Planning Bureau, 2011a

2. Rationale for using financial engineering instruments

The government has traditionally favoured grants over any other type of funding, because they were considered an attractive mechanism for restructuring and modernising the economy, after the accession of the country to the European Union.

FEIs were for the first time introduced in the current programming period because it is recognised that they have higher multiplication effects for the economy, application procedures are faster and payments are easier to be disbursed. Hence, it was considered that the Structural Funds – EIF combination offered an opportunity to diversifying support instruments:

- The Risk Sharing Facilities (BoC and CCCB) and the First Loss Portfolio Guarantee scheme are expected to have **higher multiplication effects for the economy** compared to grants since the funds provided by EIF are intended to generate equal matching funds for loans and additional multiplication effects through guarantees. The funds are used for investments, which are expected to generate income for the repayment of the loans granted. Moreover, in the case of the First Loss Portfolio Guarantee scheme, the collaterals provided are expected to stimulate 6 times more loans.
- Investments decisions by FEIs **are likely to be more rational** since all costs are properly evaluated and scrutinised by the BoC. Since funding is first provided by the credit institution and then follow the funds provided by EIF (Funded Risk Sharing Scheme), investments are audited and monitored by senior credit officers of financial institutions.
- The **application procedures are faster** compared to traditional grants since these are filed to BoC, a financial institution with the prospect of generating additional income from this initiative, therefore incentivised to process them faster. It is estimated that the application process, including also the evaluation, could take 30-45 days within the BoC, while the traditional grants would involve open tenders by the Ministry of Commerce, Industry and Tourism, the Planning Bureau or the Research Promotion Foundation, with mandatory EU publicity requirements that could take 5-6 months, including the evaluation process.
- For the same reason, **disbursements are also faster**. Loans are granted as soon as they are approved, either as lump sums or through regular payments, which in any case cannot exceed 6 months from the approval of the loan. BoC releases the approved disbursements, as soon as the invoices for the agreed investments are filed. Traditional grant schemes involve regular payments pre-defined in the contract, and are subject to verification of actual works by the competent authority. Within this context, there are significant delays that may be even longer if there are disputes between the beneficiary and the competent authority with respect to the realised expenditures.

FEIs are more appropriate for more mature investments which can rapidly generate income, and would be less appropriate for R&D and innovation initiatives that are risk-loaded and take long time to commercialise.

Direct costs are higher for FEI, as both the EIF and the BoC charge management fees. In particular the EIF charges appear disproportionate to the service offered. While one cannot directly compare with the cost of grant management (which is composed of the salaries of civil servants and other costs of the public administration) the overall perception is that the administration of grants costs less than that of the equivalent loans and guarantee schemes.

3. The effectiveness of financial engineering instruments: selected examples

All schemes are dedicated to micro and small companies, as defined by 2003/361/EC:

- Micro-companies with personnel less than 10 people and total sales or net asset value lower than or equal to EUR 2 million.
- Small companies with personnel less than 50 people and total sales or net asset value lower than or equal to EUR 10 million.

It is considered that these thresholds cover the overwhelming majority of Cypriot companies; therefore the schemes are appropriate for the size of the market and the business sector. Loans must be channelled to investments for the upgrading of the existing infrastructure or for the expansion of companies, and could also include working capital needed for such purposes.

The Managing Authority exerts no influence over the way these funds are allocated. BoC assesses loan proposals that are being filed, taking into account the risk profile of potential beneficiaries versus the overall risk exposure of the bank. BoC may not approve loans to high-risk clients in excess of 35% of its total loan portfolio. Currently, this threshold has been reached and loans are only granted to low risk clients.

Although specific sectors have been prioritised (renewable energies, R&D, informatics and communications, waste management, cultural and social services), in practice loans are granted to all sectors with high demand from the retail sector. **Except for the risk profile of potential beneficiaries, no other criteria are applied** for approving the support from this scheme.

Funded Risk Sharing Scheme (BoC)

The scheme, which is managed by the EIF, provides for favourable financing terms – interest rate at 4.5% (4 percentage points lower than the current prime rate), repayment period up to 10 years and up to 2 years grace period - for loans up to EUR 100,000.

The performance of the Funded Risk Sharing Scheme is assessed by its absorption rate and there are no other formal criteria. In this respect, performance is considered to be satisfactory, even if demand was lower than anticipated. By April 2012, 190 applications corresponding to loans of EUR 15.1 million had been filed, of which 122 applications corresponding to loans of EUR 11 million had been evaluated and approved[2]. About EUR 8.7 million of funds had been reimbursed, accounting for 43% of progress[3]. The majority of the funding was allocated to trade companies: 20% to retail trade and 17% to wholesale trade companies. 188 applications remain pending[4].

It is believed that the scheme could have higher absorption rates, if working capital unrelated to upgrading of infrastructure or expansion could also qualify for funding. A specific amendment for this purpose has been included in the contract signed between BoC and EIF.

[2] Interview with Bank of Cyprus (Andreas Kythreotis)
[3] Interview with Planning Bureau (Agathi Charalampidou).
[4] Interview with Bank of Cyprus (Andreas Kythreotis)

First Loss Portfolio Guarantee scheme (BoC)

The scheme provides for favourable financing terms – interest rate at 7%, repayment period up to 10 years and up to 2 years grace period. For start ups, loans may not exceed EUR 70,000, while for developing companies the threshold may not exceed EUR 100,000. For loans up to EUR 50,000 no collaterals are needed and such loans are addressed mainly to individuals.

The credit rating of BoC has been downgraded, because of the high share of Greek bonds in its portfolio, which suffered from the Private Sector Involvement (PSI) that repaid only partially the Greek sovereign debt. This has resulted up to now to 4 revisions of the contract with EIF and caused significant delays to the programme. In addition, there was insufficient advertising and the schemes were mostly promoted within the branches of the BoC. In March 2012, BoC engaged in advertising through TV and the press for a total cost of EUR 120,000. These initiatives are expected to generate additional demand.

Contractually the BoC is expected to have settled 35% of its estimated loans; otherwise the EIF may chose to terminate the scheme.

The performance of the First Loss Portfolio Guarantee Scheme is assessed by its absorption rate and there are no other formal criteria. The scheme experiences low absorption rates since the majority of potential beneficiaries seeks favourable financing terms rather than less collaterals. By April 2012, 8 applications had been filed and 5 had been evaluated and approved, corresponding to EUR 250,000, of which EUR 234,000 had been reimbursed[5] (less than 1% of the expected loans).

4. Main problems in using financial engineering instruments

Interviews pointed at several problems

- related to **the reporting** to the EIF about the use of these instruments;
- associated with the **identification of grant beneficiaries**;
- related to the **type of intervention of the schemes (inherent problem)**;
- associated with **high management costs**.

With respect to reporting, it is indicated that there is too much documentation involved in the monitoring of both schemes. A sizeable amount of the standardised reporting requested by the EIF is not covered by the MIS of BoC; hence it needs to be effected manually. This is time consuming and risks leading to omissions or errors. BoC expressed the view that the reporting methods implemented in EIB programmes in the past were far friendlier and could easily be supported by the internal systems of the bank.

Another problem that has been identified refers to difficulties in the ex ante identification by BoC of the beneficiaries of grants who are not eligible for financing. Although the Planning Bureau intends to clarify with the EIF whether grant beneficiaries are indeed eligible for FEIs as well, for the time being these beneficiaries are not allowed to seek funding from these resources too. However, in practice such cases are only identified ex post when BoC communicates the beneficiaries of FEIs to the Planning Bureau and the latter cross checks the names with their beneficiaries. By that time, it is difficult to reverse the loan.

[5] Interview with Planning Bureau (Agathi Charalampidou).

The operation of the two FEIs in Cyprus has also **revealed a preference of final beneficiaries towards favourable financing terms** rather than collaterals, thus rendering the Funded Risk Sharing Scheme more successful. This could be considered in the next programming period and lead to the introduction of schemes more appropriate for the market.

A final reported problem has to do with **high management costs from the part of the Managing Authority** which are often prohibitive for the operation of small scale funds.

The above-mentioned problems have not been overcome.

5. Evaluations of financial engineering instruments

FEIs are too recent to be formally evaluated. As pointed out above, the overall perception is that the country needs a diversification; policies should not continue to be based exclusively on grants. The economy is at a level that can significantly benefit from the leverage effects and rapid management of loan and guarantee schemes. However, any evaluations of even rough comparisons cannot take place before the completion of the first schemes.

6. Concluding remarks

Cyprus, being a small economy dominated by SMEs and very small companies in need of modernisation, after the access of the country to the EU, has traditionally used grants as the only incentives for private investments. The JEREMIE initiative (and a similar non-ERDF-funded initiative) was considered an attractive opportunity to test risk sharing loans and guarantee schemes. The initial impression from the experience is rather positive as a complementary scheme. However, as the new initiatives constitute pilots a few points emerge for discussion, in case such schemes are to be replicated:

- The management cost needs to be carefully scrutinised: centralised EIF management and the cost of intermediaries may end up being prohibitive for small scale funds; while it is acceptable that there are significant economies of scale for larger funds, smaller ones suffer from non-competitive charges.
- Interaction with the EIF can occasionally become complex and legalistic: contract amendments, reporting needs and clarifications about the compliance of different schemes have created initial drawbacks that need to be eliminated/clarified for a potential smoother future operation/replication.

A formal evaluation of the pilot experience is lacking but, when sufficient data will be available, it would provide enough evidence to decide whether similar schemes should be supported with national funds, which constitute the bulk of development financing in the country.

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Interviews

Agathi Charalambidou	Planning Officer, Directorate of Structrural Funds and Cohesion Fund, Planning Bureau
Andreas Kythreotis	P.A. to General Manager, Bank of Cyprus
Ploutarhos Pantelides	Tourism Officer, Strategy Department, Cyprus Tourism Organisation
Costas Christofides	Assistant Director General, Cyprus Employers and Industrialists Federation
Maria Theodorou	Commerce and Industry Officer, Ministry of Commerce, Industry and Tourism
George Hadjiafxentis	Senior Commercial Officer, Ministry of Commerce, Industry and Tourism
Leonidas Paschalides	Director Department of Education and Development, Cyprus Chamber of Commerce and Industry

Annex

Annex Table A: Rough estimate of ERDF support to the business sector in the form of grants[6]

Title	Total funds earmarked 2007-2013 (EUR million)
Support to female entrepreneurship	5.0
Support to youth entrepreneurship	6.0
Grant Scheme for the strengthening of Competitiveness of SMEs in the manufacturing sector	23.0
Grant scheme for the support of entrepreneurial innovation. Development of innovative products and services.	4.0
Incentive scheme for investments in the sustainable enrichment and upgrading of the tourist product	13.0
"DIDAKTOR" Programme	6.0
"EUREKA Cyprus" Programme	5.5
Programme "Support for Young Researchers-PENEK"	8.0
Programme "Research and Innovation"	9.0
Action "Innovation Coupons"	3.0
Action "Patents"	3.0
Provision of incentives to SME's for promoting rural tourism related activities	15.0

[6] This is a very rough estimate as in many of the programmes included the share going to companies is only part of the total budget, which is shared with research organizations. Allocation between the two is not known. In other cases the figures refer to funds earmarked but it is unclear whether they will eventually be spent for the purpose for which they were earmarked. Besides, companies are also beneficiaries of part of the EUR 14 million going to Programmes of the "Multi-thematic Development of Research" but the share they receive is not known.