Expert evaluation network delivering policy analysis on the performance of Cohesion policy 2007-2013

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Task 1: Financial engineering

Lithuania

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A report to the European Commission Directorate-General Regional Policy

Contents

List of abbreviations

- EEN Expert Evaluation Network
- EIB European Investment Bank
- EIF European Investment Fund
- FEI Financial Engineering Instrument
- EU SF European Union Structural Funds
- FEI Financial Engineering Instrument
- HF Holding Fund
- INVEGA The guarantee institution UAB "Investicijų ir verslo garantijos"
- OP Operational Programme
- SME Small and Medium Enterprises

Executive summary

In the programming period of 2007-2013, allocations for Financial Engineering Instruments (FEIs) co-financed exclusively from ERDF are foreseen in two Operational Programmes (OP) – the Economic Growth OP and the Cohesion Promotion OP. Funds from the Economic Growth OP are allocated to promote the development of SMEs (EUR 305.4 million assigned from the ERDF), the Cohesion Promotion OP finances investments in housing energy efficiency (EUR 127 million assigned from ERDF and EUR 100 million as a national contribution).

The funding of FEIs for SME development has changed over the programming period. Currently, EUR 210 million is transferred to a JEREMIE-type Holding Fund (HF) managed by the European Investment Fund (EIF), but it is planned to remove a further EUR 40 million from this fund. Out of EUR 227 million of total contribution to a JESSICA HF, EUR 149 million have actually been transferred up to now.

The Economic Growth OP refers to market gaps and identifies limited opportunities for SMEs to obtain financing as one of the key problems encountered by SMEs. During the economic crisis of 2008-2009, the main concern was the inability and/or unwillingness of financial institutions to meet the demand of funding. As to the energy efficiency measures, the Cohesion Promotion OP notes that the market is not effective in areas suitable for investments in housing, therefore, state intervention and additional investment from the SF are needed. The revolving nature of the fund which enables multiplication of the funds invested as well as leverage of additional public and private sector funding are cited among the main benefits of employing JESSICA-type instruments rather than traditional grant financing.

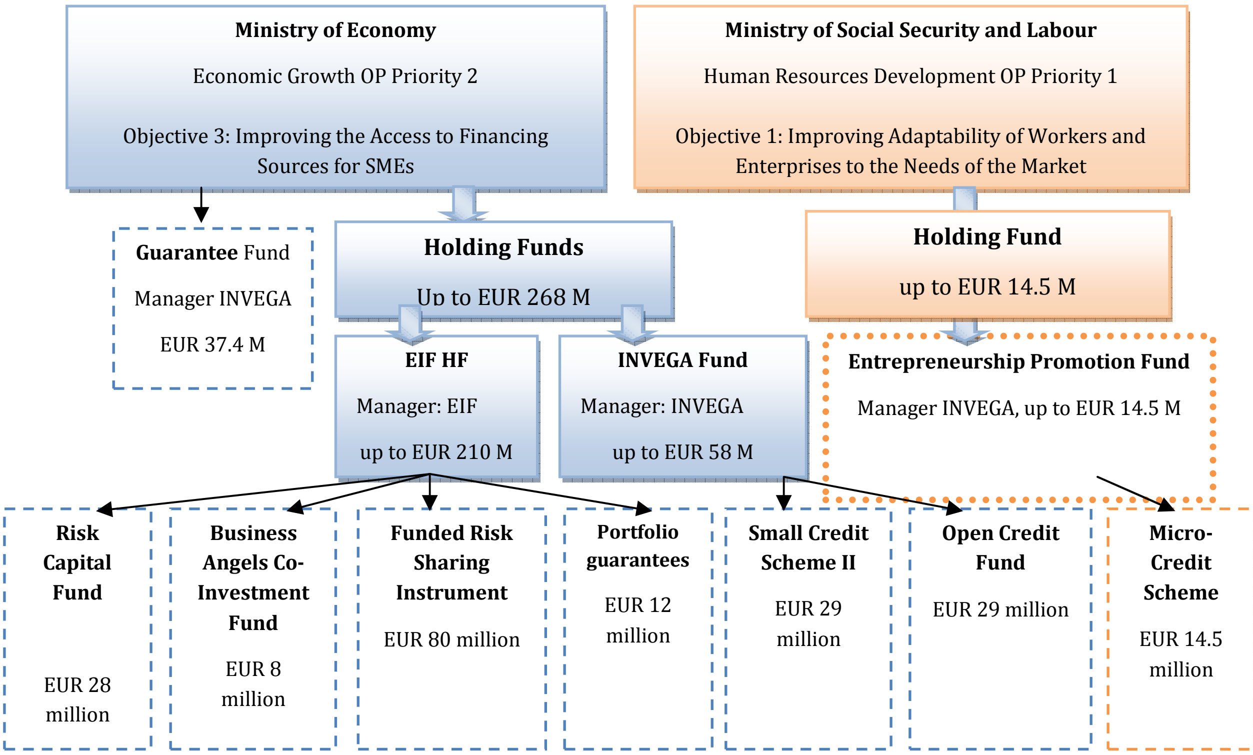
The difficulties of combining FEI and grants, and rules on eligibility of investment in risk capital are the main problematic issues as regards the implementation of FEIs. The uncertainties over the regulations governing FEIs and the general tightening of rules increase the risk that part of the costs incurred will not be considered eligible at final closure of programmes.

1. Use of financial engineering instruments

FEIs funded from the EU Structural Funds and the state budget are a new means of business support. Funds for FEI are allocated to 1) promote SME and 2) increase energy efficiency in apartment buildings and student dormitories.

1. FEIs for SME development in Lithuania have been employed for the first time during the present programming period. However, prior to this period, SMEs had access to two FEIs financed by the national funds. Now allocations to FEIs to promote SMEs **funded exclusively from the ERDF**[1] are foreseen in the **Economic Growth OP**[2]. Currently, several forms of assistance to SMEs using FEI are possible in Lithuania, namely soft loans, micro-loans, guarantees, credit insurance, and venture capital investment. Figure 1 below displays the types of FEI related to the development of SMEs used in Lithuania in the period of 2007–2013, with boxes in blue referring to FEIs funded exclusively from ERDF:

Figure 1: Types of FEI related to the development of SMEs in Lithuania



NB1: Entrepreneurship Promotion Fund is financed exclusively from ESF and will not be further evaluated in this report.
NB2: Not all funds in the EIF HF are distributed between specific measures, and the scope of Funded Risk Sharing Instrument and Portfolio Guarantees may change.

[1] FEIs to promote SMEs are also foreseen in the Human Resources Development Operational Programme (Priority 1 "Quality Employment and Social Inclusion", Objective 1 "Improvement of Adaptability of Workers and Enterprises to the Needs of the Market", Measure VP1-1.1-SADM-08-K "Entrepreneurship Promotion"), but they are financed from the ESF and will not be further evaluated in this report.
[2] Priority 2 "Increasing Business Productivity and Improving Environment for Business", Objective 3 "Improvement of the Access to Financing Sources for SMEs", Measure VP2-2.3-ŪM-01-K "Holding Funds" and Measure VP2-2.3-ŪM-03-V "Guarantee Fund"

The ERDF funding allocated to the Economic Growth OP amounts to EUR 1966.6 million in total[3], of which EUR 305.4 million[4] are allocated to FEIs. FEIs are financed exclusively from EU SF (there is no national contribution), and FEIs are expected to attract EUR 319.2[5] million of private investment for SMEs development by the end of 2015.

In relation to what was initially planned, there were no changes in the Guarantee Fund where the assigned amount is maintained. It is planned to extend the INVEGA HF[6]. The funding of the EIF HF has changed over the programming period. In October 2008, EUR 80 million were allocated to this. The Funding Agreement was amended in March 2009 to extend the amount to EUR 210 million[7]. The Ministry of Economy is planning to remove EUR 40 million from the fund[8] to respond to the needs of SMEs[9] during the financial crisis and also to react to the fact that the disbursement rate from the fund was relatively low, mainly because of the unwillingness of SMEs to invest during the economic crisis, and some FEIs under the fund seemed not to be attractive enough for SMEs. The money will be reallocated to other types of FEI for SMEs[10].

2. In the programming period of 2007-2013, the allocation for investment in housing energy efficiency projects is financed through FEIs from the **Cohesion Promotion OP**[11]. On 11 June 2009, the Ministries of Finance and Environment and the European Investment Bank (EIB) signed a Funding Agreement establishing the JESSICA Holding Fund Lithuania*,* managed by the EIB, for purposes of investing funds in housing energy efficiency projects through the banking sector. The contribution foreseen to be invested in the JESSICA HF is EUR 227 million, EUR 127 million from the ERDF and EUR 100 million from national sources. The ERDF funding allocated to the Cohesion Promotion OP amounts to EUR 1475.4 million in total[12]. To this date, EUR 149 million have actually been transferred to the JESSICA HF. Selected financial intermediaries (banks) provide preferential credits (soft loans with promotional interest rates and long maturities) to owners of

[3] EU SF website http://www.esparama.lt/es_parama_pletra/failai/fm/failai/skaidres_regionai.pdf, 15th May 2012

[4] A Guarantee Fund and two JEREMIE-type funds managed by EIF and INVEGA.

[5] EUR 112 million of private investment attracted in the Guarantee Fund and EUR 206.2 million of private investment attracted in JEREMIE HF and INVEGA Fund

[6] Additional EUR 2.9 million will be assigned to the Open Credit Fund, and a new FEI of venture capital “Development of Innovations” investing in early stage business ideas will be created with allocation of additional EUR 11.6 million. Funds returning to the INVEGA HF from previous investments to FEIs will be used to finance the new venture capital instrument. Interview with INVEGA Acting Managing Director Mr Audrius Zabotka, 16th April 2012. Interview with Mrs Inga Miliauskienė, Ministry of Economy. 25th April 2012

[7] Interview with Mrs Inga Miliauskienė, Ministry of Economy. 25th April 2012

[8] It is not decided yet what measures will be financed with these funds. Priority will be given to measures most in demand from SMEs and to measures aimed at reducing youth unemployment. Interview with Mrs Inga Miliauskienė, Ministry of Economy. 25th April 2012

[9] SMEs make up around 99.3% of all companies in Lithuania and account for two thirds of GDP

[10] Interview with Mrs Inga Miliauskienė, Ministry of Economy. 25th April 2012

[11] Priority 1 “Local and Urban Development, Preservation of Cultural Heritage and Protection of Nature and its Adaptation to Development of Tourism”, Objective 1 “Reduction of Differences between Environment and Quality of Life in the Main and the Rest of the Towns of the Country with Special Attention to Improving Housing Conditions”, Measure VP3-1.1-AM-01-V “JESSICA Holding Fund”

[12] EU SF website http://www.esparama.lt/es_parama_pletra/failai/fm/failai/skaidres_regionai.pdf, 15th May 2012

apartment buildings. In 2011, the scope of activities financed from the JESSICA HF was extended in order to finance energy efficiency renovation in student dormitories[13].

2. Rationale for using financial engineering instruments

1. **The Economic Growth OP** for 2007-2013, when justifying the need to improve SMEs access to financing sources, refers to market gaps and identifies limited opportunities of SMEs to obtain external financing as one of the key problems encountered by SMEs, also indicating that this gap is particularly relevant to start-ups and enterprises which have a high growth potential but requires venture capital investments. Furthermore, an opportunity to receive small-scale loans (micro-credits) is very important for start-ups. The OP refers to purposes and objectives of the priorities (see the Annex, Textbox 1), but not to the reasons for the use of FEIs rather than non-refundable grants.

The Evaluations Studies on SME Access to Finance in EU Member States/Regions[14] carried out by EIF identified the following market failures in Lithuania[15]: 1) the existing start-up and micro-financing schemes do not cover the demand of potential and existing micro enterprises; 2) banks should be encouraged to build SME loan portfolios in order to increase the supply of debt-financing for SMEs in Lithuania; 3) existing guarantee schemes have limited resources and mainly rely on external support in order to continue their activity; 4) insufficient levels of risk capital investments, especially for the early stages (pre-seed, seed, start-up and early stage), partly due to the absence of local players. First-time entrepreneurs have access to a number of programmes offering small grants, but largely lack equity products which offer adequate financing to support them through the critical first years of life; 5) there is a gap for expansion investment for the smaller established companies needing capital to increase production capacity, working capital and capital for the further development of the product or market. 6) insufficient level of Business Angels' activity. There is no legal base for this class of investors, and no Business Angels network has been established so far. In order to address these market gaps, a set of recommendations concerning the setting up of new, or strengthening of the existing financial instruments has been made, and respective FEIs have been designed in the EIF HF[16]. During the economic crisis of 2008, the main concern was the **inability and/or unwillingness of financial institutions to provide loans** to business, while the demand of funding increased in SMEs. FEIs were supposed to be created or re-designed to better fill this market gap. **The revolving nature** of the holding funds and the **possibility to attract private investments** to SMEs are identified as one of the main benefits of using FEIs rather than grants[17].

2. The **Cohesion Promotion OP** for 2007-2013 notes that the market is not effective in areas suitable for investments in housing, therefore, state intervention and additional investment from the Structural Funds are needed. The OP mentions the JESSICA initiative as highly important in

[13] At least EUR 20 million from the EIF HF will be allocated to renovation of dormitories of public higher education and vocational education and training institutions.
[14] Executive Summaries of Evaluations Studies on SME Access to Finance in EU Member States/Regions carried out by the EIF in the Context of JEEMIE. EIF, March 2009.
http://ec.europa.eu/regional_policy/archive/funds/2007/jjj/doc/pdf/jeremie_sme_access.pdf
[15] Data provided on Lithuania refers to September 2007.
[16] Executive Summaries of Evaluations Studies on SME Access to Finance in EU Member States/Regions, *op cit.* .pp 76-77.
[17] Interview with INVEGA Acting Managing Director Mr Audrius Zabotka, 16th April 2012. Interview with Mrs Inga Miliauskienė, Ministry of Economy. 25th April 2012.

this respect.[18] The OP refers to purposes and objectives of the priorities (see the Annex, textbox 2), but not to reasons for the use of FEIs rather than non-refundable grants.

When preparing for the implementation of a JESSICA fund in Lithuania, the EIB commissioned evaluation studies to analyse the market gap for FEIs for support of sustainable urban development co-financed by the ERDF for the period 2007-2013. The evaluation study "JESSICA Instrument for Energy Efficiency in Lithuania"[19] concluded that there was a considerable market gap in the provision of financing which was further widened by the economic downturn in 2008. As a result, there was a substantial potential for the use and application of JESSICA-type instruments in Lithuania which could eliminate the shortage of finance for urban development. The same evaluation and a subsequent supplementary study[20] concluded that one of the market segments where a JESSICA fund could be of particular use was energy efficiency in apartment buildings, to cut energy bills and reduce the country's dependence on external fuel suppliers. The second supplementary study[21] stressed the need for investment to increase energy efficiency in student dormitories of public higher education institutions and vocational education and training institutions.

The evaluations clearly indicated that the main benefit of employing JESSICA-type instruments versus traditional grant financing lies in the **revolving nature of the fund**, which enables **multiplication of the funds invested** as well as **leverage** of additional public and private sector funding. This was very important having in mind the demand and scope of investments needed as many multi-apartment buildings in Lithuania were built before 1993 and required essential investments to increase energy efficiency. The evaluation study concluded that the application of repayable JESSICA instruments in Lithuanian would enable the number of renovated houses to be increased by nearly 50% to compare with the existing grant schemes[22]. Almost the same argument was used when deciding to extend the JESSICA fund to finance renovation of student dormitories: more than half of the student dormitories concerned have been in operation for 29–49 years and require renovation. The volume of investment needed was significant and could not be met by contributions from the national budget in the form of grants[23].

It is not possible to evaluate and compare costs of using grants and FEIs as there are no figures available on the costs of grant administration system, and HF management fees are considered confidential. But certainly there were additional costs incurred when setting up FEIs as a new administration system had to be created. Setting up an institutional, legal, technical and financial infrastructure for FEIs required more time and resources than initially thought. The Financing Agreement for the JESSICA fund implementation in Lithuania was signed in June 2009, the first call for expression of interest for financial intermediaries was announced in November 2009 and the agreement with the first bank selected (Šiaulių bankas) was signed in May 2010[24]. As compared with the initial schedule set up in the Financing Agreement for the implementation of the JESSICA fund (September-October 2009), there was a significant delay. The first apartment

[18] Cohesion Promotion OP. P. 72

[19] JESSICA Instrument for Energy Efficiency in Lithuania. EIB, January 2009

[20] JESSICA Instrument for Energy Efficiency in Lithuania. Supplementary study. EIB, April 2009

[21] JESSICA Instrument for Energy Efficiency in Lithuania. Supplementary Study. EIB, February 2010

[22] JESSICA Instrument for Energy Efficiency in Lithuania. EIB, January 2009. P. 12.

[23] JESSICA Instrument for Energy Efficiency in Lithuania. Supplementary Study. EIB, February 2010

[24] Later, in September 2010, an agreement was signed with a second financial intermediary (Swedbank), and in February 2011 with a third (SEB bankas)

building was renovated only in September 2011, more than two years after the signature of the agreement with the EIB. This delay also caused considerable political frustration as renovation was made a cornerstone of the Government's Economic Recovery Programme.

3. The effectiveness of financial engineering instruments: selected examples

a) Financial institutions in Lithuania provide guarantees and loans to SMEs as well as making venture capital investments. However, requirements for SMEs in terms of minimum turnover, income, existing contracts with clients and business plans are naturally tighter than applied in FEI schemes financed by the ERDF. The evaluation studies on SME Access to Finance in EU Member States/Regions[25] clearly refer to the gap of such services in the market (see Part 3 for details). ERDF co-financed FEIs and private funded FEIs have different objectives: ERDF co-financed FEIs seek to support the development of SMEs in the country, while private FEIs are exclusively profit-oriented. As regards the energy efficiency measures in -apartment buildings, currently banks do not offer a similar product at all. Before the financial crisis, one small bank (Parex Bank) provided loans for renovation, but it did not survive the crisis. Theoretically, renovation can be financed from consumer loans provided by financial institutions to individuals, but due to the high risk, the amount of the loan would be very limited and subject to unfavourable borrowing conditions. This would make energy efficiency renovation in apartment buildings practically impossible.

b) The control of managing authorities exerted over the way that the funds set up by FEIs are allocated differs according to the measures implemented. The control in the implementation of FEI for SME development funded from the ERDF is delegated to the Ministry of Economy acting as the Intermediary Body[26]. The coordination and signature of the Financing Agreement with the EIF took a long time because of negotiations on the division of responsibility between parties. The Government was not satisfied with the asymmetry of responsibility for results of the operation. The Financing Agreement still limits the responsibility of EIF to wilful misconduct and gross negligence – the EIF is not responsible or liable for the financial performance or the financial results of any of the operations (see the Annex, Textbox 3 for details).

When implementing energy efficiency measures under the JESSICA fund, at the beginning there were no clear provision of accountability and control in the agreement with the EIB. It was two years later, in May 2011, when results were not satisfactory, that amendments to Financing Agreement were made. Significant changes include clearer responsibility of the EIB as the fund manager, measures of control over the use of funds and the specification of indicative results to be achieved. However, the responsibility of the EIB in terms of achieving results, checking the eligibility of expenditure, etc. is still very limited (see Annex, Textbox 4 for details).

c) As regards FEIs for the development of SMEs, the criteria final beneficiaries need to fulfil depend on the measure, but the general requirement is to have the status of SME[27]. Then specific requirements are applied depending on the measure, e.g. loans can qualify for a **guarantee** only if

[25] Executive Summaries of Evaluations Studies on SME Access to Finance in EU Member States/Regions carried out by EIF in the Context of the JEEMIE. EIF, March 2009 http://ec.europa.eu/regional_policy/archive/funds/2007/jjj/doc/pdf/jeremie_sme_access.pdf

[26] Interview with INVEGA Acting Managing Director Mr Audrius Zabotka, 16th April 2012

[27] According to the Law on Medium-sized Business Development, the enterprise has the status of an SME if it meets the following criteria: 1) there are less than 250 employees; 2) financial indicators meet at least one of these requirements: annual income – LTL 138 million (EUR 40 million); book value of assets – LTL 93 million (EUR 27 million).

they are intended to finance tangible investment, intangible investment, working capital and the refinancing of investment from enterprise funds. INVEGA guarantees the repayment to credit institutions of the first loan instalment of up to 80% of the amount of principal in the case of all loans, but the amount of guarantee is limited and depends on the period the final beneficiary has been operating in the market.[28] When granting a **micro-credit**, the borrowing conditions for SMEs are as follows: the maximum micro-credit amount should not exceed EUR 100,000, the SME has to be registered and operating in Lithuania and the project must be implemented in the country.[29] As regards **energy efficiency measures**, only investments increasing energy efficiency to achieve at least class C or D after the renovation of a building can be financed and thermo energy consumption needs to decline by at least 30% after the implementation of the project.[30]

d) The criteria applied to assess the performance of FEIs are indicated in the OP and consequently in the financing agreements. For SMEs, it is the number of enterprises supported, the amount of funds used to promote development and private investment attracted that matter. For example, for measure VP2-2.3-ŪM-01-K "Holding Funds", the OP Annex identifies two types of monitoring indicator: a result indicator (the private investment (private capital) attracted, with a target of EUR 206.2 million by the end of 2015) and of an output indicator (the number of SMEs supported: with a target of 2,505 by the end of 2015). The results to be achieved by individual FEIs are also indicated in the financing agreements (Investment Strategy and Plan). For the development of SMEs, they are similar to the criteria indicated above, but their selection differs according to the purpose of the FEI.

For the implementation of energy efficiency in housing, the OP annex defines two types of monitoring indicator, a result indicator (the increase in energy efficiency in renovated apartment buildings[31]) and an output indicator (the number of renovated apartment buildings by the end of 2015[32]). In the Financing Agreement with EIB, the number of credit agreements signed and the number of projects implemented (where the project is an apartment building renovated from JESSICA funds) are set as indicators. These criteria were included in the Financing Agreement with the EIB in 2011.

As regards energy efficiency measures under the JESSICA fund, the criteria were only included in the Financing Agreement with EIB 2 years after the beginning of the implementation of the fund, which is not satisfactory.

By end-December 2011, the results of the Guarantee Fund exceeded expectations: the target for guaranteed liabilities was exceeded by 37%, and the number of SMEs supported by 49%[33]. Two FEIs implemented under the INVEGA Fund are in high demand from SMEs, too: by 31 December 2011, the target for "Small Credit Scheme II" had been exceeded by 149% (the number of SMEs

[28] http://www.invega.lt/en/services/issuance-of-guarantees/issuance-conditions.htm. 24 April 2012
[29] http://www.invega.lt/en/administration-of-small-loans.htm. 24 April 2012
[30] As requested in the task, no more than three FEIs are selected as examples: guarantees, micro-credits and energy efficiency measure
[31] By 30%
[32] 1,000 multi-apartment buildings renovated
[33] Information from audited annual report of INVEGA, http://www.invega.lt/site/files/failai/Ataskaitos/INVEGA_finansine_ataskaita_uz_laikotarpi_pasibaigusi_2011_12_31.pdf. P. 27.

supported)[34]; 82% of the target for the "Open Credit Fund" in terms of the amount of private investment attracted had been achieved by 81.5% and target for the number of SMEs supported exceeded by 90%[35]. In addition, 80% of the finance allocated to the "Open Credit Fund" had already been lent[36]. In view of these results, it is planned to extend the scope of the INVEGA Fund[37]. The EIF HF has experienced some difficulties, especially when implementing portfolio guarantees which were not popular among SMEs and had to be redesigned. As regards energy efficiency measures, to date only 4 apartment buildings have been renovated under the JESSICA programme, where the target is 1,000 buildings renovated by the end of 2015 (see Part 5 for more details).

4. Main problems in using financial engineering instruments

1) *SME development in Lithuania*: the inability and/or unwillingness of financial institutions to provide funds to businesses were one of the main problems during the economic crisis. According to the evaluation study[38], SMEs needed funds to support turnover and/or to finance credit lines (this is not allowed under EU Structural Fund regulations) rather than to expand and finance investment projects. The study also concluded that new FEIs were not best suited to respond to the crisis as they required a considerable time for deployment and identified a clear need for additional interventions to promote exports (export insurance) and venture capital development (especially at the pre-seed stage), and to increase funding for micro-credits.

The difficulties of **combining FEIs and grants** are one of the biggest issues according to the officials interviewed. Seemingly, the European Commission is using the same approach to FEIs as to the management of grants, and tends to apply the same control measures. While current EU regulations[39] allow preferential loans, guarantees and grants to be combined, the present interpretation of them makes it virtually impossible to do so: the EC has stated[40] that the three operations should not co-finance the same expenditure, and in all situations, at final maturity of the loan, the total reimbursements made by the borrower should be at least equal to the principal borrowed. At the same time, the EC have also stipulated additional requirements for grants and FEIs to be combined, grants and loans needing to originate in different operations or priority axes of the OP and to be separately accounted for and documented. Although grants and loans may finance the same project, grants cannot be extended to write off loans.

[34] Information from audited annual report of INVEGA, http://www.invega.lt/site/files/failai/Ataskaitos/INVEGA_finansine_ataskaita_uz_laikotarpi_pasibaigusi_2011_12_31.pdf. P. 25.
[35] Information from audited annual report of INVEGA, http://www.invega.lt/site/files/failai/Ataskaitos/INVEGA_finansine_ataskaita_uz_laikotarpi_pasibaigusi_2011_12_31.pdf. P. 26.
[36] Interview with INVEGA Acting Managing Director Mr Audrius Zabotka, 16th April 2012.
[37] Interview with INVEGA Acting Managing Director Mr Audrius Zabotka, 16th April 2012.
[38] Evaluation of the Relevance of Lithuania's Legal and Financial System Created for the Establishment and Implementation of FEIs Financed from the EU Structural Funds to Promote SMEs. The Ministry of Economy, December 2010.
[39] Council Regulation No 1083/2006 and the Guidance Note on Financial Engineering Instruments (COCOF_10_0014_04_EN) in particular.
[40] The response of DG Regio and DG Employment of 5 May 2011 to Lithuanian authorities.

In the view of the officials responsible[41], this interpretation narrows down the use of FEIs, increases the burden of Structural Fund administration and contradicts the earlier message from the EC. Contracts with financial intermediaries for implementation of FEIs were signed in 2009 or 2010, with the understanding that loans issued could co-finance the expenditure supported by grants as long as state aid rules are respected[42]. The new interpretation could punish countries like Lithuania which were the first to follow the invitation of the EC to use FEIs more widely as a means of mitigating the effects of the financial crisis.

Rules on the **eligibility of investment in risk capital** are another problematic issue.[43] Currently such is eligible only if it is undertaken at the latest at the closure of the OP, which contradicts the very nature of market practice in the risk capital market as the typical life-time of venture capital funds is 10-12 years. It means that part of ERDF resources assigned to financing these instruments will not be invested until the closure of the programme at the end of 2015 and consequently will not be declared as eligible expenditure. Costs incurred for managing the non-invested amounts as well as management costs incurred after 2015 will also become ineligible at the end of 2015. The latter situation implies that Article 44 of Regulation 1083/2006, which indicates that venture capital funds may be financed from the Structural Funds, cannot be properly implemented in practice.

2) Despite the fact that there was a huge need and potential for the modernisation of apartment buildings as well as the political will to implement a JESSICA fund , the setting up of the fund was difficult and the results are disappointing. To this date, only 4 apartment buildings have been renovated, 47 are in the process of being renovated, 80 tenders for contracts have been launched, and another 90 buildings are in the process of procuring technical renovation projects[44]. The target of 1,000 buildings renovated by the end of 2015 is highly unlikely to be achieved[45]. When preparing the programme and the JESSICA investment strategy, the complexity of the task and the time needed for creating institutional, legal, technical and financial infrastructure and building administrative capacity were not properly appreciated, nor were the specific nature of the target group and their expectations. The financial crisis of 2008 added uncertainty to the banking system and target groups. The income of those living in apartment buildings was relatively low and was further reduced during the economic crisis.

[41] Interview with INVEGA Acting Managing Director Mr Audrius Zabotka, 16 April 2012. Round table discussion on financial engineering with Mrs Loreta Maskalioviene and other representatives of the Ministry of Finance. 18 January 2012.

[42] According to the officials interviewed, respect for the state aid rules should be the main and sole restriction for the combination of grants and FEIs and FEIs themselves, and management of measures combining FEIs and grants has to be easy to administer.

[43] Interview with INVEGA Acting Managing Director Mr Audrius Zabotka, 16 April 2012. Round table discussion on financial engineering with Mrs Loreta Maskalioviene and other representatives of the Ministry of Finance. 18 January 2012.

[44] Information of www.atnaujinkbusta.lt, 24 April 2012; Interview with EIB representative Mrs Junona Bumelytė, 24 April 2012

[45] More than 34,000apartment buildings in Lithuania were built before 1993 and are eligible for renovation under the Programme. It was expected to renovate 70% of these by 2020. Information from www.atnaujinkbusta.lt, 24 April 2012

It is important to stress one general problem cited by government officials working with FEIs[46] - the uncertainties over the regulations governing FEIs, which have not been fully addressed so far either in the Guidance Note on FEIs[47] or in the proposals for the new Structural Fund regulations. This, according to officials, has increased the risk that part of the costs incurred will not be considered eligible at the final closure of the programmes and that FEIs will barely be used at all in the future.

5. Evaluations of financial engineering instruments

In December 2010, an *Evaluation of the Relevance of Lithuania's Legal and Financial System Created for the Establishment and Implementation of FEIs Financed from the EU Structural Funds to Promote SMEs*[48] was carried out at the request of the Ministry of Economy. Besides evaluating the legal and institutional system, it was aimed at assessing the sufficiency and adequacy of existing FEIs the face of the changed economic situation, identifying market failures (if any), assessing the adequacy of particular FEIs to correct these failures, and identifying the need for the Structural Funds to be redistributed. The evaluation concluded that FEIs were a satisfactory means of supporting SMEs during a time of economic downturn, but some new FEIs were not effective because of their long deployment time. A need was identified for additional interventions to promote exports (export insurance) and venture capital development and to increase funds for micro-credits.

6. Concluding remarks

The difficulties of launching the large scale renovation of apartment buildings, of combining FEIs with grants and the rules on eligibility of investment in risk capital are the main problematic issues for the implementation of FEIs in Lithuania. While there is a great deal of optimism regarding FEIs and there are plans to extend their use in the new programming period, the European Commission is regarded as lacking consistency when explaining current rules and drafting new regulations on FEIs. Uncertainties in the regulation of FEIs and the general tightening of rules create too much risk that the costs incurred will not be eligible for co-financing and FEIs could lose their attractiveness in the future programming period.

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[46] Interview with INVEGA Acting Managing Director Mr Audrius Zabotka, 16 April 2012. Round table discussion on financial engineering with Mrs Loreta Maskalioviene and other representatives of the Ministry of Finance, 18 January 2012

[47] COCOF_10_0014_04_EN

[48] Evaluation of the Relevance of Lithuania's Legal and Financial System Created for the Establishment and Implementation of FEIs Financed from the EU Structural Funds to Promote SMEs. The Ministry of Economy, December 2010.

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Interviews

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Interview with Mrs Junona Bumelyte, EIB. 24 April 2012

Interview with Mrs Inga Miliauskiene, Ministry of Economy. 23 April 2012

Round table discussion on financial engineering with Mrs Loreta Maskalioviene and other representatives of the Ministry of Finance. 18 January 2012

Annex

Textbox 1

The Objective 3 “Improving SMEs access to financing sources” of the Priority 2 “Increasing Business Productivity and Improving Environment for Business” is therefore aimed at improving conditions for start-ups and SMEs with good growth prospects to obtain necessary funding. For this purpose, measures to improve access to risk capital (in particular, seed capital and early-phase capital) for SMEs have been identified. Promotion of such financial instruments as microcredits for start-ups and the smallest enterprises is also planned; such instruments contribute to resolving problems of individual social groups (such as women and young people). The priority also includes support for the provision of guarantees and partial financing for loan interest, so creating more favourable conditions for borrowing for the start-up or development of innovative businesses. It is anticipated that the use of these will improve SME financing opportunities considerably, while increased access to venture capital will encourage the realisation of innovative business ideas, the establishment of new technology businesses, and the development of high and medium-high tech sectors. The JEREMIE initiative is analysed in detail in close cooperation with the EIF when designing the implementation of financial instruments.

Economic Growth Operational Programme for 2007-2013. P. 78

Textbox 2

The Objective 1 “Reduction of Differences between Environment and Quality of Life in the Main and the Rest of the Towns of the Country with Special Attention to Improving Housing Conditions” of the Priority 1 “Local and Urban Development, Preservation of Cultural Heritage and Protection of Nature and its Adaptation to Development of Tourism” as one of the essential directions for investment in housing development identifies renewal of blocks of flats by, first of all, increasing the efficiency of energy consumption. The OP refers to the fact that worsening conditions are mostly observed in *blocks of flats*, especially in hostel-type ones, and the most important aim of the first investment direction in housing development is to renew blocks of flats by, first of all, improving their features which determine the efficiency of energy consumption. Decreasing energy input would allow the cost of maintaining housing by residents and funds from the state budget to be reduced as well as being a kind of a compensation for heating to households with low income. In addition, a reduction of energy input would allow emissions of CO_2 to be reduced Investment will be undertaken in blocks of flats built before 1993 after assessing their prospective use in the light of the projected social-economic and demographic development of the area. Investment in housing development will not only reduce energy consumption but will also improve environmental quality as well as being of real economic benefit. First, investment in housing in problem areas will create additional jobs for residents. Secondly, the work concerned will add to business activity. Thirdly, investment in housing development is likely to reduce social exclusion and the extent of emigration from the areas in question. Fourthly, the funds from the state budget saved because of increased energy efficiency may be directed to improving the environment and quality of life in the areas so promoting cohesion.

Cohesion Promotion Operational Programme for 2007-2013. P. 72, 73

Textbox 3

13.1: Any liability of EIF connected to its own performance of the JEREMIE action shall be limited to willfull misconduct and gross negligence. Compliance with any provisions of the Investment Strategy and Planning having a direct impact on the JEREMIE Action and with the decision of the Steering Committee shall exclude liability of the EIF. The EIF shall not be liable to any of the Ministries fos consequential damages.

The EIF shall under no circumstances be held responsible or liable for the the financial performance or the financial results of any of FI operations [...].

13.3: Each of the Ministries shall indemnify the EIF for any costs or liability incurred by the EIF as a result of third party claim brought against the EIF as a result of the EIF performing the JEREMIE A ction.

Financing Agreement between EIF, the Ministry of Economy and the Ministry of Finance.

Textbox 4

4.2.1: The EIB shall have no obligation for overall monitoring and review of compliance with EU Rules.

12.2: “Any liability of the EIB shall be limited to wilful misconduct or grossly negligent actions or omissions.”

12.3: The EIB shall under no circumstances be held responsible or liable for the financial performance of the JESSICA Holding Fund or for the financial results of any of the Operations.”

12.4: Compliance with any provision of the Investment Strategy and Planning having a direct impact on the JESSICA Action, and with the decisions and opinions of the Investment Committee, shall exclude liability of the EIB. The EIB shall not be liable to the Ministries for consequential damages or loss.”

5.8.3: The Investment Committee “Reviews the progress of the strategy of the JESSICA Holding Fund, approve the Progress Reports, and discharge EIB for its performance of the JESSICA Action, during the reference period of each approved Annual Progress Report in accordance with this Agreement.”

Financing Agreement between EIB, the Ministry of Finance and the Ministry of Environment.