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

Year 2 – 2012

Task 1: Financial engineering

Latvia

Version: Final

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BICEPS

A report to the European Commission
Directorate-General Regional Policy

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List of abbreviations

- ECB European Central Bank
- EEN Expert Evaluation Network
- EIF European Investment Fund
- ERDF European Regional Development Fund
- ESF European Structural Funds
- FEI Financial Engineering Instrument
- LGA Latvian Guarantee Agency
- LIAA Latvian Investment and Development Agency
- OP Operational Programme
- NSRF National Strategic Reference Framework

Executive summary

Latvia planned for quite extensive use of Financial Engineering Instrument (FEIs) in the 2007-13 programming period with planned funding at about 28% of Operational programme (OP) 2 which covers ERDF activities. This is several multiples higher than in 2004-6. All forms of instrument have been used but to date take up has been limited. Thus as of end March 2012 for the Holding Fund activities only 15% of the loan funds and about 21% of the venture capital funds had been contracted to final recipients. The Holding Fund administration was initially implemented by the European Investment Fund (EIF) but at start of 2012 was transferred to the Latvian Guarantee Agency. The slow take up of funding is partly to do with the slow implementation of activities and partly to do with the fact that the recession inhibited both lenders and borrowers. The reasons for using financial engineering instruments are couched in terms of shortage of finance for SMEs and start-ups but no explicit market gap analysis or market failure arguments have been made in the documentation. Lack of experience in both the Latvian administration and in the EIF in dealing with JEREMIE and inflexible rules in using FEI in Cohesion policy are identified as the main problems.

1. Use of financial engineering instruments

FEI in Latvia are largely[1] part of the ERDF Measure (2.2.1.), Accessibility of Financing which comes under Priority (2.2) Access to Finance of the Operational Programme 2 "Entrepreneurship and Innovations"[2]. All the FEI funding in Latvia has been committed to the financial intermediary partners implementing the instruments therefore in reporting the FEI activities are listed as fully signed and financed activities even though disbursements to businesses are much less. Table 1 below lists the activities supported by the ERDF.

From a total Cohesion policy budget of EUR 4.5 billion for 2007-13 (ERDF+ Cohesion Fund +ESF) the planned allocation to FEIs was nearly EUR 326 million. Funding for FEIs from the ERDF now stands at EUR 293.5 million[3]. This represents nearly 27% of total funding for OP2 as compared with nearly 58% of OP2 allocated to Priority 2.1 "Science and Innovation" and nearly 12% to Priority 2.3 "Promotion of Entrepreneurship[4]. One change from the plan made in 2011 has been a reduction in funding for Activity 2.2.1.3, Loan Guarantees, in order to create a new Activity 2.2.1.4.2, Mezzanine investment loans.

As can be seen all types of instrument are present: loans, guarantees and venture capital. Table 1 provides a summary of the available funds

Table 1: FEI Activities in Latvia in 2007-2013 planning period as of end of March 2012

No.	Activity	Total funding (EUR million)	ERDF (EUR million)	National Public (EUR million)	Private (EUR million)
2.2.1.1.	Activity "Holding fund for the investment in guarantee, high-risk loans, and venture capital funds and other financial instruments"	153.5	83.3	8.2	62.0
2.2.1.3.	Activity "Guarantees for development of enterprise competitiveness"	28.5	28.5	0.0	0.0
2.2.1.4.1.	Sub-activity "Support in a way of loans for development of enterprise competitiveness" (capital equipment)	86.3	57.4	7.3	21.6
2.2.1.4.2.	Sub-activity "Mezzanine investment loans for development of enterprise competitiveness"	25.2	15.2	10.1	0.0
2.2.1.	Total for the measure	293.5	184.3	25.6	83.6

Source: http://www.esfondi.lv/upload/04-kohezijas_politikas_nakotne/EMProgr_120312_2DPP.pdf

Activity 2.2.1.1 "Holding fund for the investment in guarantee, high-risk loans, and venture capital funds and other financial instruments" is made up of the following instruments: a loan programme implemented by two Latvian banks and three venture capital funds managed by two local fund managers. The Holding Fund was established in mid-2008 as part of the JEREMIE

[1]There is an activity for start-up and self-employed financed from the ESF.
[2] In fact measure 2.2.1. is the only measure under the priority 2.2.
[3] EUR 32.45 million was switched to OP1 "Human Resources and Employment" to address unemployment issues.
[4] A small amount (2%) goes to Technical Assistance.

programme with the EIF as the managing agency. In January 2012 the administration of the Holding Fund was transferred to the Latvian Guarantee Agency (LGA). Holding Fund projects are described in Table 2, below.

Activity 2.2.1.3. is a loan and export guarantee programme for SMEs run by the Latvian Guarantee Agency. However, in 2011 some funding was transferred from this programme to a new activity 2.2.1.4.2, Mezzanine loans.

Activity 2.2.1.4.1. is a programme to improve the competitiveness of existing businesses. The programme provides working capital and investment loans to medium-sized and larger enterprises with higher risk and is run by the state-owned Hipoteku un Zemes Banka (Mortgage and Land Bank). Under this programme the bank provides secured loans of up to EUR 10 million per qualifying project.

Activity 2.2.1.4.2. Mezzanine investment loans for the development of enterprise competitiveness is a new product, introduced by the Latvian Guarantee Agency at the end of 2011 to broaden access to financing for medium-sized and larger enterprises by both providing financing and strengthening the capital base of the enterprises.

In addition to the ERDF instruments there is a European Social Fund instrument for start-up businesses and self-employed people, offering small grants, small loans and training run by the Hipotēku un Zemes Banka (Activity 1.3.1.2.) with total loan funding of just over EUR 23 million.

Table 2: Status of the Activity 2.2.1.1. "Holding Fund for loans and equity investments" as of end March 2012 in Latvia

Activity 2.2.1.1. "Holding fund for the investment in guarantee, high-risk loans, and venture capital funds and other financial instruments"	Total Financing (EU+State +Private) (EUR million)	Signed Investments (EUR million)	Total Signed Investments (EUR million)
SME Loan programme with SEB bank	44.0	16	8.2
SME Loan programme with Swedbank	44.0	14	5.2
Total loans	88.0	30	13.4
Private Equity instrument - Baltcap	30.0	7	4.6
Seed Venture Capital instrument –	3.0	7	0.5
Imprimatur Capital	-	-	-
Start-up Venture Capital instrument –	6.0	2	0.6
Imprimatur Capital	-	-	-
Total VC instruments	39.0	-	-

Source: http://esfondi.lv/page.php?id=1064

Table 2 shows the current status of the instruments available in activity 2.2.2.1. – the "Holding Fund for loan and equity instruments". Here it should be noted that the available financing amounts to just over EUR 127 million, in contrast to EUR 153.5 million in Table 1. This is because only about 78% the funds available in the Holding Fund have been contracted to the second level financial intermediaries.

The SME Loan programmes offered by SEB and Swedbank were originally designed as additional sources of funding for small and medium-sized manufacturing exporters in order to finance the purchase of new equipment and other longer-term investments. However, as the economic crisis evolved credit demand shifted from longer-term capital investment to short-term working capital needs. Moreover, the economic crisis caused most banks to become much more conservative in their lending and consequently, just when their need was most acute, many enterprises were not able to access bank credit for working capital. The loan instrument has been implemented by SEB and Swedbank and as of 31 March 2012 had provided a total of EUR 13.4 million in 30 loans to small and medium-sized mostly manufacturing and exporting enterprises for investments, expansion and working capital.

In contrast to the loan programme implemented by SEB and Swedbank, Activity 2.2.1.4.1 offered working capital loans from Hipoteku un Zemes Banka (Latvian Mortgage and Land Bank), albeit at relatively high cost to the borrowers, and in 2010 the instrument was very active. However with the resumption of economic growth in 2011, commercial banks also resumed lending to enterprises, and with low-cost funding from their foreign parent banks or the ECB-sponsored interbank market, loans from commercial banks were cheaper than loans from the FEI programme. Consequently FEI loan activity decreased as the commercial banks resumed lending.

The venture capital programme was launched in 2010, with Baltcap aiming to invest expansion capital into existing medium-sized enterprises in Latvia in a broad range of industry sectors but with predictable cash-flow. Imprimatur Capital's high-technology seed and start-up venture capital funds invest specifically in high-growth technology start-ups based on innovative intellectual property and global market potential. As of 31st March 2012 the three funds had invested a total of EUR 8.1 million in the form of 16 investments in 14 companies with Imprimatur Capital's Start-up Venture Fund investing as a next-round investor in Seed Funded SMEs.

The scope of the different types of FEIs is different. For example, only two local banks[5] from a total of 19 privately-owned banks have participated in the loan facility under the Holding Fund Activity 2.2.1.1 and as of 31 Dec 2011 the FEI represented only 1.6% of the total loan portfolio of these banks. With the equity funds FEI there are also only two participants, BaltCap and Imprimatur Capital, but, apart from the internal Aizkraukles Banka Private Equity Fund, these are the only local institutional private equity or venture capital investors actively investing in Latvia at the moment.

In 2004-2006 FEIs were included in Measure 2.4: Access to Finance for SMEs when the following instruments were used. It can be seen that the scale of support was much less than in the current programming period.

1) A loan scheme for start-ups, implemented by the State Regional Development Agency. Loans for investments in fixed assets were issued to projects with development potential with projects for EUR 12.15 million.
2) A guarantee scheme for SME projects with insufficient collateral, implemented by the Latvian Guarantee Agency with projects for EUR 11.9 million.
3) Three Venture capital funds, providing equity capital to start-ups and young companies with good growth potential, implemented by the Latvian Guarantee Agency with projects for EUR 6.06 million.

[5] They are the two largest banks.

Access to capital was combined with consultancy and advice with the activity: Enhancing Business Support Measures for SMEs.

2. Rationale for using financial engineering instruments

The Latvian National Strategic Reference Framework 2007-13 states that improvement of economic activity indicators can be achieved through the creation of new enterprises, promoting self-employment and strengthening the competitiveness of existing companies. All this should have a focus on high technology and high value-added products. EU Structural Funds are available to support improvement of the business infrastructure, increase the availability of financial resources, increase access to information and advisory services and strengthen export capacity. Improved competitiveness and promoting the development of a knowledge-based economy are also mentioned as objectives.

In OP2, Entrepreneurship and Innovation, Priority (2.2) Access to Financing (2.2) the following problems are identified:

- Low number of enterprises in relation to population;
- Low rate of new enterprises being formed[6];
- A shortage of start-up equity and venture capital;
- Insufficient business knowledge among start-up founders;
- Insufficient availability of loan funding for young businesses;
- Short credit history of many enterprises;
- Insufficient collateral quality for bank loans;
- Low number of enterprises operating with high added value; and
- Insufficient use of new technologies.

The objective of the priority is stated as “to facilitate access to financial resources to enhance business development, at the same time reducing the negative effects of direct State aid on market competition and achieving a more efficient use of State aid assets by exploiting them repeatedly for the business development or applying a multiplier.”

Latvia's SME Development Policy Guidelines (2004–2013) state as a priority the promotion of access to finance to encourage SME entrepreneurship. This reflects the European Charter for Small Enterprises where a key priority for entrepreneurship is to improve accessibility to financial resources over the lifecycle of the enterprise, especially by facilitating access to credit and venture capital and particularly for high technology companies. Improved access to finance should expand sources of start-up capital (equity and loans) and provide medium and long-term loan guarantees to SMEs.

Although a number of studies were undertaken and are referred to in the official documents, they do not specifically identify market gaps or in particular to market failure as a reason for using FEIs. Perhaps this is because gaps are difficult to quantify since demand is latent and unobservable until supply appears.[7]. Also an EIF assessment argues that the lack of data

[6] According recent data from the Global Entrepreneurship Monitor 2010 Latvia report, early stage entrepreneurial activity has increased in the recession – mainly as a result of a growth in necessity driven entrepreneurship. See Rastrigina and Krumina (2010).

[7] See Vanags et al (2010).

compromises the feasibility of measuring the demand for FEIs.[8] This is because it is difficult to model the supply and demand dynamics of the SME sector in Latvia due to the lack of appropriate benchmark data, particularly over the 5-year period covering the unsustainable credit-fuelled growth from 2004 to 2007, followed by the dramatic slump and contraction in 2008 to 2010. Consequently it has proved difficult to define empirically a market failure in terms of an absolute or persistent financing gap. However, government reasoning implicitly assumes that a gap exists.

Reasons for not using FEIs

There is no real discussion in the main documents of the merits of grants vs FEIs. There is discussion of the economic situation and of the need for financing but not the forms. Grants are often chosen when a loan or equity investment does not fit – such as the LIAA (Latvian Investment and Development Agency) assistance grant of about EUR 500 per case to do an EU Patent search. Another factor mentioned in relation to FEIs is that for relatively small funding requirements there is disproportionate administrative cost for an SME in application and reporting effort compared with the grant cash benefit.

Relative benefits of FEIs vs grants

There is very little discussion of the relative benefits of FEIs vs grants, e.g. in terms of incentives. One of the stated considerations for using FEIs over grants was to create fewer market distortions because FEIs would be provided based on commercial financing terms assessed by qualified and experienced financial intermediaries[9]. The idea that the funds would be recycled is also mentioned in the documents. Grants as traditional Cohesion policy instruments are not seen as requiring justification as such except in terms of the social or economic 'need' they address. There is no explicit discussion of the relative costs of grants vs FEIs. It is typically believed that the administration of traditional Cohesion policy instruments is cumbersome and costly for beneficiaries however, the slowness in developing the Holding Fund instruments and the weak take up suggest that some FEIs have their own administrative burdens.

3. The effectiveness of financial engineering instruments: selected examples

a) Differences in objectives and operational practices

All FEI financing is provided to final recipients on commercial terms apart from the operational constraints imposed by ERDF regulations. The final beneficiaries are selected according to sound commercial principles, whether by state financial institutions or by private sector participants.

The two loan programmes were standard in terms of providing loans on fully commercial terms to existing small and medium-sized enterprises; however the economic crisis at the time highlighted the need for the loan FEI because most banks had stopped lending to the real economy. The loan programme goals were set based on commercial banking and EU Structural Funds criteria, which constrained to some extent the banks' ability to address market demand.

[8] European Investment Fund (2007), "JEREMIE Report for Latvia".
[9] There is no explicit justification for intervention in terms of a gap between social and private returns.

The equity FEI was an opportunity to support existing or new potentially high-growth enterprises aiming to expand value-added and high-technology industries over a longer time horizon.

From an economic policy perspective, it would be desirable to evaluate whether providing a large number of small loans to start-ups and small companies with growth potential is likely to be more effective than providing a small number of large loans to existing medium-sized and larger companies. Such an evaluation could inform the next round of FEI development however an active small loan programme requires micro-lending expertise with proven credit-scoring models.

b) *What is the control of the managing authority over the allocation of funds and the selection of businesses receiving support?*

The managing authority had considerable control over the way the FEI programmes were set up and how financial intermediaries were selected. Conversely they have very little control (other than the usual EU monitoring and audit rights) over the final beneficiary firms which receive financial support. A core principle is that the FEI programmes delegate implementation responsibility to specifically-selected and experienced finance professionals.

c) *Criteria for receiving support*

Final beneficiaries need to fulfil the financial, legal and commercial criteria defined and applied by the respective managers of the loan, guarantee and equity FEIs. Criteria for receiving a loan or loan guarantee are typical for banks providing corporate loans and include an assessment of the applicant's credit history, balance sheet, cash-flow forecast, collateral quality and assessment of the business segment in which it operates. Criteria for receiving an equity investment are typical for venture capital funds investing in SMEs with high growth potential and include an assessment of the applicant's relevant experience, business plan, revenue model, competitive advantages in the target market segment and likely exit strategy.

d) *Criteria for assessing performance*

For the loan and loan guarantee FEIs, performance targets are based on the respective financial institution's existing loan-loss rates and non-performing loan rates. Performance of the venture capital funds is according to usual venture capital industry practice, comprising a hurdle rate of 6% and a 10-year fund term. Since financing to final beneficiaries commenced only in 2010 and FEIs are medium to long-term financing instruments, it is too early to conclude actual performance of any of the FEIs.

In terms of Cohesion policy performance, rather limited targets are listed in the main documents. This reflects a general inadequacy in defining targets. Thus one set of targets is: the number of enterprises which have received venture capital investments – 65 (target in 2009 – 8), the number of seed capital investments passing on to higher investment stages – 45 (base value 2004 – 0, target value in 2009 – 10.

4. Main problems in using financial engineering instruments

The main problems experienced in using FEIs have been as follows:

Lack of experience in government ministries in dealing with JEREMIE (Activity 2.2.1.1).

This led to lengthy policy discussions among government ministries, inter-ministerial negotiations and government approvals during the initial establishment in mid-2008 and through to subsequent implementation in 2010 of the Holding Fund managed by EIF. As a consequence, for example, by the time the loan FEIs with SEB and Swedbank were available, the market need (working capital loans for SMEs in general) had largely moved beyond the initial FEI eligibility criteria (capital equipment loans for larger exporting manufacturers) so deployment of loans to final beneficiaries was much lower than expected.

EIF's lack of experience as a manager of JEREMIE Holding Funds (Activity 2.2.1.1).

Latvia was only the third country to engage EIF as manager of its Holding Fund, with Romania signing a few months earlier in Feb. 2008, and Greece being the first. Consequently EIF was "learning by doing" and, according to the managing authority in Latvia, EIF substantially misjudged the time and effort required for FEI implementation, including negotiating financing terms with the two banks participating somewhat unwillingly in the loan programme, managing the public procurement of venture capital firms, negotiating with the EC any deviations from State Aid rules and then the several months spent by EIF in negotiating the financing agreements with the respective financial intermediaries. Consequently the deployment of FEIs under Activity 2.2.1.1 started in mid-2010 rather than end 2008 or early 2009 as originally anticipated, significantly reducing the time available for full deployment prior to end 2013.

FEI Programme rules were rigid.

Since ERDF is the primary source of public financing in the FEIs, the ERDF rules on top of EC's State Aid rules must be applied and that has implications during FEI implementation. For example, all FEI monies must be fully deployed by the end of 2015 because that is the eligibility end date of the current EC budget period (n+2). That immediately affects the banks' loan crediting process and the equity funds' investment process, to the extent possibly of distorting usual commercial market practice based on respectively sound banking principles and venture capital investing cycles. In addition, State Aid rules prohibit FEIs from financing certain industries, such as agriculture, fisheries and some transport, some of which are significant in Latvia, because these are supported through other EC subsidy programmes. If a final beneficiary has received *de minimis* State Aid support from other programmes, the amount of potential financing from FEIs is reduced. Some participating banks were not willing to modify their credit procedures to enable cost-efficient processing of small loans to micro- and small enterprises. However, where possible the respective government ministries and agencies worked to amend or remove obstacles affecting FEI implementation.

Have these problems been overcome and if so how?

The Latvian Ministry of Finance commented that in the second quarter of 2011 certain modifications of some of the loan eligibility criteria were done so that it is possible now for SEB and Swedbank to issue loans for longer maturities and the maximum size limit of a loan to one

SME has been increased. Hipoteku un Zemes Banka has issued working capital and investment loans from the beginning of the programme.

The Latvian Guarantee Agency, which took over the management of the Holding Fund from EIF in January 2012, is developing new FEIs to broaden the access to financing for a wider range of SMEs. This has resulted in a plan for a micro loan facility that aims to create a micro financing instrument deployed through private market institutions. The Guarantee Agency also has a plan for a two or three additional equity funds. However the implementation time to end 2013 is short.

5. Evaluations of financial engineering instruments

Evaluations are being carried out by the Ministry of Finance, including a mid-term review and selected internal audits, however no reports are yet publicly available.

6. Concluding remarks

The main conclusions from the FEI programme that can be drawn at this relatively early stage of implementation are the following:

- Lack of experience in managing JEREMIE Holding Funds on the part of all key participants combined with incomplete Commission rules led to significant delays in programme implementation;
- The perceived high administrative cost of establishing and implementing the bank loan FEIs, meant that the privately-owned commercial banks were somewhat reluctant participants in the loan FEI because they saw very little benefit from it other than marketing value;
- Eligibility criteria for the loan FEI implemented by SEB and Swedbank, targeting capital equipment loans for medium-sized and larger manufacturing exporters, were rather limiting and disconnected from the actual market demand for working capital loans by smaller companies;
- Probably, there remains a financing gap in the market: loan and equity financing for start-ups and young companies in need of working capital and growth capital.

For the future, in particular for the next programming period when it is very likely that more use will be made of FEIs there needs to be a clearer view of where such instruments are most suited and where and why they are superior to grants. This actually requires research: for example, is it the case that FEIs are 'less distortionary' than grants or how important are differences in incentives? Attention should also be paid to the possibility of mixing FEIs and grants – it is very likely that there are projects or programmes for which this would represent an optimal approach. However, the bottom line is that across the EU as a whole FEIs have been, and will be, promoted with inadequate hard evidence on their impact and merits. The operative word here is 'evidence'.

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