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Task 1: Financial engineering

Poland

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Błażej Lepczyński

Monika Liszewska

Marta Penczar

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Directorate-General Regional Policy**

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List of abbreviations

- BGK Bank Gospodarstwa Krajowego
- CIP Competitiveness and Innovation Framework Programme
- EEN Expert Evaluation Network
- FEI Financial Engineering Instrument
- NCF National Capital Fund
- OP Operational Programme
- OP DEP Operational Programme Development of Eastern Poland
- OP IE Operational Programme Innovative Economy
- PRFPK Pomorski Regionalny Fundusz Poręczeń Kredytowych
- ROP Regional Operational Programme
- VC Venture Capital

Executive summary

In Poland, financial engineering instruments (FEIs) are being supported both by the EUs Competitiveness and Innovation Framework Programme (CIP) and by the ERDF, which co-finances them under the national level Innovative Economy Operational Programme (OP) as well as under the regional OPs.

Their major advantage is seen to be the revolving nature of funding and the fact that they can provide support for many more enterprises over a period than grants. It is recognised, however, that not all areas of economic activity are suited to their use. This applies especially to projects that generate no income, where grants are more appropriate.

The evaluations carried out on them indicate that there are delays in the implementation of FEIs, resulting from the need to create a new system for allocating EU funds to them. For example, by the end of 2011, the National Capital Fund (NCF), the 'fund of funds', had signed 10 contracts with VC funds (as opposed to the 23 targeted) which had invested in only five companies (as against the 184 targeted by the end of 2015).

The major problems in implementing FEIs arise from the lack of previous experience of using them and the need to establish a new legal framework, combined with a lack of demand from SMES which tend not to use debt financing and to have no forward-looking investment strategy.

1. Use of Financial Engineering Instruments

In Poland, FEIs are being implemented under the EU CIP and international cooperation programmes (Josefina, and JASSMINE) as well as under the ERDF. The latter co-finances two OPs at national level:

1. Operational Programme Innovative Economy (OP IE), some 5.6% of the amount allocated to this going on FEIs, 4.8% coming from the ERDF
2. Operational Programme Development of Eastern Poland (OP DEP), just over 1% being allocated to FEIs (measure 1.2.) and just under 1% financed by the ERDF

FEIs are also included in the 16 Regional Operational Programmes (ROPs).

In the case of the national OPs, FEIs take the form of 'Technological loans' or Venture Capital (VC) funds. Technological loans, as the name implies, are intended to support investment in new technology. VC funds operate under the umbrella of the NCF, which is a fund of funds providing finance for investment for small, innovative businesses through individual VC funds which need to apply for public support and which must involve the participation of private investors to be eligible for support.

In 5 of the 16 Polish regions, FEIs are implemented under the JEREMIE initiative. In the remaining 11 regions, they are operated by financial intermediaries directly selected by the Managing Authorities (without a holding fund) and take the form of loans and loan guarantees for SMEs.

JESSICA funds, which also operate at the regional level, are at an early stage of implementation. At the end of 2011, four regions had signed agreements with the European Investment Bank (EIB) on the financing of such funds.

The use of FEI has increased over the period in some cases and declined in others. The use of JEREMIE funds in particular has expanded, while, in general, support for VC funds has been reduced.

2. Rationale for using FEIs

The OPs and the accompanying documents emphasise the revolving nature of funding and the fact that a given amount of financing can support many more businesses over a period than non-repayable grants as the major advantage of FEIs. They also lay stress on the fact that FEIs do not interfere with the operation of competitive market forces as much as grants.

The strength of the FEIs currently in operation is claimed to be that they meet the needs of the vast majority of businesses, which are micro or small enterprises, most of them under sole ownership. OPs, therefore, also highlight the problems which these businesses have in accessing capital.

FEIs are specifically aimed as well at reducing the equity gap, especially in respect of business start-ups and young companies, support being targeted at those sections of the market where commercial financial institutions are not able or willing to finance the growth of SMEs or where prospective borrowers have to meet often prohibitive conditions to obtain finance. It is noted that such difficulties are faced in particular by start-up companies, which have no credit history, or do not have the collateral required by financial institutions.

At the same time it is recognised that not all areas of economic activity are suited to the use of FEIs. This applies especially to projects that generate no income, where grants need to continue to be the predominant form of support. This also applies to sectors or projects that are an essential part of the development strategy of particular regions, though equally there is a need to reduce the scale and extent of support provided by grants and to establish a mixed system which has less of a distorting effect on competition.

However, it is not possible to indicate in general which projects or policy areas are not suited to the use of FEIs because these vary between regions because of their specific features. Decisions on the scale and division of FEIs, therefore, have to remain with individual Managing Authorities. Nevertheless, the potential areas of use include all those that generate income, such as:

- energy supply, though taking due account of the long-term nature of investment and the returns on this and the demand for "green energy";
- urban transport, after review and possible revision of state aid rules in this regard;
- projects for combating climate change and protecting the environment, such as recycling plants.

A less obvious area for use of FEIs is scientific R&D, due to the lack of profitability of most basic research as well as the inefficiency of the system for commercialising the results of research in Poland (see the Task 1 Report on Innovativeness, 2010).

Delays in the implementation of FEIs are also a factor, given the lack of experience of their use in Poland and the need to establish new procedures. Because of this, there are no estimates of their cost, though it can be assumed that because of their novelty, administrative costs will be higher than for grants over the next few years.

3. The effectiveness of FEIs: selected examples

The effectiveness of FEIs can be illustrated by the JEREMIE initiative (implemented as part of ROPs) and VC support (under measure 3.2 of OP IE).

Re-guarantees for guarantee funds under the JEREMIE initiative in Pomerania

The JEREMIE initiative, as noted above, is currently being implemented in five regions, in four of which (Lower Silesia, Lodzkie, Pomerania and Wielkopolska and Western Pomerania) the programme manager is Bank Gospodarstwa Krajowego (BGK). In the other one (Kuyavian-Pomeranian), it is the Kuyavian-Pomeranian Loan Fund Ltd.

The primary objective of the measure is to increase access to capital for SMEs operating in the region. Detailed rules for its implementation are determined by the Managing Authority, which has formulated a set of guidelines (in the "Investment strategy of the JEREMIE trust fund") which stipulate both the size of allocation of the re-guarantees (amounting to PLN 156.1 million or around EUR 39 million) and the criteria which final beneficiaries need to fulfil in order to receive support. These are the same as the usual conditions applied for EU support of FEIs:

- not being in financial difficulties
- not being in the process of having to repay support
- being a micro or small enterprise, as defined by the Commission regulations
- carrying out business activity in Pomerania

- not being in an 'excluded' sector ineligible for aid.

In addition, the loan or credit covered by the guarantee, needs to be used for financing construction, expansion or extension of the scope of activities of the borrower.

The guarantees provided under JEREMIE are on more favourable terms than available from the market – in practice, the cost being up to 72% lower – and in general serve to reduce barriers to access to capital for micro and small enterprises, which is the main objective of the measure.

Assessing the effectiveness of the fund involves examining the indicators and targets which have been set and the progress made towards achieving the latter. Progress, in practice, is monitored on two levels, first at programme level, target values of indicators being included in the "Investment strategy of JEREMIE trust fund." This specifies that 13,502 entities will be supported in total, 5,346 of which by guarantee funds. Start-ups are to receive 15% of the total allocation, micro firms 35% and small firms 50%.

The value of the indicators reported at the end of 2011 suggest that implementation had only just got underway, support being given to 176 companies (around 3% of the target) – though the fund was set up in March 2009, the first contracts were only concluded in July 2010.

Progress is also monitored at the level of the financial intermediary in relation to fund performance. The indicators used for this are:

- the number of guarantees provided (broken down by size class)
- the value of guarantees (broken down by size class)
- the number of companies supported
- the average maturity of guarantees
- the value of 'lost' capital (i.e. the value of outstanding loans covered by guarantees)
- the value of the guarantee limit used
- the income from guarantees
- management costs

The financial intermediary has to submit to the BGK quarterly and annual reports on its operations. It should be emphasised that, although the list of indicators is determined by the programme manager, the target value of indicators is decided by the financial intermediaries joining the programme. This means that when selecting financial intermediaries to participate, the fund manager's role is essentially to assess the business plan presented (including these target values).

Support for VC funds under the OP Innovative Economy

As part of measure 3.2 of the OP, a VC support project is being carried out at national level under the NCF at a total cost of EUR 156.8 million. NCF support for VC funds takes the form of:

- investment in equity, quasi-equity and debt instruments of funds created to invest in SMEs
- partial refunding of the management costs of VC funds.

The report on the implementation of OP IE for the second half of 2011 shows slow progress in implementing the measure, due to the lengthy process of contracting between investment funds and SMEs. The aim up to the end of 2015 is to create 23 equity funds and to invest in 184

companies. By the end of 2011, the NCF had signed 10 contracts with funds and these funds had invested in 5 companies.

4. Main problems in using FEIs

FEIs are new use of the ERDF. In the course of implementing them, the various parties involved in the allocation of resources have met many difficulties. Major problems have arisen both in the implementation process and with beneficiaries. FEIs have taken much longer to set up than expected because they involved different procedures and a different legal framework than grants. In addition, there was an absence of complete and accurate state aid rules, including a lack of a formal basis for extending it to the capital inputs into JESSICA projects.

Problems arose with beneficiaries because:

- many businesses had no need to obtain debt financing, so that there was a lack of demand for external finance. Studies indicate that about two-thirds of SMEs do not actively plan their activities, have no forward-looking strategy and operate from month to month¹;
- the system of loan and guarantee funds is not widely known among banks, leasing and factoring companies and financial consultancy firms and so such services tend not to be promoted and their existence communicated to businesses affected by financial constraints;
- application procedures are highly complex and FEIs require much greater involvement from banks or other financial applying for funding than in the case of grants²;
- the finance provided by Managing Authorities to funds, unlike in the case of grants to businesses, has at some stage to be repaid, which made some financial intermediaries reluctant to take it up;
- there is a need for extensive reporting, which deterred cooperative banks in particular;
- in the case of JESSICA, there was no experience of implementing integrated programmes of urban regeneration and a lack of a sufficient number of projects eligible for financing³.

5. Evaluations of FEIs

Evaluations of FEIs are included in the periodic evaluation schedules of ROPs. The evaluations which have been published show that their primary purpose is comprehensive assessment of the activities carried out with the support of FEIs.

¹ Market survey of selected services to support the development of entrepreneurship and innovation in Poland, (Badanie rynku wybranych usług wspierających rozwój przedsiębiorczości i innowacyjności w Polsce, Obszar: Finansowanie zwrotne), PSDB Sp. z o.o., Quality Watch Sp. z o.o., ASM Centrum Badań i Analiz Rynku Sp. z o.o., September 2010,

http://ksu.parp.gov.pl/res/doc/badania_eksprtyzy/raport_koncowy_finansowanie_zwrotne.pdf

² Mechanisms of financial engineering in improving the efficiency of absorption of EU funds and their role in the cohesion policy after 2013, (Mechanizmy inżynierii finansowej w podnoszeniu efektywności absorpcji środków UE i ich znaczenie w polityce spójności po 2013 roku), The Gdansk Institute for Market Economics, November 2010,

http://www.mrr.gov.pl/aktualnosci/fundusze_europejskie_2007_2013/Documents/MRR_Publikacja%20IBNGR_24012011.pdf

³ Pozadotacyjne instrumenty finansowe w polityce spójności UE po 2013 roku – wymiar wspólnotowy i krajowy, Marek Szczepański, Warszawa, luty 2011 r.,

http://www.mrr.gov.pl/rozwoj_regionalny/Polityka_spojnosci/Polityka_spojnosci_po_2013/Raporty/Document/MSzczepanski_ekspertyza_dla_MRR_21_02_2011.pdf

Another aspect has been to analyse the benefits and limitations of supporting businesses by means of refundable and non-refundable instruments, as well the historical results and prospects for development of enterprises in Poland which have received external sources of financing.

The evaluation reports indicate that there were delays in the implementation of FEIs, resulting from the need to create a new system for allocating EU funds. The main barriers to the implementation of FEIs have also been identified.

Attention was also drawn to the indicators of achievement. In past programmes, the only measure of whether the funds were used effectively or not was the *de facto* completion of the project itself, namely the achievement of the target number and value of guarantees and loans. Sometimes this was complemented by the value of losses (loan defaults and guarantees paid out) as well as by the number of jobs created, but there was no attempt to explore the real value-added of the funds and their contribution to the elimination of the funding gap or the influence of support on the viability of the businesses supported.

6. Concluding remarks

The main points to emerge from the above are:

1. The strength of the FEIs currently available is that they meet the needs of the vast majority of businesses, which are micro and small enterprises, most of them under sole ownership.
2. There were delays in the implementation of FEIs, resulting from the need to create a new system for allocating EU funding.
3. The main barriers to the use of FEIs are:
 - the problems and delays in their implementation, including the need to establish a new legal framework and to gain experience of their use;
 - the lack of demand from enterprises for debt financing, combined with the fact that most firms do not have an active investment strategy but operate from month to month.

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