



**Expert evaluation network
delivering policy analysis on the
performance of Cohesion policy 2007-2013
Year 2 – 2012**

Task 1: Financial engineering

Portugal

Version: Final

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List of abbreviations

- EEN Expert Evaluation Network
- EIB European Investment Bank
- FEI Financial Engineering Instrument
- OP Operational Programme
- MA Managing Authority
- NSRF National Strategic Reference Framework
- SAFPRI Support System for the Financing and Risk Sharing of Innovation
- FINOVA Support Fund to Finance Innovation
- EIB European Investment Bank
- UDF Urban Development Funds

Executive summary

The Portuguese National Strategic Reference Framework (NSRF) includes several financial engineering instruments (FEIs), in the form of guarantee funds and venture capital funds, which are used in two policy areas: urban development and support to SME innovation and modernization. The total ERDF participation in these FEIs is approximately EUR 460 million, which is approximately 3.9% of the total allocated ERDF. There was a clear increase of the use of FEIs during the programming period, but also a significant increase in comparison to the 2000-2006 period, both in terms of the allocated budget and of the scope of the instruments.

Behind the rationale for using FEIs to finance SMEs lies the fact that innovative projects in the early stages of the life cycle of companies and products continue to find it difficult to obtain the funding and resources needed for their development; difficulties in funding business internationalization activities is considered another market failure in this area. The fact that investments in company modernization are no longer supported through grants is another justification for using FEIs under the business support instruments of NSRF.

According to managers, FEIs have significant benefits in terms of leverage of financial resources, less bureaucracy and an easier process of expenditure validation, more professional management of resources and a closer support to project implementation.

The main perceived difficulties are related to the adverse economic context and its effects on financial institutions and the investment plans of final beneficiaries, as well as the specific features and the relatively innovative character of these instruments which requires public managers to adapt to them.

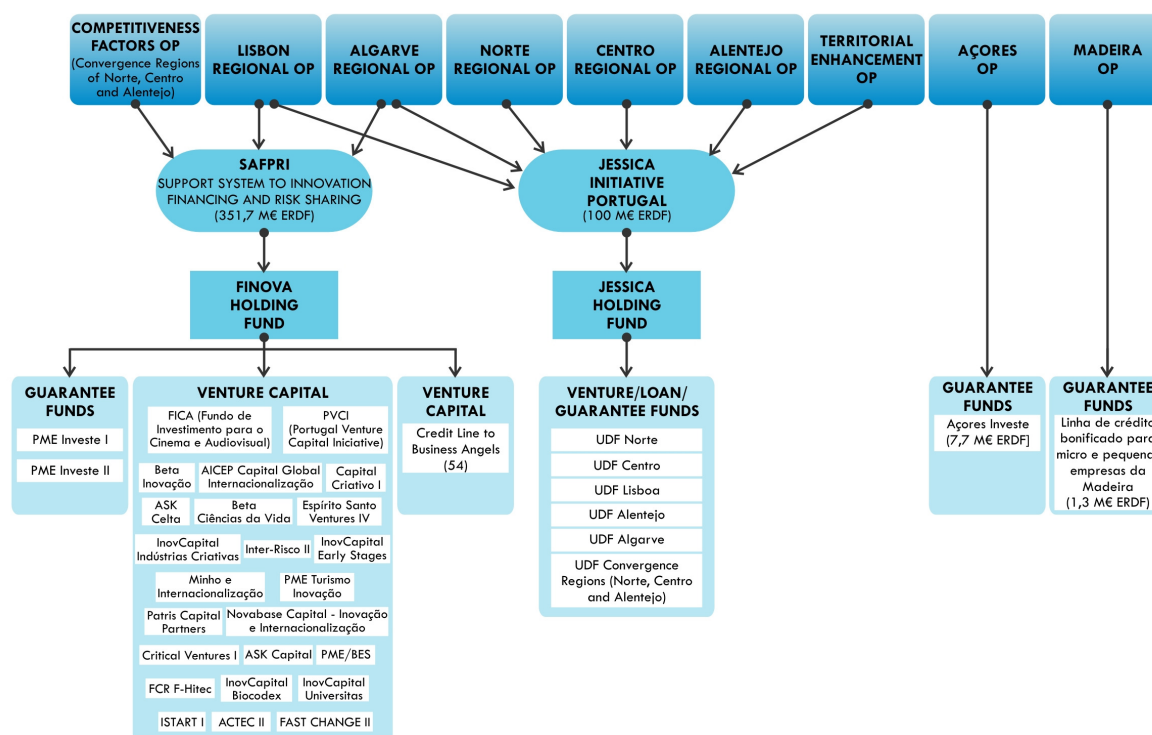
There is no specific evaluation study planned that will focus solely on the use of FEIs as part of the Cohesion Policy in Portugal, and still no evaluation of the achievements of OPs has been carried out.

1. Use of financial engineering instruments

In the 2007-2013 programming period, the Portuguese NSRF includes several FEIs, which are available for beneficiaries in every Convergence and Competitiveness region. Essentially, these FEIs take the form of guarantee funds and venture capital funds and are used in two different areas: urban development and support to SME innovation and modernization. The total ERDF participation in these FEIs is approximately EUR 460 million, which represents about 3.9% of the total ERDF allocated in NSRF.

Most of these instruments were created under the Support System for the Financing and Risk Sharing of Innovation (SAFPRI) financed by the Competitiveness Factors Operational Programme (OP), the Lisbon Regional OP and the Algarve Regional OP. SAFPRI establishes different eligibility conditions and co-financing rates for beneficiaries according to their location, either in the Competitiveness regions of Lisbon or Algarve, or in the three Convergence Regions of Mainland Portugal - Norte, Centro and Alentejo (covered by the Competitiveness Factors OP). The following chart synthesizes the use of FEIs under the NSRF programmes co-financed by the ERDF and the corresponding allocation of ERDF resources:

Figure 1 – Financial engineering instruments in NSRF 2007-2013, co-financed by the ERDF



Source: CEDRU

The implementation rules of SAFPRI are defined in an NSRF specific regulation, which is applied under its financing OPs. The ERDF funds allocated to SAFPRI are concentrated in the FINOVA Holding Fund, managed by PME Investimentos. This entity – a public-private partnership – is responsible for selecting and monitoring venture capital funds, but is also in charge of the management of the PME Investe credit lines. Although these instruments are essentially credit

lines to SMEs, the ERDF funds are applied only as guarantee funds, while the loans are supported by the banks own funds.

Regarding the Jessica Initiative, the ERDF resources are allocated from the OPs to the Jessica Holding Fund, managed by the European Investment Bank (EIB).

In synthesis, as regards business enterprise support in 2011 there are:

- 28 national funds: 26 venture capital funds¹ (including some with a sectoral dimension) and 2 guarantee funds (PME Investe I and II).
- 2 regional funds: one guarantee fund in each of the autonomous regions (Azores and Madeira).

As regards urban development, within the JESSICA initiative, there are 6 funds:

- 5 urban development funds, one for each of the Portuguese mainland NUTS II;
- 1 urban development fund specific for the three Convergence regions of the Portuguese Mainland.

The introduction and strengthening of credit lines supported by the structural funds gained momentum during the current programming period, as a way to facilitate credit access for SMEs during the crisis, mainly through subsidising interest rates and by minimizing the risk of financial operations, using the mechanisms of the National Mutual Guarantee System. Not only did the use of FEIs increase during the programming period, but there was also a significant increase in comparison to the 2000-2006 period, both in terms of the allocated budget and of the scope of the instruments.

Although they are not considered as FEIs in the NSRF context, the three major support schemes to enterprises granted by the Competitiveness Factors OP and the Regional OPs of the Mainland include both reimbursable and non-reimbursable grants. Thus, in practice, the Support Schemes to Innovation, to SME Qualification and to R&TD, also constitute FEIs, although these differ in type and limits of expenditure.

2. Rationale for using financial engineering instruments

According to the Competitiveness Factor OP, financing SMEs - and particularly innovative projects by SMEs - is one of the areas where the need for public intervention is felt more acutely. In spite of the fact that financial markets have reached a considerable degree of sophistication in most developed countries, innovative projects undertaken in the early stages of the life cycle of companies and products continue to face major obstacles in obtaining the funding that is necessary and appropriate for their development.

Therefore, public intervention in this area, through SAFPRI and FINOVA, is justified as a way to address market failures, such as credit limits and loan denial. The process of risk evaluation of innovative projects by some credit institutions is an important obstacle to the use of FEIs, because the necessary loans may be made available in inadequate terms, be insufficient, or can simply be denied. The funding of business internationalization activities also faces specific difficulties which justify public intervention in order to revise the perception of the higher risk that the market associates with this type of investment.

¹ 6 out of the 26 venture capital funds approved in 2011 were dropped in 2012 (see Chapter 5).

This OP also stresses that, given the priorities adopted for business support in the present programming period (business innovation, production of knowledge and technological development, internationalization, networking) more direct investments in the modernization of companies are no longer supported as part of support schemes to SMEs - in other words, through grants. Considering this, innovative mechanisms within the framework of FEI were expected to create alternatives that lead to quality funding for projects of smaller companies.

Regarding the perceived benefits (by programme managers) of using FEIs rather than grants as business support, the former involve less bureaucracy and have an easier process of expenditure validation. This is also considered to be a benefit for the beneficiary companies, as they do not need to wait for expenditure validation to receive the funds.

However, compared to other instruments such as businesses grants, there are also limitations and issues associated with the use of FEIs. For instance, it is considered to be easier to focus the typology and policy scope of the investments supported by grants in policy priorities such as business innovation, internationalization and R&TD. In the case of grants the eligibility of projects and expenditure are fully verified, as some problems were identified in the investment validation sample controls carried out by the MAs. It must also be mentioned that, although it is simpler for the OPs to transfer the management of these resources to financial entities, the time they require to set them up and to adapt to the ERDF conditions and regulations is considerably higher than in managing grants.

Regarding JESSICA, the use of FEIs rather than grants in the area of urban development is considered to have several major advantages. One advantage has to do with the reinforcement of the Urban Development Funds (UDF) by the selected managing consortia, making the entire process more attractive to investors. In fact, the initial resources of EUR 130 million (EUR 100 million from ERDF, plus EUR 30 million of national funding) have been more than tripled by the UDF managing consortia, which include one public bank (Caixa Geral de Depósitos), one private bank (Banco Português de Investimentos), the national housing institute (Instituto da Habitação e da Reabilitação Urbana) and the national tourism institute (Turismo de Portugal). In total approximately EUR 335 million have been collected. Furthermore, considering the fact that JESSICA is managed by the EIB, the spread associated with the interest rates of the loans is below real market values.

Another advantage of using FEIs in this area is related to ERDF eligibility issues. Under the structural fund regulations, certain expenses such as, for instance, land acquisition, urban rehabilitation for housing purposes, implementation of projects through direct administration or second hand purchase of equipment are not eligible and this can become an important barrier for the conception, funding and implementation of urban development programs and projects, which often limit the interventions to public spaces. Through the use of financial instruments like the JESSICA urban development funds, projects can be created and developed with a more integrated approach, complementing the ERDF eligible costs with other types of expenditure, which can be financed through the managing consortium's own resources.

Another benefit from JESSICA is that it is able to fund the national counterpart of projects supported by other forms of incentives within the NSRF, which can be an important leverage for investment by both public and private beneficiaries. It must also be stressed that, through the UDFs, there is a more professional management of the financial resources. Moreover, the

evaluation of the financial viability of the projects increases the sustainability of the projects and their effectiveness.

In general there is a common advantage for using FEIs as part of Cohesion policy programmes: the resources allocated to these funds are accounted as certified expenditure and this gives a clear advantage to Managing Authorities in relation to the n+2 rule.

3. The effectiveness of financial engineering instruments: selected examples

The analysis of the effectiveness of FEIs is focused on the two major instruments in the NSRF context: FINOVA and JESSICA. In both cases, the role of the managing authorities in orienting the resources towards specific targets was expressed mainly during the conception of the FEIs, through the definition of regulations and specific criteria these should comply with, and agreed upon with the intermediate beneficiaries through protocols. The selection of projects depends upon the market criteria (such as economic viability, profitability) applied by the financial institutions which manage the funds. At that level, the OP managing authorities have little or no influence.

In the case of FEIs used in business support, the control that managing authorities exert over the allocation of funding or selection of projects is determined by the protocols signed with the financial entities which manage the funds. Within the FINOVA Holding Fund, the entity in which the management authorities delegated the administration of the holding (PME Investimentos) closely accompanies and validates every investment, and also performs regular audits. In addition, these financial entities are obliged to deliver quarterly reports to the management authorities, which in turn perform regular sample verifications of the financed projects.

The Managing authorities relationship with the management of the JESSICA Holding Fund is completely different: the OP Managers are members of the Holding Fund Management Committee and, therefore, in theory can monitor the FEI management closely. Nevertheless, in practice they do not exert much influence or control. Other than that, the EIB delivers annual reports of the JESSICA implementation, regular audits of the investments are scheduled and, before the end of the OPs, there should be an accountability analysis.

In terms of the criteria that final beneficiaries need to fulfil in order to receive support, the FEIs created under FINOVA can support any company which fulfils all of the following conditions:

- a) to be located in mainland Portugal, accordingly with the territorial eligibility rulings of the respective financing OPs;
- b) to be a certified SME;
- c) to develop a business activity in one of the supported sectors (industry, energy, construction, commerce, tourism, transportation and logistics, services), according with the National Classification of Economic Activities.

The OPs managing authorities can introduce exceptions to these conditions, in justified cases considered of special interest regarding public policies, on condition that they are in line with European and national legislation and ERDF regulations.

Access to FINOVA support is denied to firms in difficulties, companies in the coal sector, and financing activities related with exports to third countries or Member States.

In order to be eligible for JESSICA support, projects should fulfil three conditions:

- a) be part of an Integrated Development Plan for Sustainable Development;
- b) be profitable;
- c) be able to use the invested resources until the end of 2015.

Regarding expenditure eligibility, projects supported by JESSICA should comply with the ERDF eligibility criteria defined in the OPs from which the funding originates (only applies to the project components which are ERDF funded).

As for the criteria applied to assess the performance of the FEIs in FINOVA, the quality of venture capital in terms of investment in seed capital and the orientation of funding to sectors with higher potential of growth (high technology and knowledge intensive sectors) is emphasized.

Table 1 presents the physical implementation indicators of the Competitiveness Factors OP Axis III – Financing and Risk Sharing of Innovation, in 2010, which are the only indicators of such type focusing on FEIs. These indicators present some limitations since they refer only to commitments, and to inputs rather than outputs. However, it is interesting that the first two, Quality of Venture Capital and Financing oriented to growth potential sectors, should allow the MAs to monitor the weight of business support given through FEIs in relation to some of the OPs strategic priorities.

In the case of JESSICA, the OPs physical performance indicators do not reflect the progress achieved through this program. This is only accounted in terms of financial performance and, as said before, the allocation of the OP funds to the JESSICA Holding Fund is accounted as expenditure.

Table 1: Physical implementation indicators of the Competitiveness Factors OP Axis III – Financing and Risk Sharing of Innovation, in 2010

Indicator	How it is measured	Departure Value	Achievements (2010)		Targets	
			Committed	Finished	2010	2015
Quality of Venture Capital	Investment in seed capital / Total venture capital investment	12,7% (2005)	100%	n.a	33%	33%
Financing oriented to growth potential sectors	Investment in companies in high technology and knowledge intensive sectors / Total investment with FEIs	11,5% (2005)	18%	n.a	18%	30%
Guarantees to SMEs	No. of guarantees to SMEs supported by the OP	4.269 (2000-2006)	3.741	n.a	1.500	5.000
Management costs	Management commissions / paid-up capital	n.a.	n.a	n.a	3%	3%

Source: 2010 Annual Implementation Report of the Competitiveness Factors Operational Programmes, 2011

4. Main problems in using financial engineering instruments

The main difficulties identified in the use of FEIs under NSRF have essentially two types of causes: one is related to the adverse economic context and its effect on the participation of financial institutions and the demand by final beneficiaries; the other has to do with the particularities and the relatively innovative character of these instruments and the fact that their managers must be able to adapt existing schemes to EU regulations.

In FINOVA, 6 out of the 26 venture capital funds approved in 2011 were dropped in 2012, either because their promoters dropped out, or decided to concentrate venture capital investments in a single fund (in this case, the same entity had contracted more than one fund initially). Furthermore, demand for guarantee funds and venture capital decreased, as an effect of the economic crisis.

The effects of the crisis are also felt in JESSICA, with some of the public investors finding it difficult to assure their part of the investment due to an overall decrease of public expenditure, which leads to some inertia on their part. Potential beneficiaries are struggling with the adverse situation in the construction sector, and the demand in some regions has been lower than expected (the major cities of Lisbon and Porto being the exception).

One venture capital fund approved by FINOVA was cancelled as the managers were unable to assure the compliance with the SAFPRI specific regulation and the European regulations associated with ERDF supported FEI. The tighter regulations in the current programming period make it more difficult to implement this type of instruments under NSRF compared to the previous programming period.

The innovative character of some types of FEIs supported in the NSRF context also required a more proactive involvement from some FINOVA managers, in particular with regard to the support to business angels. Initially, the demand for this type of FEI exceeded expectations, circa 200 business angels in 54 companies (under SAFPRI regulations, each business angels society needs to have at least 3 investors), which called for an increase in resources (from EUR 10 million to EUR 23 million). However, after selecting companies, the FINOVA managers need to monitor and assist the business angels in most parts of the process.

Although some difficulties and delays have been reported, in general the adaptation of financial entities to the particularities of ERDF regulations is proceeding without major problems. In the case of FINOVA, the decentralization of the management to PME Investimentos facilitated that process, thanks to a greater proximity to the financial entities. The OP Managing Authorities would find it difficult to handle the degree of monitoring that these solutions allow.

5. Evaluations of financial engineering instruments

No specific evaluation study focussing solely on the use of FEIs as part of the Cohesion Policy in Portugal has been planned, and a mid-term evaluation of OPs has still not been carried out.

According to the Global Evaluation Plan of the NSRF, the OPs' Mid-Term Evaluations should begin only in the 2nd trimester of 2012 and only one evaluation is expected to focus on this issue, namely the Study on the Support Schemes and Financial Engineering Instruments in Place in the Autonomous Region of Madeira 2007-2013. This study is scheduled to be delivered by the end of the 2nd trimester of 2012.

An analysis of the feasibility and benefits of using JESSICA was developed before its implementation, in 2009, through the JESSICA Evaluation Study. This study was meant to be a key preliminary step in order to allow the definition of an investment strategy in accordance with the managing authority's objectives in the field of sustainable urban development.

One of the major conclusions of this ex-ante evaluation is that, JESSICA solves not only the initial private unattractiveness of investments in urban regeneration, but a more permanent multiplying effect of Structural Funds can also be expected.

6. Concluding remarks

The importance of ERDF funded FEIs in the current programming period has increased, although these instruments are still used for a very small share of the total available resources. The fact that ERDF reimbursements become national funds which have to be reinvested in the same policy area, should produce a positive effect in terms of the sustainability of public support to certain sectors.

The major advantages of using FEIs are the leverage effect on private and public investments and the ability to provide a more professional management of resources, through societies or holding funds which can provide a great of assistance in project selection, resource allocation and management of the supported instruments. This also has the advantage of liberating the OPs managing authorities from a bulk of administrative aspects in programme management, such as project selection or expenditure validation.

It should be noted that, regardless of the efficiency of FEIs in delivering much needed financial resources to the economy, the use of these instruments currently implies a less control of the managing authorities over the selection of investments. Considering that the business support policy defined under NSRF establishes certain priorities, such as support to business innovation, internationalization and networking, this factor may divert funding from these areas, reducing the policy focus and its concentration effect.

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- Dr. Ricardo Banha - Coordinator of the Area of Financing and Risk Sharing – Managing Authority of the Competitiveness Factors Operational Programme
- Dr. Fernando Alfaiate - Managing Authority of the Competitiveness Factors Operational Programme
- Dr^a Manuela Ribeiro – Director of PME Investimentos SA
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