APPLICA

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Task 1: Financial engineering

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Contents

List of abbreviations

- ECA European Court of Auditors
- EEN Expert Evaluation Network
- EIB European Investment Bank
- EIF European Investment Fund
- FEIs Financial Engineering Instruments
- NADSME National Agency for Development of SMEs
- NSRF National Strategic Reference Framework
- OP Operational Programme
- OP BK Operational Programme Bratislava region
- OP CaEG Operational Programme Competitiveness and Economic Growth
- OP R&D Operational Programme Research and Development
- SGDF Slovak Guarantee and Development Fund
- SMEs Small and Medium Enterprises
- SZRB Slovenská Záručná a Rozvojová Banka (Slovak guarantee and development bank)

Executive summary

The experience with financial engineering instruments (FEIs) in Slovakia has been rather limited to date. Therefore the present programming period represents a unique opportunity to set up the appropriate FEIs. The SMEs are important contributors to the economic growth of Slovakia and adequate FEIs could provide important stimuli for SMEs to cope with the existing market failures (i.e. low provision of micro finance for self-employment and start-ups, low ratio of SME domestic credit and guarantee activities as percentage of GDP, low share of venture capital activities on GDP compared to other Central European EU members, non-existent network of business angels). The financial instruments which are being set up could, if properly implemented, address the mentioned market failures and provide domestic SMEs with additional financial resources.

The JEREMIE initiative is governed by the European Investment Fund and the Slovak Guarantee and Development Fund. The total allocation of financial resources for JEREMIE amounts to EUR 100 million. The financial support for JEREMIE is provided by the Operational Programme Bratislava region (OP BK), OP Competitiveness and Economic Growth (OP CaEG) and OP Research and Development (OP R&D). The JEREMIE initiative does not provide support to SMEs directly but targets financial intermediaries, which, after being selected, set up their own criteria for assessing project performance.

The expected benefits of using FEIs rather than grants are flexibility, revolving of financial resources, a leverage effect and exchange of know-how. However, the financial implementation of FEIs in this programming period is only starting. To date only two calls for selecting financial intermediaries for loan guarantees and risk capital instruments have been completed. Moreover, the non-refundable grants basically cover similar investment needs and are more accessible and thus potentially could displace the FEIs when they start to operate in Slovakia.

The main problems in using FEIs are lack of experience with FEI instruments, changes in the initial allocations of the relevant Operational Programmes (OPs) related to the JEREMIE initiative, difficult and time consuming negotiations between European Investment Fund (EIF) and relevant national authorities, clarification of rules and procedures related to FEIs implementation in the regulatory framework of the Structural Funds and insufficient critical mass (scattering effect) in allocation of resources. The regulatory problems related to concept of “assisted” and “non-assisted” set-up by the Commission meant that numerous SMEs in the Bratislava region have been excluded from the benefit of guarantee instruments and were allocated a very small amount in equity instruments[1].

[1] A third of all Slovak SMEs and half of Slovakia’s potential in research and development are based in the Bratislava region.

1. Use of financial engineering instruments

The use of FEIs in the framework of Cohesion policy support has been introduced in the present programming period. The implementation of JEREMIE is carried out by the JEREMIE Holding Fund which is governed by the EIF via the Slovak Guarantee and Development Fund (SGDF). The SGDF was set up within the Framework of the JEREMIE initiative in Slovakia to be a local state-owned entity through which EIF will contract financial intermediaries, with the aim of building SGDF up to continue the activities in support of SME financing in the longer-term, ensuring sustainable support. Slovenská Záručná a Rozvojová Banka (SZRB) and EIF are the shareholders, with EIF participating on behalf of the Slovak government until its exit at the end of 2015.

In August 2011, the EIF launched an open competition (Call for application submission) to select the most appropriate financial intermediaries for providing loan guarantees to SMEs (First Loss Portfolio Guarantee Financial Instrument).

In January 2012 the EIF launched a second open competition (Call for application submission) for risk capital financial instruments. The eligible applicants are financial intermediaries which should invest in SMEs.

The current investments strategy is providing EUR 38 million for loan guarantees, which should create a total loan portfolio of EUR 200 million, and EUR 31 million for risk capital financial instruments (equity).

The risk capital financial instruments are implemented through three types of funds:

- Seed Fund,
- Venture Capital Fund and
- Co-Investment Fund (equity instrument).

The use of FEIs in this programming period is still very limited to date. The setting-up of appropriate schemes and managerial arrangements has been difficult and accompanied by a revision of allocated resources in the respective operational programmes.

The total allocation of financial resources for JEREMIE (EUR 100 million), which was set at the beginning of the programming period, remained unchanged. Originally five OPs were supposed to be involved in financing the JEREMIE initiative. However, already in 2009, the government approved reallocation of financial resources devoted to JEREMIE in the National Strategic Reference Framework. At present, the support is provided in the framework of OP Bratislava region, OP CaEG and OP R&D (OP Environment and OP Informatisation of Society are not financially involved in the JEREMIE allocation). Additional resources amounting to EUR 25 million have been discussed.

- **OP Competitiveness and Economic Growth** with a total allocation of EUR 67.05 million, (EUR 57 million provided by the ERDF, EUR 10.05 million is national co-financing). *The First Loss Portfolio Guarantee Financial Instrument* is funded from OP CaEG; Priority Axis 1 "Innovation and growth of competitiveness", Measure 1.3 "Support of innovation in enterprises" and from Measure 1.1 "Innovation and technology transfers". Further funding may be allocated to the instrument from Measure 1.1 "Innovation and technology transfers". The purpose of this financial instrument is to support loans to Eligible SMEs by providing credit risk protection (in the form of a first loss portfolio financial guarantee with a cap) in order to reduce the particular difficulties that SMEs face in accessing finance because of the lack of sufficient collateral in combination with the relatively high risk they represent.

- **OP Research and Development** with a total allocation of EUR 29.41 million, (EUR 25 million provided by ERDF and EUR 4.41 million through national co-financing).
- **OP Bratislava region** with a total allocation of EUR 3.52 million, (EUR 3 million provided by ERDF and EUR 0.52 million through national co-financing).

The Risk Capital Financial Instruments are funded from the OP R&D; Priority Axis 2 "Support to research and development"; Measure 2.2 "Transfer of knowledge and technology from research and development into practice" and Measure 4.2 "Transfer of knowledge and technology from research and development into practice in the Bratislava region" and from OP Bratislava region; Priority Axis 2 "Knowledge-based economy", Measure 2.1 "Innovation and Technology Transfers". Funding from the two separate OPs cannot be combined for the same investment into any one SME.

2. Rationale for using financial engineering instruments

The rationale for using FEIs is included in the GAP analysis titled *SME Access to Finance in Slovakia* conducted by the EIF and published in January 2007. The analysis identifies several market failures which justify the use of FEIs:

- Low provision of micro finance for self-employment and start-ups;
- Low ratio of SME domestic credit and guarantee activities as percentage of GDP;
- Low factoring-to-GDP ratio compared to EU-25 average;
- Low VC activities compared to GDP and other Central European EU member states;
- Low R&D-GDP ratio, poor technology transfer record;
- No business angels network.

The three OPs that use FEIs refer to different kinds of market failures. The main reasons given in the framework of the OP CaEG for the use of FEIs include: insufficient provision of micro finance for self-employment and start-ups, low provision of domestic credit and guarantee activities for SMEs. The managing authority of the OP R&D is addressing the low R&D-GDP ratio and the limited capacity to facilitate technology transfer. The managing authority of the OP Bratislava region mostly refers to SMEs' credit rationing.

In the present economic conditions influenced by the economic and financial crisis, SMEs tend to rely more on non-refundable grants than on FEIs to finance their current and future business activities. SMEs already have experience with grant schemes while the FEIs are still in a very early stage and the attitude of SMEs in Slovakia to use FEIs is generally low. It can be concluded that the FEIs are being displaced by the non-refundable grants.

The expected benefits of using FEIs rather than grants are the following:

- Flexibility. Immediate disbursement of the funds to a 'Holding Fund' within the Member State. JEREMIE is designed to optimise the use of ERDF funding and to simplify the management of financial engineering by the Managing Authority. Contributions from the national or regional operational programmes to the JEREMIE fund will be eligible for interim up-front payment by the ERDF. The Holding Fund is able to change the allocation of financial resources in a flexible way depending on the actual situation at a given time.

- Revolving of financial resources in the Holding Fund, which creates preconditions for long-term and sustainable support of SMEs.
- Leverage effect. The involvement of financial institutions will provide additional financial resources for SMEs.
- Know-how and experience of the EIF. The mutual cooperation of EIF and national stakeholders provides valuable know-how exchange especially in the field of capacity building in less developed countries, with limited experience with FEIs.

At the moment it is difficult to evaluate the differences and relative costs of using FEIs and non-refundable grants. At present FEIs are not being used due to following reasons:

- Existing displacement effect (non-refundable grants basically cover similar investment needs, are more accessible and are already being implemented).
- Limited "tradition" and experience of domestic SMEs with FEIs.
- The time necessary to set-up the FEIs in Slovakia, and early stage of their financial implementation (no projects supported to date).

3. The effectiveness of financial engineering instruments: selected examples

The managing authorities are involved only in the process of establishing the Holding Fund and allocating the appropriate financial resources from the respective OPs. The subsequent implementation is carried out by the EIF and Slovak Guarantee and Development Fund. The actual disbursement of financial support (in case of loan guarantees) is carried out by the selected financial intermediaries.

The criteria that SMEs, which are selected by the financial intermediaries, need to fulfil in order to receive support from the funds are specified in the individual Calls for Expression of Interest. In general the eligibility criteria are the following:

- Beneficiaries must be micro, SMEs as defined in the Commission Recommendation,[2]
- The SME shall not belong to restricted sectors (gambling, production and trade of weapons, tobacco and alcohol production etc.)[3],
- The SME shall be established and operate in Slovakia,
- The location of the investment of the target SMEs must respect the regional restrictions of the funds (Bratislava region/Non-Bratislava region limits).

In the field of Risk Capital Investments, the following eligibility criteria are applied:

- The Seed Fund, Co-Investment Fund and Venture Capital fund invest in micro, small or medium-sized enterprises,
- FEIs financed from OP R&D can be used to support SMEs in the following priority areas:
    - 1. Health – quality of life

[2] Number of employees lower than 250; turnover lower or equal to EUR 50 million; or balance sheet lower or equal to EUR 43 million.
[3] The full list of restricted sector is available at http://www.eif.org/what_we_do/jeremie/calls-for-expression-of-interest/2011_Jeremie_Slovakia_005_1/flpg-call-slovakia-full-text-v2.pdf

  - 2. Progressive materials and technologies
  - 3. Biotechnologies
  - 4. Knowledge technologies supported by ICT
  - 5. Infrastructure for development of society
  - 6. Energy and energetics
  - 7. Security and defence (only SMEs of civilian character)
  - 8. The use, protection and reproduction of biological resources
  - 9. Protection of the environment
  - 10. Use of domestic raw materials resources
- Investments financed from the Seed Fund can be made in SMEs which are eligible for aid from OP BR, namely new or existing SMEs which support innovations either directly or SMEs which spend funds on innovation or development of products or processes with a technological component.

An example of project selection criteria related to risk capital investments is included in Annex Table A.

The performance assessment is the competence of the fund manager, which in the case of Slovakia is the EIF, not the managing authority of the respective OPs. The JEREMIE initiative does not provide support to SMEs directly but targets financial intermediaries, which, after being selected, set up their own criteria for assessing project performance.

The framework agreement between Slovakia and the EIF, defines the following indicators for monitoring the implementation of the JEREMIE initiative:

- Number of new jobs created (in total and specified by gender),
- Number of supported projects in SMEs,
- Private investments related to supported projects,
- Value added growth in supported SMEs.

The set of indicators which have been set-up is under the circumstances considered adequate and will provide at least basic information on the implementation of the JEREMIE initiative with connection to the relevant OPs.

At present, it is difficult to provide any information on the functioning of FEIs in practice, because no projects have been supported to date.

The only relevant **public company** in the field of FEIS is the Fond Fondov s.r.o. Company (previously known as Seed Capital Company). It was established by the National Agency for Development of Small and Medium sized enterprises (NADSME) in 1994 to manage the Start-up Capital Fund financed by the National PHARE Programme and state budget. During its existence the company has provided financial support to more than 140 companies amounting to EUR 10 million and created or helped to create more than 1,000 jobs. The relatively low number of supported companies and jobs created in the last eighteen years confirms the marginal role of FEIs in SME support.

4. Main problems in using financial engineering instruments

The main problems related to the setting-up and implementation of FEIs in Slovakia are:

- Lack of experience with FEI instruments.
- Changes in the initial allocations of the relevant OPs related to the JEREMIE initiative (the changes in the allocations and negotiations between the managing authorities responsible for the respective OPs created delays in setting up the FEIs).
- Difficult and time consuming negotiations between EIF and relevant national authorities.
- Clarification of rules and procedures related to FEI implementation in the regulatory framework of the Structural Funds (see paragraph 6).
- The European Court of Auditors (ECA) highlighted that the allocation of financial resources is below the critical mass in Slovakia. Sub-critical fund sizes had originally been sourced from up to five different national operational programmes against the explicit advice of the EIF, the holding fund manager. The sub-critical mass size problem has been worsened by the application of the Commission concepts of 'assisted' and 'non-assisted' areas, which are used in the context of compliance with EU state aid rules and are unrelated to the concept of the SME financing gap. In order to secure a national exemption from state aid rules, the Slovak authorities defined Bratislava as a 'non-assisted region'. A third of all Slovak SMEs and half of Slovakia's potential in research and development are based in the Bratislava region. As a result, numerous SMEs have been excluded from the benefit of guarantee instruments and were allocated a very small amount in equity instruments (ECA, 2012)[4].

The above mentioned problems related to the setting-up of the FEIs have been more or less overcome. At present, the call for financial intermediaries has been completed although the deadline had to be prolonged as the financial intermediaries showed little interest in participating in the FEIs funded by JEREMIE. In the next stage, the financial intermediaries should set-up appropriate financial products for SMEs.

5. Evaluations of financial engineering instruments

To date, no evaluations have been carried out on the national level.

However, on the European level, the European Court of Auditors published a special report titled *Financial Instruments for SMEs Co-financed by the European Regional Development Fund* in February 2012.

The ECA addressed the flowing key issues in the report:

- The quality of the assessment of the SME financing gap;
- The suitability of the ERDF framework to implement financial instruments,
- The effectiveness and the efficiency of the financial instruments in achieving results.

The gap assessments prepared by the EIF were conducted independently from the OP preparation process, often subject to delays and leading to a sub-optimal fund allocation from

[4] The SMEs in Bratislava region are eligible for support from equity instruments jointly financed from OP Bratislava region and OP R&D. SMEs in Bratislava region are not eligible for equity instruments financed solely from the OP R&D.

OP measures to financial instruments. Therefore, as the consequence of this approach considerable OP constraints resurfaced (e.g. allocation between different types of instruments, territorial constraints, monitoring and reporting requirements).

The ECA also identified that the management of repayable assistance to SMEs under the same legal framework as non-repayable grants is causing problem. The Commission has taken action in interpreting the legal framework, however not all regulatory problems have been solved. The following problems remain to be addressed:

- Insufficient leverage and fund revolving provisions.
- The possibility to commit unjustified allocations to financial instruments.
- The possibility for unjustified recourse to preferential treatment of the private sector.
- Unclear eligibility conditions for working capital.

Due to the still early stage of implementation the ECA did not evaluate the efficiency of the financial instrument in achieving results.

6. Concluding remarks

The present implementation of JEREMIE based on the framework agreement between Slovakia and EIF is about to expire in 2015. After this "learning period", it is expected that the relevant stakeholders would accumulate the necessary experience and knowledge to ensure a smoother implementation of FEIs in the future. Further implementation of FEIs, in the next programming period 2014-2020, can be governed by the national authority (Slovak Guarantee and Development Fund) which should also provide the necessary knowledge and experience to other potential national stakeholders involved in the future implementation of FEIs.

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Interview:

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Annex

Annex Table A: Selection Criteria for Seed&Venture Capital&Co-Investment Funds Financial Instruments

1.	ELIGIBILITY CRITERIA	System of appraisal Yes / No
1.1.	The Expression of Interest is submitted within the Deadline	
1.2.	The Expression of Interest is submitted both by registered mail and e-mail	
1.3.	The Expression of Interest is completed and submitted in English	
1.4.	The Expression of Interest is duly signed	
1.5.	The Expression of Interest is prepared in accordance with Annex 1 to the Call for Expression of Interest. All necessary supporting documents are provided	
1.6.	Applicant's absence of conflict of interest (as per template provided in Appendix 4 to the Expression of Interest)	
1.7.	Applicant and its senior management are not in any situation of exclusion (as per template provided in Appendix 5 to the Expression of Interest)	
1.8.	Ability to communicate in Slovak and English	
1.9.	The Expression of Interest addresses all the items set out in the Project Description (Appendix 2 to Annex 1)	
1.10.	The Expression of Interest addresses all the items of the Financial Instrument, including any special conditions, set out in the relevant parts of the Financial Instrument description (Part I of Annex 2)	

2.	QUALITY ASSESSMENT CRITERIA	Max. score
2.1.	**Project Relevance, Quality and Coherence** 2.1.1. Fund focus and proposed investment strategy, including viability of Fund's size; 2.1.2. Fund Manager team profile, stability and ability to implement the Financial Instrument. 2.1.3. Assessment of Fund Manager's operational, financial, technical and VC competences; 2.1.4. Detailed investment track record of the Fund Manager and/or its team members; 2.1.5. Team's history as board members and/or members of committees of an investment and/or advisory nature; 2.1.6. Evaluation of Applicant's investment processes, including deal flow generation, ability to invest, ability to add value to companies and exit strategy;	**60 points**
2.2.	**Project Sustainability** 2.2.1. Deal flow: Fund Manager's ability to source investment opportunities in Slovakia (SMEs) and existence of pipeline; 2.2.2 Fund Manager's ability to raise funds from the private sector (as required for each Financial Instrument). 2.2.3. Networks and relationships with public and private research centres.	**20 points**

2.	**QUALITY ASSESSMENT CRITERIA**	**Max. score**
2.3.	**Institutional Capacity** 2.3.1. Fund Manager organisation, structure and long-term viability; 2.3.2. Corporate governance in place; 2.3.3. Legal structures and independence; 2.3.4. Fund's Terms and Conditions, including management fee and profit share arrangements; 2.3.5. Alignment of interests between the Fund Manager and the Investors; proposed mechanisms to resolves conflict of interest issues (if any). 2.3.6. Reporting and Control Procedures.	**20 points**