Financial engineering instruments: the way forward for cohesion policy support? Recent experience from the Baltic states[1]

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1. Introduction

Traditionally, EU cohesion policy support to businesses and local authorities has almost exclusively taken the form of non-repayable grants or subsidies. However, in the current structural funds programming period (2007-2013), financial engineering instruments (FEIs) have emerged as a significant support mechanism in addition to grant assistance[5]. Thus, "in 2007-2013 the use of different modes of financial instruments has become more widespread. Financial instruments are quickly growing in variety, scope and amounts committed to them. In the 2014-2020 period an even wider application is envisaged – the financial instruments can be used in all policy areas where feasible" (European Commission 2012, p.1). Financial engineering instruments include the following: equity (venture capital), loans, loan guarantees, micro-finance, mezzanine finance and other forms of revolving assistance. The final recipients can be SMEs or other recipients of public funding, such as urban development funds and energy efficiency/renewable energy projects, and even individual citizens.

The European Union takes a rather favourable view of FEIs. The European Commission Staff Working Document puts it the following way: "The possibility of using the same funds several times through various revolving cycles contributes to the impact and sustainability of the instruments. As such, the impact of revolving funds can be many times greater than grant assistance, giving them a particular added value and relevance in times of budgetary constraints. The impact/multiplier effect is further strengthened by the accumulation of interest generated and dividends paid to the funds. The revolving character of such instruments creates enhanced incentives for better performance on the part of the final recipients – such as better quality of projects and greater financial discipline. Also, the participation of private

[1] Research for this paper was carried out as part of the Evaluation network delivering policy analysis on the performance of Cohesion policy 2007-2013 (EvalNet) see:
http://ec.europa.eu/regional_policy/information/evaluations/index_en.cfm#1.
The work involved analysis of official documents, evaluation studies, etc. In addition interviews were carried out in 2012 in Estonia, Latvia and in Lithuania with policy-makers, representatives of managing authorities, banks and other financial intermediaries. For detailed country reports see Kalvet (2012), Maniokas and Miseliuniene (2012), Vanags and Moore (2012).

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[5] So-called 'revolving assistance' was available under cohesion policy in limited amounts in some countries in the previous programming period in particular for SMEs. For, example Latvia had a cohesion policy financed venture capital programme in 2004-6.

sector funding guarantees the input of expertise and know-how. Specific expertise in supporting, for example start-up SMEs, can be invaluable. Drawing upon this expertise helps to improve the overall quality of projects." (European Commission 2012, p.2). It should, however, be said that few of the above claims have been empirically tested though the EU policy document recognises the many challenges involved in the implementation of FEIs.

Furthermore, the academic literature on venture capital and the role of the public sector (see e.g. Lerner 2009) suggests that introduction of market conditions and market mechanisms might improve the efficiency of public SME funding from a resource allocation perspective, thereby strengthening the case for financial engineering instruments as policy tools.

During the first four years of the current programming period the use of FEIs has grown quickly. Thus as of the end of 2010 the scale of FEIs can be summarised as follows:

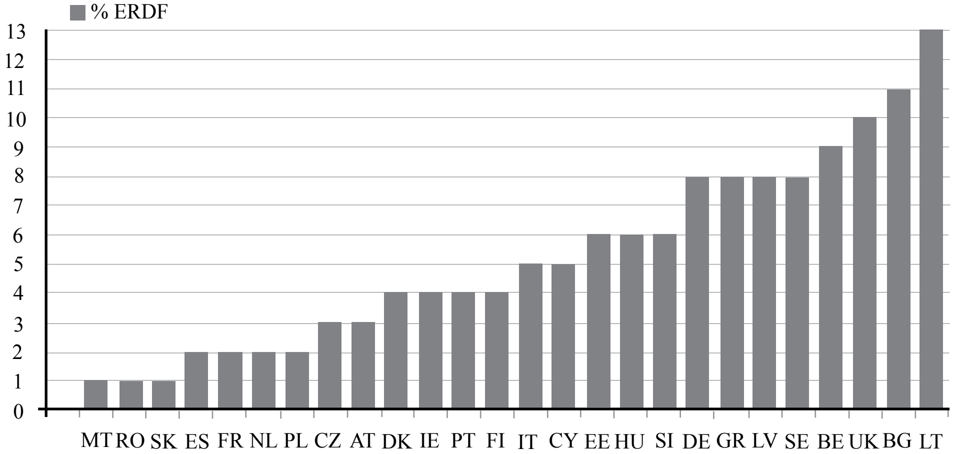
- Around 5% of European Regional Development Fund (ERDF) allocations have been committed in the form of different types of financial instruments[6].
- Almost 400 funds have been set up. Most of these funds support businesses but assistance is also available to urban development fund, energy efficiency and renewable energy projects.
- All Member States have at least one fund in place for enterprises.
- 11 Member States have funds for urban development, and one Member State has set up a fund exclusively focused on renewable energy and energy efficiency activities.
- Investments have been made in over 20,000 businesses (see European Commission 2012, p.3)

In short, there is a growing popularity in the use of FEIs in the implementation of EU cohesion policy, with the Baltic states (especially Lithuania and Latvia) in the vanguard of this trend (see Figure 1).

Hence, the three Baltic states offer an interesting case study in the use of FEIs in cohesion policy. Not only are the Baltic states among the more intensive users of FEIs to date but they have taken somewhat different approaches in terms of policy focus and implementation mechanisms. Moreover, their rather similar size, prosperity and productivity levels as well as rather similar economic problems as well as administrative capacities make their experience of FEIs something of a 'quasi-experiment' in the use of these instruments. The objective of this paper is to analyse the set-up and perfomance to date of FEIs in the Baltic states with a focus on ERDF funded instruments. Where possible we attempt to draw lessons for the future including for the next programming period. The analysis builds on hard empirical data supplemented by a number of interviews with stakeholders in the three Baltic states.

[6] Use of financial instruments in the European Social Fund (ESF) has been much more modest with thirteen Operational Programmes (OPs) in five Member States co-financing financial instruments with ESF resources, for a total amount of nearly 330 MEUR, representing about 0.7% of declared ESF expenditures. All three Baltic states have FEIs funded by the ESF as well as by the ERDF although in relatively small amounts (see Figure A and Tables A and B in Annex).

Figure 1. Allocation of ERDF to FEIs, 2007-2013



Source: National reports LU=zero
Source: Country reports on Financial engineering instruments: summary of main points 2012.

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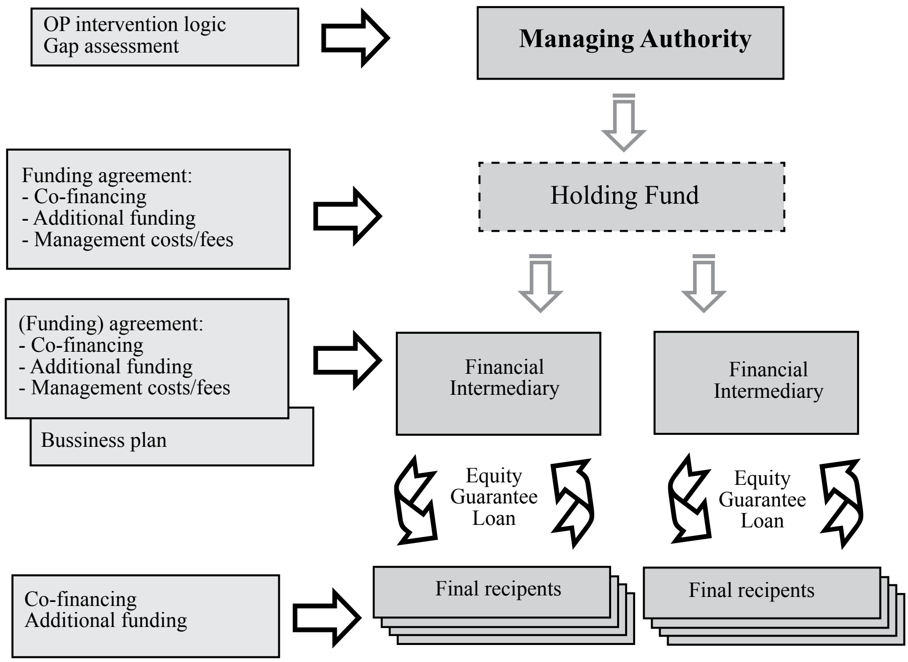
2. The holding fund methodology

Financial instruments require a rather different implementation mechanism than do classical non-repayable grants. This is reflected in the institutional and organisational set up of FEIs for the 2007-13 programming period which is characterised by the widespread use of holding funds as first stage intermediaries between the Managing Authority and the disbursement of funds to final beneficiaries.This applies in particular for the EU12, many of which started using FEIs for the first time. This form of management was promoted by the EC together with the European Investment Bank (EIB) and the European Investment Fund (EIF) both of which benefited from special treatment which by-passed the requirement for tendering. Figure 2 shows the typical structure for implemetation of FEIs in the current programming period.

It can be seen that delivery of FEIs has two levels of intermediary between the Managing Authorities and final beneficiaries: the holding fund (HF) and the standard financial intermediaries such as banks or venture capital funds. In many cases, the holding fund is organised within the framework of either JEREMIE (for SME support) or JESSICA (for urban development)[7]. This structure is important for at least two reasons: firstly, the involvement of commercial financial intermediaries means that loans, guarantees, and equity capital are subject to normal financial scrutiny by professionals in a way that does not happen with grants and secondly, the two-way flow between financial intermediaries and final recipients indicated in Figure 1 signals the 'revolving' characteristic of FEIs (see European Commission 2012).

Figure 2. Set-up of financial instruments in 2007-2013



Source: European Commission (2012), p. 15.

3. FEIs in the Baltic states

A summary description of FEIs funded in the Baltic states from cohesion resources appears in Table 1. FEIs can be found in all three Baltic states, although the focus and the implementation mechanisms are different.

The commonality is that in all countries ERDF funds are used to support innovation and growth of enterprises and that all three have small scale ESF funding for start-up, self em-

[7] JEREMIE (Joint European Resources for Micro to Medium Enterprises) is a joint initiative of the European Commission and the European Investment Fund to promote the use of financial instruments to improve access to finance for SMEs via structural fund interventions. JESSICA (Joint European Support for Sustainable investment in City Areas) supports urban development through the structural funds. However, holding funds can be established independently of the JEREMIE and JESSICA frameworks.

ployment or micro-credit. The importance allocated to different FEIs varies. In Lithuania, soft loans, micro-loans, guarantees, credit insurance and venture capital are all available for SME assistance. Similarly, in Latvia all types of instrument are present: loans, guarantees and venture capital. Estonia has just two instruments: loan funds and two guarantee funds.

Cohesion policy-funded FEIs for SME development in Lithuania were employed for the first time during the 2007-2013 programming period[8] and deployed within the "Economic Growth Operational Programme"[9] within which about 15.5% of funding is allocated to FEIs. FEIs are deployed in two main directions: a) promotion of SMEs and b) increasing the energy efficiency of residential buildings (Figure A in the Annex).

Table 1. ERDF and ESF funding of financial engineering instruments in the Baltic states

	EE	LT	LV
FEIs in 2004-2006	no	no	yes
FEIs in 2007-2013	yes	yes	yes
FEIs for competitiveness and innovation (MEUR)	100.9	305.4*	184.3
Loan funds	70.3	138	72.5
Guarantee funds	30.6	49.4	28.5
Venture Capital (VC)	no	36	83.3
FEIs for energy efficiency (MEUR)	17.0	127**	no
FEIs for start-up and micro credit (ESF) (MEUR)	6.0	14.5	17.3
FEIs total	123.9	446.9	201.6

Source: Authors. * It has not yet been decided among which specific instruments Lithuanian JEREMIE HF funds will be distributed. The figures indicated for loan funds and venture capital funds are not final.** In total, 227 MEUR are invested in the Lithuanian Jessica HF: EUR 127 million from the ERDF and EUR 100 million as the national contribution

In Latvia, ERDF-funded FEIs are part of the Operational Programme (OP) "Entrepreneurship and Innovations". Funding for FEIs from the ERDF stands at EUR 184.3 million and together with national and private funding total FEI funding for ERDF activities is EUR 293.5 million representing nearly 27% of total funding for this OP (Table A in Annex).

In Estonia, four instruments are allocated a total of EUR 100.9 million within the OP for the Development of Economic Environment, constituting 7.0% of the total budget of the OP and are associated with innovation and the growth capacity of enterprises (see Table B in the Annex). Public venture capital support is provided from national funds via the Estonian Development Fund established in 2007.

On the management side there are considerable differences (Table 2).

[8] Prior to the current period two instruments from the national budget were available for SMEs.
[9] Lithuania has three Operational Programmes (OP): the OP for the Development of Human Resources; the OP for Economic Growth, the OP for Promotion of Cohesion.

Table 2. Management of FEIs in the Baltic states

	EE	LT	LV
Loan and guarantee fund manager	Kredex and KredEx Credit Insurance	INVEGA	Latvian* Guarantee Agency
Main VC fund manager	n/a	EIF	Latvian* Guarantee Agency
Energy efficiency fund manager	Kredex	EIB	-
Start-up fund/microcredit manager	Kredex	INVEGA	Mortgage and Land Bank

Source: Authors. * Until January 2012 the European Investment Fund managed the Latvian Holding Fund

Energy efficiency related FEIs can be found both in Lithuania and Estonia[10]. In Lithuania the allocations for investments in housing energy efficiency projects of multi-apartment buildings and student dormitories are financed through FEIs from the Cohesion Promotion OP from the ERDF in the amount of EUR 127 million. In Estonia, the OP for the Development of Living Environment has one instrument allocated in the amount of EUR 17 Million (constitutes 1.1% of the total budget of the OP) and is associated with energy efficiency in multi-apartment buildings (Figure 2 in Annex).

In Lithuania FEIs for business are mainly operated via a JEREMIE HF created in March 2009 with funding of EUR 210 million. The INVEGA HF manages funding of EUR 58 million and provides loans to SMEs and EUR 14.5 million is allocated to the ESF funded Entrepreneurship Promotion Fund. For urban development the JESSICA Holding Fund Lithuania was established in June 2009. This is managed by the EIB for the purpose of investing in energy efficiency projects intermediated by the banking sector in Lithuania. The total contribution envisaged in the JESSICA HF is EUR 227 million, of which EUR 127 million is ERDF funding.

In Latvia the main FEIs are implemented through the "Holding fund for the investment in guarantees, high-risk loans, and venture capital funds and other financial instruments" which at the next level is implemented by two banks and by two local venture capital fund management companies. The Holding Fund was established in mid-2008 as part of the JEREMIE 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). Other ERDF programmes are the "Support by way of loans for development of enterprise competitiveness" (capital equipment) and is run by the state-owned Hipoteku un Zemes Banka (Mortgage and Land Bank) and the newly created mezzanine funding facility managed by the Latvian Guarantee Agency.

In Estonia, all FEIs for enterprises are managed by Fund KredEx, established in 2001 by the Ministry of Economic Affairs and Communications, and by the more recent KredEx Credit

[10] Latvia also has an energy efficiency programme for residential buildings but this is financed by grants.

Insurance Inc. (KredEx Krediidikindlustus AS). Both are publicly owned holding funds and are established as legal persons governed by private law.

There are also differences on how actively the FEIs have been used. The most active use has been observed in Estonia, where high demand for FEIs operated by KredEx occurred in 2009 and 2010. For example, in 2009, KredEx guaranteed and financed 409 companies (with 24,000 employees in total) with subordinated loans and project-based loan resources totalling EUR 83 million (KredEx, 2010). In 2010, KredEx guaranteed and financed 470 enterprises (with 16,100 employees) with subordinated loan and credit lines totalling EUR 108 million (KredEx, 2011). However, in 2011 as the credit policies of the banks softened, the demand for FEIs decreased with a funding total of only EUR 67.4 million. The funds of the FEI for energy efficiency are expected to be used up in 2012 (KredEx 2012a).

In Lithuania, results are mixed. The Guarantee Fund and the INVEGA Fund show very good results. By 31st December 2011, the results of the Guarantee Fund exceeded expectations: the volume of guaranteed liabilities was 137% of the target, and the number of SMEs supported was 149% of the targeted number. Two FEIs implemented under the INVEGA Fund have also had high demand among SMEs: by 31st December 2011, the expected results of the FEI "Small Credit Scheme II" were 249% of the target (the number of SMEs supported by FEI); on the other hand the FEI "Open Credit Fund" had 81.5 % of the target in terms of the amount of private investments attracted, and 190 % in terms of the number of SMEs supported. 80% of the funds from the FEI "Open Credit Fund" are already lent.

The Lithuanian JEREMIE HF has experienced some difficulties, especially when implementing FEIs of portfolio guarantees as this measure was not popular among SMEs and the instrument has been redesigned. Energy efficiency measures have a dismal outturn: to date only 4 multi-apartment buildings have been renovated under the JESSICA programme, where the target is 1,000 buildings to be renovated by the end of 2015.

In Latvia, take-up of FEIs has been slow, especially for Holding Fund activities. As of end March 2012 only 15% of loan funds and about 21% of venture capital funds had been contracted to final recipients. By contrast the programme offering working capital loans was very active in 2010.

4. Discussion

4.1. Market gaps, market failure and FEIs vs grants

Two related issues in evaluating the role of FEIs in cohesion policy (or as instruments of public intervention in general) are: a) is there a gap in financing especially of SMEs that the market does not fill? And b) if there is such a gap, does it represent a 'market failure' that needs to be addressed and corrected?

In practice, the deployment of FEIs in the Baltic states cannot be said to have been based on clearly identified market gaps or market failures. Perhaps this is because gaps are difficult to quantify since demand is latent and unobservable until supply appears (see Vanags et al 2010). Similarly, the EIF (2007) argues that lack of data compromises the feasibility of measuring demand for FEIs. As a result, it has been difficult to define empirically a market failure in terms of an absolute or persistent financing gap.

Although hard empirical data are also not available in the Estonian case, all the Estonian stakeholders interviewed argued that the private market in Estonia did not offer adequate levels of capital to entrepreneurs who lacked sufficient collateral, self-financing and/or appropriate financial history. That is, the amount of collateral required from borrowers sometimes exceeded their asset endowment, and even reasonably good low-risk borrowers experienced 'unfairly' rationed credit. Furthermore the financial crisis caused serious problems in the operation of financial markets. Additionally, the overall low capitalisation level of the Estonian industrial sector and low investments – especially in traditional industries that could benefit from international technology transfer – suggests important market imperfections remain.

Similar qualitative arguments were provided as a justification for intervention in Lithuania. In quantitative terms, the first estimates of the relevance and effectiveness of intervention in the area of SME support in Lithuania appeared in 2010, in particular estimates of the amount of investment needed for venture capital and micro-credits. The rationale for intervention in energy efficiency measures in the housing sector was simply that there was no available and affordable market alternative.

Moreover, in none of the three countries has there been detailed discussion in the main policy documents of the merits of grants vs FEIs. One stated consideration for using FEIs over grants is that FEIs create fewer market distortions because FEIs are provided on commercial terms and are assessed by qualified and experienced financial intermediaries.

The need to better understand the merits of grants vs FEIs is illustrated by an Estonian case. From 2011 a technology loan, a special type of subordinated loan, has been offered to entrepreneurs. Through the technology loan, investments by entrepreneurs in machinery and equipment are co-financed in cooperation with a private bank or leasing company. This is funded by the ERDF in the amount of EUR 19.3 million (see Kredex 2012b for details). This FEI is interesting because of its close alignment with the objectives of Enterprise Estonia's support to technology investments (Tööstusettevõtja tehnoloogiainvesteeringu toetamise tingimused ja kord (2008)), co-funded by the ERDF for EUR 73 million (Ministry of Finance, 2012).

The measure assists with acquisition of machinery and equipment, and intangible assets required for use of these machines and equipment and has been very popular. For example, in 2010 in response to the third call for the measure, 169 applications were received and 71 were funded with a budget of EUR 18.5 million. For the period 2009-2010, altogether 185 proposals were funded (Enterprise Estonia, 2011). A feasibility study on the measure was carried out by Technopolis (2008) and alternatives (grants vs. loan support) were discussed. It was suggested that grant-based support mechanisms were potentially more effective. The authors also suggested that such investment support should be accompanied with in-depth consultations on best available technologies.

Both in Lithuania and in Estonia in the field of energy efficiency, the unaffordable cost of apartment building renovation is the main reason for public intervention, as was concluded in evaluations carried out in Lithuania (EIB 2009, EIB 2010). The main benefit of employing JESSICA-type instruments (FEI) versus traditional grant financing was perceived as located in the revolving nature of the fund. This enables multiplication of funds invested as well as leverage of additional public and private sector funding.

4.2. Evaluations of FEIs

In all three countries there is limited evidence-based evaluation of FEIs. The need for good quality evaluations is well illustrated by the case of Estonia: although an increasing number of policymakers support wider implementation of FEIs, less support comes from beneficiaries. There is an issue of path dependency with entrepreneurs continued expectations for support in the form of grants and lack of supporting argumentation to deviate from the current path. Also, 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(r) loans to existing medium-sized and larger companies. Such an evaluation could inform the next round of FEI development.

In Lithuania an evaluation for the Ministry of Economy was carried out to assess, among other things, the sufficiency and adequacy of existing FEIs to the changed economic situation generated by the economic crisis. The aims included: to identify market failures (if any), to assess the adequacy of particular FEIs for covering such failures, and identify the need for redistribution of structural fund resources. The study concluded that FEIs were satisfactory instruments for promoting SMEs during a time of economic downturn, but some new FEIs had an over-long deployment period. The need for additional interventions to promote exports (export insurance), venture capital development (especially at the pre-seed stage), and to increase funds for micro-credits was identified.

In Estonia two evaluations have been carried out on FEIs in relation to the innovation and growth capacity of enterprises but none on renovation loans for apartment buildings. An Estonian National Audit Office (2010) impact assessment of companies that had received support from 2004 to 2009 concluded that in terms of productivity, value-added, turnover and exports, the performance of these companies was not significantly different from that of businesses that had not received support. The report raised several methodological issues such as the appropriate time scale for measuring impact. Both the Ministry of Economic Affairs and Communications and KredEx disagreed with the main conclusions of the audit, as did some policy analysts and researchers. As a result of dissatisfaction with the National Audit Office report an ongoing impact assessment of enterprise support measures is being carried out by the Ministry of Economic Affairs and Communications. Preliminary results show that clients of KredEx are mostly SMEs and that beneficiaries have grown more rapidly compared with the control group.

In Latvia, evaluations are being carried out by the Ministry of Finance, including a mid-term review and selected internal audits; however no reports for 2007-13 are yet publicly available.

4.3. FEIs and the financial crisis

The different nature of FEIs applied across the Baltic economies meant that the impact of the financial crisis on the uptake of FEIs has been different.

A perception emerging from many of the persons interviewed was that the more turmoil there is on the markets the higher the need for some intervention in the form of loans and loan guarantees. Thus quick and broad interventions were desired by local enterprises. This has been most successfully accomplished in Estonia where for 2009-2010 demand for enterprise-oriented FEIs increased as commercial banks cut back on lending. In response to this additional measures were introduced along with other changes.

For example, the "Additional support programme for the availability of entrepreneurs' loan capital" was initiated in the spring of 2009 and additional loan capital was intermediated for exporting entrepreneurs via success-based subordinated loans, long-term loans for investment projects and credit lines for banks. Additionally, there was more provision of mid- and long-term export guarantees to entrepreneurs, in particular export insurance was extended to all countries (previously guarantees were limited to third countries located outside the EU and OECD due to EU State Aid rules). The time taken to introduce ERDF-funded FEIs has been rather similar to that of other policy instruments in Estonia as existing organisations have been largely used for implementation and delivery of new FEIs.

The SME Loan programmes offered in Latvia 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. At the same time, 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. In contrast, capital loans from the Latvian Mortgage and Land Bank, albeit at relatively high cost to the borrowers, were a popular instrument in 2010, but with the resumption of more normal lending in 2011 this activity decreased. Because of limited co-funding options for investment projects, the pick-up of VC related measures has been slow in both Latvia and Lithuania. In Lithuania the Ministry of Economy is planning to reallocate EUR 40 million to FEIs most demanded by SMEs. Similarly, in Latvia a new EUR 25 million mezzanine activity was introduced at the end of 2011.

4.4. JEREMIE and JESSICA Holding Funds versus national funds

Involvement of both JEREMIE and JESSICA in delivery of FEIs has been less than smooth. In Latvia inclusion of JEREMIE 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 the EIF. As a consequence, for example, by the time 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 so deployment of loans to final beneficiaries was much lower than expected. Latvia was only the third country to engage the EIF as manager of its Holding Fund. Lack of EU fund experience meant that the EIF was "learning by doing" and, according to the managing authority in Latvia, the time and effort required for FEI implementation was substantially underestimated. Consequently deployment of FEIs 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.

In Lithuania similar problems occurred. When implementing energy efficiency measures under JESSICA the agreement with the EIB lacked clear provisions on accountability and control. Only after two years, in May 2011, when JESSICA results were less than satisfactory were amendments to the Financing Agreement initiated. Changes include: a clearer responsibility for the EIB as HF manager, control measures for use of JESSICA funds and indicative results to be achieved. However, the responsibility of the EIB in terms of achieving results, checking the eligibility of expenditure, etc. remains limited.

In short, despite a huge need and potential for modernisation of multi-apartment buildings as well as the political will to implement JESSICA in Lithuania, the start of the programme was difficult, and its results remain disappointing. To date, only 4 multi-apartment buildings have been renovated under the JESSICA programme, 47 are being renovated, 80 tenders for construction contracts have been launched, and another 90 buildings are in the process of procuring technical renovation projects. The target of 1,000 buildings renovated by the end of 2015 as provided by amendments to the Financing Agreement with the EIB is unlikely to be achieved. When preparing the JESSICA Investment Strategy and programme, the complexity of the task was not properly assessed, nor was the time necessary for creating an institutional, legal, technical and financial infrastructure, and the building of administrative capacity in this area, nor was the specificity of the target group and its expectations sufficiently evaluated at the beginning. The financial crisis of 2008 added uncertainty to the banking system and to the target groups as the already low incomes of residents living in multi-apartment buildings were further reduced during the economic crisis.

4.5. Rigidity and lack of clarity in FEI programme rules

Since the ERDF is the primary source of public financing of FEIs, the ERDF rules on top of EC State Aid rules must be applied. This has implications for 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. That immediately distorts the loan crediting process of banks and the investment process of equity funds. In addition, State Aid rules prohibit FEIs from financing certain industries, such as agriculture, fisheries and some transport 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.

Stakeholders in Estonia have pointed out that introduction of some ERDF-funded FEIs in Estonia were accompanied by negotiations with the European Commission so that FEIs suggested by the Estonian government could be approved. For example, this applied to renovation loans for apartment buildings, where approval of the specific design of the support instrument was needed to overcome design disagreements with the European Commission. Moreover, concern was expressed by those interviewed that the guidelines for FEIs from the European Commission published in 2011 should have been issued earlier.

Uncertainties regarding regulation of FEIs were also stressed by stakeholders in Lithuania. Several issues have not been fully addressed so far either in the Guidance Note on Financial Engineering Instruments (European Commission, 2011) or in the proposals for the next period. This, according to the view of the government officials, has increased the risk that part of the expenses incurred will not be considered eligible at the closure of the programmes and that incentives to use FEIs in the future will be compromised.

In Lithuania the difficulties of combining FEIs and grants has generated particular concern. Seemingly, the European Commission is using the same approach to FEIs as to the management of grants and applies the same control measures. While current EU legal acts (in particular EC, 2011) allow the combination of a preferential loan, guarantee and grant, its recent interpretation makes it virtually impossible: the EC has stated that the three instruments should not co-finance the same expenditures, and in all situations, at final maturity of the loan, total reimbursements by the borrower should be at least equal to the principal borrowed. At the same time the EC have imposed additional requirements for the combination of grants and FEIs. These require that grants and loans originate in different priority axes of the OP and are separately accounted for and documented. Although grants and loans may finance the same project, grants cannot be used to write off loans. In the view of Lithuanian officials, this interpretation narrows the potential use of FEIs and increases administrative burdens as well as contradicting earlier messages from the Commission. Contracts with financial intermediaries for implementation of FEIs were signed in 2009 or 2010, in full understanding and interpretation that loans issued can co-finance expenditure also co-financed by grants as long as state aid rules are respected. The current interpretation might punish countries like Lithuania who were the first to follow the invitation of the Commission for wider use of financial engineering measures as a means of mitigating the effects of the financial crisis, including combined use of grants and FEIs.

5. Conclusions

FEIs funded from cohesion policy resources can be found in all the Baltic states, although the focus and implementation mechanisms are different. The evidence from the Baltic states suggests that use of FEIs was encouraged by the European Commission with inadequate administrative preparation and inadequate understanding of the underlying economic problems that the instruments were meant to address and of why FEIs represent the preferred solution. The reasons for using FEIs are couched in terms of shortage of finance for SMEs and start-ups but very little explicit market gap analysis or market failure arguments to justify the scale of intervention has been offered and little concrete evidence exists of the expected benefits. Further research needs to be done in this respect. This applies also to analysis of the merits of grants vs FEIs.

Lack of experience in managing JEREMIE and JESSICA Holding Funds on the part of key participants combined with incomplete Commission rules led to significant delays in programme implementation both in Latvia and Lithuania. Thus, Latvia planned for quite extensive use of financial engineering instruments in the 2007-13 programming period, but implementation has been slow partly as a result of set-up delays and partly to do with the fact that the recession inhibited both lenders and borrowers.

In Lithuania the difficulties of implementing large scale renovation of multi-apartment buildings, problems of combining FEIs and grants and rules on eligibility of investment in risk capital have been the main implementation problems.

Estonia has had a more trouble-free ride compared with Latvia and Lithuania. Enterprise-related FEIs have become important policy instruments in Estonia, targeting what are regarded as important market failures. They supplement private sector instruments. The demand for such FEIs increased during the global financial crisis and funds were made available to meet the demand. There is an emerging consensus among Estonian policy-makers that more extensive use of FEIs should be considered for the next programming period (compared to grants) even if continued support in the form of grants might be expected or even preferred by businesses.

Thus, optimism remains regarding use of FEIs in the new programming period. A key factor in success will be more thorough feasibility studies and consistency in terms of explaining current rules and drafting new regulations. Uncertainties in regulation and the general tightening of rules make FEIs unattractive to financial intermediaries and to potential beneficiaries. At the same time, the evidence suggests that much of this period continues to represent a learning process and that if the lessons are taken on board there is hope for the next programming period.

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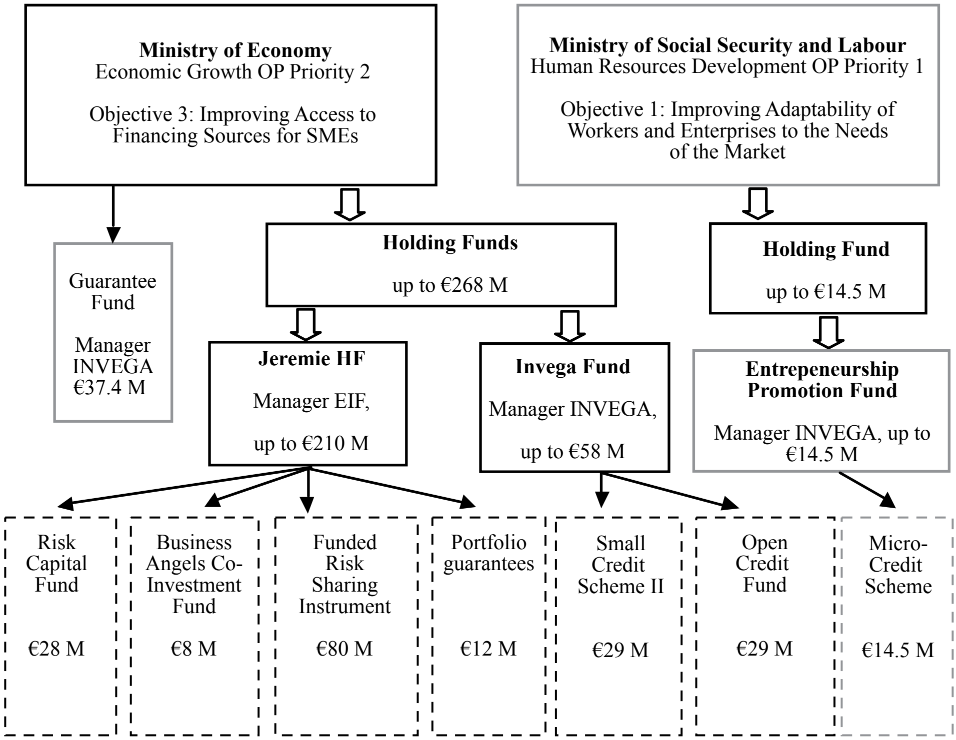
ANNEX

Figure A. Structural Funds and FEIs in Lithuania, 2007-2013



Source: Maniokas and Miseliuniene (2012).

NB1: The Entrepreneurship Promotion Fund is financed exclusively from ESF.
NB2: Not all funds in JEREMIE HF are distributed between specific measures, and the scope of Funded Risk Sharing Instrument and Portfolio Guarantees are subject to change.

Table A. FEIs funded by the ERDF in Latvia in 2007-2013 (as of end of March 2012)

Activity	Total funding EUR	ERDF	National Public	Private
Activity "Holding fund for investment in guarantee, high-risk loans, and venture capital funds and other financial instruments"	153,500,000	83,280,404	8,219,596	62,000,000
Activity "Guarantees for development of enterprise competitiveness"	28,457,436	28,457,436	0	0
Sub-activity "Support by way of loans for development of enterprise competitiveness" (capital equipment)	86,310,326	57,362,564	7,305,882	21,641,880
Sub-activity "Mezzanine investment loans for development of enterprise competitiveness"	25,239,694	15,184,734	10,054,960	0
Total	293,507,456	184,285,138	25,580,438	83,641,880

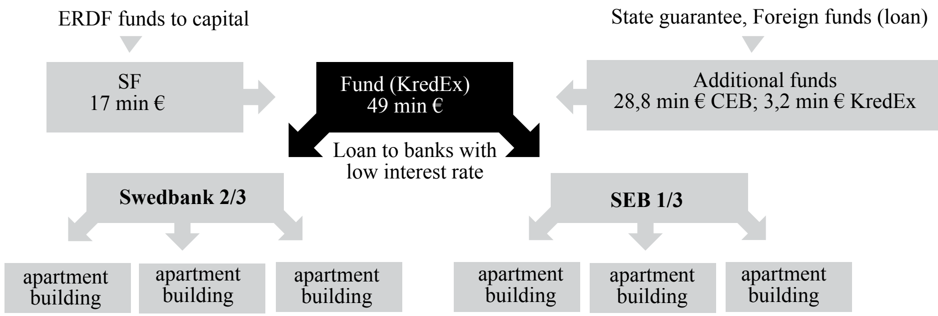
Source: Vanags and Moore (2012)

Table B. Structural Funds and FEIs in Estonia, 2007-2013

FEI	Allocations (EUR Million)				
	EU contribution		Estonian public sector	Estonian private sector	Total
Programme of start-up loans and micro-loans	6.0	ESF			6.0
Total OP for Human Resource Development	351.4		53.7	23.2	428.2
Renovation loan for apartment buildings	17.0	ERDF	32.0		49.0
Total OP for the Living Environment	1,306.2		271.4	85.7	1,663.2
Additional Support Programme of Availability of Loan Capital by Entrepreneurs	43.0	ERDF	26.2		69.2
Export credit insurance programme	12.8	ERDF			12.8
Subordinated Loan Programme	27.3	ERDF			27.3
Business loan guarantees and capital loan programme	17.8	ERDF	0.2		18.0
Total OP for the Development of Economic Environment	1,307.3		197.1	318.0	1,822.3

Source: Ministry of finance of Estonia, 2012

Figure B. Renovation fund scheme in Estonia



Loans of banks to apartment buildings. Bank adds a margin and covers the credit risk

Source: KredEx 2012, p. 26.

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