The Role of Financial Instruments in Improving Access to Finance

Combined Microcredit in Hungary*

*Györgyi Nyikos***

Access to financing is certainly one of the most important components for the creation, survival, performance and growth of SMEs. The combined microcredit is a unique financial development tool where micro-credit and non-repayable assistance can be requested within one construction (other type of combined microcredit is delivering both micro-insurance and micro-credit products). The paper analyses the Hungarian practice using this financial instrument, both looking at the empirical evidences and seeking for answer to the question, whether this form of support is effective, useful or not. Operating under conditions of economic uncertainty, fiscal deficit and consequent budgetary pressures, and encouraged by the early performance and leverage effects of financial instruments, policymakers see considerable value in supporting the further development of FIs and for their use in both existing and new policy-related areas of activity.

I. Introduction

Microcredit is receiving increasing attention in the consequences of the financial and economic crisis and several Member States have introduced it within their operational programmes (OPs) as well. The combined microcredit (*micro-credit and non-repayable assistance together*) is a new unique tool, which is completely in line with the priority of using synergies and integrated approach in the field of economic development. Few studies evaluate the combined microcredit, which can become one of the new products to provide a more comprehensive response to existing market failures often leading to a lack of access to financial services for excluded populations.

The paper focuses on the Hungarian experiences using micro-credit in the 2007-2013 financial period, with attention also on the specific framework of EU cohesion policy. The primary source of data is on one hand information from the Managing Authority for Economic Development OP and the intermediary body, on the other hand from the Fejér Enterprise Agency (FEA), particularly the result of a survey carried out by the FEA. The paper explores also the legislation on the new financial instruments (FI) proposed for the 2014-2020 programming period and responds to the question, if the new tools can be able to achieve the top priority in practice: Supporting SME competitiveness. The paper uses sources of information based on desk research (studies, evaluation, official documents and adopted regulation) and experiences from managing and implementing operational programmes and projects.

The findings showed that to enhance the impact of microfinance and to make the efficient use of the sources available, it is crucial to strengthen complementarities and synergies between different instruments. The use of FIs complementing with the more traditional delivery instruments (grants and support services) can be a solution. The Hungarian experience shows a strong need for using combined microcredit which indicates that the tool can meet primarily the need of access to finance for those excluded from conventional financing. However, providing the adequate mix of access to finance and guidance is crucial. Financing needs to be complemented by

* Based on a presentation made on the 2nd joint EU Cohesion Policy Conference Challenges for the New Cohesion Policy 2014-2020 4th- 6th February 2015 Riga, Latvia.

** Associate professor, cohesion policy expert, Hungary, National University of Public Service/Permanent Representation of Hungary.

intelligent support services tailored to the needs of businesses at their different stages of development and for the beneficiaries[1]/final recipients[2] – especially for micro-entrepreneurs - the "one stop shop" for the access to different sources is the best solution. Providing this is not so easy for the institutional system because of the different regulations (State aid, different funds...etc.), but necessary for the simplification and reduction of the administrative burden.

II. Microfinance and Cohesion Policy

Cohesion policy was and is at the heart of the EU development, and will be the main investment mechanism for the delivery of the Europe 2020 targets in the next decade.

The ideas and aspirations behind micro-finance are not new. Today, micro-finance is a field that has received an increased policy attention and donor interest. These issues have been studied worldwide and are well known in less developed countries as well as in EU development policy.[3]

Microcredit[4] aims at people (micro-entrepreneurs) who wish to enter into business but face obstacles in accessing traditional banking services due to banks' lending conditions and it could help to start up a new enterprise. However microcredit can be useful even in the EU Member States also to encourage new businesses, self-employment and stimulate economic growth.[5]

The using of the cohesion policy sources for microcredit is not a completely new phenomenon. It started already in the 2000-2006 programming period when several initiatives were launched (e.g. EQUAL MFI in Germany, specific of Global Grants in Spain, regional ESF programme in Tuscany). In the 2007-2013 period some Member States set up microcredit schemes using FIs from the start; but others have had to introduce them following the economic and financial crisis. FIs[6] have attracted interest because of their revolving character meaning that FIs invest on a repayable basis, as opposed to grants which are non-repayable investments. FIs are defined also in Financial Regulation as measures of "*financial support provided from the budget in order to address one or more specific policy objectives by way of loans, guarantees, equity or quasi-equity investments or participations, or other risk-bearing instruments, possibly combined with grants*".

Their use has been promoted because of the added value of revolving instruments compared to that of grants in terms of the efficiency of use of public resources. The revolving nature allows for a much greater efficiency in the allocation of public capital and the long-term sustainability of public investment. Secondly, by unlocking other public sector funding and private sector resources through co-financing and co-investment, FIs aim to increase the overall capital available. Additionally the private sector participation enables policymakers to make use of private sector skills and expertise in areas such as identifying investment, decision-making, management of commercial operations and the ability to achieve returns. Repayable assistance can also act as incentive for better quality investments as investments need to be economically viable to be able to repay the assistance provided (see *Figure 1*).

The specific regulatory provisions on the setting up and implementation of FIs in the programming period 2007-2013 are the following[7]:

– Art. 44 and Art. 78(6)-(7) of Council Regulation (EC) No 1083/2006 as well as Art. 55(8) of Council Regulation (EC) No 1198/2006 on financial engineering instruments;
– Art. 43-46 of Commission Regulation (EC) No 1828/2006 and Art. 34-37 of Commission Regulation (EC) No 498/2007.

1 A public or private body and, for the purposes of the EAFRD Regulation and of the EMFF Regulation only, a natural person, responsible for initiating or both initiating and implementing operations; and in the context of State aid schemes, the body which receives the aid; and in the context of financial instruments it means the body that implements the financial instrument or the fund of funds as appropriate.

2 A legal or natural person receiving financial support from a financial instrument (CPR Art 2 (12).

3 EU manages the Microfinance Programmes within the 9th European Development Fund (EDF) in ACP (African, Caribbean and Pacific), worth €15 million. A further investment of €15 million is foreseen in the 10th EDF.

4 Microcredit is defined as a loan of up to €25 000; but in reality many businesses need even smaller amounts of capital in some cases as little as €1 000 to set up their business, with the majority being around €5 000. See Commission Staff Working Paper, 'Microcredit for European small businesses', 2004, p. 5.

5 Report on Implementation of the European Progress Microfinance Facility, COM/2011/0195 final.

6 Financial instruments are the term used in preference to financial engineering instrument (FEIs) for the next programming period.

7 Additionally four COCOF notes on financial engineering instruments from 2007 (COCOF/07/0018/01), 2008 (COCOF 08/002/03) 2011 (COCOF 10/0014/004) and 2012 (COCOF 10/0014/05) form an important part of the framework as they provide COM interpretation and clarification on the applicable provisions.

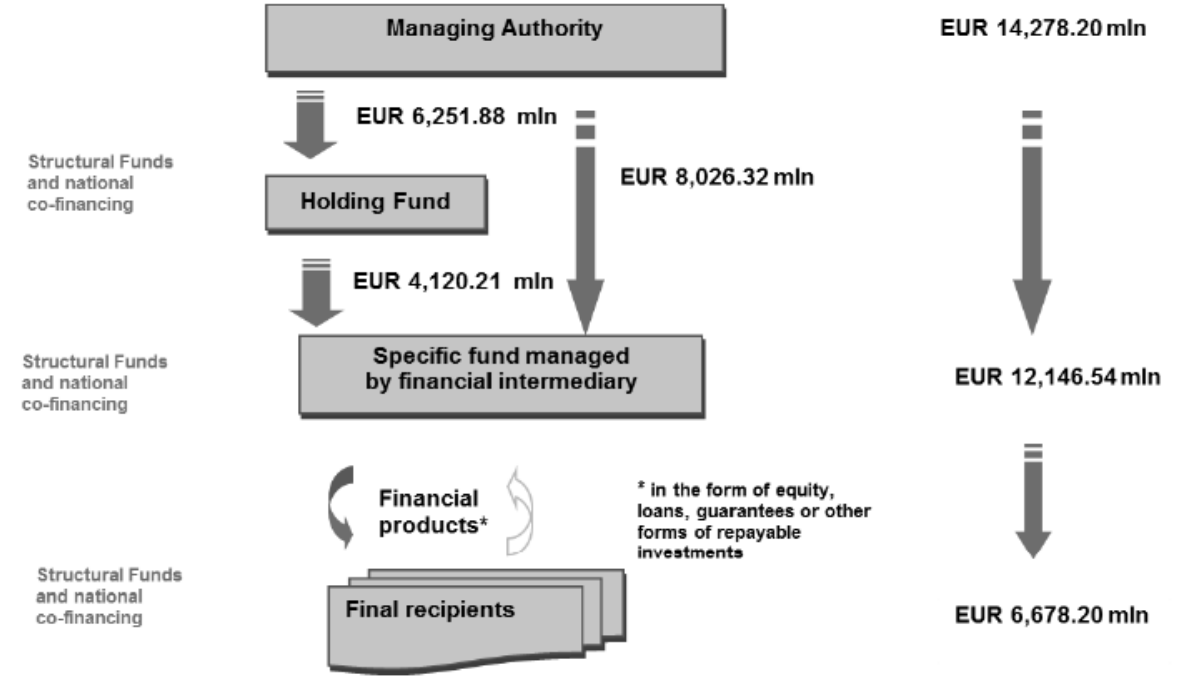

Figure 1: Operational Programmes Contributions used in the Financing of the FEIs and Investments made by the FEIs at the End of 2013
Source: Summary Report 2014, European Commission (from data until end of 2013).

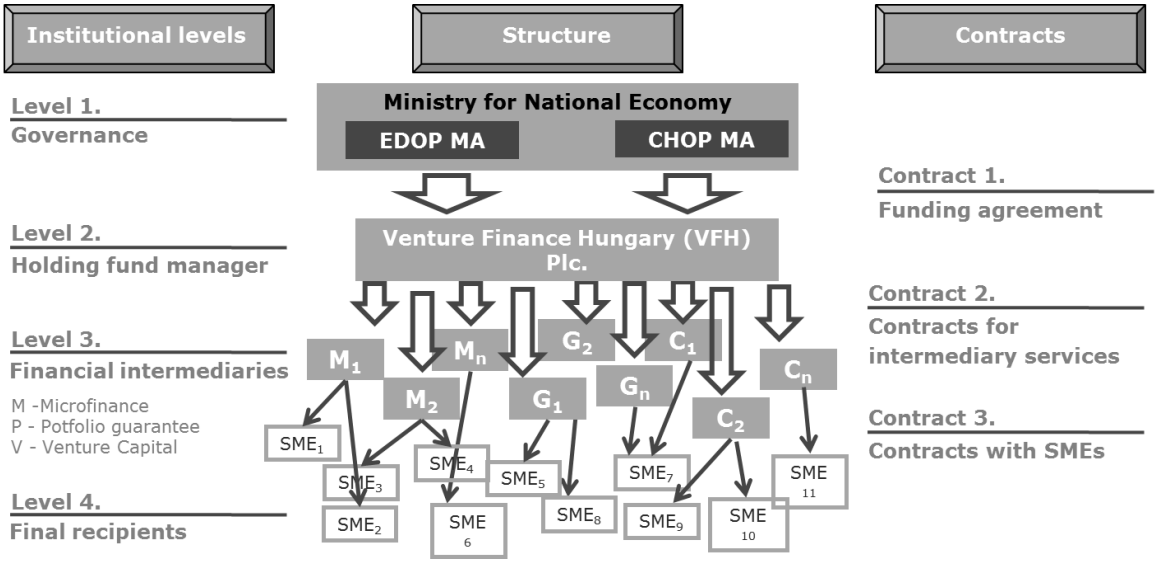

Figure 2: Institutional Set-up of the Hungarian JEREMIE-type Programmes
Source: Author's compilation.

An FI can be complicated and require specialist management teams: A usual management structure involves a cascade system whereby a Managing Authority (MA) selects a holding fund manager. The fund manager is responsible for launching a 'call of interest' looking for possible financial intermediaries who

Table 1: FIs by Specific Fund-type Classification

Form	Description
Equity	Direct investment in the share capital of an undertaking. Involves ownership and capacity to influence governance of the investee firm. May cover seed, start-up and expansion capital. May also be known as venture capital, which is a subset of private equity, strictly defined. Can take various forms, with different levels of risk. Risks for investors may be high (depending on security); so may be returns (depending on performance).
Loan	Borrowing to finance businesses or projects over a period of time and at an agreed rate of return, typically on the basis of the quality of cash flow and strength of the underlying assets; may be on commercial or subsidized terms.
Guarantee	Underwriting funds to provide security for firms that are unable to obtain financing otherwise; may cover all or part of the capital. May take the form of guarantees on bank loans, micro-credit or equity. May involve a fee or higher interest rate for the borrower.

Source: Michie, R. and Wishlade, F. (2011). Between Scylla and Charybdis: Navigating financial engineering instruments through Structural Fund and State aid requirements, IQ-Net Thematic Paper, 29(2), European Policies Research Centre, University of Strathclyde, Glasgow.

will then reach final recipients on the ground (see *Figure 2*).

There are three principal forms of FI used in 2007-13 cohesion policy programmes: Equity, loans and guarantees (see *Table 1*).

The JEREMIE[8] initiative taps into Structural Funds to promote the use of FEIs and improve access to finance for SMEs. Several Member States – also Hungary - have also taken this opportunity to launch microcredit schemes at national and regional level within their OPs. The Member States have followed 2 main different organizational models: Some of them used national development organizations *(e.g. see Figure 1. on the Hungarian institutional model; Germany: Mikrokreditfonds by Germany GLS bank; Lithuania: Entrepreneurship Promotion Fund by INVEGA; Spain: Microcredit Initiative INCYDE)* and several MAs have called upon the expertise of the European Investment Fund (EIF) to manage these instruments.

Eligibility of expenditures within microcredit schemes imply adhering to detailed rules on the EU definition of microenterprises[10], *de minimis*, the possibility of financing working capital in early stages or as part of the expansion of a business activity, and spending before the end of 2015.[11] Companies in difficulty and firms supported by other EU Funds should be excluded, as well as certain sectors. Microcredit schemes also need to comply with proper monitoring and evaluation requirements, and not to underestimate the required reporting and administrative burden. However it was a legal problem that these requirements were not clearly at that start in the legislation and the Commission via COCOF[9] guidance tried to give clarifications and explanations about the proper implementation.

The fund size should neither be over proportionate[12] nor below the critical mass, therefore needs a gap-assessment to be carried out, supported by a proper *ex-ante* evaluation of the SMEs' financing needs. In reality competition could arise between grants and loans, or between loans at market rates or at reduced interest rates: Generally, a mix of non-reimbursable grants and FIs is welcome, but coordination between different funding sources and programmes must mitigate any distortions.

8 Joint European Resources for Micro to Medium Enterprise.

10 Commission Recommendation 2003/361/EC of 6 May 2003.

11 Article 45, Commission Regulation (EC) No 1828/2006 of 8 December 2006.

9 Four COCOF notes on financial engineering instruments from 2007 (COCOF/07/0018/01), 2008 (COCOF 08/002/03) 2011 (COCOF 10/0014/004) and 2012 (COCOF 10/0014/05) form an important part of the framework as they provide COM interpretation and clarification on the applicable provisions.

12 MAs is usually tempted to make oversized allocations to financial instruments for the purpose of increasing 'absorption' and avoiding N+2/N+3 automatic decommitments.

The European Commission have also published a European Code of Good Conduct[13] as a mandatory requirement for microcredit provision in order to support the microcredit sector itself in increasing quality and moving towards sustainability. Unfortunately, this document was also not available at the start of the 2007-2013 period.

III. The Hungarian Case – the Use of the Combined Microcredit

During the early 1990s, after the political changes in Hungary, the number of micro and small enterprises rapidly increased, mainly due to people who had been made redundant by the closing of factories establishing their own enterprises. The Hungarian government aimed to strengthen this newly created SME sector due to its potential to provide employment and economic development. The first entrepreneurship promotion projects were implemented within the framework of the PHARE[14] programme. The programme was providing financing with beneficial interests (on the level of the prevailing central bank prime rate) for micro entrepreneurs excluded from traditional banking services without any discrimination on gender, racial, or other basis and was operated by non-profit foundations. PHARE required also the setting up of a Local Enterprise Agencies (LEA) network.

In the 2004-2006 Hungarian OPs there were no FIs, but in the 2007-2013 programming period the situation changed.

At the start of the programming period during the OP development process 3 documents[15] analysed the market and evaluated the necessity of the use of FIs. They stated that the financial sector's contribution to the financing of SMEs was still limited. The principal factors behind the market insufficiencies were also familiar in other EU Member States: Information asymmetry due to short business history, and the economies of scale problem arising from the high fixed unit costs of financial service providers. The SME development strategy 2007-2013[16] based on these documents summarised the existing financial constraints.

Consequently in the 2007-2013 programming period the total amount of FIs set up in percentage of the ERDF support is around 6%. FIs are financed mainly by the Economic Development Operational Programme (EDOP).[17] The financial allocation of the EDOP 4th priority (financial instruments) was increased by 3% in 2009 through an OP modification. The concrete forms of FI include credit, guarantee and capital as well. In 2007 the Hungarian government decided to implement JEREMIE without the European Investment Fund (EIF) acting as a holding fund, but with the newly created Venture Finance Hungary Plc. *Table 2* shows how the FIs are used in the following OPs in Hungary.

ERDF support between 2007-2013 amounted to €14,44 1 million. The total amount of FI in percentage of the total ERDF support was around 6%. The allocation among OPs was as follows:

- EDOP: 5% of the total ERDF support.
- CHOP: 0.7% of the total ERDF support.
- RDOPs 0.3% of the total ERDF support.

Microcredit was the earliest started[18] FEI in Hungary, with the aim of the programme to develop micro enterprises that have no or not enough access to commercial bank loans. Since the start the main parameters of the programme were changed 3 times as a reaction to the crises. As a consequence of the economic crisis in Hungary it became practically impossible for the SMEs to receive commercial bank loan even for the finance of their own (co-financing) part of the investment supported by grants. To tackle this problem, the objective was to develop the methods of micro-financing and to increase the amount of available resources.

As a possible solution in 2011 the already functioning microcredit programmes were supplemented with a new combined microcredit plus grant scheme.

13 „European Code of Good Conduct for Microcredit Provision" European Union, 2011. ISBN 978-92-79-30654.

14 Programme of Community aid to the countries of Central and Eastern Europe (PHARE) was the main financial instrument of the pre-accession strategy for the Central and Eastern European countries.

15 EIF (2007): SME access to finance. Evaluation study //Ministry of Economy and Transport (2007): SME access to finance, analyses of market failures supporting the elaboration of the financial instruments of the Economic Development OP // Ministry of Economy and Transport (2007): SME development strategy.

16 Ministry of Economy and Transport (2007): SME development strategy 2007-2013. <http://www.terport.hu/webfm_send/2733>.

17 Economic Development Operational Programme 2007-2013. CCI number: 2007HU161PO001. <http://www.nfu.hu/umft_operativ_programok>.

18 The calls for tender for the banks and micro financing institutions were launched in October 2007, while the first contracts with the intermediaries were drawn up in December 2007. In January 2008 the first microcredit transactions were carried out.

Table 2: FIs in the OPs in Hungary

Ops	Budget of OP (without Technical Assistance - TA)	FI forms in the OP	FI budget in the OP	FI in % of the OP
Economic Development Operational Programme 2007-2013 (EDOP) which covers the convergence regions (6 regions out of 7)	€3,257 million	Credit, Guarantee, VC	€727 million (the total FI priority axis)	22%
Central Hungary Operational Programme–fnref:19– 2007-2013 (CHOP) for the Regional Employment and Competitiveness objective	€1,663 million	Credit, Guarantee, VC	ca €117 million (FIs cover part of the 1st priority)	7%
6 Regional Development Operational Programmes–fnref:20– (RDOP) for the Convergence regions	€4,881 million	VC	€7 million /OP (in Strengthening the region's SME sector priorities)	0,8%

Source: Author's compilation.

In accordance with Article 43 (6) of the Implementing Regulation, "*Enterprises, public private partnerships and other projects ...which are supported by financial engineering instruments, may also receive a grant or other assistance from an operational programme.*"[19] However, since the two streams of funding fall under separate operations[20] (and possibly different priority axis) separate accounts and records for each stream of financing must be maintained, to provide clear and independent audit trails for each operation. Whenever a final recipient benefits from grant assistance delivered through aid schemes or through any other type of operation financed under an OP and from investments provided by FEI, Article 54(5) of the General Regulation[21] as well as the State aid rules regarding the accumulation of aid must be respected. In line with State aid guidelines, accumulation of different measures of assistance is possible, as long as they concern different identifiable eligible costs. The combined microcredit in Hungary is functioning from the State aid point of view under the *de minimis* principle. Both calls for applications (for grants and for loans) were published within the framework of *de minimis* aid.[22]

The amount can then be used to buy equipment, ICT tools and basic infrastructure for start-up businesses. Another interesting characteristic of the mechanism is that applying for a loan is a mandatory part of the scheme even if microenterprises have enough of their own resources to cover the amount of the co-financing. Therefore, in combining a refundable microloan and a non-refundable grant, this feature makes it a unique structure for providing microcredit (see *Figure 5*).

In the combined scheme the SMEs can get maximum 45% of the tender project value or 10 million HUF grant, maximum 60% of the tender project value or 20 million HUF microcredit and contribute with own resources to 10% of the total investment. The amount of grant cannot exceed that of repayable assistance and application requirements stipulate that

19 Regulation (EC) No 1828/2006 setting out rules for the implementation of Council Regulation (EC) No 1083/2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund (hereinafter: Implementing Regulation).

20 A project, contract, action or group of projects selected by the managing authorities of the programmes concerned, or under their responsibility, that contributes to the objectives of a priority or priorities; in the context of financial instruments, an operation is constituted by the financial contributions from a programme to financial instruments and the subsequent financial support provided by those financial instruments (CPR Article 2 (9))

21 Council Regulation (EC) No 1083/2006 of 11 July 2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999 (hereinafter: General Regulation).

22 Under Commission Regulation (EC) No 1998/2006.

Figure 3: Combined Microcredit - Project Structure/Financing
Source: Author's compilation.

applicants have to make 10% own contribution available which cannot be financed by any other subsidized loan. In the decision process first the amount of the loan will be calculated where the amount of 10% own contribution will be automatically considered and then the remaining gap can be covered as grant in accordance with the conditions of the call.

The interest rate cap of the current credit products is 9% p.a., while throughout the programme the average interest rate was at around 7% p.a. This combined microcredit product became a success product (see *Table 3*).

An outstanding advantage of the combined products is that they develop the financial attitude and business thinking of micro enterprises through the mandatory use of FIs.

The admission and assessment of loan applications, the disbursement of loans and the management of loan accounts are carried out by the financial intermediaries. Until the contracts are concluded, intermediaries offer services to applicants under a one-stop-shop scheme, which enables the managing authority to satisfactorily monitor both operations and accelerates the decision-making process compared with earlier practice.

In the one-stop-shop system the SMEs applied to the financial intermediaries that granted the microcredit part, while the State-owned body decided on the grant (evaluation and decision within 30 days). These 2 level institutional systems had to evaluate different aspects of the project and shared the risks.

In order to facilitate co-operation between the individual institutional actors, to ensure transparency and avoid duplication, the managing authority published procedural rules to be abided by financial intermediaries, Venture Finance Hungary Plc. (MV Zrt.) and Hungarian Economic Development Centre Plc (MAG Zrt).

In order to implement the JEREMIE programme in Hungary a widespread external intermediary network was set up (see *Table 4*). In line with the EU regulations, the financial intermediaries must add their own funds to these refinancing funds in predetermined amounts. The rate of own funds in the case of financial institutions/financial enterprises owned by financial institutions is at least 25%, in the case of micro-financing organizations it is at least 10%. The financial intermediaries are attracted by the profit gained from the difference between the low source cost (the refinancing interest rate is 0.4%) and the interest paid by the clients. Profit-oriented financial companies receive the JEREMIE funding sources under the same conditions as non-profit foundations. However the operation has to be financed from these profits, because no management cost is eligible from the programme sources.

In the portfolios of *banks*, JEREMIE-products could not gain ground in the desired amount. This is partially due to the fact that the internal banking processes could not easily deal with these products, but also because of the bank were ruled out to be an intermediary for the most successful product, the combined microcredit.

Many *financial enterprises* started work providing JEREMIE-products. After 2011 they became primary promoters of the credit products and their role in the success of the combined microcredit product is remarkable as well. In the case of profit-oriented financial enterprises, the maximum amount that may be granted is HUF 50 million, and, if the loan is combined with a non-refundable subsidy, this amount can reach HUF 20 million (€61,200). *Local founda-*

Table 3: The Existing Forms of FIs

OP	FIs	Short description	Launching the programme
EDOP, CHOP	"New Széchenyi" Combined Micro Credit and Grant	For micro enterprises, for 120 months Min HUF 1 million, max HUF 20 million (ca min €3,500, max €70,000) 10% own resources, 45% microcredit, 45% grant	2011
EDOP, CHOP	"New Széchenyi" Credit (previously Micro Credit)	For micro and small enterprises, for 36/120 month (depending on the type of the credit, e.g. investment or asset) Max. HUF 50 million (ca max €175,000)	2007
EDOP, CHOP	"New Hungary" Small and Medium Credit[1]	For small and medium sized enterprises, for 10 years Min HUF 10 million, max HUF 100 million (ca min €35,000, max €350,000)	2008 (closed in 2012)
EDOP, CHOP	"New Hungary" Working Capital Loan	For small and medium sized enterprises, for 1-2 years Min HUF 1 million, max HUF 200 million (ca min €3,500, max €700,000)	2008 (closed in 2010)
EDOP, CHOP	Portfolio guarantee	Up to 80%	2007
EDOP, CHOP	Venture capital	Trough venture capital fund management firms, tasked with raising a fixed proportion of additional private funding to the resources committed by Venture Finance Hungary Plc. The above-mentioned partners were selected by open tender in the second half of 2009.	2009
7 RDOPs	Equity fund	Venture capital in the regions.	2010

1 ...: together with the Hungarian Development Bank. At the end of 2008 in cooperation with MFB (Hungarian Development Bank) two new credit products were introduced targeting primarily medium-sized enterprises: The so-called SME investment credit (SME Credit) and the New Hungarian Working Capital Credit (UMFOR). However, these products became not as popular as expected mainly due to their complex operational procedures.

Source: Author's compilation.

tions for enterprise promotion have been dealing with corporate microcredits since their launch in the 90s. Initially, they were the number one intermediaries of the credit products; later the combined microcredit product became the key element of their portfolio. According to the rules of the programme the maximum amount that may be granted by non-profit foundations is HUF 10 million (€30,600) (in Hungary this is the amount under which the commercial banks are unwilling to grant loans due to economic reasons).

After the amendments of the programmes and the implementation in 2011 SME support measures in EDOP made the greatest progress in implementation, making the largest contribution to some of the important core indicators related to the programme. All of the combined microcredit priority sources (EDOP-2.1.1/M; CHOP-1.2.1/M) were given to micro enterprises. This scheme is/was also open for start-up businesses. According to the data of the MA at 21.10.2014 the resource utilization of EDOP-2.1.1/M was 100%; and of CHOP-1.2.1/M 100%, too (see Figure 4).

The use of FIs has been given special weight in the less developed regions; on the one hand because the size of the funds allocated to these territories exceeds

several times the funds earmarked for more developed regions, on the other hand due to the fact that the typical financing problems of the SME sector have prevailed there.

However, if the sources are coming from public money especially from the EU budget besides the social factor the sustainability and the effective and responsible financial management are very important. In the context of FIs the principle of *economy* would require inter alia that public resources allocated to FIs should be limited (in quantity) to the amounts and products (quality) necessary to meet the demand for such instruments, that such resources should be delivered in accordance with an investment strategy and delivery planning (timely)[23] consistent with the objectives and assistance priorities of the relevant programme(s). The FIs and financial intermediaries have to be selected based on a transparent selection process. The principle of *efficiency* would entail a demonstrable advantage of using FIs as compared to other forms of support, namely by leveraging additional resources or producing higher results in support of the objectives and assistance priorities of the relevant programmes, at a lower cost to the Union budget, by having a longer term impact on the Union budget through recycling of funds for further investments and through better quality and sustainability of the actions supported. Finally, the principle of *effectiveness* would require that support provided through FIs achieve the intended results indicators in a timely manner (within the programming period), in line with the funding agreements and the objectives of the programmes concerned. Micro-finance is in this case, by definition, no more a poverty alleviation tool but rather an economic development tool.

The strength of a micro-finance institution is often – also in Hungary - based on its close relationship with clients and distribution coverage within a geographic region and it is also important from the grant-decision point of view. While the finance function is central to microcredit and grants, it is on its own however usually not sufficient. Other functions such as capacity building and business support need to be integrated to accompany the financing. In Hungary it is building-up both the provision of trainings, individual consultations and the possibility to apply for a microcredit integrated in a one-stop-shop, thereby providing a simplification for the entrepreneur. However, as stated above, the combined microcredit seems to be one of the most sought after call by the SMEs in Hungary and making the largest contribution to some of the important core indicators related to the programme. Apparently the combined model reached a large number of final recipients through a good blending of private and public resources and adequate risk sharing between SMEs, financial intermediaries and public sector.

Looking at the results so far, the number of EDOP final recipients was the highest among micro enterprises. The increase of the net revenues of the FI final recipients after the 2nd priority's beneficiaries after the project had been closed compared to the initial status was 3.5%. The *microfinance institutions* by paying out 41.179.002.280 HUF (approx. €135 million) from the 2007-2013 period sources (EDOP, CHOP) for 6783 projects created 7172 jobs total, from this the combined microcredit was 27.242.112.438 HUF (approx. €89,3 million) for 4559 projects with 4850 jobs (see *Figure 5*).

Clearly the combined microcredit in Hungary is supporting and helping feminine beneficiaries (41%) and entrepreneurs working in rural territories (47%) also, therefore the "market" demonstrates that the combination has found its applications even in the problematic areas too.

The result of a survey carried out by the Fejér Enterprise Agency (FEA) with almost 392 respondents shows that the used combined microcredit contributed to retaining 452 jobs and creating 349 new jobs. The SMEs involved even indicated that during the next one year they are planning to hire 2270 new employees. It seems to be a high figure; hopefully they are not overoptimistic about the economic opportunities. According to the given answers of the SMEs which used combined microcredit the plans and expectations are positive also, namely they are planning during the next 1 year further investments, technological developments, training and education, innovation or R&D expenditure, to purchase tangible assets and to start a new activity (see *Figure 6*).

To the question how the combined microcredit of FEA helped to improve the living conditions only 102 (26%) answered that it did not have an effect on the living conditions, all the other responders, 290 (74%) indicated improvement (significant or slight) in the

23 Article 43(3) of Regulation (EC) No 1828/2006.

Table 4: Types of Financial Intermediaries and the Number of Agreements

	Number of agreements concluded with financial intermediaries			Type of products			
Financial intermediaries	December 2011	December 2012	31 December 2013	Loan	Combined microcredit	Guarantee	Venture capital
Venture Capital Fund Managers	7	17	27	-	-	-	X
Commercial banks	50	58	65	X	-	X	-
Financial enterprises	25	42	56	X	X	-	-
Saving cooperatives	69	109	126	X	X	-	-
Microfinance institutions	29	29	29	X	X	-	-
Total	180	255	303				

Source: Figures from the Venture Finance Hungary, 31 December 2013 and compiled by the author.

living conditions also beside the positive economic effects linked to the project(see *Figure 7*).

Based on the results so far, in Hungary, microcredit has helped bring activities from the non-formal to the formal sector by financing small businesses. The combination of grants and loans allows to combine a static approach (investment oriented) for grants with a dynamic approach (cash flow oriented) for FIs and make the financial conditions better for access to sources, especially for micro-entrepreneurs.

However, also ***several new audit risks*** have been appeared linked to combined microcredit: The one was the declaration by Commission saying that combination of FEI (loans, guarantees) and grants for the same eligible expenditure item is irregular.[24] As description of the deficiency the Commission indicates that:

a) *The same eligible expenditure item received an investment from a financial engineering instrument and a grant and at least one of the following applies: the grant and the investment do not form part of two separate operations with separate eligible expenditure,*
b) *the two forms of support were used to pre-finance or reimburse one another;*
c) *the combination of the two forms of support resulted in an over-financing of the expenditure item;*
d) *there are no separate accounts and records for each stream of financing for each operation;*
e) *maximum aid intensity allowed by State aid rules was not respected;*
f) *there is a double financing of the same eligible expenditure.*[25]

The legislation in force allows the combination of FIs and grants as long as the State aid rules are respected and the same eligible expenditure is not double financed in accordance with Article 54(5) of the General Regulation. The regulation[26] even recognizes that a final recipients operating in any of the three areas normally targeted by a fund may require grant in addition to repayable assistance. Using a mix of grant and loan to fund the same eligible expenditure item is not automatically double funding. But obvi-

24 Refering to Art. 14 GR 1083/2006 and Art. 10 GR 1198/2006, Art 60 (f) GR 1083/2006 and Art. 59 (f) GR 1198/2006 and Article 15 IR 1828/2006 and Art. 41 IR 498/2007 and State aid rules.

25 EGESIF_14-0015, European Commission, Guidelines for determining financial corrections to be made to expenditure co-financed by the EU under Structural Funds and the European Fisheries Funds for non-compliance with the rules applicable to financial engineering instruments for the 2007-2013 Programming Period, p. 13, <http://ec.europa.eu/regional_policy/sources/docgener/informat/2014/guidelines_financial_corrections.pdf>, dated 06/06/2014.

26 1828/2006, Art 43(6) explicitly identifies enterprises as eligible final recipients of both loan and grants.

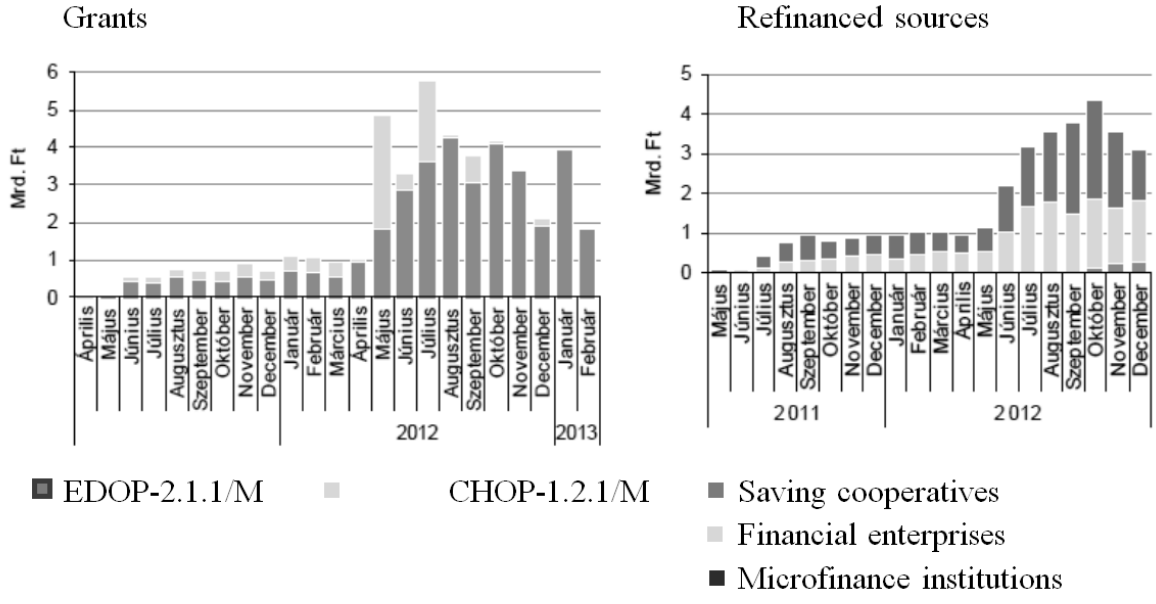

Figure 4: Combined Microcredit Grants and Loans
Source: Figures from the Venture Finance Hungary, 25 Feb 2013 and compiled by the author.

ously there is a need for guidance and clarification in order to protect against double funding in the same investment.

Hungarian Case

In the Hungarian case the expenditure related to one operation is financed by a grant, a loan and by own resources of the final recipient. Accordingly we have had to examine whether that combined micro loan facility is meeting or not the above listed conditions:

Ad a) In the Hungarian case calls for repayable assistance and loan products were published separately under separate priorities and in separate calls. Grants and loan transactions are managed by separate organizations. Grants are managed by MAG Zrt. and loans are managed by the financial intermediaries accredited by MV Zrt. Two separate contracts are concluded with two separate financial mechanisms, one for the loan and another for the grant.

Ad b) The loan is approved first; whether or not grant can be awarded is decided on subsequently. If the loan application is rejected, it means the automatic rejection of the grant. Likewise, loans are disbursed first (which pre-supposes that the relevant application for grant has been approved and an assistance document has been issued). Subsequently, and subsequent to the implementation of the project, once the supporting accounting documents and invoices submitted by the final recipient have been checked and cleared and accounting has been approved, the grant is disbursed.

Ad c) Based on the calls for applications, the grant cannot exceed 45% of the tender project value or HUF 10 million. Loan cannot exceed 60% of the tender project value or HUF 20 million. The amount of grant cannot exceed that of loan. Application requirements stipulate that applicants make 10% own contribution available which cannot be financed by any other subsidized loan. The financial module of the account management system automatically calculates the amount of the disbursable grant where the actual costs of the project are established based on the invoices submitted. The system automatically separates the amount of 10% own contribution (stating it as own contribution) and then deducts the subsidized repayable assistance. The remaining amount can be disbursed as grant up to the approved sum specified in the sponsor's document.

Ad d) The investment is implemented on the basis of two separate priorities and two separate calls for applications, i.e. in two separate operations.

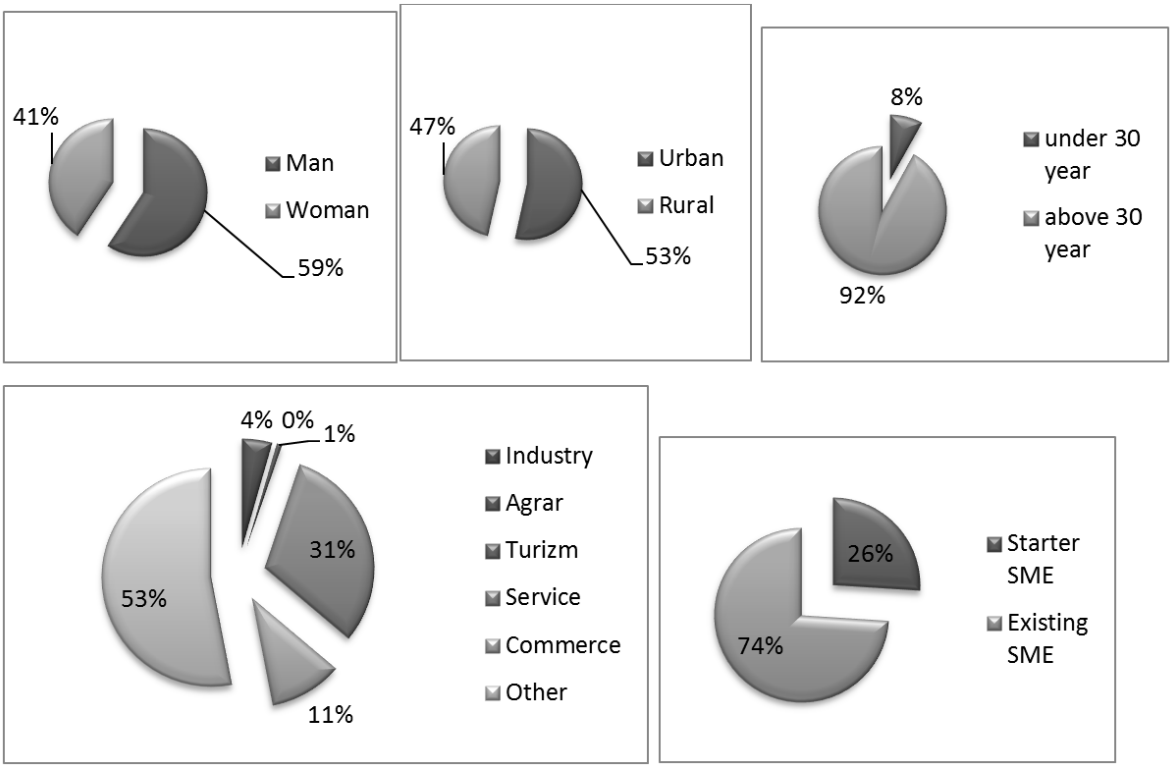

Figure 5: Breakdown of the Combined Microcredit Beneficiaries
Source: Figures from the CREDINFO IT system, used by all local foundations for enterprise promotion (16) and by 14 financial enterprises and compiled by the author.

Ad e) A pre-condition for the award of both the loan and the grant is a declaration by the final recipient on the small-amount assistance it received in the current fiscal year and the previous two years. Assistance/loan is awarded only after the entity providing the assistance has satisfied itself that the threshold value has not been exceeded.

In conclusion, there is no double or over-financing of the same eligible expenditure or of the same piece of investment and all the other conditions for the combination of grants and loans are also met. The procedure employed ensures that the total eligible expenditure under the two schemes (FI and grants) never exceeds 100% of the investment.[27] Consequently the Hungarian combined micro-loans comply with both EU and Hungarian legislative requirements and the very process of processing the applications rules out both over- and double financing. Also the Commission's auditors agreed that the Hungarian authorities have provided sufficient justifications to conclude that all the conditions allowing receipt of a grant and a repayable assistance falling under a FEI for the same physical piece of investment were met.

Another audit issue is concerning the selection procedure of financial intermediaries. The main issue is whether we have an obligation to use public procurement for selection of financial intermediaries or not. According to the cohesion policy regulation we have to follow "*open, transparent, proportionate and non-discriminatory procedures, avoiding conflicts of interest*" – which would allow for normal

27 In this context it should be noted that double financing does not occur as for the operational programme ERDF co-financing is provided on the basis of the public costs. This practically means that if there were two projects (one loan and one grant) both with €100 total eligible expenditure and with 45% financing rate the actual total ERDF contribution would amount to €76.5 (2X €45(public cost)*85% (ERDF co-financing)) for the two projects. If the system was changed to the total cost system the ERDF contribution could potentially increase to €170 (2X €100(total cost)*85% (ERDF co-financing)).

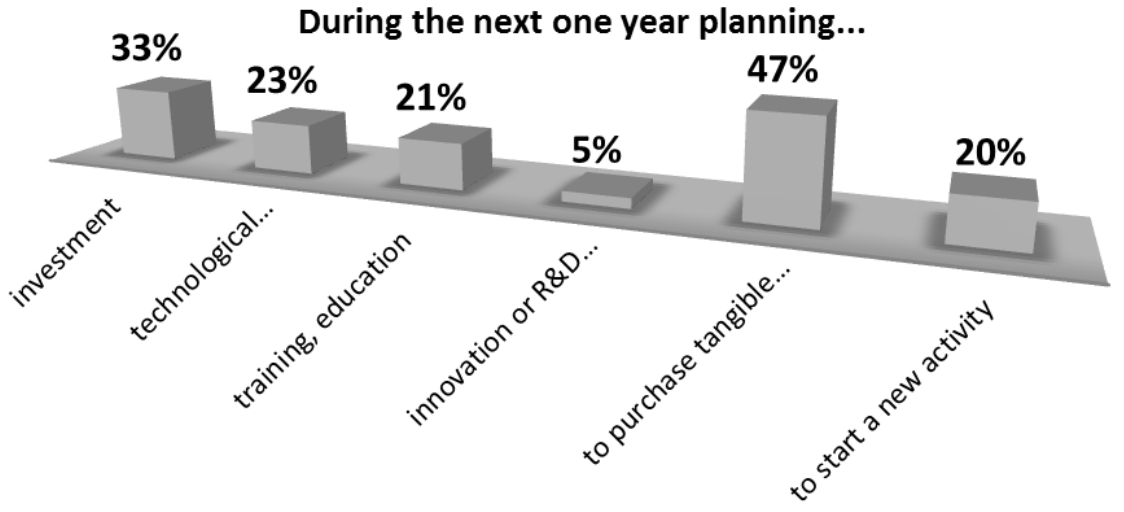

Figure 6: Rate of the Beneficiary SMEs Planning Different Future Development Activities
Source: Figures from the result of the survey by carried out by the FEA "Social Impact Assessment of Microcredit Questionnaire" and compiled by the author.

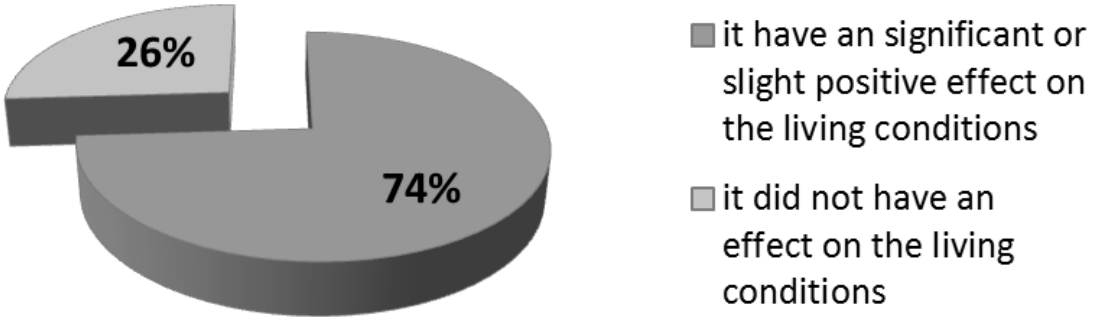

Figure 7: How the Combined Microcredit of FEA Helped to Improve the Living Conditions?
Source: Figures from the result of the survey by carried out by the FEA "Social Impact Assessment of Microcredit Questionnaire" and compiled by the author.

calls for proposals without public procurement. But the Commission is recently heavily hinting that we better use the public procurement rules. This is a different interpretation that was applied in programming period 2007-2013 when numerous Member States selected the financial intermediaries in open tender procedures and not as a result of public procurement process. Naturally the managers of FEI (financial intermediaries) should be selected through an open, transparent and non-discriminatory procedure. However, a public procurement procedure for the selection of financial intermediaries may in many ways potentially decrease efficiency of the implementation of FIs, because amendments to terms and conditions of FIs during the implementation-period (potentially 15 years) cannot be handled under inflexible service contract conditions and it could cause significant implementation issues for private

Figure 8: Access to Finance for SME-s in Hungary (2011 versus 2013)
Source: 2013, 2014 SBA Fact Sheets, European Commission.

investors and final recipients. Hungary – as described before - is working with a widespread external intermediary network in the case of JEREMIE and with the use of public procurement it will be one winner only. Also the mandatory use of public procurement is legally questionable. Depending on the structure of the implementation mechanism the definition of the public procurement's subject is not easily clarified, especially if the contracting authority is not the paying one and instead of services rather co-investments are the main element of the contract (as in the Hungarian case). However the main principles of public procurement can also be applied by using an open, transparent, proportionate and non-discrimination selection procedure as provided by the Common Provisions Regulation[28] (CPR).

There is need for clarification on a lot of issues which are strongly affecting the implementation of FIs.

Based on the data until 2013 the Hungarian SME sector did not manage to fully recover from the initial shock of the crisis in 2008 and has been sluggish since 2009. However the overall ranking of Hungary in access to finance for SMEs is in line with the EU average[29] mostly due to specific financing schemes. Despite all this, the financing situation for most SMEs remains difficult. Access to bank loans has gradually improved, but it has also become more expensive.[30] 28% of SMEs in Hungary reported that banks are less willing to grant loans, as against 26% for the EU. The 2014-2020 FIs, especially the combined micro-loan can help to improve this situation (see *Figure 8*).

Hungary is planning to use 60% of the European Structural and Investment (ESI) Funds sources to support SMEs and also to provide the SMEs adequate access to funding even if the market actors are not sufficiently motivated to do that yet. The planned tools of the FIs are i) credit, leasing and factoring, ***ii) combined products***, iii) venture capital programmes and iv) guarantee instruments.

IV. Cohesion Policy 2014-2020

The new regulation puts increasing importance on the use of FIs which are to become more important in 2014-2020 as a more efficient alternative to traditional grant based financing and aim to increase the flexibility, taking into account national and sector specificities, improve the coherence and consistency between instruments, raise visibility and transparency, and to reduce the number of instruments to ensure a sufficient critical mass in a context where the

28 Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (CPR).

29 According to 2014 SBA Fact Sheets, <http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2014/hungary_en.pdf>.

30 While the interest rate differential between smaller loans of less than €1 million — mostly for SMEs — and larger loans remains smaller in Hungary than in the EU, this mark-up increased from 12 % in 2007 to almost 19 % in 2013.

	2007-2013	2014-2020
Scope	Support for enterprises, urban development, energy efficiency and renewable energies in building sector	Support for all thematic objectives covered under a programme
Set-up	Voluntary gap analysis for enterprises and at the level of Holding fund	Compulsory ex-ante assessment
Implementation options	Financial instruments at national or regional level – tailor made only	Financial instruments at national, regional level, transnational or cross-border level: Tailor-made OR off-the-shelf OR MA loans/guarantees Contribution to EU level instruments
Payments	Possibility to declare to the Commission 100% of the amount paid to fund – not linked to disbursements to final recipients	Phased payments linked to disbursements to final recipients National co-financing which is expected to be paid can be included in the request for the interim payment
Management costs and fees, interest, resources returned, legacy	Legal basis set out in successive amendments of the regulations and recommendations/interpretations set out in three COCOF notes	Full provisions set out from outset in basic, delegated and implementing acts
Reporting	Compulsory reporting only from 2011 onwards, on a limited range of indicators	Compulsory reporting from the outset, on a range of indicators linked to the financial regulation.

Table 5: Changes on FI Regulation Relating to the ERDF and ESF
Source: Financial Instruments in ESIF programmes 2014-2020 - A short reference guide for Managing Authorities, European Commission.

amount of funding available is scattered across a large number of regions and recipients. The regulatory texts on FIs for the 2014-2020 period show that the legislators have attempted to address many of the challenges that have arisen in this programming period in the regulatory provisions. These include a number of modifications that directly address issues raised by managing authorities and the European Court of Auditors.[31]

The specific provisions on FIs are set out in the Common Provisions Regulation and the delegated and implementing acts linked to the relevant articles of this regulation. Other relevant provisions for FIs (e.g. information on priorities/measures, co-financing, eligible expenditure etc.) can be found in the fund-specific regulations and applicable horizontal regulations (see *Table 5*).

Any FI supported by the ESIF must be in compliance with the relevant programme, its objectives under priorities (and focus areas for EAFRD); eligibility rules (under measures for EAFRD); expenditure related provisions; co-financing elements; monitoring and reporting requirements.

The regulation also frequently references the need to ensure compliance with State aid requirements and there is some clarification on management fees and costs (with further provisions to be included in the secondary legislation) as well as the use of revolving resources.

While preparing their future OPs, Member States need to think about how to build up FIs. A greater use of FIs should be accompanied by quality assess-

31 For example revised provisions relating to the *ex-ante* evaluations that must be undertaken before FIs are established in the OPs. It has been made clear that *ex-ante* evaluations will tie the findings related to market gaps more closely into the objectives and priorities of the OPs, and will include more information on what type of financial products should be put in place.

ments of SME financing gaps, reinforced attention to ensure added value and requirements for leverage from the private sector, more synergies between ESI Funds, as well as proper systems that allow compliance with EU rules. It will be also important to give due attention to consideration of economies of scale and critical mass, where relevant.

The CPR makes it clear that more types of combination will be possible: Combination of different programme contributions and different funds in one FI, combination of FIs and grants and other forms of assistance. Advantage of the combination of funds from different sources in one FI can be the achievement of critical mass and economies of scale as well as a wider spectrum of policy objectives.

However, as Hungarians use to say, the devil lives in the details. The Commission intend to release guidance on different issues linked to FIs and after examination of the first drafts these documents seem to be more restrictive than the regulation.

In the draft of "Guidance for Member States and Programme Authorities on Combination of Support from a FI with Other Support"[32] the Commission presented two types of combination of support: Within a FI operation (a single operation) and at the level of the final recipient (combination two separate operations). One of the main critics of the Member States is that the Commission's draft guidelines go beyond the scope of the regulatory provisions e.g. by limiting the grant-component amount only to the financial costs, requiring all the capital to be covered by a FI only or by introducing an additional condition excluding the possibility to pay any grant component directly to final recipients in the case of combining the grant with a FI[33] or by requiring that distinct eligible expenditure have to be defined for combination of grants and FIs when the combination is done through two separate operations (point 3.1.2 of the draft of the Guidance) within the same priority axis...etc.

I do not share the Commission's interpretation of CPR 37(7), according to which in case of combination of FIs with grants, the combined product cannot be managed within one operation. The CPR uses the term "including" for the specifications (interest rate subsidy, guarantee fee subsidy, technical support), which does not exclude other cases such as grant or capital rebate to be used as a part of FI within a single operation. In my interpretation grants can also be combined with FIs within one operation if - in line with the regulations - they (1) directly relate to the FI and (2) final recipients are the same. According to the legal text the two types of combination can be separated on the basis of these two conditions and not on the basis of the form of support. Also the Commission's restrictive interpretation that under the EU regulation national co-financing cannot be provided by the final recipient[34] is not really justified: CPR Art. 38(9) explicitly allow providing national public and private contribution at the level of final recipient.

Despite it was a clear intention of the legislator to make it possible to combine grants with loans or other FIs in a simple way avoiding the need to artificially split expenditure into sub-operations, I think that the draft guidelines do not provide any encouragement to use the simplest option and without proper legal basis try to restrict combination to only those cases where the option of covering the same expenditure item explicitly provided by Art. 37(9) is not used. However, artificially splitting an investment into 2 parts with distinct eligible expenditure, one of them benefiting from a FI and the other from a grant is too complex, destroys transparency, creates audit risks and in several cases defeats the whole purpose of combination: It is no longer any real combination, but two separate streams for two separate sub-investments.

Evidently, the main difference in the 2007-2013 and 2014-2020 regulation is that while in the 2007-2013 period we had short and limited rules and lately few guidance on FEIs which gave a lot of space for manoeuvre for the Member States, in the 2014-2020 period we will have more sophisticated regulation with several guidance on FIs which are not always in line with the current Member States practises. However one of the main issues is timing, because for the preparation of efficient FIs we need all the relevant information and documents in time. Above all enhancing of combined microcredit have

32 EGESIF_15_0012_00; European Comission, European Structural and Investment Funds, Draft: Guidance for Member States and Programme Authorities on Combination of support from a Financial Instrument with other support; dated: 01/04/2015.

33 *"The support is for the benefit of final recipients but it is not directly paid to the final recipient"* (point 3.1) - this condition derives neither from Art. 37(7) nor Art. 42(1)(a) of the CPR.

34 *"the own contribution by the final recipient cannot be declared as eligible expenditure under the financial instrument operation, because in accordance with Article 42(1)(a) eligible expenditure is the payment to the final recipient".*

to rely on increasing legal certainty for all parties through proper and timely rules on FIs and guidance by the European Commission.

V. Conclusion

The recent EU Budget Review as well as the new Investment Plan for Europe noted that FIs could provide an important new financing mechanism for strategic investments by attracting co-investment from other public and private sector sources in order to achieve EU policy goals more efficiently. Within cohesion policy it is proposed that FIs are able to cover a wider range of policy areas and that there is a greater flexibility in relation to establishing and implementing FIs. However, before the launch of the next period's FIs it is recommended to analyse the intermediary institutional system closely and the operation of the scheme's built-in control mechanisms; to closer coordinate control and monitoring activities; and to further simplify the procedures.

Based on the positive experiences of the combined products, it is recommended to further strengthen the role of such products during the 2014-2020 programming period by introducing new combined schemes. In addition to policy and absorption goals this may foster entrepreneurial culture through the mandatory use of FIs. It would also recommended to include the non-refundable and the FI components of such combined schemes into one priority, which would give more flexibility for the fine-tuning the programme during its progress. But first of all we need clear situation about the regulatory environment with clear guidelines also regarding the combination of repayable FIs and grants in order to accelerate its implementation. It would present unacceptable risk for the Member States to establish a FI without the knowledge of the exact legal conditions at the start of the period.