

# LIETUVOS TEISINĖS IR FINANSINĖS SISTEMOS TINKAMUMO SVV PLĖTRAI SKIRTŲ FINANSINĖS INŽINERIJOS PRIEMONIŲ, FINANSUOJAMŲ IŠ ES STRUKTŪRINIŲ FONDŲ LĖŠŲ, STEIGIMUI IR ĮGYVENDINIMUI VERTINIMAS

## Summary

### Legislation regulating the setting up of financial engineering instruments

**Conception. EU regulations.** Financial engineering instruments funded from EU structural funds and the state budget is a new assistance instrument of the Structural Funds in Lithuania. The funds used for financial engineering instruments are repayable funds that are allocated not by way of subsidies, but by lending funds, providing guarantees, and investing funds in other ways.

The concept of financial engineering instruments was not in use in legal acts until 2006. This concept began to be used after the EU Structural Funds Regulation and the Implementing Regulation (the main EU legal regulations governing the use of Structural Funds by setting up financial engineering instruments) came in force. According to the Implementing Regulation, financial engineering instruments shall apply in the form of actions which make repayable investments, or provide guarantees for repayable investments, or both<sup>1</sup>. Meanwhile the EU Structural Funds Regulation provides a more detailed definition stating that financial engineering instruments may include venture capital funds, guarantee funds, and loan funds.

Prior to the 2007–2013 programming period, the following three financial engineering instruments were established in Lithuanian legislation – provision of micro-credits, guarantees and investment of venture capital funds to assist small and medium size companies. It should be noted that only two of these instruments were implemented – INVEGA guarantees and micro-credits.

Current version of the Law on Small and Medium Size Business Development stipulates several forms of assistance to SMEs using financial engineering instruments: granting of soft loans, provision of very small loans, provision of guarantees, credit insurance, and venture capital investment<sup>2</sup>. The following financial engineering instruments related to the development of SMEs operate in practice in Lithuania today:

- 1) Invega Fund (manager – INVEGA, contract signed on 7 April 2009) offers two instruments: Small Credit Scheme and Open Credit Fund.
- 2) JEREMIE Holding Fund (manager – EIF, contract signed on 1 October 2008) offers four instruments: Credit Scheme; Venture Capital Funds; Business Angels Co-Investment Fund; and Portfolio Guarantees.
- 3) Guarantee Fund (manager – INVEGA, contract signed on 31 August 2009) offers one instrument: Guarantee Fund Financing.
- 4) Entrepreneurship Promotion Fund (manager – INVEGA, contract signed on 30 December 2009) offers one instrument: Entrepreneurship Promotion by Providing Micro-Credits.

**National regulation.** Prior to the 2007–2013 programming period, financial engineering instruments were regulated in national legislation. Prior to this period, the use of financial engineering instruments for promotion of small and medium size businesses was established in the legal acts of the Republic of Lithuania and also in the Law on SMEs, subsequently, strategic trends and measures for implementing the instruments stipulated in the law were adopted by Government resolutions and Ministerial decrees. One of the key documents is decree No. 1K-334 of 24 October 2008 of the Minister of Finance of the Republic of Lithuania adopting the Rules for the Administration and Funding of Financial Engineering Instruments. These legal acts are currently the main national legal acts that regulate the setting up of financial engineering instruments in Lithuania.

**Compatibility with EU law.** In essence, provisions of Lithuanian national legal regulations are compatible with the provisions of EU regulations on the use of EU Structural Funds which stipulate the

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<sup>1</sup> Commission Regulation (EC) No 1828/2006 (Implementing Regulation) Article 43 (1).

<sup>2</sup> Please note that the author provides an exhaustive list of financial assistance instruments, whereas the EU Structural Fund Regulation does not provide such a list.

setting up of financial engineering instruments. However, due to the fact that the EU Structural Funds Regulation and the Implementing Regulation regulate the setting up of financial engineering instruments in a rather abstract manner, the Republic of Lithuania has far-ranging opportunities to regulate the issues for setting up financial engineering instruments within the framework of EU law. It should also be noted that there are several issues that are not regulated by either EU regulations or Lithuanian legal acts in detail. Therefore, it is essential to resolve incompatibilities of regulation and to interpret the provisions of national and EU legal acts correctly and uniformly.

**The use of different concepts.** One of the mentioned incompatibilities of regulation is the use of different concepts in national and EU legal acts.

In the Rules for the Administration and Funding of Financial Engineering Instruments, the terms “financial engineering instruments” and “beneficiary” are used as different concepts. According to the guidelines for financial engineering, the beneficiary is the financial engineering instrument itself. Even though this does not directly contravene the Implementing Regulation, however it may determine a different interpretation of the texts (as discussed below). This must be considered when developing national regulations and implementing financial engineering instruments.

In the Rules for the Administration and Funding of Financial Engineering Instruments, the concept of a manager of the financial engineering instrument is used, whereas such concept is absent from the Structural Funds Regulation or the Implementing Regulation. Such regulation determines a different interpretation of the legal acts, particularly when analysing the possibility to perform an intermediary review of the financial engineering project in order to allocate another holding fund manager provided in the Rules for the Administration and Funding of Financial Engineering Instruments. This possibility is not clearly established in EU legal acts; the EU Structural Funds Regulation and the Implementing Regulation use only the concept of a financial engineering instrument, but not of a manager of the financial engineering instrument. The risk therefore exists that once the manager of the financial engineering instrument is changed, from point of view of the European Union regulations it will be considered that the financial engineering instrument was also changed. If this were to happen it would mean that the funds which would be presented to the Commission as spent and subsequently refinanced by the Commission, would be withdrawn and transferred to a new financial engineering instrument. Such a change could result in a violation of the Community legal acts. In case the EU Structural Funds Regulation and the Implementing Regulation were interpreted in this manner, the first fund had to be closed and a new one had to be set up, but this would not be practical. Despite a change of the manager of the financial engineering instrument, the funds of the financial engineering instrument are not actually repaid to the state, but are allocated to the financial engineering instrument having the same goal alike the previous one; we could say that the EU regulations would not be breached if the manager of the financial engineering instrument changes without either changing the goals for which the financial engineering instrument is intended or the final beneficiaries of the financial engineering instrument. It is recommended that a decision be adopted on this matter only after receiving a positive EC position (the EC position may be expressed in the guidelines for action regarding the JEREMIE Fund scheduled for issue in November this year).

**Insufficient regulation.** Another problem related to regulation of financial engineering instrument is insufficient regulation of some significant issues both on the national and EU level.

**Regulation of repayable funds.** National legal acts insufficiently regulate proper re-use of funds which will be repaid to the holding fund and independent financial engineering instruments. The Rules for the Administration and Funding of Financial Engineering Instruments stipulate that the obligation of the institutions which perform the selection of managers of the financial engineering instruments is to ensure that *“the funds repaid when implementing financial engineering instruments, as stipulated in Article 78(7) of Regulation 1083/2006, would be re-used for the same goals.”* Even though these issues are partially discussed in financing agreements, it is recommended that the re-use of funds is governed by legal acts, because inadequate re-use of funds would mean inadequate implementation of EU legal regulations. In addition, inadequate use of funds and therefore the possibility to interpret the Law on Management, Use, and Disposal of State-Owned and Municipal Property and the Law on Budget Structure of the Republic of Lithuania differently could prevent further successful use of funds. In order to eliminate legal uncertainty regarding the status of funds at the end of the operational programme, we recommend including in the Law on Budget Structure of the Republic of Lithuania a provision stating that the funds used for setting up financial engineering instruments and constituting the assets of a holding fund shall not be repaid to the

budget, but are used in the manner prescribed in the financing agreement with the holding fund manager or by the Government or its authorised institution without prejudice to the applicable EU legal acts. The Ministry of Finance, as the institution authorised by the Government of the Republic of Lithuania, prior to the end of the operational programme and having analysed a further need for the funds, should identify specific ways how the funds should be used (in the form of financial engineering instruments or subsidies). In order to ensure adequate compliance with EU legal regulations, we recommend establishing that before the funds are finally used, they must be accounted for in such a way that it would be possible to segregate such funds from other funds. In this way further legitimacy of the use of the funds as well as opportunities for the efficient use of funds would be ensured.

As has been mentioned, detailed regulation of infringement procedures must be ensured in national legislation as currently they are ambiguous<sup>3</sup>. Regulation of infringement procedures related to the financial engineering instruments must be more detailed and include provisions that the loans, guarantees or invested venture capital granted unjustifiably should be subject to a subsidy equivalent which must be repaid together with the total unjustifiably granted amount (in the event of loan and venture capital).

It should be noted that the EU legislation does not regulate clearly the re-use of returned funds. At the final closure, eligible expenditure is considered to be use of funds via financial engineering instruments<sup>4</sup>. The EU Structural Fund Regulation defines eligible expenditure as the funds used by way of financial engineering instruments for the first time, i.e., the funds are invested in enterprises, provided as guarantees to enterprises or lent to them. Considering that the final beneficiary of the EU Structural Fund projects is considered the holding fund or an independent financial engineering instrument, in the meaning of the national law, funds should also be considered eligible expenditure at the same time, i.e., when these funds of financial engineering instruments are used for SMEs entities. Returned funds must be used for the same goals, however the exact method of use is left to the discretion of the Member State. It is worth noting that the EU legislation only requires that the returned resources of financial engineering instruments intended for assistance to SMEs be used for the benefit of SMEs<sup>5</sup>. A mandatory demand to use these resources via financial engineering instruments is absent; therefore we are of the opinion that other methods for using returned resources are available provided they are allocated to SMEs. However, even if such requirement is absent, considering that there are no clear criteria how to use the returned funds to the benefit of SMEs, the risk of irregularities can only be eliminated if funding is continued via the same financial engineering instruments. Neither is there a clear answer in the EU legislation as to whether funds repaid prior to the end of the programming period would become national funds.

**Regulation for setting up and administering financial engineering instruments.** National legislation also fails to provide clear regulations with respect to setting up and administering financial engineering instruments.

According to EU legislation the financial engineering instruments, including holding funds are provided, may be set up in the following manner:

- 1) Financial engineering instruments, including holding funds, shall be set up as independent legal entities governed by agreements between the co-financing partners or shareholders, or
- 2) Financial engineering instruments, including holding funds, shall be set up as a separate block of finance within a financial institution (in the financial agencies in Lithuanian law).

The same legal forms of financial engineering instruments are provided both in the legislation of the Republic of Lithuania and in the European Union legislation.

**Independent legal entity.** According to national legislation, when setting up a financial engineering instrument, including a holding fund as a separate legal entity, the recommended forms of legal status are a limited partnership, an investment company (a public limited company) or a private limited company. Other

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<sup>3</sup> Decree No. 590 of 30 May 2005 of the Government 'On approval of the rules for repayment into the budget of the republic of Lithuania the financial aid paid out and/or used by violating legal acts' (*Official Gazette*, 2005, No. 69-2469; *Official Gazette*, 2008, No. 55-2077; *Official Gazette*, 2010, No. 33-1570) is ambiguous. According to Clause 5, the funds must be repaid only when (i) the violation was committed by the administering or implementing institution or (ii) the beneficiary of the project. Pursuant to this clause, we may conclude that any violation committed by the end beneficiary does is excluded from these rules and that the relationship with the financial engineering instrument is regulated on the basis of a mutual agreement. However, the majority of subclauses of Clause 24.1 mention the end beneficiary.

<sup>4</sup> Council Regulation No. 1083/2006 (EU Structural Fund Regulation), Article 78 (6).

<sup>5</sup> *Ibid*, Article 78 (7).

forms of legal status of entities would not ensure proper implementation of the manager's functions and efficient attraction of private investment.

It should be noted that according to the Law on Management, Use, and Disposal of State-Owned and Municipal Property, the list of entities in which it is allowed to invest state funds does not contain limited partnerships as entities performing the function of collective investment. It is assumed that for this reason the possibilities for setting up financial engineering instruments provided for in the EU legislation has been excessively constricted in the national legislation by eliminating the legal entity which by nature is suitable to manage and use state funds. It should be noted that according to the law of the Republic of Lithuania as currently in force, limited partnerships are managed by its full members who are liable to the extent of all their property for the obligations of the limited partnership. Unlimited liability is not acceptable to many professional entities which comply with the requirements for competence allowed for managing limited partnerships and using funds allocated for financial engineering instruments.

In view of the above, we recommend including in the exhaustive list of entities in which it is allowed to invest state funds, provided in the Law on Management, Use, and Disposal of the State-Owned and Municipal Property, a provision which would allow investment in limited partnerships and to stipulate in the Law on Partnerships of the Republic of Lithuania that one full member is sufficient to establish a limited partnership and that the member-partner has the right to participate in decision-making regarding investment policy of the funds of the limited partnership.

Funds to independent legal entities, state institutions, and appropriation managers may be provided as appropriations according to the Law on Budget Structure of the Republic of Lithuania for the implementation of a specific budget programme. After transferring funds as appropriations, the provisions of the Law on Management, Use, and Disposal of State-Owned and Municipal Property would not be applied since the Law on Budget Structure of the Republic of Lithuania supersedes the Law on Management, Use, and Disposal of State-Owned and Municipal Property due to the fact that the previous law regulates special matters and the funds transferred to a financial engineering instrument would be used for the implementation of state-funded programmes.

**Block of finance.** The financial engineering instrument, including a holding fund, as a block of finance in a financial institution, could be established as either an investment fund (a block of finance administered by the manager in trust) or the block of finance could be governed by agreements without establishing a separate entity regulated by the law.

The form of administration of block of finance depends on how the funds were provided, i.e., whether this was done on the basis of the Law on Public Procurement of the Republic of Lithuania or as a financial grant. If the funds have been provided as a financial grant, the block of finance may be established either as an investment fund or provided in trust. If the block of finance has been transferred on the basis of the procedures stipulated in the Law on Public Procurement of the Republic of Lithuania, the procurement of the fund management services may also be subject to public procurement procedures. Following the general rule, an appropriation may be made only if the block of finance is governed by agreements without establishing a separate entity regulated by law. In this case the funds are owned by the entity which manages the funds; meanwhile if the funds are provided to an investment fund, the rules for investing state funds according to the Law on Management, Use, and Disposal of State-Owned and Municipal Property should apply.

In view of the above, it is recommended allocating funds to a holding fund (i) as an appropriation when the financial engineering instrument is organised as a block of finance – the manager of the financial engineering instrument, as stipulated in the law on Budget Structure of the Republic of Lithuania, will in this case not be the manager of appropriations (ii) as an investment according to the Law on Management, Use, and Disposal of State-Owned and Municipal Property – when a separate legal entity is established.

**Implementation via individual financial engineering instruments.** The rules for setting up and administering financial engineering instruments stipulate that financial engineering instruments may be implemented via a holding fund or as individual financial engineering instruments. The forms for implementing financial engineering instruments selected by other than the holding fund are not regulated by the EU legislation. For this reason, following the principle of subsidiarity established in the Treaty, the legislator of the Republic of Lithuania has the right to prescribe the implementation of the financial engineering instruments by other than via the holding funds. Such separation between the implementation of

financial engineering instruments via a holding fund on the one hand and the implementation of a separate financial engineering instrument on the other hand is also observed in national legal acts.

**Implementation via a holding fund.** The Lithuanian law defines a holding fund as a fund for investing several financial engineering instruments controlled by the manager as it is defined in the EU Structural Fund Regulation. Meanwhile, the structure of rules used in the EU Structural Fund Regulation does not provide for strict separation of the holding fund from the holding fund manager as two separate entities.

**Managers of financial engineering instruments.** According to the Lithuanian law, EIB, EIF, financial institutions, and other legal entities can be managers of financial engineering instruments. Private individuals cannot be appointed managers of financial engineering instruments. The requirement laid down in the Lithuanian law that a legal entity must be appointed the manager of both a holding fund and an individual financial engineering instrument is based on a practical appraisal of the operation capacities and competencies of the entity and the national regulation, therefore it shall not be considered as restricting the possibilities stipulated in the EU legislation for selection of the manager of a holding fund and an individual financial engineering instrument.

**Management selection procedure.** The general rule for selecting the holding fund manager is via a public procurement procedure on the basis of the Law on Public Procurement. Another method for implementing a holding fund is by direct allocation of the financial grant to EIB, EIF or a financial institution, if the contract is not considered a contract for public services. The manager of an individual financial engineering instrument may be an entity, including a financial institution, which complies with the criteria established by the Supervisory Committee, chosen by way of selection that is organised according to the provisions for public procurement if any such provisions are applicable in a particular case.

The contracts concluded between INVEGA and the Ministry of Economy (and the Ministry of Finance) regarding the administration of funding programmes for SMEs cannot be considered contracts for public services, because they do not comply with the objective for concluding such a contract as stipulated in the Law on public Procurement of the Republic of Lithuania, i.e. the objective of economic benefit for the parties of the contract. The pecuniary interest of the contracts is not related with economic benefit for INVEGA, but only with the compensation to INVEGA for implementation of the functions allocated by the law. Considering such interpretation of the provisions of the Law on Public Procurement, INVEGA may also be appointed the financial institution for implementing financial engineering instruments according to the EU Structural Fund Regulation. This regulation establishes that if Member States are satisfied that public procurement law is not applicable, the definition of the tasks of the EIF and EIB justify Member States awarding them a financial grant, i.e. a direct financial contribution from operational programmes by way of donation. Under the same conditions, national law may provide for the possibility of awarding a financial grant to other financial institutions without a call for proposal. We think that it were possible to apply the said provision of the EU Structural Fund Regulation without any risk, i.e. to assign INVEGA implementation of financial engineering instruments without a call for proposal, if the Law on Public Procurement of the Republic of Lithuania or other legal act, e.g., the Law on Small and Medium Size Business, clearly stipulated such a possibility for a state institution whose area of responsibility is implementation of the relevant instrument. Regardless of what has been said, it should be noted that the existing legal regulation allows us to conclude that the possibility stipulated in the EU Structural Fund Regulation to establish selection of financial institutions for providing financial grants without a call for proposal has been implemented in national legislation.

INVEGA implements financial engineering instruments (except guarantees) with the help of credit institutions. Since INVEGA complies with the requirements for the purchasing body stipulated in the Law on Public Procurement of the Republic of Lithuania, it must organise procurement of goods, services and works according to the procedure prescribed in the said law. When organising the procurement of goods, services and works, INVEGA must observe the procedures stipulated in the Law on Public Procurement of the Republic of Lithuania and select one of the methods for procurement stipulated in the law.

So far, for implementing loan financial engineering instruments credit institutions have been selected on the basis of calls for proposals for credit institutions (commercial banks), conducted according to the procedures adopted for implementation of individual instruments. Tied loan contracts were concluded with intermediaries selected during the calls for proposals. According to the contracts, financial intermediaries undertake to use funds allocated to them in the manner stipulated in the contracts for implementation of financial engineering instruments. Tied loan contracts, according to the Law on Public Procurement of the Republic of Lithuania, are not considered public procurement contracts, because granting of a loan in its

essence is not related to the acquisition of goods, services or works. Yet considering the nature of tied loan contracts, there is a risk that the procedure for concluding contracts stipulated in the Law on Public Procurement of the Republic of Lithuania may be applicable to transactions with financial intermediaries, because, firstly, INVEGA is a purchasing organisation and financial intermediaries in the meaning of the Law on Public Procurement of the Republic of Lithuania are considered to be suppliers. Secondly, INVEGA gets direct economic benefit in the form of interest for tied loans. Meanwhile, the economic benefit of financial intermediaries includes a possibility to receive income from SMEs receiving loans. Thirdly, even though formally no services are acquired from financial intermediaries, according to tied loan contracts, financial intermediaries provide services related to implementation of financial engineering instruments, e.g., they lend funds to SMEs. In other words, the tied loan contracts, which regulate the use of the loan in detail and establish obligations of the financial intermediaries related to implementation of financial engineering instruments, also presuppose obligations of financial intermediaries with respect to the provision of services.

Even in the cases when the Law on Public Procurement of the Republic of Lithuania does not apply to INVEGA operations, by acquiring services INVEGA must ensure that the services have been acquired by way of a call for proposal, whereby the conditions and appraisal criteria of the proposals are non-discriminatory, objective, and transparent. It is therefore ensured that the credit institutions used for the implementation of financial engineering instruments do not receive unjustified benefit that can be treated as state assistance. In addition, competition of credit institutions is ensured and INVEGA has an opportunity to acquire services under the most favourable conditions. As far as the selection of commercial banks implementing a certain instrument is concerned, selection conditions in all cases have been the same. In view of this and the fact that the calls for proposals were open to all commercial banks operating in Lithuania and the same requirements were applied to applicants, such calls for proposals in our opinion complied with the non-discriminatory, objective, and transparent criteria.

In view of the above reasons, it is recommended that services from third parties (including the services of financial intermediaries) required for INVEGA to implement financial engineering instruments for which it is responsible, shall be purchased by INVEGA in the manner prescribed in the Law on Public Procurement of the Republic of Lithuania.

Current version of the Law on Public Procurement of the Republic of Lithuania provides an opportunity to involve financial intermediaries in the implementation of financial engineering instruments in the same way as has been done so far, because the law stipulates both the possibility to conclude contracts with several suppliers and to define the object of procurement in a flexible way which is important when purchasing services of financial intermediaries related to the implementation of financial engineering instruments. The Law on Public Procurement of the Republic of Lithuania provides an opportunity to conclude contracts with several suppliers if the object of procurement is subdivided into several parts. Procurement conditions may also establish restrictions as to how many parts it is allowed to submit a proposal for or that one tenderer may submit proposals only for one part of the object of procurement.

The object of procurement must be defined according to the principles laid down in the Law on Public Procurement of the Republic of Lithuania, however, it may not necessarily be precisely specified in the tender documents. The Law on Public Procurement of the Republic of Lithuania stipulates that technical specification may be prepared (i.e. the object of procurement may be defined) by: (1) specifying the standard, technical certification or providing general technical specifications; (2) describing the expected result or functional requirements; and (3) describing the object of procurement as a combination of technical specifications, expected result or functional qualities. Accordingly, the object of procurement may be defined flexibly, including a possibility to define the object of procurement without specifying the scope.

**Surplus regulation.** The majority of provisions of the Rules for Administration and Funding of Financial Engineering Instruments either directly repeat other legal acts or make references to them. Therefore in the event of any amendments to these legal acts e.g., the Implementing Regulation, prior to equivalent amendments to the rules, they would be incompatible with EU legislation. Furthermore, the structure of the rules may determine a different interpretation of the legal provisions from their interpretation according to the Regulations, therefore, the requirements of EU law would be violated. In the event of amendments to national legal acts or enactment of new acts, the Rules for Administration and Funding of Financial Engineering Instruments that have not been updated may be misleading, whereas the passing of a decree by the Minister of Economy with each amendment of any relevant legal acts would be inefficient.

Seeking to solve this problem, elimination of the provisions that repeat other provisions from the Rules for Administration and Funding of Financial Engineering Instruments should be considered. In addition, a set

of legal acts should be prepared combining all the relevant provisions of both national and EU legal regulations, i.e. all regulation on financial engineering should be provided as information.

### **The system of administration of financial engineering instruments**

Financial engineering instruments for SME development in Lithuania began to be used during the 2007–2013 EU Structural Fund support programming period, however prior to this period, small and medium size entities also had the opportunity to use financial engineering instruments funded from the budget of the Republic of Lithuania. The operation of the **system for administration of financial engineering instruments from the budget of the Republic of Lithuania for development of SMEs** is regulated by the Law on National Debt of the Republic of Lithuania<sup>6</sup>, the Law on Small and Medium Size Business Development of the Republic of Lithuania<sup>7</sup>, and Resolution No. 887 of the Government of the Republic of Lithuania ‘On small and medium size business development’<sup>8</sup>. The financial engineering instruments funded from the state budget are set up by the Government which by its resolution No. 887 ‘On small and medium size business development’ established a guarantee institution – the private limited company (UAB) ‘Investicijų ir verslo garantijos’ (INVEGA) and assigned to it implementation of financing of SME development from national appropriations. Subsequently, depending on the need, the functions of INVEGA were expanded to embrace the use of EU Structural Funds, financial engineering instruments, and possibilities to provide guarantees not only for SME loans, but also for the loans of home-owner associations of multi-apartment buildings and/or apartment owners of multi-apartment buildings and other owners implementing multi-apartment building modernisation projects. The Ministry of Economy carries out the function of founder of INVEGA and supervision of INVEGA operations.

The analysis of the system for administration of financial engineering instruments implemented from the state budget shows that each institution participating in administration has clear cut functions. However, some important stages in the system for administration of financial engineering instruments implemented from the state budget are not regulated, e.g., the implementation stage of financial engineering instruments is poorly regulated, no procedures for monitoring, control or investigation of irregularities are in place and improvement of these areas should be addressed.

During the 2007–2013 EU Structural Fund support programming period, financial engineering instruments as a method for SME promotion were more widely applied: new financial engineering instruments were adopted funded from the 2007–2013 EU Structural Fund support Operational Programme on Economic Growth and Operational Programme for Human Resource Development. Correspondingly, key EU regulations that define procedures for using EU support applied for planning, management, and control of **financial engineering instruments funded from EU structural support**, which required enactment of new national legal acts<sup>9</sup> and appointment of more institutions responsible for certain defined functions.

The Ministry of Finance participates in the system for administration of financial engineering instruments as a managing body of operational programmes responsible for regulation of administration and funding of financial engineering instruments. To summarise the functions of the managing body in the system for administration of financial engineering instruments it should be noted that compared to the general management and control system for assistance granted under the EU Structural Funds, the managing body, in this former system, fulfils certain functions which in other operational programmes are delegated to implementing bodies. E.g., functions such as the recording of information in the SFMIS about actions carried out, the preparation of cost statements and their submission to a certifying body, or the investigation of irregularities, are delegated by the managing body to implementing bodies.

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<sup>6</sup> The Law on National Debt of the Republic of Lithuania, 22 August 1996 (*Official Gazette*, 1996, No. 86-2045)

<sup>7</sup> The Law on Small and Medium Size Business Development of the Republic of Lithuania, 24 November 1998 (*Official Gazette*, 1998, Nr. 109-2993)

<sup>8</sup> Resolution No. 887 of the Government of the Republic of Lithuania ‘On small and medium size business development’, 11 July 2001 (*Official Gazette*, 2001, No. 62-2272)

<sup>9</sup> The Rules for Administration and Funding of Financial Engineering Instruments adopted by decree No. 1K-334 of 27 October 2008 of the Minister of Finance of the Republic of Lithuania (*Official Gazette*, 2008, No. 125-4765).

Planning of EU funds and national budget funds for funding financial engineering projects in accordance with operational programmes, their appendixes, and the legislation of the Republic of Lithuania and without exceeding appropriations for such programmes is delegated to the Ministry of Economy and the Ministry of Social Security and Labour as intermediary authorities. Supervisory committees are formed according to the provisions laid down in the Rules for Administration and Funding of Financial Engineering Instruments for supervision of the holding fund and financial engineering instruments implemented via the fund. The administration system also includes holding fund managers or managers of financial engineering instruments (if a holding fund is not in place) and financial intermediaries.

It should be noted that, pursuant to the Rules for Administration and Funding of Financial Engineering Instruments prepared on the basis of European Commission notes, setting up of the holding fund and its activities as well as the implementation of financial engineering instruments are considered an operation. Therefore, holding funds or managers of financial engineering instruments are in essence beneficiaries and are not formally included in the general management and control system for assistance granted under the EU Structural Funds defined in Commission Regulation (EC) No.1828/2006 and national legislation implementing this Regulation. The main functions and responsibility of holding fund managers are defined in the Rules for Financial Engineering and in the trilateral financing agreement between the managing body, the intermediary body, and the fund manager.

Summing up the financial engineering measures planned and implemented using the assistance granted under the EU Structural Funds for SME development by the main participants and considering provisions of Council Regulation (EC) No. 1083/2006 and Commission Regulation (EU) No. 1828/2006 regarding management and control functions as well as the national legal acts which detail implementation of the functions stipulated in the Regulations, it may be stated that **all the necessary functions are in place**. However, a few cases may be distinguished when **the regulation is insufficient or to the extent that it does not comply with the normative documents**. The key areas where regulation must be enhanced include identification of the functions and the extent of the Supervisory Committee; regulation of preparation, submission, and endorsement of the annual and final reports; regulation of the re-use of resources and identification of the responsibilities of authorities in this area; expansion of the functions of the Guarantee Fund (investigation of irregularities, submission of the final report, and observation of information dissemination and publicity requirements according to the EC regulation).

Summing up the distribution of the “traditional” functions of the implementing body in the administration system of financial engineering instruments allocated for SME development, it may be stated that the functions in the stages of conclusion of the contracts, payments and supervision are too dispersed among different participants, therefore causing the risk of suboptimal spending of resources. The following functions of the managing body should be delegated to individual Ministries: recording of information in the SFMIS about a financing agreement signed; recording of information in the SFMIS about payments; recording in the SFMIS data required for the preparation of the annual report of the operational programme; and preparation of project cost statements and submission to a certifying body.

Another problem is that monitoring and control of the implementation of financial engineering instruments are insufficiently regulated. In order to implement financial engineering instruments efficiently and ensure timely identification of problems and rapid responses, monitoring and control of implementation are particularly important. However, insufficient attention is paid to it in the current system for administration of financial engineering instruments: a small amount of data is collected about implementation of the instruments, reports are infrequent (the annual progress report must be submitted by the holding fund manager to the Supervisory Committee once a year), collaboration with financial intermediaries who can ensure provision of the latest and most relevant information on any changes in the SMEs market to the holding fund manager of the manager of the financial engineering instrument is insufficient. It is therefore recommended enhancing this area by collecting more detailed data about implementation of the financial engineering instruments and submitting not only annual, but also semi-annual reports regarding the progress of implementation of financial engineering instruments. Institutions participating in the implementation of the financial engineering instruments must collaborate more actively with financial intermediaries (organise work groups, include representatives of the Commercial Bank Association into the Supervisory Committee).

**Institutions able to fulfil the functions of the holding fund manager and requirements for such institutions**

The valid national legislation establishes neither mandatory requirements nor sufficient skills and competencies for the administration of financial engineering instruments for holding fund managers (or the managers of the financial engineering instrument). The evaluation report analyses the types of institutions that may participate in the administration of financial engineering instruments and fulfil the functions of the holding fund manager, as well as the requirements for their selection, and the skills and competences of the holding fund manager (or the manager of the financial engineering instrument) necessary for administration of financial engineering instruments.

Having assessed the provisions of the EU and Lithuanian law, the first requirement for a financial engineering instrument, including the holding fund manager, is identified, namely that this must be a financial institution.

Considering that the holding fund manager must select financial mediators for implementation of a financial engineering instrument yet another requirement must be in place, namely that the financial institution fulfilling the functions of the holding fund manager would not operate in the same market as selected financial mediators. This restriction is important in order to ensure confidentiality of information. When selecting financial mediators, the holding fund manager may become privy to confidential information of financial mediators (competitors) and use this to increase its own competitive advantage.

One of the requirements for the holding fund manager should be particular competence. The competence is defined as a set of knowledge and skills of the institution for efficient implementation of its functions, i.e. ability to perform the functions allocated to the institution. The second requirement necessary when selecting the holding fund manager should be the competence of the financial institution in a particular area.

The extent of the competence when administering financial engineering instruments is first of all defined by the content of the financial engineering instruments. Considering that the financial engineering instruments analysed are exclusively targeted for SME development, experience in working with the SME sector – awareness of the needs of this sector, ability to assess them under changing economic conditions, and development of financial products relevant for SMEs – is required for successful implementation of the holding fund investment strategy and adaptation to changing economic conditions.

Since today the majority of financial engineering instruments are implemented by way of assistance granted under the EU Structural Funds, experience in managing assistance under the EU Structural Funds or in administering national aid programmes should be considered as a necessary requirement, as well as an awareness of the rules on state aid and the ability to apply them properly.

Following the analysis conducted, it is recommended that the following eligibility and effectiveness requirements be applied for selecting the holding fund manager (or the manager of the financial engineering instrument), the fund manager must

- (1) be a financial institution as it is defined in the Law on Financial Institutions of the Republic of Lithuania (*eligibility requirement*),
- (2) be able to ensure confidentiality of financial mediators' information (*eligibility requirement*)
- (3) The fund manager must have competence in planning and/or implementing and/or administering financial products for SME development (*effectiveness requirement*),
- (4) have skills in the area of project and/or programme administration of assistance granted under EU Structural Funds or national aid (*effectiveness requirement*).
- (5) offer a lesser price for administration of holding funds (*effectiveness requirement*).

According to the proposed requirements, the following eight institutions (or groups thereof) were assessed for the position of holding fund manager (or the manager of the financial engineering instrument): commercial banks, Lithuanian Central Credit Union, the Bank of Lithuania, Turto Bankas, INVEGA, the Lithuanian Business Support Agency, ESFA, and the new venture capital fund founded by the state. Following their analysis, INVEGA was identified as the best institution to comply with the said requirements. However, allocation or selection of the national institution (INVEGA) for the JEREMIE Holding Fund manager gives rise to some risks:

- a. The allocated or selected national institution will not have sufficient competence and skills to fulfil the fund manager's functions;
- b. Simple/scattered institutional responsibility for the performance of JEREMIE Holding Fund (performance usually depends on due planning, rapid implementation, etc.);
- c. The transfer of the holding fund to a new manager is not sufficiently regulated (management transfer procedures).

Therefore, the decision regarding the JEREMIE Holding Fund manager should be made considering all the risks listed above.

**Competence and skills sufficient for implementation of the functions of the holding fund manager.** The competence and skills of an institution necessary for administration of financial engineering instruments must first of all be identified on the basis of the functions determined for holding fund managers or managers of the financial engineering instrument (when the holding fund is not established) defined in trilateral financing agreements. Even though the financing agreements with holding fund managers establish the same functions, but their content is different depending on the administered financial engineering instrument, correspondingly, requirements for the competence and skills of holding fund managers are different.

Since appointment of a new JEREMIE Holding Fund manager will be discussed in the near future, specific requirements were laid down for the competence and skills of the institution that will take over the functions and rights of the JEREMIE Holding Fund.

A preliminary assessment of INVEGA skills (on the basis of the matrix of competence and skills of the JEREMIE Holding Fund provided and the functions to be performed by the JEREMIE Holding Fund manager) reveals that INVEGA lacks experience in investing venture capital and providing risk sharing. When administering these financial engineering instruments, INVEGA must be able to implement an investment strategy successfully, conduct the selection of the manager of financial engineering instruments (prepare a technical assignment and assess business plans of the candidates), supervise operations of the managers of financial engineering instruments, and assess the efficiency of financial engineering instruments. Once the decision is made to appoint INVEGA as an assignee of the rights of the JEREMIE Holding Fund manager, INVEGA's skills in these areas must first of all be strengthened.

INVEGA human and technical resources are not sufficient to perform the functions of the JEREMIE Holding Fund. The need for additional human resources to manage the JEREMIE Holding Fund will depend not only on the amount of resources managed by the fund, but also on the specific functions assigned to INVEGA in managing the JEREMIE Holding Fund, the type of engineering instruments implemented by the fund (for direct implementation of the instrument, e.g., provision of guarantees, a larger number of employees is required, whereas for compensation of interest and provision of loans – a smaller number is needed), and at a specific stage of the implementation of financial engineering instrument (fewer employees are required for administration of the instrument than at the initial stage of implementation of the instrument).

Sufficient funds should be allocated in the INVEGA budget for the purchase of consultancy services in the areas where INVEGA lacks skills – consultations on legal, state aid, financial product structuring, assessment of financial product risk and effectiveness, and other issues. Outsourcing of consultancies is a good means for strengthening skills within a short time. This is how EIF, the current manager of the JEREMIE Holding Fund, compensates for its lack of competence in certain areas. A framework agreement should be drawn up for consultancy services with companies providing the relevant consultation services.

If INVEGA accepts the management of the JEREMIE Holding Fund, the volumes of the sources managed would increase, therefore the technical capacities (information systems).of INVEGA should be strengthened and enhanced for administering the additional funds.

If INVEGA is assigned as the manager of the JEREMIE Holding Fund, the company's capacity audit must be conducted, competences assessed, skills gaps identified, the technical capacity of INVEGA assessed, internal work procedures reviewed, and a detailed plan for strengthening skills must be prepared. After performing the preparatory work stipulated in the plan by a certain set term by INVEGA, verification of INVEGA's skills to perform the JEREMIE Holding Fund manager's functions must be conducted as well as

verification of whether INVEGA has implemented audit recommendations and is ready to take over and fulfil the holding fund manager's functions.

**Appointment of the JEREMIE Holding Fund manager.** When the Ministry of Economy makes the decision regarding the national institution to manage JEREMIE Holding Fund, the decision must be adopted by a separate decree of the Minister of Economy or (alternately) the assignment of the rights and obligations may be conducted by signing a contract. In order that the rights and obligations of the holding fund manager be smoothly transferred/accepted between the former (EIF) and the new manager of the JEREMIE Holding Fund and the responsible authorities, the contract should define the assignment of the rights and obligations to the new holding fund manager and regulate liability of the parties in the interim period and other issues. Pursuant to the recommendations of the European Commission and the provisions of legal acts of the Republic of Lithuania, appointment of the holding fund manager should specify the appointed institution, the goals of public policy justifying the appointment (assistance to SME development), the mandate of the institution appointed to implement public policy, and justification of the competence of the appointed institution for successful implementation of the functions of the holding fund manager. It is recommended that justification of the competence on the basis of eligibility and effectiveness criteria provided (which, are to be defined in the Rules for Financial Engineering) be performed.

**Compatibility of financial engineering instruments funded from different EU Structural Funds and operational programmes.** Resources are currently allocated from EU Structural Funds for the implementation of financial engineering instruments according to two 2007–2013 operational programmes – the Operational Programme on Economic Growth and the Operational Programme for Human Resource Development. The Operational Programme on Economic Growth is financed from the European Regional Development Fund (ERDF), whereas the Operational Programme for Human Resource Development – from the European Social Fund (ESF). For the use of both the ERDF and the ESF funds, the main regulations are applied – the EU Structural Fund Regulation which sets general provisions for the EU Regional Development Fund, the European Social Fund, and the Cohesion Fund, and the Implementing Regulation which sets rules for implementation of the said EU Structural Fund Regulation and also European Parliament and Council Regulation (EB) No. 1080/2006 regarding the European Regional Development Fund. Therefore the EU legal framework applied for the use of resources of both the ERDF and the ESF is the same. The Note of the European Commission<sup>10</sup>, which provides some broad explanations for setting up and managing financial engineering instruments, does not provide any exceptions or differences between the use of sources from either the ERDF or the ESF. The European Commission's draft Guidance Note on Financial Engineering Instrument<sup>11</sup> stipulates that a financial engineering instrument may be implemented from several funds and operational programmes, however, in this event the manager of the financial engineering instrument must ensure, for the sake of financial accounting and audit, separate accounting of funds. The Lithuanian operational programmes, however, clearly separate investment areas for financial engineering instruments and therefore at the moment it is not possible use the ERDF resources (e.g., via INVEGA Fund) for financing activities supported by the ESF, i.e., to grant very small loans to private individuals starting their own business. Consequently, the limitations preventing development of a more integrated administration of financial engineering instruments for development of SMEs are in the national legislation. They can be eliminated by harmonising an amendment to the Operational Programme on Economic Growth with the European Commission<sup>12</sup> and foreseeing a cross-financing opportunity, therefore using cross-financing in the 2014–2020 EU structural support programming period provided it is compatible with the EU legislation regulating the use of funds for the 2014–2020 EU structural support programming period.

Today nearly all financial engineering instruments are implemented or administered by INVEGA (except for the financial engineering instruments implemented through the JEREMIE Holding Fund). We believe that further facilitation of financial engineering instruments is possible by combining holding funds. For example, if INVEGA is assigned to take over the rights and functions of the JEREMIE Holding Fund

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<sup>10</sup> Note of the Commission on Financial Engineering in the 2007-13 programming period. 16 July 2007, COCOF 07/0018/01

<sup>11</sup> European Commission. Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006 implemented with funding from the European Regional Development Fund. Draft document (Version 28/07/2010).

<sup>12</sup>The provision stipulating that financial engineering instruments financed from this programme shall not be used for ERDF support for projects of social companies seeking to develop their business and very small and small companies and private individuals wishing to start their own business, if they are financed using the ESF financial engineering instruments, should be eliminated from the Economic Growth Operational Programme. The programme should be supplemented with the provision that these activities may be financed by applying the cross-financing principle.

manager, the possibility of combining INVEGA, JEREMIE and Entrepreneurship Promotion holding funds into one fund should be considered. All three holding funds were established for the same purpose (assistance to SME development), financial engineering instruments implemented by the funds aim to have the same impact on the market; the funds are administered according to the same administration system for financial engineering instruments financed under the EU Structural Funds, and finally the same requirements apply to management of the funds. By combining the holding funds into one, administrative costs would be reduced and some resources could be saved: only one progress report would have to be prepared and endorsed, only one audit would have to be conducted, and funds would be paid out to the same holding fund manager, i.e., fund management would be more effective. It should also be noted that contracts with managers regarding the JEREMIE Holding Fund, the INVEGA holding fund, and the Entrepreneurship Promotion holding fund are similar. On the other hand, combination of the funds into a single holding fund would give rise to certain legal risks. Therefore, even though combination of the three holding funds would lead to more effective management, considering current valid legal aspects we may conclude that establishment of a single fund might have been considered before implementation of the JEREMIE initiative in Lithuania, whereas today, due to the said restrictions, joining the funds would be a rather complex and time consuming matter. We would recommend, however, that serious consideration be given to the possible joining of the funds in the future, when preparations for the 2014 financial perspective are underway and establishing a single Entrepreneurship Promotion holding fund responsible for planning and implementation of financial engineering instruments for SMEs and private individuals.

When considering the possibility of a single system for setting up and managing financial engineering instruments (therefore combining two separate administrative systems – the national budget and financial engineering instruments financed from EU Structural Funds – into a single general administrative system), the following aspects should be taken into consideration. To make administrative systems uniform in this case would mean making administrative procedures uniform. In addition, the same legal acts must be applied to setting up and management of the financial engineering instruments financed both from the EU Structural Funds and the state budget. As can be seen from this analysis, both administrative systems differ in terms of the institutions participating in administration; different procedures for initiating, planning, implementing, and supervising financial engineering instruments are applied; different national legal acts are applied to financial engineering instruments; and for setting up and management of financial engineering instruments funded from EU funds, requirements of EU Regulations are additionally applied. Consequently it is not possible to facilitate the administration system of financial engineering instruments funded from EU Structural Funds and administer resources from EU Structural Funds according to the system for administration of national budget funds due to the mandatory requirements of EU regulations that the Member State has to fulfil; furthermore the system for administering financial engineering instruments implemented from budget funds is currently insufficiently regulated – the implementation stage is insufficiently regulated (e.g., selection of financial intermediaries) and no monitoring, control, and investigation of irregularities procedures required for administering EU funds are in place.

We, therefore, believe that unification of the administration systems of financial engineering instruments funded from EU and state budget funds is not appropriate due to essential differences between the systems. However, during the administration of budget funds some aspects should be borrowed from the system for administration of financial engineering instruments funded by EU funds, namely, to regulate in more detail the implementation stage and identify monitoring, control, and investigation of irregularities procedures.

More detailed regulation of the use of national funds for financial engineering instruments will be particularly relevant in the future. After the expiry of the contracts regarding the setting up of holding funds or an individual financial engineering instrument, it will be possible to direct repayable funds for special programmes with the same goal as that of the financial engineering instrument. The Ministry of Economy and the Ministry of Social Security and Labour will have to make a decision regarding further use of the funds. If the decision is made to continue funding of financial engineering instruments for assistance to SMEs, the funds from the Structural Funds will be transferred to the national budget and it will then be possible to administer them according to the national system for administration of financial engineering instruments. In order to prepare for proper administration of the funds transferred from holding funds to the national budget, administration of funds from the national budget should be done according to the system for administration of EU funds and funded financial engineering instruments, without applying EU regulations to national funds.

## **Sufficiency and adequacy of financial engineering instruments to the economic situation**

The sufficiency and adequacy of financial engineering instruments to the economic situation are assessed in this study starting with analysis of the macroeconomic environment, assessment of changing needs of SMEs, identification of market failures, and assessment of the adequacy of particular financial engineering instruments to cover the failures. Financial engineering in this study is assessed as the means (method, instrument) used to achieve the goal. The main goal is to solve specific market failures, justify state intervention logic, and promote SME development. The Triangulation principle is used for discussion of the issue, i.e., several sources of information and/or methods of analysis are used.

**The need for financial engineering instruments and changing needs.** SMEs make up around 99.3% of all companies in Lithuania and contribute two thirds of GDP. Therefore it is assumed that changes in the financial indicators of SMEs directly correlate with changes in the financial indicators of all Lithuanian companies and trends in economic development of the country in general. These trends have seen a significant change since adoption of the Lithuanian Operational Programme on Economic Growth in 2007. At that time there was overall economic growth characterised by a rapid increase in internal demand, private consumption, and investment, however the global economic recession that began in the second half of 2008 brought considerable changes to the situation in the country – both internal and external demand together with investment dropped, the number of bankruptcies increased.

With the changing economic situation in the country, the financing needs of SMEs have also changed. According to surveys of SMEs conducted by the ECB, access to financing resources – the second biggest problem for SMEs became even more relevant in 2009. During the first half year of 2009, nearly half the respondents stated that they did not have a greater need for external financing; however, half of the respondents who tried to get external financing said that financing conditions were worse. The larger the company and the longer it had been operating, the more likely it was to get a loan.

However, the results of the survey conducted by the ECB cannot be directly related to SMEs in Lithuania, because the economic situation during the economic collapse differed a great deal from many other European Countries. For this reason, during the study, a separate survey (in the form of a questionnaire) of SMEs was conducted. The results of this survey, however, essentially confirmed the results of the ECB survey as well as other external studies which show that access to financing resources is one of the key problems that the SMEs face, particularly during an economic collapse.

**Assessment of financial engineering instruments.** The assessment of particular financial engineering instruments consists of an analysis of the adequacy of the instruments to the current economic situation. The analysis relies on the data provided in the financial statements of the banks, other secondary resources, and scientific literature.

According to the data provided by the Association of Lithuanian Banks, during 2009 and 2010, bank portfolios for private companies shrank. Even though the bank financial statements do not single out data on the loans for SMEs, considering the importance of SMEs for the Lithuanian economy, we may assume that the trends for granting loans to private companies and SMEs are similar or even worse.

At the start of the collapse in the economy, the portfolios of both small and large banks shrank to a great extent. Lending to companies, including SMEs, depends not only on the availability of money, but also on the lending policy of the bank; because larger banks are able to borrow from their parent banks, they did not face a shortage of capital during the economic downfall. This also explains the more passive involvement of the banks during this period in the capital based financial engineering instruments administered by INVEGA.

Analysing the problem of capital shortage it should be noted that it was most relevant at the beginning of the economic downfall when, with the growth of loans, deposits declined rapidly. As a result, the banks had to borrow on the interbank market or look for alternative financing resources, such as the capital-based financial engineering instruments. However during 2009, the structure of financing sources of the banks changed. Following the increase in interest rates on deposits, starting from 2009 Q2, the banks were successful in attracting deposits in the local market. Meanwhile with the growth of the credit risk of debtors and subsequently more stringent conditions for granting loans, the bank loan portfolio decreased, and funds

available in the banks and other credit institutions increased and risk-based financial engineering instruments became relevant.

To sum up the results of the data analysis conducted during the study, we can say that financial engineering instruments are adequate instruments for promoting SMEs during a time of economic downturn. This is attested to by the rather wide use of such instruments in international practice and confirmed by the conclusions of academic research.

In the study commissioned by the European Commission about the financing of SMEs (EC, *Cyclicality of SME finance*, May 2009), a survey of literature related to SME financing and the relevant market failures is provided, additionally the market failure is discussed with respect to the financial crisis. It is stated that in SME financing, the largest and most obvious market failure is related to venture capital. Marc Auboin (World Trade Organisation) and Moritz Meier-Ewert (Princeton University) in their study *Improving the Availability of Trade Finance during Financial Crises* (2003) maintain that adequate and reliable sources of financing generally constitute one of the main conditions for business development not only in a time of economic downturn. They particularly emphasise export financing in developing countries or less-developed countries, because the recovery of international trade is the main factor helping to balance the budget at a time of economic collapse. The importance of export financing is also emphasised by other studies of the World Trade Organisation and the International Monetary Fund.

In this study, the assessment of particular financial engineering instruments in order to solve problems arising for SMEs during the economic downturn first of all considers compliance with the needs of SMEs, the ability to achieve their targeted results and observing the planned term for the implementation of a financial engineering instrument.

One of the obvious areas for increasing efficiency of both the Guarantee Fund and the instruments of the INVEGA holding fund (with respect to compliance with SME needs and market failures) is allocation of financial engineering instruments to SME development. During a time of economic crisis many companies do not expand, but try to remain in the market by retaining their market share and their customers, however this is a limitation determined by the use of EU Structural Funds (from the European Regional Development Fund) in financing these instruments. Generally assessing support provided to SMEs in the form of guarantees for loans or soft loans, it may be stated that they are sufficiently attractive. Around two thirds of the respondents of the study agreed or fully agreed with the statement that such forms of assistance would help their company (individual activity) to solve the problems arising during an economic crisis.

The assessment of the use of financial engineering instruments during an economic downturn should also take into account the lifecycle of an instrument. In this respect, instruments of the INVEGA holding fund compared with those of the JEREMIE Holding Fund are relatively more advantageous. Even though rapid implementation of the instrument cannot be considered the key criterion for evaluating efficiency of the instrument, but during an economic downturn, “flexibility” of the measure and rapid implementation are very important due to rapidly changing market demands.

Despite being efficient instruments for increasing the level of venture capital investment, the Venture Capital Fund and the Business Angels Co-Investment Fund are not suitable instruments for promoting SMEs in the economic downturn in Lithuania. Firstly, both measures, very much like other instruments of the JEREMIE Holding Fund, are new in Lithuania and their implementation takes longer. Secondly, they are intended for rather a small number of SMEs and are more like pilot instruments for expansion of related processes. Thirdly, the results of venture capital instruments can only be seen in the long run –5-7 years after the venture capital investment in the company.

Several factors point to the need for an instrument such as the Entrepreneurship Promotion Fund. During nearly all the expert interviews, the opinion was expressed that it is not sufficient to provide only external funding to businesses, instruments are also required to increase the competences of businessmen. Another advantage of the Entrepreneurship Promotion Fund is that loans according to this instrument will be granted to very small and small companies starting a business, which in our assessment, is in short supply in Lithuania. Further assessment of the Entrepreneurship Promotion Fund within the context of the economic downturn should also consider the fact that this instrument is new and that there are therefore not any actual results.

**Assessment of the redistribution of the resources of EU SF.** The Operational Programme on Economic Growth of Lithuania stipulates two indicators for monitoring implementation of financial

engineering: the number of companies supported and the amount of private investment attracted. Even though these indicators for monitoring implementation of financial engineering in the Operational Programme on Economic Growth of Lithuania are handy due to the simplicity of their calculation, their achievability, in our opinion, should not become the main criterion for assessment of the allocation of funds for individual financial engineering instruments. Firstly, monitoring indicators for the Operational Programme on Economic Growth are preliminary. Secondly, the instruments are modelled in such a way as to ensure maximum achievement of indicators irrespective of whether or not they meet the demand of SMEs. In order to make conclusions regarding redistribution of resources between EU Structural Funds, financial instruments should therefore be analysed not only with respect to the indicators of the Operational Programme on Economic Growth, but also with respect to such overall criteria as compatibility with market failures, total use of the fund resources, and return of the resources.

As of now it is too early to assess the loss ratio of financial engineering instruments implemented in Lithuania as their implementation is only in the start-up stage; the assessment provides an analysis of efficiency and primary market failures related to external financing of SMEs. It should be noted that even in the case of instruments implemented in a relatively efficient manner (e.g. Guarantee Fund), their effectiveness can only be assessed after the receipt of information on their loss ratio, because the return of funds is one of the key aspects of financial engineering.

According to the activity report of the INVEGA Fund, and assessments made during focus group discussions, as well as the evaluation of project experts, implementation indicators set for the INVEGA Fund instruments should be achieved.

The possibility of increasing financing for the INVEGA Fund instrument Granting Small Credits – Stage 2 will depend on the interest of financial intermediaries wishing to participate in the scheme. On the basis of the results of expert interviews with the representatives of the banks and INVEGA, we think that the need to increase financing for the instrument Granting Small Credits – Stage 2 is doubtful at the moment as the banks have already encountered problems in lending funds received for this instrument. Neither is there a need to increase financing for the instrument Open Credit Fund, as the instrument satisfies similar needs of SMEs as those satisfied by the newly established Funded Risk-Sharing instrument of the JEREMIE Holding Fund.

At this stage it is too early to assess the effectiveness of the Funded Risk-Sharing instrument by the JEREMIE Holding Fund according to its implementation indicators, however the results of the study show that the market saturation aspect could be an important factor affecting implementation of this instrument. Reduction of financing for the Funded Risk-Sharing instrument at this stage would be an irrational and detrimental step due to agreements already concluded with financial mediators and the start-up stage of the implementation itself.

According to the activity report of the Guarantee Fund, and assessments made during focus group discussions, as well as the evaluation of project experts, implementation indicators set for the Guarantee Fund instrument should be achieved at the end of the programming period. Yet financing for the Guarantee Fund instrument should not be increased until the introduction of the new instrument of the JEREMIE Holding Fund – Portfolio Guarantees, because both instruments cover for the same market failures related to improvement of SME access to external financing.

It is not reasonable to assess redistribution of assistance under EU Structural Funds for venture capital financing instruments within the context of the Operational Programme on Economic Growth, because these instruments plan to support very small number of SMEs. It is possible to state, though, that both venture capital financing instruments are implemented in Lithuania successfully and as a result of them the first business angels were identified, in April 2010, the first venture capital fund and in May – the second venture capital fund were established. Financing for venture capital instruments in the long run should be increased in order to cover for market failures in all stages of the company lifecycle. Considering the current maturity and readiness of this market in Lithuania, financing should be increased gradually in order to retain the quality of investment; the problem of attracting private investors should also be solved.

In addition to the said market failure – the shortage of financing for venture capital, particularly in the start-up stages of the company lifecycle, other market failures related to improvement of SME access to external financing were identified during the study and have to be taken into consideration when establishing new financial engineering instruments or redistributing funds among currently available instruments.

As has been mentioned, export insurance is most frequently mentioned in the literature as a financial engineering instrument for solving problems during an economic downturn, in Lithuania, however, such instruments are only starting to be implemented. After analysing the export structure of Lithuanian industries, it is seen that with the start of the economic slump, export volumes decreased rapidly. Export promotion is important not only during an economic downturn it is an indicator used for judging changes in the country's competitiveness, therefore alternatives should be sought for continuation of the export insurance instrument which was initially implemented by INVEGA.

Considering the structure of SMEs in Lithuania according to the size of the company, greater attention should be paid to provide support to very small, rather than small or medium size companies through financial engineering instruments. According to data provided by the Department of Statistics of the Republic of Lithuania, very small companies with under 10 employees account for around 75% of all SMEs in Lithuania. Even though financial engineering instruments are today accessible to very small, small and medium companies, due to the shorter history of operations and other factors, it is relatively more difficult for very small companies to receive financing.

The need for micro-credits is justified by the fact that of the currently available instruments, only the Entrepreneurship Promotion Fund is oriented to micro-financing (credits up to 86,000 LTL). The Entrepreneurship Promotion Fund seeks to support 1,200 individuals and companies by allocating 50 million LTL for this purpose. We believe that the need for micro-credits in the market is far larger, therefore additional funding or additional instruments for granting micro-credits to very small and small companies is one of the issues to be addressed. Pursuant to the methodology provided in Annex 4 to Commission Communication of 13 November 2007 'A European initiative for the development of micro-credit in support of growth and employment', a preliminary estimate may be made that the need for micro-credits in Lithuania may amount to 24.2 million EUR or 83.5 million LTL.

Considering implementation of the new financial engineering instruments, we recommend that consideration be given to the setting up such instruments in combination with instruments increasing the competencies of businessmen therefore achieving a synergistic effect. Even though according, to the preliminary legal analysis, the general rule is that cross-financing is prohibited, exceptions to this prohibition may be used.

### **The impact of financial engineering instruments on the state budget deficit**

The report addresses the issues related to the accounting of financial engineering instruments, the impact of financial engineering instruments on the state budget deficit and their risk compatibility with the budget capacity, organisation of finance flow to financial instruments, and the practice of Slovakia and Hungary on these issues.

The EU Structural Fund regulations do not define in detail how the accounting process of financial engineering instruments should be conducted or what accounting standards should apply. Since Member States may select the method for programme implementation, a unified procedure may not be applied. The accounting process, its reliability and the extent of detail of the data must ensure preparation of the required reports and information to the European Commission and performance of monitoring procedures. The accounting process and applicable accounting standards should be compatible with the valid national legislation.

Starting from 1 January 2010, Lithuanian public sector entities conduct accrual basis accounting when economic events are recorded in the accounts of the public entity when they take place and are submitted in the financial statements for that reporting period. Revenue is recorded when it is earned and costs – when they are incurred irrespective of either the receipt or payment of money.

No specific legal acts are currently enacted in Lithuania that would detail requirements for accounting financial engineering instruments. Agreements for financing of financial engineering instruments within the scope of this assessment do not detail any accounting requirements either. Valid legal acts are applied to the operations related to financial engineering instruments.

All financial engineering instruments under assessment are financed exclusively from EU funds. When the funds are transferred to the managers of the holding funds of these financial engineering instruments, the EU and other international financial aid funds are accounted in the state budget as income. Therefore, financing of these financial engineering instruments did not have any impact on the budget deficit. After

completion of the implementation of the financial engineering instruments, resources properly used and returned may have a positive impact on the budget deficit, however, the requirement to re-use these funds for the same goals, i.e. for the benefit of SMEs must be taken into consideration.

The risk of financial instruments is currently assessed in the financing agreements. Comparing currently operating financial instruments, it is evident that their risk rates differ significantly. This can be explained by the very different nature of the financial instruments and the different goals of their implementation. Supervisory committees, founded on the basis of the financing agreements, analyse and approve the risk of the proposed financial instruments and other important issues of implementation of financial engineering instruments and are examples of implemented good practice.

The flow of financing for financial engineering instruments is today regulated by the Rules for Administration and Funding of Financial Engineering Instruments adopted by decree of the Minister of Finance. These Rules stipulate that funds for the holding fund manager or the manager of a particular financial engineering instrument must be transferred pursuant to the terms of the financing agreement.

Funds paid to the holding fund or financial engineering instruments may be accounted as costs in the statement submitted to the European Commission. These costs are preliminary, considered to be incurred in the meaning of the EU Structural Fund Regulation. Due to this reason, when setting up financial engineering instruments covered under this assessment, the rapid transfer of funds to holding funds and their declaration to the European Commission was particularly emphasised.