

POLICY BRIEF 5

INNOVATIVE FINANCIAL INSTRUMENTS FOR BETTER UTILIZATION OF THE EUROPEAN UNION FUNDS



PROJECT:

“EU-DESK FOR INNOVATIVE
FINANCIAL PACKAGES FOR
BETTER UTILIZATION
OF EUROPEAN FUNDS”

**THIS POLICY BRIEF ANALYZES
THE CONDITIONS REGARDING
THE UTILISATION OF
EUROPEAN FUNDS BY
SMALL AND MEDIUM-SIZED
ENTERPRISES AND GIVES
RECOMMENDATIONS FOR
CREATING NEW INNOVATIVE
BANKING FINANCIAL
INSTRUMENTS FOR PROJECT
FINANCING IN THE PHASES
OF: PRE-FINANCING,
MIDTERM-FINANCING
AND CO-FINANCING, IN
ORDER TO RESOLVE ONE
OF THE PRESSING ISSUES IN
PROVIDING COVERAGE FOR
SECURING UTILIZED FUNDS.**



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INTRODUCTION

Small and medium-sized enterprises (SMEs) have a significant impact on the reduction of unemployment and significant share in the growth of the domestic gross product. One of the main challenges for SMEs remains the lack of financial resources in the initial phase of establishment, and even more so for supporting their growth in the course of further operations.

Our country is among the last countries in the region in respect to utilization of European funds, i.e. in respect to proposing projects that will allow using money from the funds and grants of the European Union (EU). Non-governmental organizations, businessmen and state institutions, unlike other candidate countries, are not applying with a sufficient number of clear projects for the use of European money. With the advancement of the process of the country's accession to the EU, the amount and type of EU funds that will be available to SMEs will be increased; therefore, it is important for commercial banks to improve the capacity to support these enterprises for efficient use of the offered funds.

SMEs have a lack of their own security funds that would make them eligible for bank loans. Due to the limited resources they have, the limited size of the business and insufficient transparency, they cannot obtain any direct financing through the capital markets either.

EU funds offer various kinds of support to SMEs, but the enterprises that are limited in their own resources, experience and knowledge cannot effectively use the opportunities that are offered.

The purpose of the conducted research is to contribute to the improvement of the business environment and to facilitate the access to financial instruments for supporting SMEs for more successful use of the funds from the EU programmes, in particular: 1) to contribute to the design of new banking packages for supporting project financing; 2) to provide inputs for the creation of programme documentation for an EU-desk for supporting SME projects; as well as 3) to provide recommendations to all competent institutions. The research was realized with the support of the re-granting program of the project "Strengthening Capacities and Mechanisms for Supporting Chapter 20 Reform Processes".

APPROACH AND CONCLUSIONS

The methodology of the conducted research included the following steps:

1. Analysis of the level of significance and importance of SMEs for the domestic economy through desk research of relevant documents of national and European institutions, as well as scientific papers in this field.
2. Analysis of the utilization of the available funds for SMEs from EU funds and analysis of the state of financing of SMEs in general.

THE RELATIVELY POOR STRUCTURE OF THE MACEDONIAN FINANCIAL SYSTEM DOES NOT CATER TO THE NEED FOR PROVIDING FUNDS FOR FINANCING THE OPERATION OF SMES. IN THIS ENVIRONMENT, ENCOURAGING SMES TO USE FINANCES FROM THE EU FUNDS IS OF GREAT IMPORTANCE FOR FURTHER DEVELOPMENT OF THIS SECTOR AND ITS CONTRIBUTION TO ECONOMIC GROWTH.

3. Analysis of SME financing models in terms of their use of EU funds by commercial banks in: Bulgaria, Romania, Slovenia, Croatia and Hungary. An analysis was also made of the project financing offers of the banks in our country and in Kosovo, Albania, Bosnia and Herzegovina and Montenegro.
4. Survey of the fifteen Macedonian banks for determining their position regarding the introduction of new products for financing the process of obtaining and implementing projects of SMEs from the EU funds. Eight banks answered the questionnaire.
5. The interest of service providers for SMEs was examined through a questionnaire sent to all nine regional centres for support and development of small and medium-sized enterprises.
6. Analysis of the data obtained from the surveys and preparation of a research report where all the findings are available.

Bank lending is the most common source of external financing for many SMEs, which are to a large extent dependent on traditional debt, to ensure the needs of the founded enterprise, the needs for cash and for investing. SMEs face higher interest rates due to lack of assets they can offer for securing loans.

ONE REASON FOR THE LOW UTILIZATION OF THE EU FUNDS IS THE SMALL AND MEDIUM ENTERPRISES' LACK OF THEIR OWN FUNDS, SO THEY ARE ABLE TO FUND ACTIVITIES FOR PROJECT PREPARATION AND OTHER ACTIVITIES PENDING THE INFLOW OF ASSETS FROM THESE FUNDS.

Results

- SMEs play a major role in the development of the economy due to their predominant participation in the total number of companies and the share of the number of persons employed by them in the total number of employed persons.
 - The level of utilization of EU funds available to SMEs in the country is low.
 - The access of SMEs to finance is a key issue for securing growth in this sector.
 - Banks from the South-east European countries, new EU members, are actively involved in the financial support of SMEs for better utilization of EU funds.
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- Banks in the countries of the western Balkans announce the development of project financing; however, in practice it is poorly used.
 - Macedonian banks do not offer special products for SME support, nor for their involvement in financing projects from EU funds.
 - Potential SME service providers are interested to engage in partnership with commercial banks in the process of financial support for the implementation of EU funded projects.

Conclusions from the research

- SMEs are limited by funding opportunities, especially in the growth phase, when they obtain new finances mostly from banking sources.
- Although the country has well developed and liquid banking system, Macedonian SMEs are still not sufficiently financed by the domestic financial institutions.
- There is a lack of measures and programmes for greater involvement of banks in the process of supporting the business sector in order to increase the level of utilization of financial support for SMEs and agricultural holdings.
- It is necessary to expand bank products in the area of creating new innovative financial instruments, so that they can accompany the enterprises in in the process of using finances from the European funds, both in the phases of inter-financing and for co-financing and resolving one of the pressing issues of securing collateral.

RECOMMENDATIONS FOR POLICY MAKERS

To the Macedonian Government

- Greater transparency should be ensured and the overwhelming bureaucracy of the system for approving financial projects should be eliminated;
- Funding for the training of consultants regarding projects from EU funds should be provided;
- Contractual relations between the various institutions at central and local level should be regulated, as should be the relations between them, the consulting firms and the projects beneficiaries;
- Criteria should be established for consulting firms in relation to preparing feasibility studies, and penalties in the event of failure to perform obligations (both in terms of quality and deadlines) should be included.

To the Macedonian Bank for Development Promotion

- Products for encouraging the use of EU funds by SMEs should be offered. Through this role, it should facilitate the absorption of EU pre-accession funds and indirectly contribute to sustainable development and balanced economic growth.
- This could be accomplished through:
 1. Credit support for projects financed by EU funds in terms of eligible costs and non-eligible costs, which are an integral part of the project;
 2. Guarantee support for repayment of deposits; and
 3. Informative role and partnership with key stakeholders.

In the current setup of the functioning of the banks, their self-initiative to play an active role for better utilization of the funds from the EU cannot be expected. In order for banks to become an active player in the successful absorption of EU funds, it is necessary for institutions and organizations of the financial system to become involved and to provide encouragement.

To the banks:

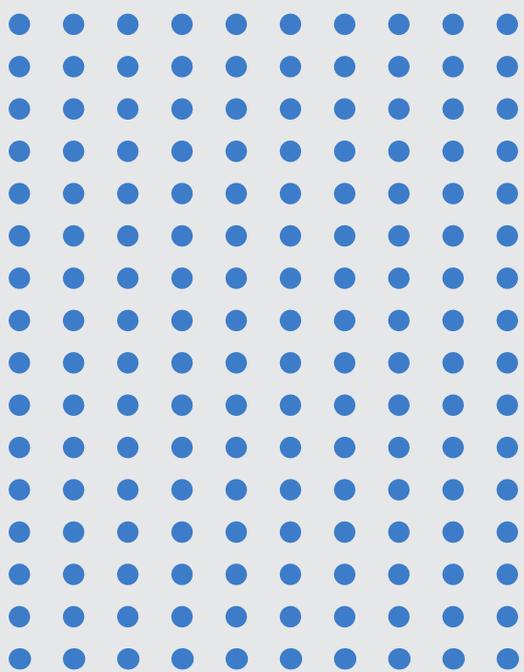
- They should actively engage in supporting the increase of the absorption of EU funds through direct involvement in pre-financing and co-financing, thus speeding up and strengthening the completion of the commenced projects, as well as its capacity for expertise in managing projects with European funds.
- The main role of the banks for absorption of European funds would be realized through: (a) confirmation of bankability of the potential beneficiaries by issuing a letter of intent, and (b) supporting selected beneficiaries by granting project advances and granting loans for pre-financing and co-financing; and the provision of additional financial instruments to support investments (financing VAT, working capital loans, financial risk management instruments).

To the institutions and organizations comprising the Macedonian financial system

Help should be provided to banks to engage in a successful absorption of EU funds:

- **The Central Bank** should adjust the legislation to provide adequate supervisory coverage for the implementation and more in-depth reviewing of the internal acts for this kind of project financing by the banks.
- **The Ministry of Finance** should organize workshops, seminars and trainings to increase the banks' understanding of the opportunities and benefits of inclusion in supporting the financing of projects from the EU funds.
- **The Association of Banks**, by establishing cooperation with state institutions involved in creating a favourable climate for better use of EU funds available for SMEs, with the European Commission, with international organizations that implement programmes to improve the access of SMEs to finance and with other stakeholders, can organize educational and informational events for the bankers. It can establish communication with banking associations from the "new EU member states" to use their experience in encouraging banks to engage in increasing the absorption of European funds. Trainings may also be intended for consultants and should include:
 1. Training on EU funds in order to present issues of access and implementation of EU-funded projects;
 2. Training on European financial instruments for banking involvement in SME financing in order to identify the specific conditions and risks that may arise in the implementation of projects.

- **Academy of Banking and Information Technology.** Project financing is made possible by the existing banking regulations; however, banks do not have experience and practice with this type of lending, therefore adequate education of the bank staff should be provided in order to provide credit support for projects for using European funds.
- **Bank managerial staff** should recognize the benefits of bank financing of EU projects and include it as an opportunity in their strategic plans through:
 1. Allocating funds for this purpose;
 2. Reorganizing and reengineering of operations;
 3. Training the staff in project financing;
 4. Training the staff on available EU funds, rules and procedures for their use;
 5. Establishing contacts with consulting firms for supporting the implementation of projects accepted for EU funding.



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