

CHANGING INTERMEDIARY SYSTEM OF REPAYABLE EU FUNDS IN HUNGARY (2007-2013, 2014-2020)

A VISSZATÉRÍTENDŐ EURÓPAI UNIÓS TÁMOGATÁSOK PÉNZÜGYI KÖZVETÍTŐ RENDSZERÉNEK VÁLTOZÁSA MAGYARORSZÁGON (2007-2013, 2014-2020)

Sára FARKAS^a

^a Magyar Nemzeti Bank, H- 1054, Budapest; Szabadság tér 8-9., farkass@mnbb.hu; University of Pécs, The Institute of Geography and Earth Sciences, Doctoral School of Earth Sciences, H-7624, Pécs Ifjúság Str. 6.

Cite this article: Farkas, S. (2018). Changing intermediary system of repayable EU funds in Hungary (2007-2013, 2014-2020). *Deturope*, 10(3), 180-198.

Abstract

Hungary was among the first member states where financial instruments of the EU were introduced in larger scale and scope in 2007. However, in the new development phase (2014-2020) experiences of the delivery system have been just partly applied. The renewed, centralized model has a lower level diversity in terms of the type of financial institutions responsible for financial intermediation. Despite their numerous advantages the structural changes hold many risks on growth and on local economic development as well, since the embeddedness of the financial intermediaries in local economies and their diversity are among the core features to provide the properly customised financial services for the targeted enterprises. This institutional change causes a rapid spending of repayable subsidies but hindering the delivery of the original objectives of the cohesion policies. The intermediary system territorially does not give priority to the disadvantaged regions, furthermore contact points are concentrated on urban areas with higher level of economic growth. Beside this, the microcredit objectives cannot be put into practice, the average credit amount increased sixfold in the new development period.

Keywords: Financial intermediary system, Development policy, Financial instruments, European Union

INTRODUCTION

According to the recommendations of the European Commission's (COM) Fifth Cohesion Report (2010) on those policy areas, where subsidies contribute directly to profit generation, certain financial instruments (FIs) should be introduced. In the forms of credit, capital, guarantee and the combination of these products with non-repayable subsidies, after this statement Hungary was among the first member states to introduce these instruments in large scale and scope in the 2007-2013 development period (JEREMIE programme²⁸). The role of these types of subsidies are emerging and parallel with EC's intentions, in Hungary the importance of these instruments is increasing.

²⁸ Joint European Resources for Micro to Medium Enterprises

This paper aims to give a brief overview of the institutional changes between the two EU development periods (2007-2013, 2014-2020), highlighting the most important experiences derived from the operation of the financial intermediaries (1), and to detail the core risks (2) and also to demonstrate some encouraging signs of meeting the objectives (3), which can be expected from the new institutional setting.

The findings were based on the analyses of the Hungarian strategic development policy documents (Partnership Agreement, Operational Programmes) and the activity data of the institutional system which handled the repayable funds between 2007-2013.

THEORETICAL BACKGROUND

The financial intermediary system's impacts on national economic growth, territorial cohesion and on local economic development

The EU FIs' intermediary system, and their ability to provide the relevant financial intermediation functions, has an indirect impact on national economic growth stimulation and it could decrease the territorial imbalances as well. Looking at the national level economic growth with this structural change the new model in Hungary still does not offer institutional guarantees to the more efficient venture capital spending, particularly the achievement of the R&D&I objectives which could offer rapid growth opportunities.

Although the banking system has a pro-cyclical impact on the economic processes, the depth of financial intermediation and its proper functioning, meeting the economic needs, have a considerable stimulating effect on the economic growth (Schumpeter, 1980; King & Levine, 1993; Mérő, 2003; Kay, 2015). In this stimulation effect both capital and credit finance plays an equally important role, though, among these mediation processes lending has a higher impact on economic growth (Mérő, 2003).

The proper functioning of the financial intermediation processes and its institutions have a significant impact on local economic development and thus on the development of regional disparities as well. The uneven regional distribution of financial flows in accordance with the given development level of the financial system can directly cause large territorial differences (Gál, & Burger, 2011 based on Porteous, 1995; Mazucca, 1999; Dow, 1999; Alessandrini & Zazzaro, 1999). These regional differences of the financial intermediary institutions can be observed mainly in the access to finance in the SME side, and in the institutional side these differences are manifested in the size of the information asymmetry arising from the local personal contacts and from local market knowledge.

In the territorial differences of the financial flows the core-periphery type disparities are dominant, characteristics of the urban network show positive correlation with the regional structure of the banking system and with the territorial spread of the financial innovations (Gál, 2014), thus the procyclical impact of the financial intermediary institution system displays not only in the economic processes, but the system amplifies the territorial disparities as well. The primary reason of the procyclical impacts of the financial intermediary system on core-periphery disparities is that the centralized corporate governance structure of the financial institutions and the low-level autonomy of the branches do not support the availability of local information in the centers and their inclusion in the decision making methods of the financial institutions. This locally gained knowledge which can be acquired via personal connections is for instance the professional competences of an entrepreneur, financial literacy and awareness of the client, or the motivations, the customer's personality traits or the payment discipline. However, in the assessment of credit risk for micro and small enterprises, the role these factor is the most relevant (Banai et al., 2016). The institutionally-coded emergence of the information asymmetry between the institutions generates a higher risk category for the institutions in peripheral regions with weaker local economy, furthermore it imposes higher expenditures and risks on these branches, which means higher transaction, information and monitoring costs. To compensate the regional imbalances of the financial transfers, only institutional and governance transformations of the intermediary institutional system are efficient steps in the long term (Gál & Burger, 2011), which factors should be highlighted by the institutions responsible for the delivery of the development policy.

In regards to the impacts of EU structural funds on regional disparities, the level of transfer intensity plays a key role as well. According to Kyriacou and Roca-Sagalés (2012), in more than 1.6% of national GDP the intended effects are actually reversed. Intensity contributes to only increasing regional disparities above this 1.6% level transfer. In order to spur regional growth, an adequate policy combination is essential to that which fits local conditions. Based on Dawid, Harting and Neugart (2014), human capital policy and SME subsidies to promote investment in technology, such as, policies which aim to facilitate convergence and also those which are supported financially by the EU, are strongly influenced by labor mobility. For instance, in regions with a more integrated labor market human capital policies are less effective in terms of convergence. As for the lagging regions subsidies awarded to SMEs for technological adoption can lead to productivity growth, but this requires improved fund absorption capacities of these firms. This paper also highlights that policy implications on regional growth are driven by the interplay of many firm related investment decisions. To

overcome the regional imbalances many path dependencies should be identified, in which, beside the investment choices, the most important determinants are the stocks of human and physical capital and the worker movements between firms (Dawid et al., 2014). Considering the effectiveness of subsidies aiming economic development in Hungary (2007-2013), Banai et al. (2017) proved that in technology oriented sectors, especially in ICT, the supported firms developed more rapidly. Moreover putting these efficiency issues in policy perspective it turned out that in Hungary there were no significant difference between refundable and non-refundable subsidies.

RESULTS AND DISCUSSION

The development resources and objectives of financial instruments have increased, but still no institutional guarantee to meet the microfinance objective in Hungary

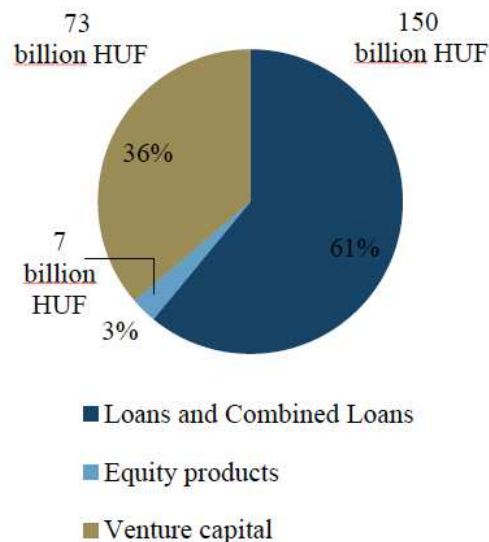
With a pilot manner Hungary has been experimenting with EU supported financial instruments since the 1990s, since the pre-accession fund PHARE has been launched. This time only a small amount of money, 1.15 million ECU was dedicated (Kovács, 2010) with a limited scope, focusing on microfinance. Between 2004 and 2006 there were no FI in the EU related development programmes, so the year 2007 called a restart.

In the 2007-2013 development period Hungary allocated 820 million EUR (with national co-financing) for FIs. In the next, 2014-2020 period, this amount has grown almost threefold to 25 billion EUR (with national co-financing). With this considerably high volume of repayable subsidies both the delivery systems and the potential beneficiaries' financial planning capacities face a serious test.

Within the framework of the JEREMIE programme (2007-2013) four types of financial products were introduced in the forms of credit, venture capital, guarantee and the combination of these products with non-repayable funds (combined products). The main objective of the JEREMIE programme was to support the development of enterprises through microfinancing, which are also apparent in the number of contracts. However, these micro-credit products represented the micro-character only in their name, by the end of the period the target groups were expanded with medium-sized enterprises as well and at the same time the available credit amount reached HUF 200 million (EUR 645,000). With this latter intervention the average credit amount increased and the focus on micro entrepreneurs has been lost. One of the most important lessons learned from the evaluations of the 2007-2013 development period is that the use of these subsidized financial products was largely unrelated to the originally intended target groups of the development policy (KPMG, 2013). Though, the end-of-cycle impact analysis (KPMG, 2017) did not examine this analytical consideration.

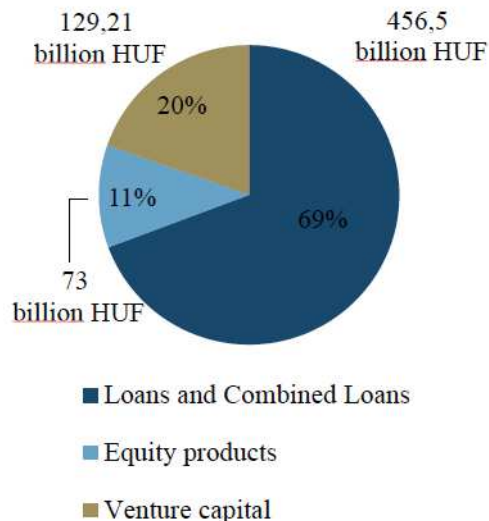
Meanwhile, the credit supply of the Hungarian SMEs needs to be further developed, according to the data released by the Hungarian Development Bank²⁹ (HDB) in 2016, the Hungarian economy is suffering from a finance gap³⁰ of 570 million HUF (HDB, 2016c).

Figure 1 EU subsidized financial products in Hungary, 2007-2013, %



Data source: Fontium, Economic Development and Innovation Operational Programme of Hungary (HDB reporting) based on Deloitte, 2016

Figure 2 EU subsidized financial products in Hungary, 2014-2020, %



Data source: Fontium, Economic Development and Innovation Operational Programme of Hungary (HDB reporting) based on Deloitte, 2016

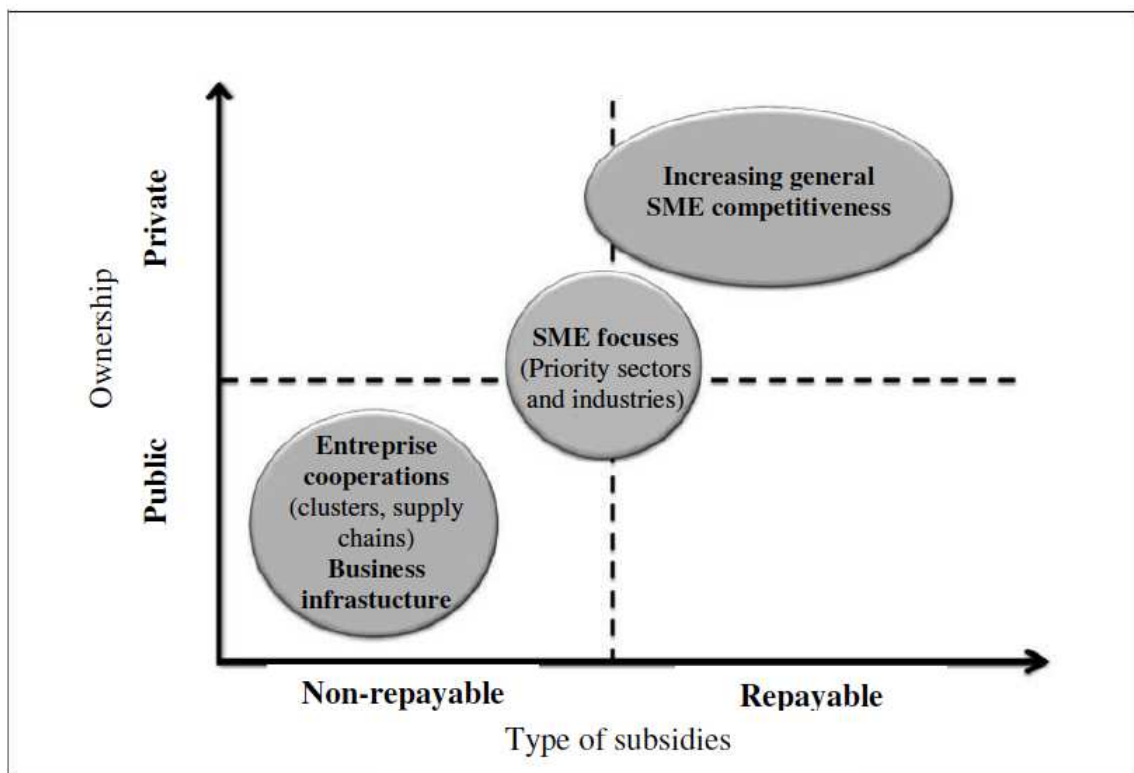
²⁹ Magyar Fejlesztési Bank (MFB)

³⁰ Based on the HDB's representative survey of inland corporations in 2015, the finance gap refers to the size of the financing loan niche, which involves the partly or completely refused credit claims (1), the shortage of credit offers (2), and also the unclaimed credits arising from the possible refusal (3).

During the development period 2014-2020, the dominance of credit instruments strengthened, and the proportion of venture capital subsidies decreased (Fig. 1, Fig. 2). However, considering the size of the available credit amounts per enterprise, the objective of microcrediting hardly seems to be realized in the present development period. Based on the data describing the present payout process, the average size of loans has increased sixfold (!) compared to the 2007-2013 period (Nyikos, 2017).

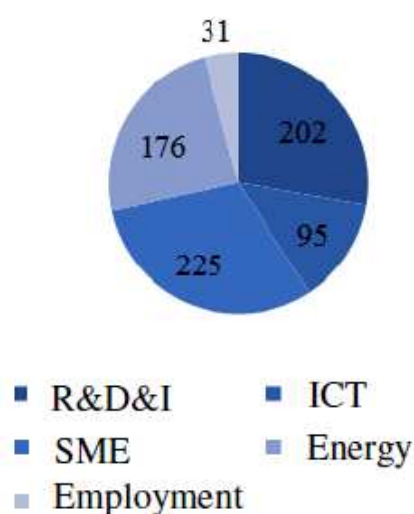
The objectives of the FIs in the 2014-2020 period have also increased, they have become more diversified. In September 2014, the Hungarian Government recorded that the EU's FIs would become the most important form of the general SME development for the 2014-2020 period. Besides the development of SMEs, these repayable subsidies also serve several other purposes.

Figure 3 Simplified method of the SME development policy in Hungary, 2014-2020



Source: Hungarian Partnership Agreement for the 2014-2020 Programme Period (ONEP, 2014)

Based on the thematic objectives of the new EU development period, the FIs amount to 730 billion HUF within the framework of the Economic Development and Innovation Operational Programme (EDIOP) in which the fund will be allocated to five development policy areas (Fig. 4).

Figure 4 Development policy areas of EDIOP (thematic objectives, billion HUF)

Source: Szabó, 2016

In addition, based on the lessons learned from the previous development period, the new economic development policy focuses on the following strategic development issues declared in the Partnership Agreement and also in the operational programmes: to support the economically underdeveloped regions and those target groups which are excluded from traditional banking services (1), to make the subsidized financial products easily available in practice (2), and in terms of the administrative obligations to make them competitive and ‘handy’ in the market of banking products (3). Considering the central governmental intent, besides the European objectives in Hungary, the rapid implementation and pay-out of the FIs were also among the strategically important issues (4).

Centralized intermediation model of the repayable EU funds

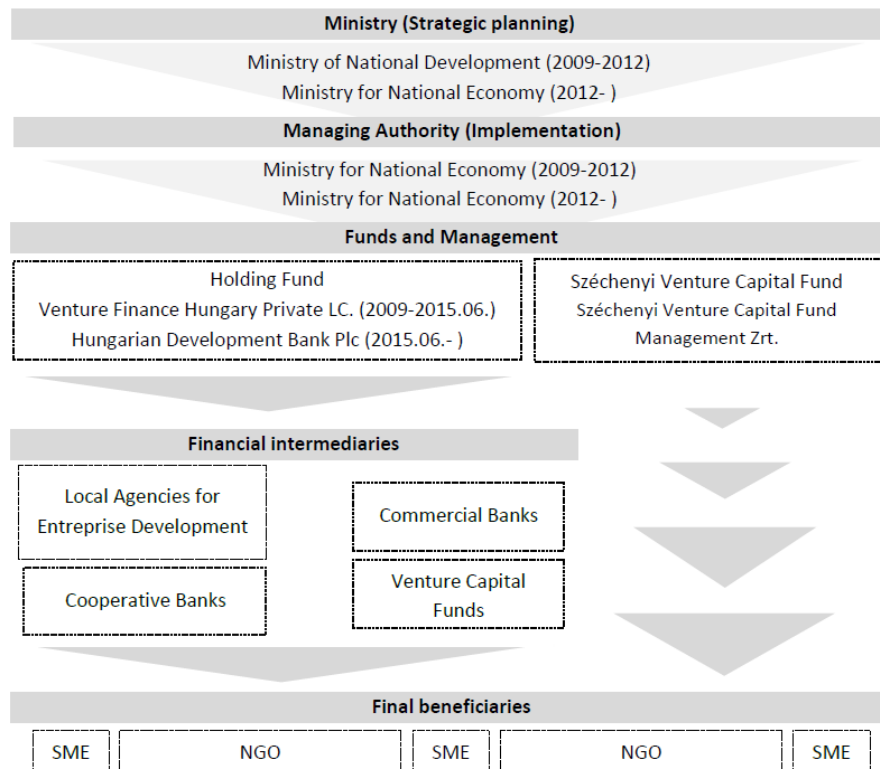
The institutional set-up of the JEREMIE programme consisted of a single holding fund and the Széchenyi Venture Capital Fund (SzVCF). Both operated directly under the managing authority, but within separate departments, because SzVCF used the sources of the Regional Operational Programmes, meanwhile all the other financial instruments were financed by EDIOP.

The final beneficiaries of the FIs received these financial products indirectly, via various types of financial intermediary institutions. In this supply chain the holding fund (Venture Finance Hungary Private LC. 2009-2015) integrated the development funds of the COM in proportion with the national co-finance and through several credit institutions, local enterprise development agencies, venture capital funds and other microfinance institutions, it could channel the subsidized financial products to the entrepreneurs. The role of the intermediary

institutions was to provide the necessary financial proficiency and the social network for the target groups locally. Capital resources were handled by the SzVCF and also by other venture capital funds. The main difference was that SzVCF operated directly under the MA and it was owned by the government in 100%, meanwhile the other venture capital funds were operated under the holding fund and with mixed capital resources requiring 30% private capital to the EU support (70%).

With this institutional structure a mixed intermediation model has been set up, it consisted of a direct and an indirect channel from the Management Authority (MA) to the final beneficiaries. (Fig. 5) The purpose of the JEREMIE Programme was explicitly the development of the micro and the SME sector.

Figure 5 Institutional system for the implementation of financial instruments in Hungary 2007-2013

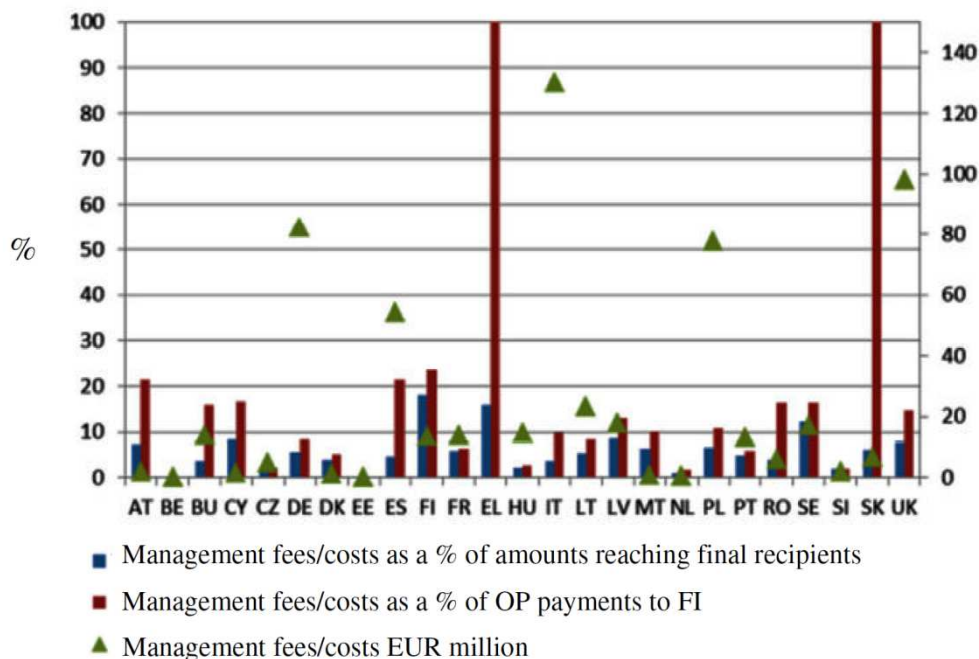


Source: Edited by the author

Featuring this institution system, four factors have been analyzed, the diversity (types of the institutions), the cost-effectiveness of the institutional set-up, the institutional activity (based on the date of accession and transaction numbers) and also the specialization for financial products.

Based on the types of institutions', the intermediation system was characterized by a high level of diversity with widespread network (Fig. 8). Among the financial intermediaries there were local enterprise development agencies, cooperative banks, commercial banks, venture capital funds and other microfinance institutions, which were usually specialized in one FI. The significance of diversity is that its high level plays a major role in developing more tailor-made solutions to SME financing needs. During the 2007-2013 period, among the Member States Hungary's specific characteristics was the very low-cost intermediary institutional system which at the same time could operate with high diversity and with a large number of intermediaries (Nyikos 2016c).

Figure 6 Management fees and costs (%)



Source: Nyikos, 2016b

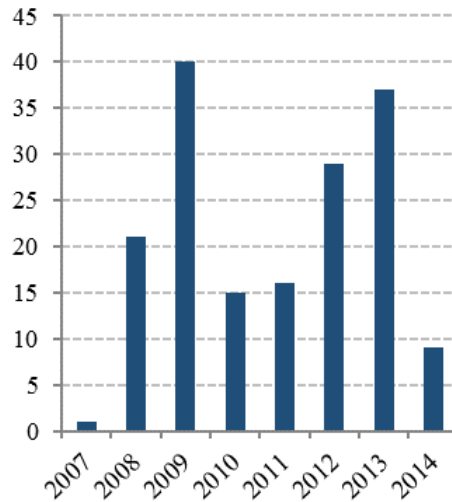
However, the varying cost-efficiency of the institutions can modify this picture. Despite the fact that the capital funds were represented in low number and share³¹ (Fig. 8) among the intermediaries, they had a disproportionately expensive institutional structure. (Bucsky, 2016 based on the data set of Bisnode and Figyelő)

Considering the intermediators' activity, the most dominant players were the microfinance institutions, focusing on one FI, and the local enterprise development agencies. (Fig. 8

³¹ Total number of the venture capital funds were 26, until 2014, but their operation in time were nor parallel.

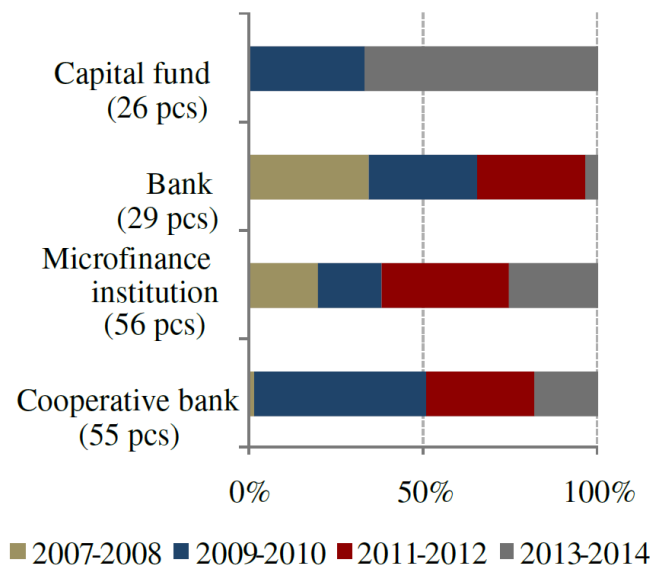
integrates these two types of intermediators as one category, called as microfinance institutions³²).

Figure 7 Number of financial intermediaries based on the date of accession (pcs) 2007-2014 (%)



Source: HDB data provision, 2016

Figure 8 Breakdown of financial intermediaries based on the date of accession and according to the institutions' type (as a percentage of those institutions which joined until 2014)

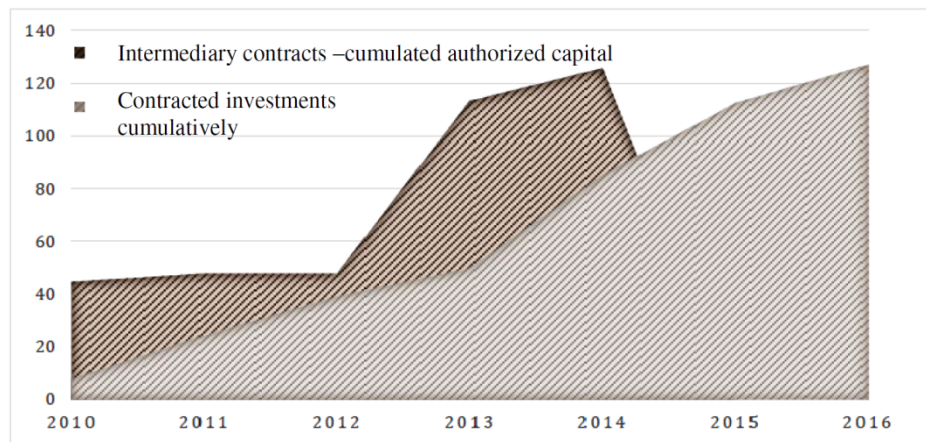


Source: HDB data provision, 2016

³² Considering the forgoing statements, it is important to highlight the fact that the institutions' number which intermediated the credit instruments in the 2007-2013 period (microfinance institutions, local enterprise development agencies, cooperative banks) cannot meet the number of the latter credit provider contact points (HDB points) operation in the 2014-2020 period (Fig. 5). The former refers to the number of the institutions (financial enterprises) and the latter refers to the intermediary points (branches) where the credit products can be requested. One credit institution had numerous credit points in the 2007-2013 period.

Considering the delayed time schedule of the pay-outs (Fig. 9), due to the slow establishment of the venture capital system, by the end of the period there was a serious time pressure on the delivery system to contract the beneficiaries in time. Most of the central venture capital programmes and tenders for the capital funds appeared only after 2012, and the capital investments started only from 2013. The delivery of the venture capital programme (contracting final beneficiaries) took place later, at the end of May 2016, with serious deadline modification approved by the COM.

Figure 9 Payout timeline of the JEREMIE programme in Hungary (Billion HUF)

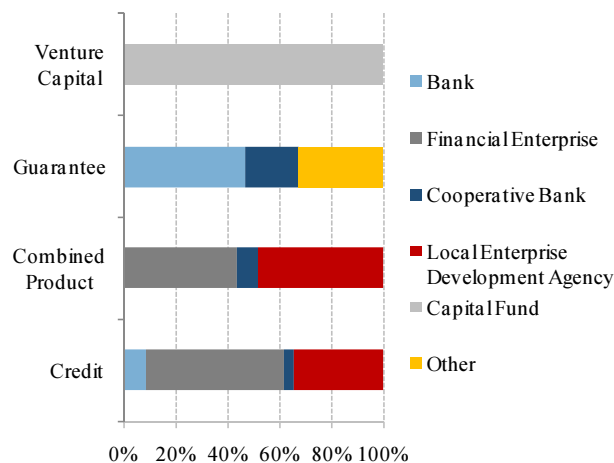


Forrás: Fontium

Source: Századvég based on Fontium, 2016

Examining financial product offers between 2007-2013 among the institution types a strong specialization can be observed (Fig. 10).

Figure 10 Breakdown of financial intermediaries by financial products, transaction number % (July 2016)



Source: HDB data provision, 2016

The product specification of the intermediary institutions was partly governed by the regulations and partly by the local embeddedness of the institutions. The most important background of the banks' low activity that they were ruled out to be an intermediary for the most successful financial product, the combined microcredit. (Nyikos, 2015) To the successful intermediation, the institutions' local social embeddedness was a critical factor, 80-90% of the enterprises employing combined micro-credit products had been informed about these FIs through local tender writers and their accounting experts (KPMG, 2013).

Simplified intermediary model

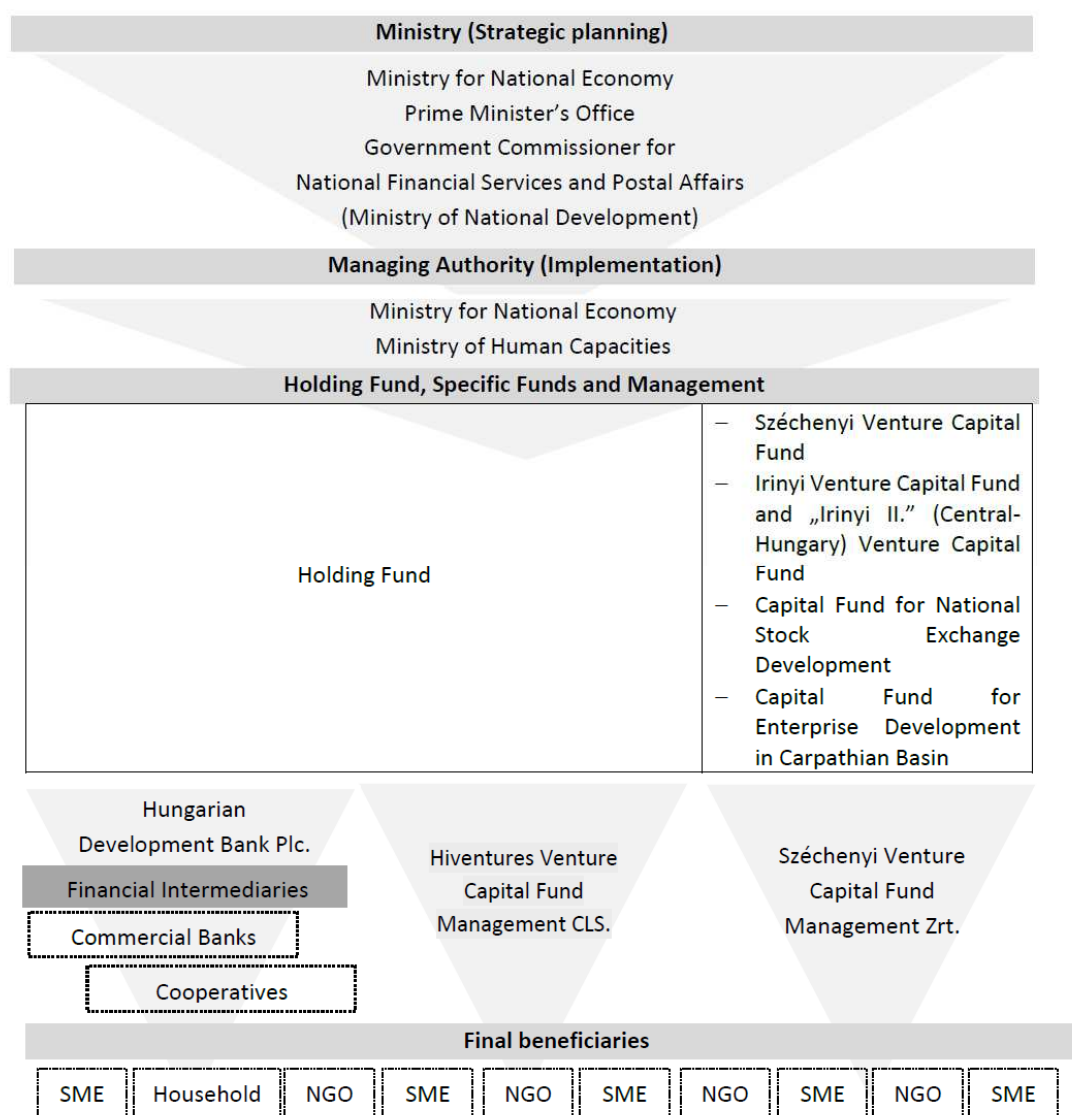
In the 2014-2020 development cycle the increased objectives of the FIs (Fig. 4) have to be implemented in an institutional structure built on more central decision-making mechanisms. In this institutional set the HDB, as the holding fund manager, chose an 'agent -type' intermediary model and contract directly the beneficiaries. Besides HDB plays the key role in venture capital investments as well. The Government invests the venture capital instruments in the development areas of research, development and innovation (R&D&I) through a state-owned venture capital fund³³, which is a significant shift from the 2007-2013 institutional practice (Fig. 11). Preventing the time pressure which had occurred in the previous development cycle call for applications of the financial instruments were fully published for the final recipients until 31 March 2017. In the case of guarantee products, the intermediary institutional structure is missing, which may show that some policy distortions happened.

The new model resulted a faster implementation method and absorption procedure, but local priorities and objectives of the development policy cannot be revealed. By end of the first quarter of the year 2017 all the call for applications were published, and by the end of august (2017) 75% of the EDIOP funds were contracted (Dányi, 2017). This shows a much higher delivery speed than in the 2007-2013 period. However, the delivery system can be improved further to serve the cohesion effects more efficiently. The delivery process does not create linkages between the Territorial Operational Programme (and the Competitive Central Hungary Operational Programme) and the EDIOP. That is why financial intermediation procedures and the financial instruments can not ensure the fulfillment of these territorial objectives efficiently, even though the policy documents intended to do so. (For example when the credit purpose of an enterprise is in line with its home counties territorial

³³ Hiventures, the State Venture Capital Fund professionally supervised and supported by the National Research, Development and Innovation Office and the Hungarian Development Bank Plc. (HDB).

development objectives it can not be prioritized over those enterprises, which plans to use the FI with other development purposes out of the locally declared territorial ones.) Another hindering effect can be that the banking and the enterprise development expertise of local enterprise development agencies and financial institutions are not utilized.

Figure 11 Delivery system of the financial instruments in Hungary, 2014-2020



Source: Edited by the author

Risks and predictable positive achievements arising from the institutional system, 2014-2020

Due to the structure of the institutional system intermediating the repayable funds, it can be outlined that the system can effectively support at least four major strategic objectives of the Hungarian economic development policy, but parallel with this the number of not or just partially accomplished goals are also the same (Tab. 1).

Table 1 Expectations of predictable strategic achievements of the financial instruments' based on the financial intermediary system, 2018

Expected achievements	Partially or entirely unachievable goals
<ul style="list-style-type: none"> – Cost effectiveness: the financial intermediary system has low operating costs because the expensive intermediation system of the venture capital instruments, operating in the 2007-2013 period, has been rationalized and completely renewed; – Statistically the institutional system reaches a high proportion of the Hungarian enterprises; – Fast absorption of the EU resources; – User-friendly claiming and handling practices. 	<ul style="list-style-type: none"> – Steady absorption through the seven years of the development cycle; – Tailor-made offers for projects which can clearly contribute to meet the five declared strategic objectives (Fig. 4); – Developing the financial literacy of the final beneficiaries by providing education, mentoring and consulting opportunities in-addition to the single financial service; – Addressing the most disadvantaged regions and target groups, as well as those who are the most talented or which are in need for the highest support.

In the currently operating system two key challenges can be identified. These are the balance creation between the successful address of the target groups and the cost-effectiveness of the intermediary system (1), and also to ensure the financial instruments' contribution to meet the EU's cohesion policy objectives, particularly to reach social progress, territorial cohesion and local economic development (2).

Creating balance between the target group reach and the cost-effectiveness of the mediation system

Key requirements for the strategic objectives of FIs that the new institutional set should assure the rapid access to the financial products and from the viewpoint of the final beneficiaries it should provide equal opportunities for accession in terms of the territorial and the social aspects. However, for the sustainability, maintaining the low-cost character of the system is also critical.

Regarding the qualitative characteristics of the intermediary system it is important to highlight that with a higher institutional diversity, the institutional system can provide customized solutions tailored to the beneficiaries' financial needs (Nyikos, 2016c) However, the local enterprise development agencies, owning the local knowledge mentioned above, could not gain an intermediary function in the delivery of the financial instruments in

Hungary in the 2014-2020 EU development period. The new, ‘agent –type’ intermediary model does not allow the decision-making system to integrate the local information owned by the branches hosting the HDB points. This can easily result in the inefficient spending of these EU funds. The institutionally- coded disorders of the intermediary system may strengthening the present territorial imbalances and governance deficits of the banking system.

The consequences of the previous development period reveal that the personal contacts between the final beneficiaries and the intermediary institution form a crucial point in spending the allocated EU subsidies for credit and the combined micro credit products. The easy physical availability of these contact points is a basic requirement to deliver the cohesion policy objectives and to address the intended target groups of the financial instruments and also to reach the catching up regions as well. From August 2017 the total number of these contact points, called “HDB points”, was 565, which number will increase to 642 by the beginning of 2018. However, these points are territorially concentrated on those city regions which already have promising growth potentials and larger population. Among the disadvantaged settlements³⁴ (total number of 1230) there are only 45 HDB points. The gradual expansion of the HDB point network was focused on the cities with county rights, for the least developed settlements the availability of the contact points remained difficult in Hungary. Based on these issues several risks can arise from meeting the development objectives and addressing the originally intended target groups.

Since the general financial flows and the HDB contact points are also concentrated on the more developed urban areas, the intermediary system of the EU financial instruments may also contribute to the increase in the Hungarian territorial disparities (spending cc. 25 billion EUR between 2016-2020 via this intermediary model). In order to enhance the FIs territorial and social cohesion impacts additional professional capacities and services (financial education, training, consulting, mentoring or financial coaching) should be linked to the financial products and also the institutional presence should be extended towards the smaller settlements and the deprived areas.

The institutional types of the Hungarian intermediary system are characterized by a lower level of diversification in the 2014-2020 period and this may prioritize other beneficiaries instead of the originally intended target groups, and which can provide access to these FIs to the already competitive enterprises as well.

³⁴ 105/2015 (IV. 23) Government decree on disadvantaged districts and settlements, Annex 2.

CONCLUSION

In order to achieve the cohesion goals, the intermediary system should be improved both in terms of the geographical penetration and governance structure, which could give opportunity to financial institutions to specialize in target groups and in regional features (1). Along the use of these instruments other financial services such as financial education, training and financial mentoring of the beneficiaries should be developed, since their role is crucial to achieve the economic development impacts on SMEs (2). In the knowledge-intensive sectors with higher growth potentials, the significance of capital or equity-type subsidies is higher, in which the origin of capital has an important role. Finding the adequate balance in the venture capital fund resources with the right proportion of the private and the state-owned resources, subsidies may also contribute to a more appropriate use of the EU resources (3.)

Comparing the two development periods (2007-2013 versus 2014-2020) in Hungary, the policy objectives of the FIs became more sophisticated meanwhile the institutional system territorially and in terms of governance transformed towards a more centralized structure. Beside this, in terms of the institution types a less diversified system has been installed, outruling the previously successful local enterprise development agencies as non-financial microcredit providers.

Cohesion policy objectives, in terms of reducing the territorial inequalities in Hungary and boost local economic development in the disadvantaged regions are not efficiently supported by the new institutional set. Region specific financial products which offer mentoring and financial guidance besides the repayable funds cannot be displayed. The technical aim of the state to deploy these types of EU funds as rapidly as it is possible overwrites all the other development policy objectives. To prevent unintended consequences, particularly the increasing regional inequalities, a stronger development banking approach would be needed.

With the latter institutional changes of the FIs in Hungary several development policy goals can be achieved, but at the same time the new model still does not offer institutional guarantees towards the efficient spending of these resources, not even to the exact addressing of the intended target groups. In 2018 it can be important to predict which goals of the cohesion policy can be met effectively with this new delivery system, therefore this paper sought to contribute to the creation of realistic expectations by examining the new institutional set based on the predictable impacts on the economic development and territorial cohesion.

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