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Do Financial Intermediaries Promote Availability of Financial Instruments for Micro-Enterprises?

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ABSTRACT

The aim of the study is to investigate the role of financial intermediaries in promoting the availability of financial instruments for micro-enterprises in Latvia. The EU financial assistance policy for supporting business activity is accomplished on a national scale through tailor-made financial instruments implemented by financial institutions. Thus, the latter have been entrusted to act as intermediaries that offer government support to companies that have hitherto had difficulty in obtaining the necessary funding. Such aid schemes significantly facilitate access to finance for companies, especially micro-entities that have faced financial constraints in recent years.

Design/ methodology/ approach. The study examines the model of corporate financing established for accessing financial instruments in Latvia and scrutinizes the functions of government institutions involved in the model. Some of the practical aspects of financial mediation have been uncovered through individual interviews with financial experts. A survey of Latvian enterprises, covering 1879 micro-enterprises, provides an overview of the remaining limitations on obtaining external financing, including state aid. It highlights the attitudes and perceptions of micro-enterprises on the likelihood of obtaining financial instruments.

Originality/ value. The role of financial intermediaries in ensuring the availability of financial instruments in Latvia has not been studied before and has mainly been made visible through everyday practice. Although the JSC Development Finance Institution Altum, as the principal intermediary, has been actively involved in implementing new forms of support, the study has revealed areas for potential improvement in providing better access to financial instruments for micro-enterprises.

Keywords: financial availability, financial intermediaries, financial instruments, micro-enterprises

JEL code: D83, G29, L29, **Research paper**

INTRODUCTION

The European Union (hereinafter – EU) has developed state aid instruments to provide funding for companies that experience difficulties in accessing external sources of funding. Tailor-made financial instruments (hereinafter – FIs) are EU financial support measures for addressing specific Union policy objectives (European Commission, 2018c). The Regulations of the European Commission allow for some flexibility in implementing priority support strategies, which, in turn, enables Member States to develop their own programmes and choose the most appropriate FIs, appoint intermediaries and identify the eligible target groups (European Commission, 2013a). An important condition for the introduction of FIs is that they should not compete with the financial products of the regular financial market operators, for example, offers from banks or leasing companies. Typically, FIs are developed for companies that are not targeted by traditional lenders because of the considerable risk involved (OECD, 2015).

This study examines the availability of FIs to both established micro-enterprises and emerging or start-up companies. For the purposes of the study, a micro-enterprise is solely seen as a micro or small-sized business performer, or a start-up that meets the definition of the European Commission (2003) for micro-enterprise (hereinafter – ME). By enterprise size, MEs are the most common type of businesses in Europe, since they represent about 93% of all European companies (European Commission, 2018a). Moreover, 99% of all the newly established enterprises in the European Union are micro-enterprises or small business performers (Kraemer-Eis *et al.*, 2016). At the end of 2016 and 2017, companies of 9 or fewer employees in Latvia accounted for about 94% of the total number of economically active enterprises (Central Statistical Bureau, 2018).

In accordance with the Partnership Agreement (Cabinet of Ministers, 2014), the EU has allocated 5.6 billion euros of financing to Latvia in the plan for 2014-2020. The total investment in the Latvian economy, with government co-financing included, will reach 6.9 billion euros over the said period (European Commission, 2018b). In accordance with EU regulation (European Commission, 2013b), each European fund is subject to the same rules of planning, management and monitoring as the Cohesion Fund, the European Regional Development Fund, the European Social Fund and other funds; therefore, this study looks at support for MEs regardless of the diverse funds from which it is sourced.

Although Latvia has been awarded substantial support from EU funds, there are still practical considerations that call into question the availability of EU support in the form of FIs for a sufficiently broad range of MEs.

BACKGROUND STUDIES

The phenomenon of financial support through state aid is influenced by various factors, and intermediaries need to take into account certain key aspects of their activities.

Aid in the form of FIs is an advantage granted by the state to selective undertakings through intermediary bodies with a certain amount of resources. As regards state support to companies in their early stages of development, the position taken by Vivarelli (2013) is that it should be limited to such cases of market failure that prevent growth of potentially powerful companies, for example, companies with outstanding human capital or innovative ideas. The author warns against automatic support for all seekers, requiring prior analysis of the factors predicting their survival prospects. The observation made is that selective support policies have a greater impact, for example, on employment growth, than support doled out to all companies that seek it. Direct financial support should be prudent and focused and support businesses promoting progress.

At the same time, the OECD (2015) finds that although alternative support from untraditional sources is particularly important for start-ups, high growth and innovative SMEs, it may also be required for a wider range of SMEs. There is also a capital loophole for those companies that wish to modify their business.

As regards MEs, Masiak *et al.* (2017a) acknowledge that the financial needs of MEs are different compared to the needs of companies in other size classes. In the EU, financing models, including schemes with intermediaries that are particularly well-suited for providing external financing for MEs, are not sufficiently developed (OECD, 2015). European MEs are more likely to use internal financing and are slower in their uptake of state support through FIs. Masiak *et al.* (2017b) show the reasons limiting MEs' access to government funding, including lack of awareness among entrepreneurs about public funding programmes, failure of the programmes to meet the needs of MEs, and the administrative burden involved.

The OECD (2018) points out that the availability of alternative sources of funding should be viewed from the aspects of both demand and supply. On the demand side, there are many entrepreneurs who lack financial knowledge, strategic vision, and in some cases may not even have the willingness or understanding to raise any other kind of financing apart from a traditional loan successfully. On the supply side, the interest of potential investors in providing private capital co-financing may be hampered by the general lack of transparency and the regulatory barriers in the financial markets of SMEs. As a result, FIs for SMEs often operate in markets with a small number of participants and low liquidity where there is less demand for them

on the part of the SMEs, which, in turn, dissuades potential finance providers. Such a market can hardly be seen as attractive for potential financiers.

The OECD (2015) shows that competition on the supply side has encouraged financial institutions to develop innovative solutions. For example, Attuel-Mendes (2016) examines models of crowdfunding along with microfinance as an instrument against financial exclusion. Crowd-to-business platforms function as intermediaries between microfinance institutions and investors. Microfinance institutions with non-traditional lending patterns initially emerged as financial market operators to overcome the ME financing gap. The author notes that the emergence of new financing models has been driven by the growing competition between the private and the public sector as well as restrictions in the banking sector with the enhancement of Basel III precautionary principles and the development of new information and communication technologies. Political and regulatory support for the introduction of new financing models has also proven important.

Allen and Santomero (1997) look at the *financial intermediation* phenomenon and its role over time in the context of the changing financial system. In the past, the role of financial intermediaries was mostly linked to transaction costs and the need to decrease the amount of asymmetric information (between the financier and borrower). The role of intermediaries as risk transfer facilitators, operating in an increasingly complex financial market, has been growing. The OECD (2015) suggests that innovative financial products in the private sector, coupled with a measured amount of state aid, has enabled the financial system to overcome the information and agency challenges typical for financing SMEs. However, in the process of loan intermediation, it is important to maintain a balance between the risks and the expected amount of compensation. In view of this aspect, finance providers have to weigh which company is worthy of support in order to avoid inefficient allocation of capital while serving as an intermediary. This situation of intermediaries is facilitated by the fact that they may be beneficiaries of state aid if the costs of implementing a financial instrument or service exceeds the market standard (European Commission, 2017b).

The availability of funding for MEs depends not only on the accessibility of state aid, but also on the overall support policies. Isenberg (2010), who mentions policies and finances among other components of the business ecosystem, indicates that each ecosystem is unique due to the manifold causal relationships between its components. This view is supported by the OECD (2015), emphasizing that the starting point for changes in the funding policy for SMEs should be to ensure balance in the wider business environment, and drawing attention to the interconnectivity between the macroeconomic environment and the financial sector.

Without overcoming the barriers within the external environment, it will not be possible to ensure demand for funding on the part of companies.

The authors Wislade *et al.* (2017) indicate that public and private investment placements have slowed down in recent years as the investment supply side is rather complex. The role of national promotion banks as financial intermediaries in the financing of the economy is growing, although the picture varies from country to country. Through carefully crafted FIs, these banks provide support to SMEs if market failures lead to underinvestment. Although the regulatory framework for FIs has improved, implementation of FIs remains a challenge for some managing authorities. The plethora of European and local initiatives could make the offer of FIs to their beneficiaries difficult to understand. The authors point out that funding intermediaries lack timely issued guidelines and more stable rules that EU fund managers should prepare. In these circumstances, policymakers face the challenge of streamlining public interventions and adapting FIs to the relevant economic and institutional context.

When assessing business policies, the OECD (2018) indicates that only in a few countries do they focus on SMEs in particular. In some cases, measures to promote accessibility of funding have not yielded the desired results, because entrepreneurs are not prepared to absorb investment due to lack of expert knowledge. The findings of the OECD have also been confirmed by Beizitere's study (2018), which concludes that one of the factors that decrease the availability of FIs for Latvian MEs is a lack of knowledge and skills for fundraising through FIs. In the study, 73% of the respondents from MEs did not know what the FIs offered by EU funds were, while 5% of the respondents had no wish whatsoever to obtain external financial resources.

The experience of the UK (Calabrese *et al.*, 2017) in supporting SMEs that wished to access bank loans has provided evidence to the effect that SMEs demonstrating awareness of government initiatives and knowledge of how loan schemes are financed were less likely to be banned from obtaining financial support. Likewise, loan requests from those SMEs that understood how support funds and bans operate were less likely to be turned down.

As he assessed Latvia's experience in implementing the business start-up programme of 2009-2015, Cebulis (2015) noted its importance for promoting access to finance for newly established companies in particular. The programme was popular in Latvia because it offered comprehensive support, involving advice and training apart from financing. The joint stock company Development Finance Institution Altum (hereinafter – Altum) implemented support worth EUR 24.2 million. The counselling offered by Altum related to the development of a business plan.

Training, in turn, was implemented by contracted training companies. The programme included 1612 participants that were trained and another 4560 participants that benefited from consultations, with 1302 loans issued. This placement of investments showed an acceptable level of risk as the rate of non-performing loans in the focused programme was 9.2%.

The experience gathered by the European Association of Development Agencies (hereinafter – EURADA) shows that the most effective measures to promote FIs' availability were those that focused not only on capital market imperfections but also on information market gaps (Saublens, 2013b). In their view, basic business consulting could be the only cost-effective form of support for micro businesses.

RESEARCH OBJECTIVES AND METHODOLOGY

The aim of the study is to find out about the role of financial intermediaries in ensuring that MEs are able to access FIs for government support in Latvia. Research was conducted with the purpose to answer, from a practical point of view, the following questions:

1. What is the financing model for delivering state support to companies through EU fund-based FIs in Latvia?
2. What kinds of FIs specifically targeted at MEs are offered by financial intermediaries?
3. Does the existing model allow for some flexibility of financial intermediaries when helping MEs to adapt to the changing situation, within the framework of the policies adopted by EU funds and local programmes?

To improve the understanding of the financing model for state aid intended for business support and the role of financial intermediaries, individual interviews with financial experts and representatives of the entities involved in the financing model were conducted. A personal interview was agreed upon by representatives from Altum, the Central Finance and Contracting Agency of the Republic of Latvia (hereinafter – CFCA), the Ministry of Economics of the Republic of Latvia (hereinafter – EM), the financial company Capitalia SE, the management consulting company Civitta Latvija and by a business expert with financial expertise.

A company survey, also covering MEs, was developed to find out their needs for external financing and explore the financial constraints that hamper the access of businesses to finance. The aim of the survey, carried out with the assistance of the Marketing and Public Opinion Research Centre SKDS, was to find out if companies

had experienced a need for financing from different financial sources, including state aid, over the last three years. The survey not only identified the difficulties faced by companies, and especially MEs, in obtaining external funding, but also clarified the grounds for rejection of their requests.

The target population of the survey consisted of companies across the territory of Latvia, operating in strategically important industries, defined as such by the government. The selected population comprised all the active companies registered in the Latvian Company Register with the NACE codes of the 11 selected sectors, totalling 32308 companies.

A structured questionnaire was developed for conducting the survey in the Internet environment, and in January 2018 it was sent out to companies with accessible e-mail addresses of all the selected sectors. The questionnaire contained 18 questions regarding the financing of the company and was addressed to the official primarily responsible for the company’s finances. Valid responses were received from 2511 companies, of which 1879 were MEs.

FINDINGS

For the purposes of financing entrepreneurial activity from EU funds, finances are distributed among financial intermediaries (banks, leasing companies, guarantee funds and other financiers), which in turn provide them to entrepreneurs (European Commission, 2018c). The finance institution Altum and venture capital funds have been entrusted to act as financial intermediaries in Latvia (Fig.1).

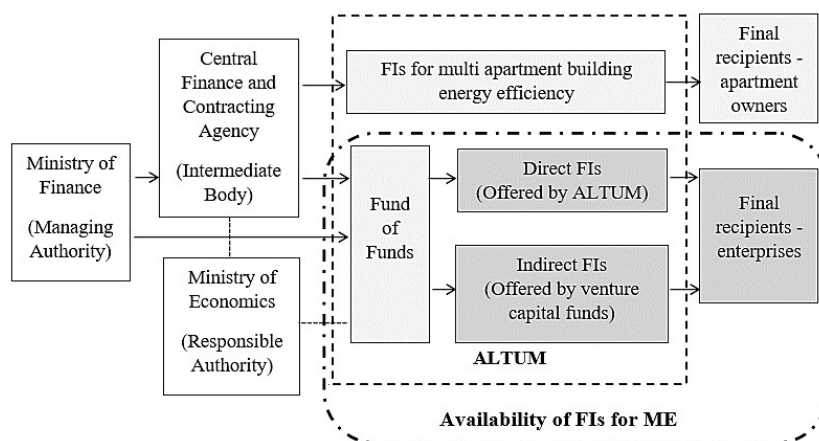


Figure 1. **Functioning of financial instruments in Latvia**

Source: created by the author based on information from Altum, CFCA, EM

The Ministry of Finance of the Republic of Latvia, as the managing authority, is responsible for the overall implementation of the EU fund programme approved by the Cabinet of Ministers. In turn, the CFCA is an institution of direct administration under the Ministry of Finance. Its mission is to monitor the implementation of EU funds and financial projects important for the development of Latvia. In turn, development and monitoring of specific national support programmes is the realm of the relevant ministry or other appropriate body. The authority responsible for supporting business is the Ministry of Economics, whereas Altum (established as a 100% state-owned JSC) acts as the financial intermediary for implementing FI programmes for companies (Saeima, 2014). Altum offers access to EU funds through direct FIs, such as loans, credit and export credit guarantees, and indirect investments in partnership with venture capital funds, which include private equity. This funding scheme for FIs could be described as rather centralized, as public support from EU funds is entrusted to one principal intermediary. It differs from other countries' schemes. For comparison, it should be noted that Lithuania had four financial intermediaries, whereas Estonia had three bodies offering EU FIs to entrepreneurs at the end of 2016 (European Commission, 2017a).

As stated by the interviewed business expert, there are different models of financial intermediation in Europe. An example of this is EURADA, offering experience-based financing solutions and schemes that include different collaborative partners, in line with the business development cycle and needs of the company. EURADA has found that the features of an efficient funding scheme are a diversified supply of financial sources, sufficient demand for financing among entrepreneurs, and coherence between supply and demand for funding. Such a funding scheme ensures that FIs not only complement each other, but also include all forms of external capital (including bank loans), private equity (family and friends, business angels) as well as formal venture capital and subordinated funding. In addition, entrepreneurs should be aware of each funding type's adequacy in the business life cycle (Saublens, 2013a).

EU support is designed so that FIs are available to a company throughout its development (Kraemer-Eis *et al.*, 2018). From the point of view of the business cycle, the FIs offered to companies in Latvia are available at every development stage of the company (Fig. 2).

		Development stage of supported enterprises			
		Pre-seed	Seed	Start-up	Development
Financial instruments	Equity or quasi-equity investments	Accelerator funds		Seed and Venture capital funds	
				Growth capital funds	
	Loans	Business microloans			
		Start-up loans		Growth loans	
	Guarantees		Credit guarantees		
			Export credit guarantees		

Figure 2. Availability of financial instruments depending on the company’s development stage in Latvia. Source: created by the author based on an interview with representatives from Altum.

Data at the disposal of Altum generally point to good availability of funding for MEs (Fig. 3). The growth rate of Altum’s portfolio for the ME segment was generally higher than the growth rate of its portfolios for companies of other size classes. In 2018, internal interim data show that 68% of a 121.7 million euro loan portfolio was made up of loans for MEs. Accordingly, in 2017, ME loans were 65% of the portfolio. The annual report notes that the structure of loan and guarantee financial instrument portfolios reflects the priorities of the Latvian government in the implementation of state aid (Altum, 2018a). However, Altum’s loan portfolio for MEs, which constituted 118 million euros towards the end of 2017, was only 0.1% of the total ME loan portfolio of commercial banks (Beizitere, 2018).

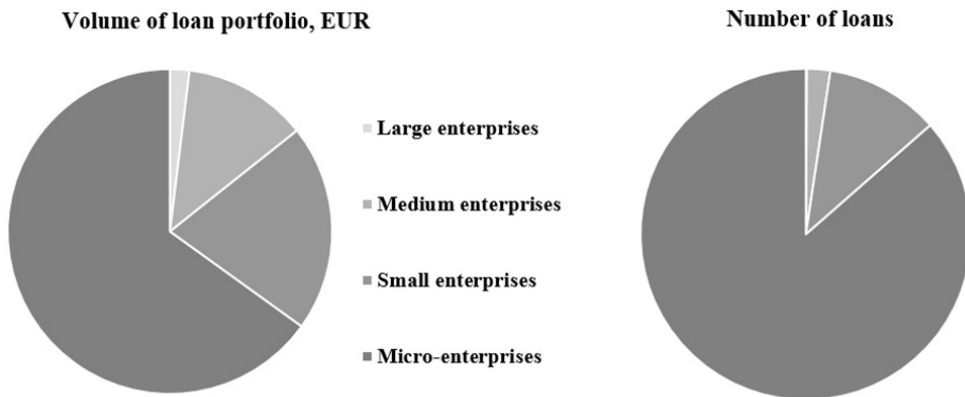


Figure 3. Share of Altum's corporate loan portfolio by company size class as of December 31, 2018. Source: created by the author based on Altum data

Altum has also been focusing on support for start-ups. Within the framework of the start-up programme, by mid-2018, a total of 47.1 million euros was granted to 2457 new business projects (Altum, 2018b). Considering that Company Register data indicate that about 10-11 thousand companies are annually registered in Latvia (Lursoft Ltd, 2018), the share of start-up companies that have received support is negligible.

Altum's credit guarantees are popular with Latvian companies. In accordance with Altum's data, the guarantees it issued to MEs covered a total of 5.7 million euros in 2017, enabling companies to take out bank loans in the amount of 8.6 million euros. However, popularity with MEs remained lower than with the larger-sized companies. The loan amounts made available to MEs through Altum's credit guarantees reached around 8% of the total corporate loans of commercial banks only in one single quarter of 2017 (Beizitere, 2018).

The high risk FI programme implemented in Latvia via Altum is not very popular within the ME segment. This is evidenced by Altum's internal information that although Altum's total investments in venture capital funds amounted to 57.0 million euros in 2017, there were only 192 projects that received funding from venture capital funds. Early stage financing came from one seed capital fund, supporting a total of 91 projects for 5.0 million euros. The rest of the financing was provided to companies in their growth and development stages and came from 4 venture capital funds and 4 expansion capital funds. In 2017, Altum, together with the Latvian Business Angels' Network, launched a pilot project for supporting microcompanies and small businesses with co-financing for innovative ideas. However, within those locally based funding initiatives, with the risk split between Altum and private investors, the amount allocated by Altum was only 450 thousand euros to 8 new

companies. Unfortunately, as the pilot project with the Latvian Business Angels' funding did not gain popularity, it is no longer offered.

In 2018, three acceleration funds started operating in cooperation with Altum to support businesses at the seed and start-up stages, focusing on support for innovative ideas or products, especially within projects with emphasis on technology and industry. Notably, this is a new initiative with national public funding and private co-financing from acceleration funds. Over the next three years, accelerated investment is expected to receive approximately 120 outlook ideas. Total public funding in these funds will amount to 15 million euro together with the Altum investment. In addition to the abovementioned funds, three venture capital funds, respectively seed, start-up and growth capital funds, started operations in the second half of 2018. Total public funding from Altum investments in venture capital funds is expected to amount to EUR 75 million (Altum, 2018a).

According to an interview with Altum's representatives, Altum is also actively providing access to finance for an ever broader range of entrepreneurs. In the framework of a recent initiative relating to Altum's loan conditions, there have been a number of improvements for business start-ups, including extension of the loan repayment term. The new Altum portfolio guarantees will help SMEs to obtain financing from credit institutions (current assets, credit lines, investment loans and finance leases) at a lower interest rate. They will also provide for faster loans and fewer documents required, since the decision will be a one-stop decision taken by the credit institution itself. Previously, the decision was first taken by the credit institution, and then Altum decided on whether a guarantee was applicable.

A financial expert, working as a project manager at the company Civitta Latvija, stated in an interview that a range of financing options for businesses was presently available in Latvia. Money is available from various sources, as long as the business has a clearly identified goal and a strategy to be investment-ready.

A company survey yielded some unexpected results in terms of funding sources. In response to the question "What are the types of financing your company uses or has used during 2015-2017?", the 1869 MEs surveyed pointed out the following sources: Altum – 4%, EU funds – 6%, venture capital and business angels – 1%, Altum guaranteed bank loans – 3%. 64% of the companies relied solely on internal financing. By contrast, 26% of MEs chose more traditional sources and financial products such as a bank loan, credit line, overdraft, leasing, or factoring. Meanwhile, 49% of the MEs surveyed acknowledged that they had needed new or additional funding over the last 3 years. Only 15% (or 141) of the MEs, however, had turned to Altum to seek it. Altum had rejected the funding requests of 55 MEs, while only 34 MEs had obtained the full amount they had been seeking. Also, 26 of the MEs had

declined to accept the offer. The reasons most commonly stated were that the process was too complicated to handle, required a large amount of documents, the required collateral was too high, and the money offered was too pricey.

When questioned about the reasons for not seeking financing from Altum, 53% of the MEs that responded stated that "they lacked knowledge about the financing opportunities offered by Altum". In turn, 19% of the MEs responded that they "felt that Altum would not provide them with the required funding".

As Adamsone (2017) points out, policymakers should better understand what our businesses need. There are cases when companies cannot find anything appropriate for their needs because the objectives of EU policy are not in line with the wishes of entrepreneurs. Often entrepreneurs deliberately choose not to use EU funds for business development. The author mentions some reasons similar to those of the company survey: lack of knowledge of EU fund financing, no suitable support programme, the entrepreneur is not satisfied with the programme requirements, the requirement of project documentation seems too complicated.

A study conducted by Altum has stated that there is an estimated need of about 7 billion euros for business development in Latvia to cover the next three years (Firmas.lv and LETA, 2018). As acknowledged by Altum, it currently finances 40% of the amount that potentially deserves support, since the majority of entrepreneurs are not even applying for it. Should Altum receive the requests of all the companies that seek financing and have been rejected by the banks, it could issue double the amount of loans. However, entrepreneurs should engage in fundraising more actively, since apparently a large part of new and small companies do not look for financing at all.

As the manager of Capitalia SE said in an interview, his financial company does not compete with Altum, nor with banks, although they offer similar financial products to FIs. He emphasized that financing from Capitalia SE can serve for micro and small businesses as a simple addition or alternative to borrowing from banks. Various financing in the form of loans and investments up to EUR 1 million are offered to businesses. The practice of this private financial company since 2007 successfully demonstrates its ability to offset the financial market failure to MEs in Latvia as an alternative finance provider. Notably in 2019, Capitalia SE plans to further develop the promotion of existing financial products, including venture capital investments. As the company has an agreement with the European Investment Fund for a total amount of EUR 10 million, this will enable it to operate more actively in microfinance with loans in the amount of up to EUR 25 000 (Capitalia, 2018).

CONCLUSIONS AND RECOMMENDATIONS

There are many aspects to ensuring that MEs can access finance via FIs. Accessibility is affected not only by the support offered by the intermediaries and their activities, but also by the willingness, approach and readiness of the entrepreneurs themselves, especially in the ME segment.

A nationally functioning financial support model and interaction and support of the involved government bodies have an essential role to play. In the case of Latvia, the model developed is operationally sound.

Rapid changes in the external environment trigger new initiatives in the financial market for companies striving to overcome financial limitations. They do not always fit in with the provisions on how the funds offered by the EU should be distributed. Although the regulatory framework is restrictive in setting down the priorities for support and specific provisions for the deployment of funds, on a national level Latvian intermediaries are implementing important initiatives aimed at supporting a broad range of MEs. With the backing of the Latvian government, Altum is expanding the model of EU fund-based financial support for companies by collaborating with private venture capital investors and funds to develop joint focused offers for MEs. This demonstrates the ability of the Latvian government and financing bodies to apply EU-developed FIs for local needs.

At the same time, the potential of the principal intermediary Altum in supporting business activity and, especially, MEs, has not been fully exploited. From the point of view of the business ecosystem, Altum has only a limited ability to influence and satisfy the demands of businesses. Also, the actual amount of funding required by MEs in Latvia has not been fully assessed: many MEs refrain from turning to Altum or solid financial institutions.

In order to improve the availability of FIs to Latvian MEs, business support policymakers should:

1. Extend the FI programme offering to include counselling and training for entrepreneurs; apart from promoting awareness among entrepreneurs about raising investment, different sources for financing and types of state aid, training could also provide specific knowledge about FIs.
2. Allow for some flexibility in the conditions for applying for FIs. Intermediaries should be able to modify the terms of the programmes entrusted to them up to an admissible risk level and in line with the needs of MEs identified in practice, so that the conditions appear feasible and the bureaucratic burden is reduced.

3. Back up entrepreneurs through other government activities not only for promoting availability of financial support, but also for organizing in-depth financial education, especially for new entrepreneurs, with a view to enhancing their ability to raise investment for the development of their companies.
4. Improve Altum's role as a state aid intermediary by extending its financial function through cooperation with various partners and complementing its offer of FIs with other services, both financial and non-financial, that meet micro-entities' needs.

Finally, to improve future availability of financing for MEs, it is crucial not to ignore new initiatives in the financial market that could be both competitive with and complementary to the existing FI offer.

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