EVALUATIONS OF THE FUNDING SUPPORT MADE AVAILABLE TO THE PRIVATE SECTOR IN THE 2014-2020 PROGRAMMING PERIOD AND EX-ANTE ASSESSMENTS FOR THE SETTING UP OF FUNDING SUPPORT FOR THE PRIVATE SECTOR IN THE 2021-2027 PROGRAMMING PERIOD IN MALTA - LOT 1

Ex-ante assessment Report

Financial Instrument

Executive summary

The present report is aimed at supporting the Managing Authority (MA) in preparing its investment strategy for the design and implementation of financial instruments (FIs) that will support SME access to finance, and more generally competitiveness, in Malta in the 2021-2027 Programming Period, through the European Structural and Investment Funds (ESIF). Building on a market assessment and the lessons from the past programming period, this report outlines the need and structure of potential FIs to help Maltese SMEs grow, survive, and expand.

This report should be read in conjunction with the thematic evaluation of the SME Initiative in Malta made available to the private sector in the 2014-2020 programming period under the Thematic Objective 3 - Enhancing the competitiveness of small and medium enterprises and the *ex-ante* assessment for non-repayable schemes that will support SME competitiveness in Malta in the 2021-2027 Programming Period.

The report includes two logically interconnected blocks: i) the market assessment (including an analysis of the Maltese context and market failures, an analysis of the value added of financial instruments and their combinations with grants, and a discussion of the lessons learnt from the previous programming periods); and ii) the investment strategy outlining a range of potential instruments. Based on the analysis developed in the first block, the second block adopts a less analytical and more operational approach to identify the main characteristics of the proposed instrument(s) and ensure smooth implementation.

Market assessment

Analysis of Maltese context, market failures, and investment needs

The Maltese economic environment remained overall favourable after the recovery from the 2009 deep recession and until it entered the COVID-19 pandemic. Since 2013, Malta has sustained several years of strong economic performance, with growing GDP per capita and investment and a positive balance of payments. Thanks to this strong performance, Malta has overall performed better than other euro-area Member States. This notwithstanding, some structural features of the Maltese economy continued to pose challenges for sustained competitiveness and long-term growth prospects.

In 2020, the COVID-19 caused a deep recession whose effects will last even if a rebound is expected by 2022. In 2020, because of the pandemic, the Maltese economy contracted more than the EU average, reflecting its high exposure to tourism and related services sector. Although Malta is expected to reach pre-pandemic levels of economic activity in 2022, the overall landscape remains fragile and extensively impacted by the COVID-19 pandemic. Persistent logistic and supply chain bottlenecks keep weighing on production, as do the elevated prices of energy, and the other uncertainties created by the unfolding conflict in Ukraine.

Malta shares some of the features typical of other insular economies. Its international competitiveness is constrained by the size of its internal market and restricted range of growth sources, due to its economic specialisation and reliance on a few service activities. Indeed, while Malta and Gozo have developed into modern service-based economies, tourism still plays a central role. As an open economy, international trade is not only an important contributor to economic performance but also to employment. Malta's ability to export goods and services is critical to sustaining the labour market and the economy.

The business sector is dominated by SMEs (constituting 99.8% of registered enterprises). Micro-enterprises, in particular, are responsible for a high share of value-added and employment; this is significantly higher compared to other EU countries. The micro enterprises dominating the business sectors are generally family-owned (traditional) businesses, predominantly active in low-value-added services sectors such as wholesale and retail trade, transportation and storage, accommodation and food service activities, with limited resources and competencies. This limits their ability to assess their growth and competitive potential and embark on investment initiatives. While some higher-value-added services (most notably professional, scientific and technical activities and financial and insurance services) have shown a positive performance over the past years, their growth still needs to be stimulated to convert these industries in engines of economic growth and structural transformation.

COVID-19 has heavily impacted the performance of Maltese SMEs and SMEs' investment plans. The share of financially distressed companies, particularly micro-enterprises, grew significantly compared to pre-COVID times. Similarly, the number of non-liquid and insolvent firms also increased, including firms that were solvent before the pandemic but started to face liquidity or insolvency problems after the pandemic.[1] This may result in greater financial constraints for the SME sector, notably smaller firms, in the form of reduced or more costly access to lending due to lower financial buffers.[2] According to the EIB Investment Survey 2021, Maltese firms are much more pessimistic than EU firms about the economic climate, the availability of internal finance, and the business prospects in their sector. Moreover, according to the EIB Investment Survey 2021, the share of firms whose investment is expected to decrease remains slightly above the share of firms expecting to increase it, making Malta the only country in the EU with a negative investment outlook.

The labour market is tightening, resulting in labour shortages and a greater reliance on foreign workers. Beset by an increasingly ageing population, Malta relies heavily on foreign workers, including many high-skilled individuals, from within and outside the EU to fill labour shortages. Labour shortages worsened due to the pandemic. Other long-term issues pertaining to the Maltese labour market are **skill mismatches and skill gaps**, particularly concerning ICT and digital technologies. Together with the skills mismatch problem, the low educational levels of the local Maltese workforce negatively impact labour productivity. Interviews with business associations also point out that attracting and retaining foreign workers with ICT and digital skills is also an issue, particularly in Gozo.

Productivity has significantly improved in the last years before COVID-19, but research and innovation still play a limited role in the economy. This low propensity to innovate ultimately hampers Maltese productivity growth. Maltese SMEs face barriers to innovation and diversification that originate from both traditional factors (financing difficulties, shortage of, and difficulties in, the recruitment of skilled staff, organisational barriers such as limited experience and know-how on how to manage innovation processes) and new emerging trends (lack of new markets, and need for knowledge and technological transfer to enter those markets).[3]

Although few firms see themselves as financially constrained, and many choose to invest, investment intensity is much lower than in the EU. This points to a mismatch between supply and demand for funding. From 2014 to 2020, SMEs' access to finance has registered a remarkable improvement, which, in all probability, is due to the government measures targeted at addressing this problem. The offer of public support measures (including financial instruments and grant schemes) available for firms in Malta has widened since 2014.

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[1] IMF (2021b).
[2] *Ibid*.
[3] See among others, European Commission (2021) Study on the effectiveness of public innovation support for SMEs in Europe. Final report. Available here: https://op.europa.eu/en/publication-detail/-/publication/d031aa03-9295-11eb-b85c-01aa75ed71a1/language-en Last access on 11/06/2021

In particular, the supply of guaranteed products in Malta increased first with the establishment of the Malta Development Bank in 2017 and then in response to the COVID-19 crisis.

However, **several structural features of the banking and financial system make external financing problematic, especially for micro firms.** According to a study by the European Commission and the EIB (2019), in 2018, 7.6% of the viable Maltese SMEs faced difficulties in seeking debt finance. This share was higher than the EU average (4.25%) and the third-highest after Greece and Cyprus. Based on this data, the study includes Malta in the list of EU Member States experiencing particular difficulties in accessing debt financing.[4] Similarly, the 2020 EIF SME Finance Index indicates that Malta is the 8th least favourable Member States in terms of SME financing conditions.[5] A few structural factors hamper access to finance, especially for micro and small enterprises[6]. These are:

- **SMEs dependency on bank-financing**. Bank-related products such as overdrafts and credit lines and, to a lesser extent, bank loans remain to date the most popular source of external financing in Malta. Market–based products and other sources of finance are still underdeveloped.[7] Business angels, venture capital funds, mezzanine finance, and other sources of finance are scarce in Malta.[8] This dependence on the banking sector is perceived as an issue of limited funding options and should be taken into account, even in the absence of financing gaps.
- The **risk aversion of local banks** intensified in the years before the pandemic. Stricter restrictions (in the form of collateral and loan covenants) create additional barriers to access credit, especially to smaller firms or start-ups that do not possess a solid credit history or do not have collateral to provide.[9] The lack of adequate collateral currently is the major source of dissatisfaction of Maltese firms, even more so in 2021 than in 2020. This challenge is even more pronounced for micro and small firms.[10] This situation creates a market failure as when it comes to traditional banking, firms are refused credit based on their **inability to provide collateral and lack of credit history** rather than their project or business plan.[11] Micro and small enterprises that are not asset-based and cannot provide collateral are consequently excluded from traditional banking finance. In turn, this situation may pose challenges for smaller companies to grow and develop.
- The **cost of financing** is the second most important source of dissatisfaction, and similar to the need to provide collateral, micro and small enterprises are the most affected. Indeed, interest rates in Malta tend to be high, further hampering access to credit.[12] The announced increase in the ECB interest rates will lead to a rise in the banks' financing cost. The latter in turn will rise interest costs for borrowers. This, coupled with a deterioration of the financial profile of SMEs, is likely to limit their possibilities to invest, thereby hindering their chances of improving their competitiveness and innovation profile.

The Maltese economy is striving to boost the growth of higher-value-added sectors

[4] European Commission and EIB (2019).
[5] Kraemer-Eis et al. (2021).
[6] Indeed, according to the survey conducted under this assignment, the importance assigned to barriers, including access to finance, depends on the size of the SMEs. While micro and small enterprises have always suffered from the issue of high interest rates, the latter was perceived as a minor barrier for medium enterprises and became a problem only since 2020, when the COVID-19 pandemic broke out. The burden or effort to obtain finance, the difficulties related to file the application process and the insufficient amount of collateral were and still will be major problems especially for micro and small enterprises, while only a small percentage of medium enterprises reported these issues.
[7] Central Bank of Malta (2020).
[8] Central Bank of Malta (2015).
[9] Central Bank of Malta (2015) and IMF (2021b).
[10] While this evidence comes from the EIB Investment Survey, this finding was corroborated by interviews.
[11] Central Bank of Malta (2015).
[12] Central Bank of Malta (2015).

(especially services) and strengthen its business sector. This process requires concrete efforts to support SMEs to invest, grow, and become more innovative, while fixing traditional market failures that affect the Maltese banking sector. The pursue of these objectives is essential to create new long-term sources of economic growth, job creation, innovation, and competitiveness.

Analysis of the value-added of the Financial Instruments

Financial instruments are viable when the purpose to which they are put has the potential to generate revenue or savings which can be used to repay the original outlay. Conversely, non-repayable grants are well-suited to finance projects that are unlikely to generate short-term revenues or where there is a need for an 'incentive effect' to persuade firms to undertake initiatives/investments that they would not do otherwise. Nonetheless, the advantages and disadvantages of financial instruments are product and policy specific. Ultimately the value-added of financial instruments also depend on the point of view of the parties involved (the MA, the FI manager, the financial intermediaries, the final recipients).

The combination of grants and financial instruments appears particularly useful when the degree of bankability of the targeted project is low. Beyond this, financial instrument/grant combination in one operation is viewed appropriate to: i) stimulate investment demand, pursue wider policy objectives, and/or attract private financing to projects that would otherwise not be financed through financial instruments alone; and ii) decrease the burden of the repayable form of finance on the project's cash flows or to reduce the final costs of the supported investment to be covered by user fees. An important change brought about by the 2021-2027 Common Provision regulation (CPR) is the enlargement of the possible options to combine financial instruments and grants in one operation.

In combining different forms of public support, it is important to avoid crowding out investments. Avoiding cannibalisation and minimising misalignments of incentives is essential to preventing conflicting elements or overlaps with other forms of public interventions. Hence, the offer of EU-backed financial instruments cannot be seen in isolation from other forms of support, both nationally and EU funded.

Lessons learnt

The thematic evaluation of the SME Initiative put forward the following recommendations.

- **Consider a more substantial involvement of national stakeholders in the design of financial instrument(s) backed by ESIF to reduce the risk of displacement effects**. Beyond the guarantee backed by the SME Initiative, during the 2014-2020 period, other guarantee instruments, managed either by MDB or Malta Enterprise, were available in Malta to support SME investment. Although there is no evidence of displaced effects, a fragmented offer risks creating confusion among firms and hampering the common vision towards the strategic direction of increasing SMEs' competitiveness in the country. Appropriate coordination between the Managing Authority, international stakeholders such as the EIF, whose role is already consolidated in Malta, and local players can limit duplication of efforts (in terms of time and resources), misalignments of objectives, and overlapping of policy instruments to support SMEs.
- **Provided the necessary coordination with national stakeholders is ensured, an uncapped guarantee scheme to support SMEs could be renewed,** for instance, by activating the so-called 'Member State compartment' of InvestEU. The "uncapped" feature of the SMEi proved effective in attracting more SMEs than the previous JEREMIE

initiative[13], in view of the higher benefits passed on to them. The SMEi also turned out to be more attractive for financial intermediaries, as they could benefit from a guarantee covering the entire portfolio without going through a securitisation process.

- **To the extent that widening bank financing to SMEs is the primary policy goal, it is recommended that guarantee schemes with broad eligibility criteria are offered.** As an illustration, a guarantee instrument specific to innovation loans or with binding innovation eligibility criteria would not be ideal in Malta for two reasons: i) the market is small, and research and innovation activity (at least as typically defined in H2020 calls) remains limited due to the structural features of Maltese SMEs and the fact that multinational companies with a branch in Malta tend to conduct R&I abroad; ii) Maltese banks need to build portfolios of a reasonable size with a high level of risk diversification. Nonetheless, even with broad eligibility criteria, innovative firms/projects could be granted extra advantages (e.g. more extended grace period or maturity).
- **The ESIF funds could be used to establish pilot SME support schemes including new products such as blended instruments** (e.g., combination of financial instruments and grants for technical support) **and equity schemes.** In this way, the ERDF could be a trendsetter, financing pilot-schemes or field experiments with a limited budget allocation, and promoting riskier, more innovative investment in addition to replicating well-established mainstream SME support schemes. This supposes the adoption of a less risk-averse attitude by policy makers, since promoting structural changes within the SMEs' behaviour implies making risky choices.

Proposed investment strategy

The proposed investment strategy aims to maintain a certain continuity with the previous programming period so as to benefit from the lessons learnt on all sides (SMEs, MA, and financial intermediaries) and, at the same time, to try out new initiatives. It revolves around the following points:

- On the one hand, it ensures continuity through a **core instrument** very similar to the one deployed during 2014-2020. The rationale is to maintain the well-tested guarantee schemes developed in the past with JEREMIE and, especially, the SME Initiative. Therefore, a **loan guarantee scheme** (possibly uncapped) is proposed as the core instrument to stimulate SME investments, reduce sub-optimal investment situations, and contribute to closing the funding gap in Malta. In line with the qualitative evidence gathered for this study, a broad scope should be kept for this instrument. Replicating the SMEi while achieving several additional advantages, especially financial ones, could be possible by activating the MS compartment of the InvestEU. Under this scenario, the funds, which Malta will transfer to the European Commission (EC), will be managed (and monitored) by the EC with an Implementing Partner chosen by the MS delivering the instrument. The alternative is setting up a guarantee instrument under shared management. Under this second configuration, a lower leverage is to be expected because Cohesion funds are directly invested in a project or operation and not used to increase the EU budgetary guarantee. Regardless of the delivery routes chosen, the ERDF resources dedicated to the instrument amount to EUR 16.3 million and should be used to guarantee newly originated loans up to EUR 250,000, with a maturity between 1 and 10 years. This focus on smaller loans is intended to minimise overlaps with the EGF SME Guarantee Scheme planned by MDB.

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[13] As of the end of March 2015, 650 SMEs benefitted from the JEREMIE Initiative in Malta for a total of 760 loans (see the Case Study on the "The First Loss Portfolio Guarantee instrument in Malta" by the European Commission and the European Investment Bank. As of September 2020, three years before the closure of the eligibility period, 937 operations have been implemented under the SMEi and 721 SMEs have been supported.

- On the other hand, the proposed investment strategy creates some scope for innovation, experimenting with a limited number of new schemes to be introduced as **pilot instruments**. These new schemes will aim at: i) reaching more specific needs which are not specifically addressed by the core instrument and ii) testing new delivery modes that could potentially replace non-repayable grants in the future. The proposed pilot instruments are expected to use a small share of the funds of the ERDF resources, with enough in-built flexibility to be discontinued, amended and/or scaled up over time depending on early implementation results. Specifically, the range of pilot instruments include:
    - A ***loan facility to fund the early phases of the investment cycle*** would be a potential solution to SMEs' limited availability of resources to start financing the investment supported by EU grants, as reported by the evaluation study of State Aid schemes, and the need to quickly find private match financing for the investment project supported by a State Aid scheme.
    - A ***loan financial instrument combined with a capital rebate*** would help address the limited investment propensity of Maltese SMEs. The rebate element would be a way to incentivise more project promoters to submit investment projects with a higher policy impact. Indeed, depending on the occurrence and level of results achieved, part of the loan may be converted into a grant, thus reducing the financial intermediary's credit exposure to the final recipient.
    - A ***one-stop-shop: a financial instrument combined with a grant for technical support*** would limit the negative impact of the lack of limited in-house resources and competencies within SMEs. Although SMEs will continue to have the option of seeking technical assistance by applying for a non-repayable grant for consultancy services in the 2021-2027 programming period, the MA could also consider the combination of a consultancy grant with the guarantee instrument or/and the loan instrument combined with capital rebate. A one-stop-shop instrument would leverage synergies better and guarantee a smooth and facilitated transition from one form of support to another.

  Not all the proposed pilot instruments need to be activated as some of them are also mutually alternative. Finally, it should be considered that Malta has already several national schemes supporting start-ups and SMEs in place hence a coordination of the different schemes would be welcome before introducing new ones.