



**Expert evaluation network
delivering policy analysis on the
performance of Cohesion policy 2007-2013
Year 2 – 2012**

Task 1: Financial engineering

Hungary

Version: Final

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**A report to the European Commission
Directorate-General Regional Policy**

Contents

Executive summary	3
1. Use of financial engineering instruments	4
2. Rationale for using financial engineering instruments.....	6
3. The effectiveness of financial engineering instruments: selected examples	8
4. Main problems in using financial engineering instruments	12
5. Evaluations of financial engineering instruments	13
6. Concluding remarks.....	13
References	14
Interviews.....	15
Annex.....	16

List of abbreviations

- CHOP Central Hungary Operational Programme
- EDOP Economic Development Operational Programme
- EEN Expert Evaluation Network
- ERDF European Regional Development Fund
- EIF European Investment Fund
- MA Managing Authority
- NDA National Development Agency
- FEI Financial Engineering Instrument
- OP Operational Programme
- RDOP Regional Development Operational Programme
- TA Technical assistance
- VC Venture Capital

Executive summary

In the 2004-2006 Hungarian Programmes there were no financial instruments, but in the 2007-2013 period the total amount of Financial Engineering Instruments (FEIs) in percentage of the ERDF support is around 6%. FEIs are financed mainly (but not only) by the Economic Development Operational Programme. The financial allocation of the EDOP 4th priority (financial instruments) was increased by 3% in 2009 through Operational Programme (OP) modification.

The concrete forms of FEI include credit, guarantee and capital as well. In 2007 the Hungarian government decided to implement JEREMIE without the European Investment Fund (EIF) acting as a holding fund, but with the newly created Venture Finance Hungary Plc.

Some of the main experiences so far:

- There was a great decrease in the credit supply in the bank sector in Hungary due to the financial crises, consequently FEIs were welcome instruments. But not only the credit supply but also the demand side shrank in the uncertain market context.
- FEIs were also expected to help establish a more market friendly SME-support system. Therefore the state tried to share the project risks with the market players, so the financial intermediaries were given large scale freedom.
- According to stakeholders' opinions, FEIs (especially guarantee and Venture Capital (VC)) need further effort to meet their target due to the lack of appropriate financial culture and the market uncertainty caused by the crisis. Stakeholders also highlight that the huge extent of the grant assistance programme partly crowds out credit schemes. They consider the Central Hungary region as the only exception where the financial market is the most developed, appropriate number of growing firms exist and the access to grant assistance is limited. In 2010 the Managing Authority (MA) made several changes to simplify the SME support system. Most importantly the MA introduced new schemes that combine FEIs with grants, making FEIs more attractive.
- FEIs have no sector or other policy (e.g. increasing employment) preferences, their aim is to develop the general business environment for SMEs, and focus on financial segments where supply is low. Although no evaluation was made with regard to FEIs, according to our survey the financial culture of the Hungarian enterprises is developing (and FEIs play a great part in it), but it needs further development to be able to benefit from a more extensive use of FEIs in the next programming period.

1. Use of financial engineering instruments

In Hungary FEIs are used in the following OPs:

Table 1: FEIs in the OPs

OP	Budget of OP (without Technical Assistance - TA)	FEI forms in the OP	FEI budget in the OP	FEI in % of the OP
Economic Development Operational Programme 2007-2013 (EDOP) <i>which covers the convergence regions (6 regions out of 7)</i>	EUR 3,257 million	Credit, Guarantee, VC	EUR 727 million (the total Financial engineering instruments priority axis)	22%
Central Hungary Operational Programme 2007-2013 (CHOP) <i>for the Regional Employment and Competitiveness objective</i>	EUR 1,663 million	Credit, Guarantee, VC	ca EUR 117 million (FEIs cover part of the 1 st priority)	7%
6 Regional Development Operational Programmes (RDOP) <i>for the Convergence regions</i>	EUR 4,881 million	VC	ca EUR 7 million /OP (in Strengthening the region's SME sector priorities)	0,8%

ERDF support between 2007-2013 amounts to EUR 14,441 million. The total amount of FEI in percentage of the total ERDF support is around 6%. The allocation among OPs is as follows:

- EDOP: 5% of the total ERDF support.
- CHOP: 0.7% of the total ERDF support.
- RDOPs 0.3% of the total ERDF support.

The EIF held several meetings in 2006 and 2007 with the Hungarian Ministry of Economy and Transport and prepared an evaluation study. In 2007 the Hungarian government decided to implement JEREMIE without the EIF acting as a holding fund, but with the newly created Venture Finance Hungary Plc (www.mvzrt.hu).

The concrete forms of FEIs are shown in the following table.

Table 2: The concrete forms of FEIs

OP	FEIs	Short description	Launching the program
EDOP, CHOP	“New Szechenyi” Combined Micro Credit and Grant	For micro enterprises, for 120 months Min HUF 1 million, max HUF 20 million (ca min EUR 3,500, max EUR 70,000) ¹ 10% own resources, 45% micro credit, 45% grant	2011
EDOP, CHOP	“New Szechenyi” Credit (previously Micro Credit)	For micro and small enterprises, for 36/120 month (depending on the type of the credit, eg investment or asset) Max. HUF 50 million (ca max EUR 175,000)	2007
EDOP, CHOP	“New Hungary” Small and Medium Credit (together with the Hungarian Development Bank)	For small and medium sized enterprises, for 10 years Min HUF 10 million, max HUF 100 million (ca min EUR 35,000, max EUR 350,000)	2008 (closed in 2012)
EDOP, CHOP	“New Hungary” Working Capital Loan (together with the Hungarian Development Bank)	For small and medium sized enterprises, for 1-2 years Min HUF 1 million, max HUF 200 million (ca min EUR 3,500, max EUR 700,000)	2008 (closed in 2010)
EDOP, CHOP	Portfolio guarantee	Up to 80%.	2007
EDOP, CHOP	Venture capital	Through venture capital fund management firms, tasked with raising a fixed proportion of additional private funding to the resources committed by Venture Finance Hungary Plc. The abovementioned partners were selected by open tender in the second half of 2009.	2009
7 RDOPs	Equity Fund	Venture capital in the regions.	2010

While there were no financial instruments in the 2004-2006 Hungarian Programmes, the use of FEIs has increased over the 2007-2013 programming period. The financial allocation of the EDOP 4th priority (financial instruments) was increased by 3% in 2009 through OP modification. Initially, no financial instruments were planned in RDOPs.

New financial instruments were introduced in addition to those that were initially planned. The new instruments are: “New Szechenyi” Combined Micro Credit and Grant financed from EDOP, CHOP, and Capital fund financed from the 7 RDOPs.

¹ EUR 1 = HUF 288.519, Conversion rate at 11 July 2012

2. Rationale for using financial engineering instruments

During the OP development process 3 documents analysed the reasons for the use of FEIs, referring to particular market failures. These documents are:

- EIF (2007): SME access to finance. Evaluation study.
- Ministry of Economy and Transport (2007): SME access to finance, analyses of market failures supporting the elaboration of the financial instruments of the Economic Development OP.
- Ministry of Economy and Transport (2007): SME development strategy.

Based on the EIF analysis of SME sources of finance, both on the equity and debt side, a number of market failures have been identified. The main failures are:

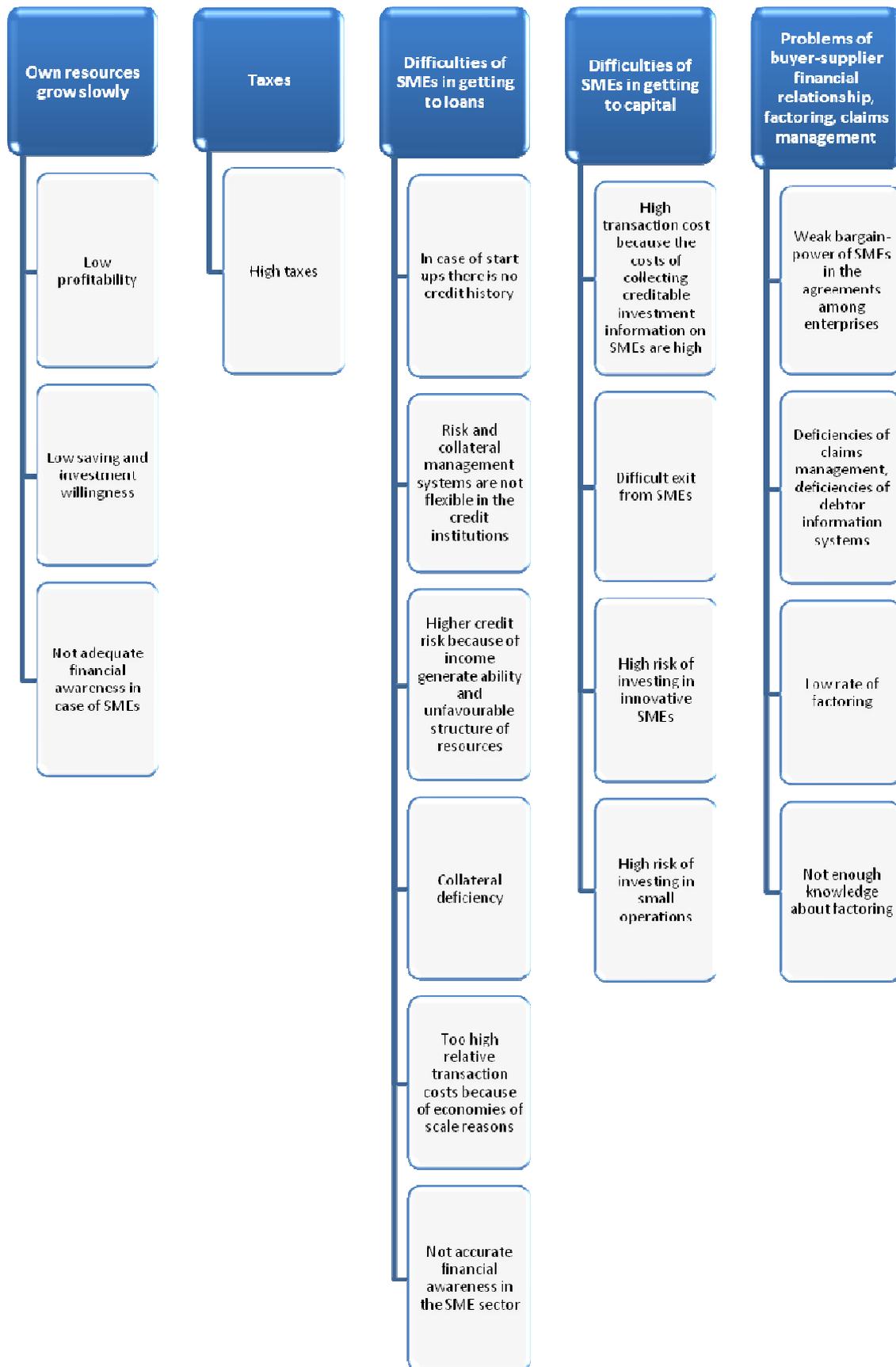
- limited supply of financing, both on the debt and equity side, to newly established enterprises;
- low volume of credit offered to enterprises;
- low provision of expansion capital in a form of equity;
- lack of revolving support for technology transfer.

The document of the Ministry of Economy and Transport highlights:

- Main market failures are: information asymmetries and the problem of economies of scale (i.e. high fixed costs of financial service providers). Financing institutions do not consider it worth their while to prepare deep risk assessment for small businesses with a short credit history.
- According to the 2005 report of Flash Eurobarometer, 14% of SMEs in EU-15 have problems with access to finance, while in Hungary this ratio is 27%. In the “old” Member States, 79% of SMEs turn to banks for financing, in Hungary it was only 54% in 2006.
- Compared to the old Member States in Hungary the SME sector lacks investment loans, 3+ year term loans, bank account loans, and venture capital. There are not enough “SME-suited” loans. To solve this problem micro credit is needed to finance the development and short term asset needs of the SME sector. With the introduction of portfolio guarantee programmes the commercial banks are encouraged to develop simple bank accounts and small-scale loan products.

The SME development strategy 2007-2013, adopted by the Hungarian government in October 2007, summarizes the existing financial constraints in the following chart.

Figure 1 Financial constraints in Hungary



On the basis of these documents the Economic Development OP and the Central Hungary OP point out:

- Despite progress in recent years, the financial sector's contribution to the financing of SMEs is still limited. The principal factors behind the market insufficiencies are also familiar in other EU member states: information asymmetry due to short business history, and the economies of scale problem arising from the high fixed unit costs of financial service providers.
- To solve these problems, it is necessary to support bridging institutions (that would supply small enterprises with information and opportunities, providing them with business management, market access, partner search and application consulting services), as well as to apply targeted intervention (first of all increasing the supply of financial instruments that are also available for SMEs).

The current strategy, as regards FEIs, is laid down in the New Szechenyi Plan (written in 2011). This plan outlines the following FEI sub-programmes:

- Micro-credit for small enterprises
- Szechenyi Card
- Venture Capital Funds

3. The effectiveness of financial engineering instruments: selected examples

Micro Credit financed by the Economic Development OP and Central Hungary OP

Micro Credit is the earliest financial engineering instrument, the calls for tender for the banks and micro financing institutions were launched in October 2007, while the first contracts with the intermediaries were drawn up in December 2007. In January 2008 the first micro credit transactions were carried out.

The aim of the programme is to develop micro enterprises in Hungary that have no or not enough access to commercial bank loans. Since launching the programme the main parameters were changed 3 times on the basis of experience and as a reaction to the crises.

In 2011 the micro credit programme was supplemented with a new combined micro credit plus grant scheme, although the simple micro credit scheme still exists. Before, the grant scheme in the EDOP provided limited aid, and many SMEs needed loans to finance their own part of the investment (advance payments were not available for them). In the combined scheme the SMEs can get a 45% grant, 45% micro credit and contribute with own resources to 10% of the total investment. As this scheme is for the smallest enterprises, at the beginning the maximum of the grant was HUF 4 million (ca EUR 13,000) and the maximum of the credit HUF 8 million (ca EUR 26,000). In 2012 both the grant and the credit were increased to HUF 10 and 20 million respectively (EUR 34,660 and EUR 69,319.5 respectively).

On the ERDF institution system side the new combined scheme became a one-stop-shop system, where the SMEs applied to the (private) financial intermediaries that granted the micro credit part. While the (state-owned) intermediate body acted as a "back-office" paying the grant. The 2 institution systems had to evaluate different aspects of the project, and shared the risks.

The combined scheme has not been evaluated so far, but after the difficult start the absorption rate increased substantially after one year.

Venture Capital Fund (financed from Economic Development OP and Central Hungary OP)

Table 3: Venture Capital Fund, first round

Name of Fund	Venture Capital Fund (registered in Hungary)
Equity Capital	HUF 40,500 million (EUR 140.4 million) financed by the Economic Development Operational Programme (HUF 36,500 million) (126.5 million) and Central Hungary Operational Programme (HUF 4,000 million) (EUR 13.7 million)
Investor	Venture Finance Hungary Private Limited Company (state owned, working as a holding fund)
Fund Manager	8 (private) venture capital fund management firms tasked with raising a minimum 30% proportion of additional private funding to the resources committed by Venture Finance Hungary Plc. The fund managers were selected by open tender in the second half of 2009.
Term of Fund	10 years (extension is allowed)
Management fee	<ul style="list-style-type: none"> The fund manager's compensation consists of a fixed fee based on the volume of the fund and a success fee. Fixed fee: established in the course of the fund managers' tender, maximized at 3% of the registered capital per year. Success fee: applicable after the termination of a fund, if the fund generated an annual profit above the agreed rate
Investment Period	From the Fund's registration date (2009) to the end of 2015
Final recipient	Only enterprise with limited liability (Ltd. or Plc.) qualified as a micro-, small- or medium-sized enterprise, registered in Hungary.
Investment Policy Guidelines	<ul style="list-style-type: none"> With a registered head office in the Republic of Hungary. In the early or growth stage. Was founded no more than five years prior to the investment decision. With a net annual turnover not exceeding HUF 1,500 million in any business year. Its business plans are well thought-out and promising; It operates in an attractive, developing industry; It is likely to meet the elevated return expectations; It has no means to tap bank resources (e.g. lack of capital, the nature or risks of the project, lack of collateral); It is ready to share ownership of the company Usual conflict of interest rules apply; Funds cannot be used for (i) commercial real estate development; (ii) repayment of loans to third parties; and (iii) acquiring shareholdings in other companies.
Sector Focus	Generalist approach (no preferred or discriminated sectors other than those excluded by EU and Hungarian general rules). It should operate in an attractive, developing sector.
Maximum Size of Equity Investment	EUR 1.5 million per year for a maximum 3 years in succession.
Provision of Loan	Shareholder loan
Form of financing	The total shareholder loan which can be provided to one final recipient may not exceed the amount invested in that final recipient, furthermore the total loan transferred may not exceed 25% of the capital registered at that time.
Reinvestment	Reinvestment of funds from sale of equity holding is allowed within the Investment Period.

Form of Equity Investment	Capital increase
Percentage of Shareholding	The Fund can invest in minority and majority position as well.
Fund Manager's Role in Investee Companies	Fund Manager will participate in investee companies' strategic decisions.
Investment Committee	Put up by the Fund manager
Exit	According to market estimation the average is at 3-5 years, but it can be 4-7 years as well

Aim of the programme is to develop start-ups or enterprises that are in their growth period, with capital. The call for tender was launched in 2009, 18 (private) fund managers applied, 8 were chosen. The first investment decisions were made in 2010. The fund managers invest ca 100-450 million HUF/enterprise. Before this, there was basically no comparable venture capital financing scheme in the Hungarian market. For greater investments, some private funds are available for enterprises in their growth period.

The Managing Authority had a limited influence on the fund managers. Both the Venture Finance Hungary Plc and the MA are represented in the Investment Board without voting rights. In addition a regular monitoring report that has to be prepared quarterly. The Fund Managers have reporting obligations to the Hungarian Financial Supervisory Authority, which is probably the strongest regulation they have to abide by.

The target company has to be founded no more than five years prior to the investment decision, with a net annual turnover not exceeding HUF 1,500 million (EUR 51.9 million) in any business year. Its business plans must be well thought-out and promising and it must operate in an attractive, developing industry.

The MA concentrates its attention on absorption. The share of VC funds committed (actual contracts to invest in firms) is in the range 20-50% for each fund manager, which is considered reasonable by the MA. However some experts who have been interviewed feel that the Hungarian market in this segment is not large enough to absorb all the resources, partly due to the lack of seed capital investments.

The new calls regarding venture capital, in the framework of the JEREMIE scheme, were published in 11th June 2012, and are expected to finance seed capital investments as well (in this case the maximum size of equity investment is EUR 150,000).

Regional Equity Investment Fund (financed from the Regional Operation Programmes)

Table 4: Regional Equity Investment Fund

Name of Fund	Regional Equity Investment Fund (registered in Hungary)
Equity Capital	HUF 14,000 million (EUR 48.5 million) financed by the 7 Regional Operational Programme (HUF 2,000 million /OP) (EUR 6.9 million)
Investor	National Development Agency of Hungary (100%)
Fund Manager	Regional Equity Investment Fund Management Zrt. (100% owned by the National Development Agency)
Term of Fund	10 years (with possible extension)
Management fee	3% of the Fund's registered capital
Investment Period	From the Fund's registration date to the end of 2015
Target companies	Small- and medium sized enterprises
Investment Policy Guidelines	<ul style="list-style-type: none"> • Final recipient company must have been registered more than two years prior to application; • Final recipient company must have had at least 25 employees in the previous two financial years; • Usual conflict of interest rules apply; • Funds cannot be used for (i) commercial real estate development; (ii) repayment of loans to third parties; and (iii) acquiring shareholdings in other companies.
Sector Focus	Generalist approach (no preferred or discriminated sectors other than those excluded by EU and Hungarian general rules)
Maximum Size of Equity Investment	EUR 200,000 (de minimis rules apply)
Provision of Loan	Fund can provide loan financing to investee companies which cannot exceed (i) 200% of the equity investment.
Interest Rate of Loans	BUBOR + 500
Reinvestment	Reinvestment of funds from sale of equity holding is allowed within the Investment Period.
Form of Equity Investment	Equity investment can be made through the increase of share capital of the investee company only.
Percentage of Shareholding	The Fund can invest in minority and majority position as well.
Fund Manager's Role in Investee Companies	Fund Manager will participate in investee companies' strategic decisions.
Investment Committee	Investment Committee will be made up of experienced investment professionals. Six will be nominated by the National Development Agency, one by the Ministry for National Economy and one by one of the regional development agencies where the given investment transaction will take place.

Exit	Primarily sale-back to the investee company and/or to its shareholders within 4 to 6 years after the investment.
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The aim of the Regional Equity Investment Fund is to help enterprises hit by the crises but have growth potential. The fund was set up legally by a government decree in 2009, while the Fund Managing body was set up in 2010 by the National Development Agency. The first investment decisions were made in 2011. There is no private capital in the fund, so the investments are made under de minimis rules.

The National Development Agency (NDA) (including the managing authority for the Regional Development Programmes) has only limited control over the fund:

- the NDA delegates one member to the investment committee (that consist of 7 members);
- there is a quarterly report to the NDA;
- the NDA has no voice in the investment policy.

The beneficiary company must have been registered more than two years prior to application, and must have had at least 25 employees in the previous two financial years. Besides these criteria the application process is as follows:

- the company has to fill in an application form;
- if it fulfils the basic criteria, a business plan is required;
- after 3-5 week negotiations an independent auditor audits the company;
- the whole process normally takes 4-5 months.

There are no specific criteria to assess the performance of the fund. Mainly absorption criteria are used.

4. Main problems in using financial engineering instruments

Starting the financial engineering instruments was slower than the non-refundable grants. The reason for this is basically the lack of experience in using refundable instruments, lack of experience in setting up an institution system with private intermediaries, and deficient EU regulation also acknowledged by the Commission (European Commission, 2012). This is partly the reason why these programmes face absorption risks at the moment. The institution system of the ERDF had to learn how to share the risks and responsibilities with the financial intermediaries. To find the techniques of this took time.

The financial crises and the uncertainty of the markets decreased the credit demand substantially. This also contributes to the low absorption rate of FEIs.

The problems that some venture capital experts raised in our interviews are the following:

- there are no or not enough potential beneficiaries in the convergence regions. The target companies are in Budapest (or nearby) which is under the Regional Employment and Competitiveness objective. This of course influences absorption as well;
- VC also needs smaller size investments. In a response to this need the MA launched the seed capital fund this June. However at the moment FEIs do not crowd out private

capital, rather help building the demand for this instrument in the future, but after the crisis the crowding out issue will arise.

5. Evaluations of financial engineering instruments

The mid-term evaluation of the Economic Development OP was prepared in 2010. At that time the venture capital scheme had not started, and the newly introduced measures were not a part of the evaluation. The evaluation highlights:

- The refundable instruments should be increased in the operational programme.
- The possible grants for the SMEs are not transparent, there are many schemes to apply for, so it is difficult for them to find the appropriate resources.
- It is recommended to combine the refundable and the non-refundable grants and to advertise the venture capital fund more.

Since 2011 the MA has introduced a new scheme that has combined the micro credit with non the refundable grant. The venture capital scheme was also running up in that year.

6. Concluding remarks

In the 2004-2006 Hungarian Operational Programmes there were no financial instruments, while in the 2007-2013 period the total amount of FEI in percentage of the ERDF support amounts to around 6%. These instruments were completely new in Hungary in 2007, and according to our interviews they filled a gap.

The amount of money to be spent on FEIs is more than Hungary can spend in this period without incurring risks. This might cause absorption problems. The reason is partly the underdeveloped financial culture (enterprises do not understand instruments other than loans), partly the slow institutional learning process.

Efficient risk sharing between state-owned and private institutions could be pursued through proper schemes (e.g. FEIs combined with grants) and could also increase the effectiveness of the SME support system.

A challenge for the future is to introduce economic policy aims, thematic focus in the use of FEIs (e.g. guarantee for energy efficiency loans). In the current period the focus was to improve general financial conditions for SMEs.

Altogether this was and still is a learning period. As the MA, the financial intermediaries and the final recipients learn the advantages of FEIs, these instruments can play a more important role in the 2014-2020 financial period.

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Mr. Gabor Ormosy. Partner of Finext Startup Venture Capital Fund Manager (before head of MAG – Hungarian Economic Development Center, the intermediate body of EDOP). Date of interview: 14th May 2012.

Mr. Jozsef Torok. Director for Business Development at Regional Equity Investment Fund Management Zrt. Date of interview: 10th May 2012.

Ms. Krisztina Szabo. Head of unit at Economic Development Operational Programme Managing Authority. Date of interview: 22nd May 2012.

Mr. Peter Szobonya. Hungarian Private Equity and Venture Capital Association. Date of interview: 15th May 2012.

Annex

Annex Table A: State of play of the EDOP FEIs

Situation in May 2012

FEI	Total resources for 7 years (HUF billion) ²	Number of financial intermediaries	Resources committed*	Number of investments in final recipient	Resources committed to final recipients (HUF billion)
Loan	88,7	120	n.a.	4817	45,522
Guarantee	58,9	39	n.a.	241	7,559
Capital	56	7	n.a.	42	11,974

Source: MA

* data are non available as limits for the partners are defined in the contracts

Annex Table B: State of play of the CHOP FEIs

Situation in May 2012

FEI	Total resources for 7 years (HUF billion)	Number of financial intermediaries	Resources committed*	Number of investments in final recipient	Resources committed to final recipients (HUF billion)
Loan	28,65	54	n.a.	1985	19,406
Guarantee	7,09	19	n.a.	94	3,959
Capital	4,09	1	n.a.	6	1,805

Source: MA

* data are non available as limits for the partners are defined in the contracts

Annex Table C: State of play of the Regional Equity Investment Fund (financed from the Regional Operation Programmes) in May 2012.

FEI	Total resources for 7 years	Number of financial intermediaries	Resources committed	Number of investments in final recipient	Resources committed to final recipients
Loan	HUF 14 billion (ca EUR 48 million)	1	HUF 14 billion (ca EUR 48 million)	7	HUF 0.4 billion
Capital				12	HUF 0.6 billion

Source: Data based on interview.

² EUR 1 = HUF 288.519, Conversion rate at 11 July 2012