fi compass ERDF

Factsheet
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ERDF guarantee financial instruments

European Commission

European Investment Bank

ERDF guarantee financial instruments

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Glossary of useful terms related to guarantees

Financial instrument: a form of support delivered via a structure through which financial instrument products are provided to final recipients.

Financial instrument products: also called financial products, are types of interventions that may be offered via financial instruments to support projects. The choice of the financial products will depend on the market failures, suboptimal investment situations and investment needs to be addressed as well as the acceptable level of risk, reward and ownership.

Beneficiary: the body that implements the holding fund or, where there is no holding fund structure, the body that implements the specific fund or, where the managing authority manages the financial instrument, the managing authority.

Holding fund: a fund set up under the responsibility of a managing authority under one or more programmes, to implement one or more specific funds.

Specific fund: a fund through which a managing authority or a holding fund provides financial products to final recipients.

Final recipient: a legal or natural person receiving support from the Funds from the financial instrument.

Shared management: Member States are entrusted by the European Commission with the implementation of operational programmes and the allocation of funds to final recipients (e.g. SMEs, municipalities, natural persons etc.).

Shared management funds: the funds governed by the Common Provisions Regulation (CPR), which include the European Regional Development Fund (ERDF), the European Social Fund Plus (ESF+), the Cohesion Fund (CF), the European Maritime, Fisheries and Aquaculture Fund (EMFAF), the Asylum, Migration and Integration Fund (AMIF), the Internal Security Fund (ISF) and the Border Management and Visa Instrument (BMVI).

Managing authority: a national ministry/regional authority/local council, or another public or private body responsible for the efficient management and implementation of an operational programme.

Body implementing a financial instrument: a body, governed by public or private law, carrying out tasks of a holding fund or specific fund.

Body providing the underlying loans: A specialised financial institution (e.g. commercial lending banks) providing loans to final recipients of a guarantee financial instrument.

Guarantee: a financial instrument product which is a written commitment to assume responsibility for all or part of a third party's debt or obligation if an event occurs which triggers such guarantee, such as a loan default.

Portfolio guarantee: a facility that guarantees a portfolio (i.e. a collection/group) of loans to be made by a specialised financial institution to final recipients, for which the parameters have been defined but individual borrowers are not yet known because the loans are only about to be given.

Loan default: a situation where a loan is not paid back by the borrower, the final recipient, which triggers the use of the guarantee to cover the losses of the lender.

Abbreviations

Abbreviation	Full name
AMIF	Asylum, Migration and Integration Fund
BMVI	Border Management and Visa Policy Instrument
CPR	Common Provisions Regulation
EC	European Commission
EFSI	European Fund for Strategic Investments
EGF	Pan-European Guarantee Fund (EGF)
EIB	European Investment Bank
EIF	European Investment Fund
EMFAF	European Maritime, Fisheries and Aquaculture Fund
ERDF	European Regional Development Fund
ESF/ESF+	European Social Fund / European Social Fund Plus
ESIF or ESI Funds	European Structural and Investment Funds
EU	European Union
FA	Funding Agreement
FI	Financial instrument
FLPG	First Loss Portfolio Guarantee
GGE	Gross Grant Equivalent
ICT	Information and communications technology
IFI	International Financial Institution
ISF	Internal Security Fund
MA	Managing authority
MS	Member State(s)
NPBI(s)	National Promotional Bank(s) and Institution(s)
PO	Policy Objective
RDI	Research, Development and Innovation
RRF	Recovery and Resilience Facility
SME(s)	Small and medium-sized enterprise(s)
TO	Thematic objective

Table of contents

1 Executive summary 6

2 Introduction to ERDF guarantee financial instruments 9

2.1 Definition of guarantee financial instruments 9
2.2 Technical features of a guarantee 9
2.3 Purpose of guarantee financial instruments 10
2.4 Types of guarantee 12
2.5 Benefits of guarantees 15
2.6 The growth of ERDF debt financing 17

3 Guarantee financial instruments: a market perspective 20

3.1 Debt financing in the real economy 20
3.2 Guarantee instruments vs equity 21
3.3 Guarantee instruments vs loan products 22
3.4 Debt market analysis – market conditions in EU macro regions 24

4 Guarantee financial instruments: key market features 27

4.1 The portfolio guarantee model 27
4.2 Transfer of benefit in case of guarantees 29
4.3 Guarantees in combination with grants 30
4.4 Implementation of guarantee financial instruments 33

5 Guarantee financial instruments: an ERDF perspective 36

5.1 Policy framework for ERDF guarantee financial instruments 36
5.2 ERDF guarantees supporting SME access to finance 37
5.3 ERDF guarantees supporting the green transition 38
5.4 ERDF guarantees supporting other sectors 40
5.5 The 'off-the-shelf' capped portfolio guarantee model 42

Further information 44

Table of figures 46

Table of tables 46

01 Executive summary

This factsheet aims to present key features of guarantee financial instruments, together with examples of best practices to support managing authorities and other stakeholders seeking to implement them in the future. The publication provides an overview of the main guarantee types, their key features as well as their potential scope of application, together with links to fi-compass resources where further information can be found. The factsheet also presents examples of how guarantee financial instruments, co-financed with resources from the European Regional Development Fund (ERDF), have successfully contributed to achieving the EU cohesion policy goals in a number of EU Member States.

The most common form of ERDF guarantee financial instruments is the capped portfolio guarantee where the guarantor uses ERDF programme resources to cover a fixed percentage of losses in a portfolio on a loan-by-loan basis (the guarantee rate) up to a fixed percentage cap of total losses within the portfolio (the guarantee cap rate). Figure 1 shows a typical portfolio guarantee and illustrates how the guarantee rate and guarantee cap rate interact to share the risk with the lending bank that makes the underlying loans.

Figure 1: A typical capped portfolio guarantee

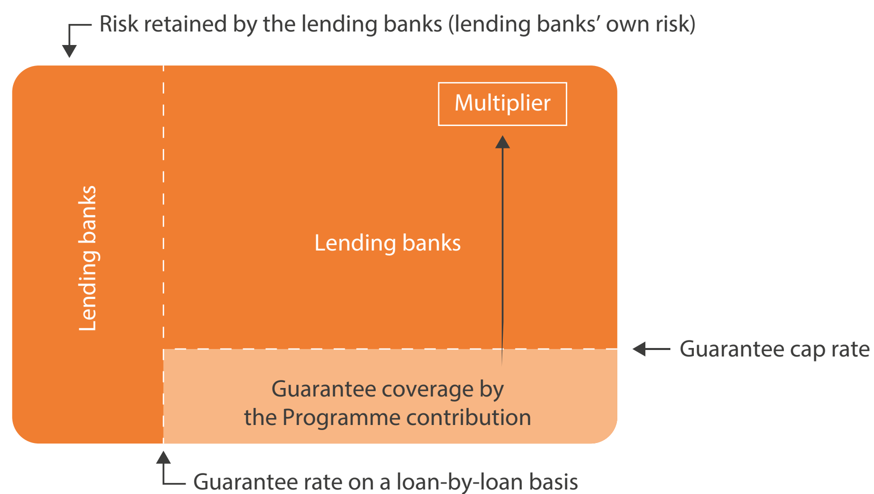


Figure 1 also shows how guarantee financial instruments achieve **a high rate of leverage** due to the structure resulting in a high multiplier. For example, EUR 100 million deployed through a portfolio loan guarantee with a guarantee rate of 80% and guarantee cap rate of 25% would support a portfolio of loans of EUR 500 million (EUR 100 million x 100/80 x 100/25 = EUR 500 million). This leverage rate is the multiplier.

Guarantee financial instruments, **by providing loss protection to the banks in case of loan defaults**, improve the banks' lending capacity and appetite for riskier projects. In case of default of a loan, the guarantee can significantly reduce the loss to be borne by the bodies providing the underlying loans (i.e. lending commercial banks). At the same time, in return for the guarantee that is often provided free of charge, the banks are obliged to improve the financing conditions towards the final recipients, usually in the form of lower interest rates and reduced collateral requirements. In this way, the whole 'ecosystem' benefits from the guarantee, including the final recipients, the financial institutions, the managing authority (MA) and the wider economy.

Guarantee instruments can address both medium and long-term needs for investments, mainly for investments in infrastructure or fixed assets, and short-term needs for working capital.

In the **2021-2027 programming period**, the use of financial instruments is incentivised with **enhanced flexibility, broader eligibility and increased opportunity for combination with grants**. The latter includes the possibility to combine **in a single operation** a financial instrument, such as a guarantee, with grants, such as interest rate subsidies, guarantee fee subsidies or capital rebate. As both forms of support are in this case provided by the same financial institution, the process to obtain both forms of financial support for the final recipients is easier and leaner than if they would need to apply for the grants and loans through two separate bodies.

The Biznesmax ERDF guarantee supporting SMEs in Poland

Launched in 2016 under the 2014-2020 Operational Programme 'Smart Growth', Biznesmax is a guarantee financial instrument combined with an interest rate subsidy, with an impressive overall financial size of EUR 628 million. Biznesmax provides guarantees for:

Loans for **investment projects** implemented by **innovative entrepreneurs** (if one of the 17 criteria of Biznesmax is fulfilled);

Loans for **green innovation investment projects** with a positive environmental impact;

Non-investment-related loans, to support the day-to-day business activities of the small and medium-sized enterprises (SMEs) impacted by the COVID-19 pandemic as well as Russia's aggression in Ukraine.

The managing authority entrusted Bank Gospodarstwa Krajowego (BGK, the Polish national promotional bank) as body implementing the financial instrument and as guarantor of the guarantee fund. Biznesmax provides a loan repayment guarantee of up to 80% of the principal amount of each loan to the participating banks. The guarantee is at no cost for the final recipients. The maximum guarantee amount is EUR 2.5 million per loan and could be granted for a period of up to 20 years. The interest rate subsidy can cover up to 3 years from the date of the loan disbursement.

For further information on the Biznesmax guarantee fund in Poland, please see the case study and video case study on the fi-compass website.

Comparison of stock-market total returns
30%
25%
20%
15%
10%
5%
0%
22.3%
10.9%
23.0%
6.6%
19.9%
16.0%
Stock market

02

Introduction to ERDF guarantee financial instruments

2.1 Definition of guarantee financial instruments

A guarantee financial instrument supports lenders to provide debt financing to final recipients by covering a part of the risk of default. A guarantee is defined[1] as:

A written commitment to assume responsibility for all or part of a third party's debt or obligation or for the successful performance by that third party of its obligations if an event occurs which triggers such guarantee, such as a loan default.

A guarantee is an unfunded product. This means that the financial instrument does not provide the loans themselves to the final recipients. Instead, a guarantee is given to one or more lenders, for instance commercial banks, which make the loans from their own resources, to the final recipients.

2.2 Technical features of a guarantee

The following elements collectively define the structure, limits and mechanisms of a guarantee instrument, influencing the risk-sharing dynamics between the guarantor and the bodies providing the underlying loans.

Portfolio volume

The aggregate amount of the underlying transaction, such as loans to be disbursed by the lender which are covered by the guarantee.

Guarantee rate

The maximum portion of the value of each loan (i.e. on a loan-by-loan basis), covered by the guarantee. It determines the extent to which the guarantor will indemnify the lender in case of default.

Cap rate

The maximum percentage or amount of the loan, or the total portfolio, that a capped guarantee will cover. It sets an upper limit on the guarantor's liability for losses.

Guarantee amount

The total value of the guarantee provided by the guarantor. It is calculated based on the guarantee rate and the size of the loan or portfolio.

Guarantee fee

A risk premium paid by the bodies providing the underlying loans to the guarantor. It compensates the guarantor for assuming the risk and is often calculated as a percentage of the guaranteed amount.

1 Article 2(3) Regulation 2018/1046.

Payment claim

A formal request or demand for payment made by the lender or the entity covered by the guarantee when a default event occurs. It triggers the activation of the guarantee and the potential payment by the guarantor.

Eligibility criteria

The set of conditions or requirements that a loan or project must meet to qualify for the guarantee. Eligibility criteria ensure that the guarantee is extended to transactions that align with specific objectives, risk parameters or policy considerations.

Collateral

A way to reduce credit risk, where the borrower offers assets such as property, receivables or investments as security which become property of the lender if the borrower defaults.

Recovery

The amount recovered or received by the lender, including by way of set-off, in respect of the losses incurred from the default event. Recoveries on defaulted transactions are shared *pari-passu* between the bodies providing the underlying loans and the guarantor at the guarantee rate.

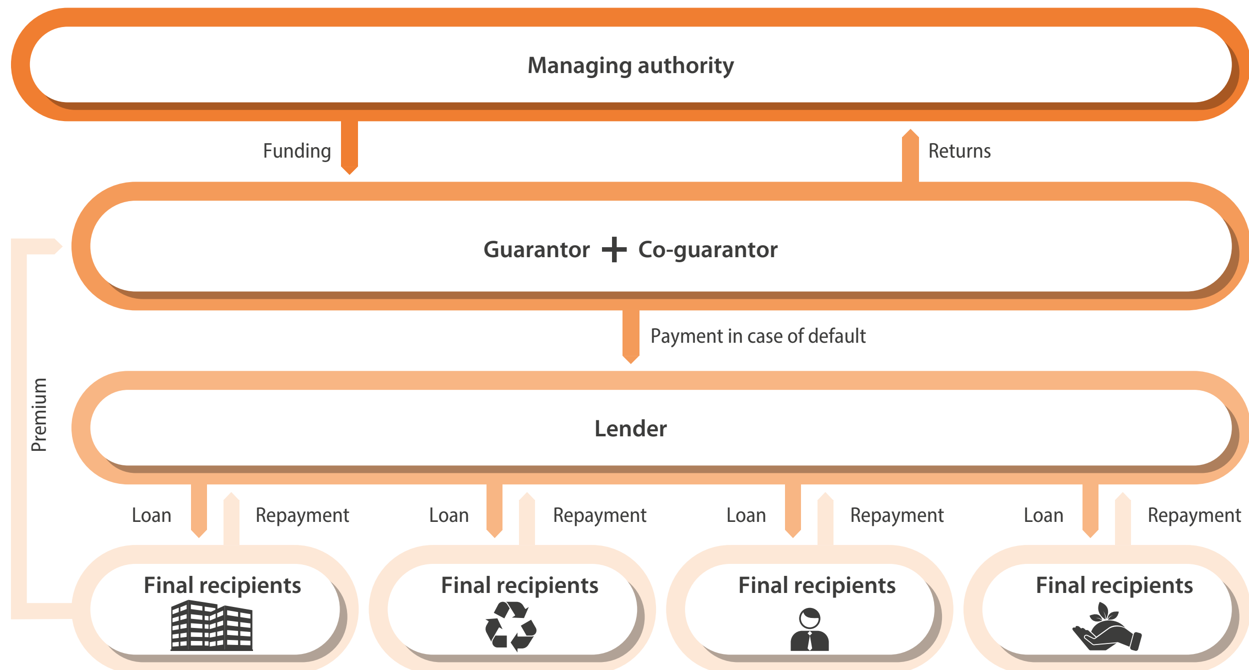
Multiplier ratio

The impact of the guarantee can be assessed by the multiplier ratio, which is the ratio between the programme contributions committed and the total amount of new loans disbursed to final recipients

2.3 Purpose of guarantee financial instruments

Figure 2 below shows the structure of a guarantee instrument, as outlined in fi-compass factsheet: 'Financial Instrument Products' providing an introduction to each of these financial products. EU shared management funds are committed by a managing authority (or Holding Fund entrusted by the managing authority) to the body implementing the financial instrument which acts as the guarantor. In turn, the guarantor enters into a guarantee agreement with lenders (typically banks) to enable loans to be made to final recipients. The guarantee can be provided for a guarantee fee or free of charge, depending on the policy objectives and the structure of the product.

Figure 2: Structure of a guarantee instrument



Guarantee instruments provide credit risk sharing to financial institutions with the purpose to create better access to finance to targeted final recipients by mitigating risks for lenders and encouraging them to provide financing to final recipients and/or projects that might otherwise be perceived as too risky. Potential benefits for final recipients could include *inter alia* lower or no guarantee fees, lower or no collateral requirements as well as lower risk premiums.

The financing gap of SMEs in the EU economy is estimated to be EUR 176.7 billion[2], which represents a significant market demand from this specific target group. In particular, smaller and younger SMEs as well as innovative companies and those active in new sectors generally face more difficulties in accessing debt financing due to the lack of credit history and the lack of tangible assets that could be offered as collateral. Difficulties in accessing finance are however not only limited to SMEs. Other types of final recipients may also face similar challenges in access to finance if they and/or their planned undertakings are perceived as too risky by financial institutions. Guarantee financial instruments may enable access to finance in such cases.

2 Gap analysis for small and medium-sized enterprises financing in the European Union. Final report. December 2019.

The First Loss Portfolio Guarantee instrument, Malta

This case study provides a good introduction to guarantee financial instruments providing financing packages for SMEs using assistance from the ERDF. It multiplied an initial ERDF investment of EUR 10.2 million to result in a total of EUR 62.6 million being invested in SMEs. Furthermore, the financial intermediary provided non-financial services such as coaching and mentoring. This extra support is considered to be extremely effective, particularly for start-ups with limited financial expertise.

fi-compass case study - The First Loss Portfolio Guarantee instrument in Malta.

2.4 Types of guarantee

There are several different types of guarantee. The most common in the context of ERDF financial instruments is the portfolio guarantee, where the guarantor covers the losses of a loan portfolio (i.e. a collection/group of loans) up to a certain level. In addition to loss coverage, this guarantee can reduce the capital required for the lending bank according to capital adequacy requirements in force.

Alternatively, a guarantee can be provided as an individual guarantee, where the guarantor issues a direct guarantee for a specific loan for an agreed amount of debt to cover the losses of the lender in case of default.

A third type of guarantee is the counter-guarantee where one institution provides a guarantee to another institution to cover part of the risk of the latter's guarantee operations.

The portfolio guarantee

A portfolio loan guarantee provides credit risk coverage on a loan-by-loan basis for the creation of a portfolio of new loans developed by the participating lending banks originating the underlying loans to final recipients.

The guarantee would indemnify the lender up to a pre-defined percentage (i.e. the guarantee rate) of the defaulted loans included in the portfolio. This implies that the actual guarantee amount offered by the risk protection, at any given time, is proportional to the actual portfolio size built up by the lending banks.

There are two types of portfolio guarantees depending on whether the guarantee instrument is capped or uncapped at the level of the loan portfolio.

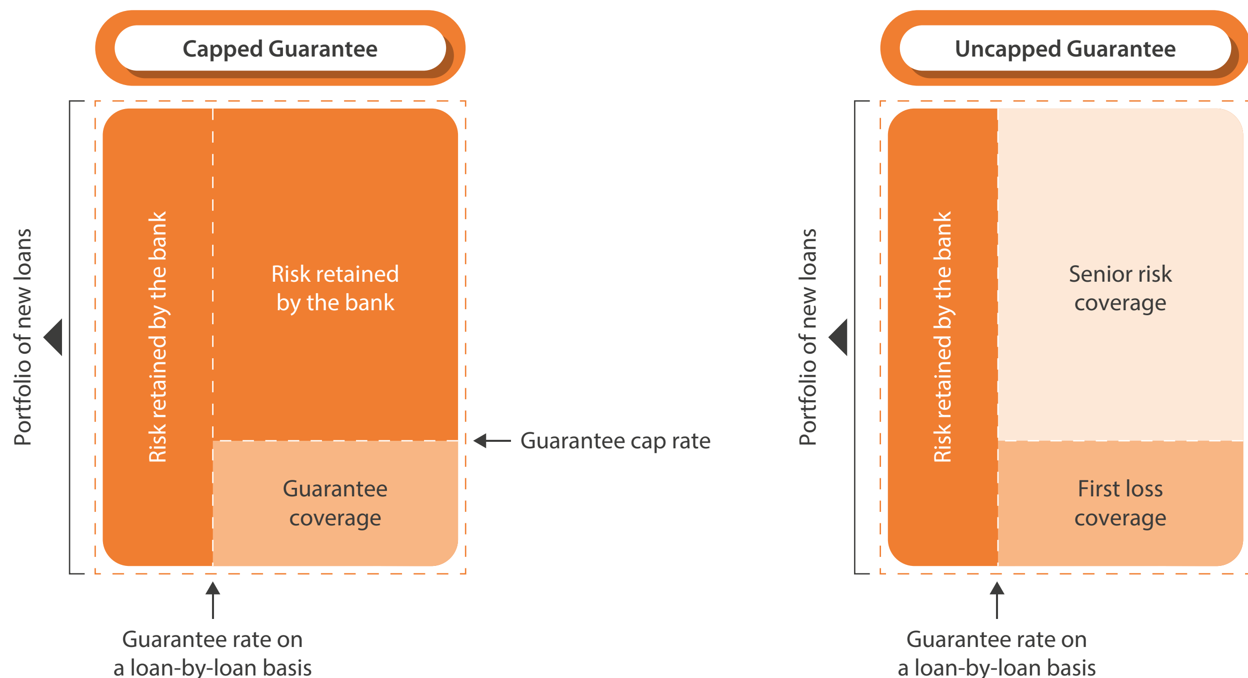
For a **capped portfolio guarantee**, the maximum liability of the guarantor for losses is limited to a percentage (referred to as the 'cap rate') of the guaranteed share of the portfolio volume. For example, a cap of 20% at the portfolio level would mean that losses incurred due to default of individual loans may be covered until their aggregate value reaches 20% of the total loan portfolio value, therefore limiting the total exposure of the guarantor to losses.

Whereas the guarantee rate indicates the maximum portion of the value of each loan (i.e. on a loan-by-loan basis), covered by the guarantee, the guarantee cap rate indicates the maximum portion of the total portfolio covered by the guarantee. A specific sub-type of capped guarantees is the **first loss portfolio guarantee**, where the first loss piece of the guarantee (i.e. typically aligned to the expected losses and potentially part of the unexpected losses) is covered by the guarantor. Therefore, the lender is potentially exposed to losses greater than the capped amount of the guarantee.

For **uncapped guarantees**, there is no cap regarding the liability of the guarantor with respect to the portfolio volumes, so the guarantee covers the guaranteed portion (according to the guarantee rate) of the full portfolio.

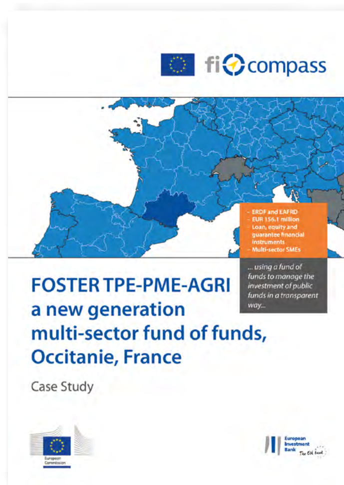
The mechanism of the two types of portfolio guarantee instruments are summarised in Figure 3 below. The figure shows how the level of coverage depends on the guarantee rate in case of an uncapped guarantee, or the guarantee rate and the cap rate in case of a capped guarantee.

Figure 3: Portfolio guarantee models



In addition to the risk protection provided to the participating banks, uncapped guarantees may also provide capital relief for banks. When the bank regulations allow, guarantees may be treated as unfunded credit protection, with the possibility to apply lower risk weights to the exposures covered by the guarantee and thereby reducing the value of the risk-weighted assets for the calculation of the required capital. Where capital relief can be applied, it can enable banks to increase their overall lending capacity, potentially further supporting the availability of capital to final recipients.

FOSTER fund of funds in Occitanie, France



The FOSTER ('Fonds Occitanie de Soutien Territorial aux Entreprises Régionales') fund of funds was set up in 2014 in the Occitanie region of France, with four underlying financial instruments: a seed loan instrument, a guarantee instrument for SMEs, a co-investment instrument and a guarantee instrument for agriculture.

The managing authority entrusted the EIF as fund of funds manager, which selected four financial institutions for the ERDF guarantee instrument: Banque Populaire du Sud, Banque Populaire Occitane, Caisse d´Èpargne Languedoc-Roussillon and Caisse d´Èpargne Midi-Pyrénées.

The initial contribution of EUR 107 million has been increased to EUR 156.1 million due to the high demand in the market. The allocation of funds to the guarantee financial instrument targeting SMEs under Thematic Objective 3 is EUR 75 million.

The guarantee instrument for SMEs features a first loss portfolio guarantee model, with the contribution by the managing authority allocated to cover the expected and part of the unexpected losses of the banks in line with the 80% guarantee rate and a pre-fixed cap rate of between 10-25%. The instrument is expected to generate new loans of approximately EUR 800 million, at preferential rates thanks to the guarantee provided free of changes to the banks.

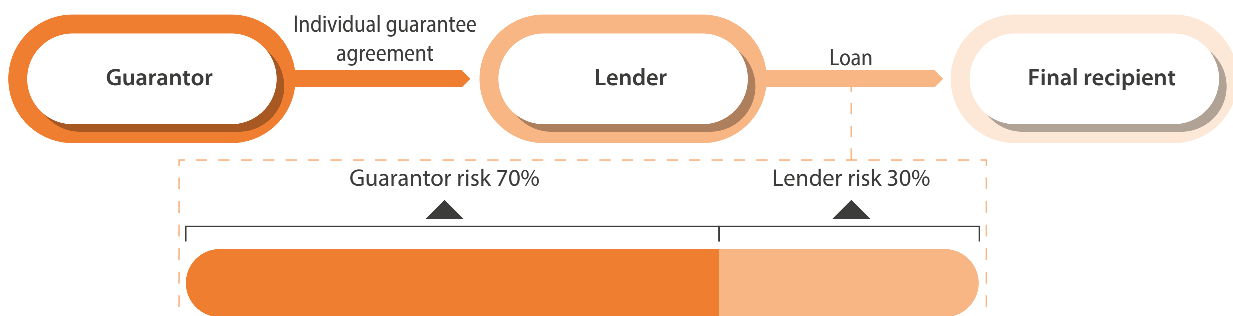
For further details about the instrument, see fi-compass case study - Foster fund of funds.

Individual guarantees

In case of individual guarantees, the guarantor issues a direct guarantee for this specific loan, for an agreed amount of debt to cover the losses of the lender in case of default. The structure of an individual guarantee is shown in Figure 4. Under an individual guarantee, the coverage of losses is capped on a loan-by-loan basis to ensure that the lender bears some risk (e.g. a guarantee rate of 70% would mean that 70% of the loss incurred due to a loan default will be covered by the guarantor).

Typically, the guarantor enters into an individual guarantee agreement with the borrower and Bank in relation to the guarantee, meaning the guarantee financial instrument has a greater involvement with each final recipient than in the case of portfolio loan guarantees.

Figure 4: Structure of an individual guarantee



Individual guarantee instrument in energy efficiency of residential buildings in Latvia

An individual guarantee product is used in Latvia to support apartment owners and homeowner associations to borrow from participating banks to improve the energy efficiency of their homes.

The ERDF managing authority for the 2014-2020 OP 'Growth and Employment has appointed Altum, Latvia's state-owned development finance institution, acting as a one-stop agency for various support programmes in Latvia, for the implementation of the financial instrument. Four banks - Swedbank, Citadele, Luminor and SEB Banka – signed operational agreements to provide the underlying loans to final recipients, i.e. apartment owners, homeowner associations acting on their behalf.

The product offering consisted of two financial instruments, both combined with grant components: an ERDF-backed individual guarantee instrument, to secure the commercial loans provided by the banks and an ERDF-backed loan instrument offered directly by Altum, if the loan application is declined by the commercial banks.

For the initial five years, the guarantee is provided free of charge. After this period, the banks are required to pay a guarantee fee amounting to 0.65%. The banks typically finance 50% of the project costs.

For further details, see fi-compass podcast with success stories from Latvia and Lithuania.

Counter-guarantees

Counter-guarantees offer an added layer of risk mitigation by allowing the guarantor to seek reimbursement if they have to pay a claim under a guarantee they issued for a loan in default. In this mechanism, the counter-guarantee provider steps in to cover a predetermined portion of the losses incurred by the original guarantor. This dual-layered guarantee structure enhances the risk-sharing capacity of financial instruments, increasing the willingness of guarantors and financial institutions in extending support to final recipients that might otherwise be deemed too risky.

2.5 Benefits of guarantees

Guarantee financial instruments can provide attractive benefits for the different types of stakeholders involved.

As with all financial instruments, when compared with grants, the three key benefits for managing authorities are:

- The **revolving nature** of the investments, allowing resources to be reused once they are released from the initial guarantee funding agreements;
- The **leverage effect** due to their ability to mobilise private sector financial resources;
- The **impact** due to the market orientated nature of financial instruments which are well adapted to meet final recipients' needs and are managed by financial intermediaries incentivised to achieve the objectives of the operation.

In the case of guarantee financial instruments, the leverage effect is often the key benefit, due to the large multipliers that can be achieved through the capped portfolio loan guarantee structure.

As guarantee financial instruments often come with standardised and well-established processes, they are familiar to banks and this can enable the rapid deployment of resources. Banks can efficiently assess and process loan applications under these schemes, reducing administrative overhead and accelerating the delivery of funds to borrowers.

Finally, a guarantee financial instrument co-financed with shared management funds can allow final recipients to benefit from more attractive lending conditions than what would be offered if they applied for standard market financing. That is because the banks are required to transfer the financial benefit to the final recipients. Such improved conditions can include lower or no guarantee fees, lower or no collateral requirement and/or lower risk premium or the combination thereof.

There are other advantages to final recipients of financial instruments, including guarantees, if compared to traditional grant programmes. Firstly, the mechanisms allow final recipients to get the funding upfront to carry out their investments. Additionally, compared to grants, where stringent reporting and documentation requirements may be in place, guarantees typically involve simpler and more straightforward application and approval processes. Furthermore, financial instruments offer broader eligibility, covering certain expenditures that may not be eligible under grant-based programmes. This flexibility allows businesses and individuals to utilise funds for a variety of purposes, providing greater adaptability in addressing their financial needs.

Huras: a rising star in challenging times

Thanks to a loan granted by BNP Paribas Bank Polska S.A. of around EUR 1.7 million under the ERDF co-financed Biznesmax guarantee, Huras, a globally active family-owned company manufacturing machinery and specialised equipment in Nowa Wieś Legnicka, Poland, was able to develop and grow – even during challenging times.

The Biznesmax guarantee secured 80% of the loan while the loan covers ca. 74% of the investment costs. The loan helped to fund the construction of an additional production hall and a connector to the existing premises, an internal power line for plots and an external water, sanitary and rain sewage system.

Huras: a rising star in challenging times | fi-compass.

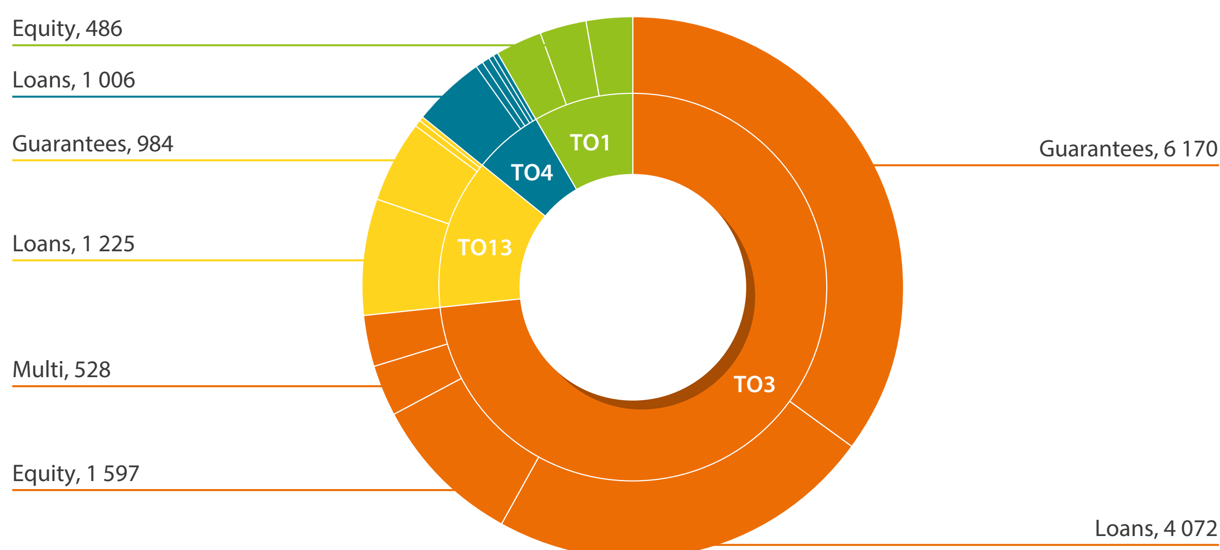
2.6 The growth of ERDF debt financing

Financial instruments have been used to support investments under the cohesion policy funds since the 1994-1999 programming period, albeit with a limited allocated budget of EUR 570 million. An increase occurred during the 2000-2006 programming period with the total allocation rising to EUR 2.1 billion.

Their importance increased significantly during the 2007-2013 programming period, when a total of EUR 16.4 billion of programme resources were used for financial instruments in the field of enterprise development (89%), urban development (7%) and energy efficiency (4%). In the period 2014-2020, the total programme contributions committed until end of 2020 were nearly EUR 29 billion. At the level of cohesion policy, the indicative programme allocation to financial instruments represent more than 10% of total ERDF and CF resources.

As at end of 2022[3], the total commitment of ERDF and CF programme resources for financial instruments amounted to EUR 31 billion, including EUR 24 billion from the ERDF and the CF. A total of 770 000 final recipients were supported out of which, guarantee financial instruments have supported around 490 000 business across the EU. Guarantees were the main financial product used to support TO3 (SME Competitiveness), although less resources were committed to guarantees than to other product types in relation to the other three main thematic objectives TO1 (RDI) and TO4 (EE/RE) and TO13 (REACT-EU).

Figure 5: ERDF and CF committed by TO and financial product



In terms of the level of commitment to the different types of financial instruments, guarantees received 28% of all programme resources. The average programme amount contributed to guarantee financial instruments was EUR 71 million and the median achieved leverage for the 89 guarantee financial instruments included in the European Commission's report was 5.2, demonstrating guarantee financial instruments' multiplier effect in practice.

3 Financial instruments under the European Structural and Investment Funds Summaries of the data on the progress made in financing and implementing the financial instruments for the programming period 2014-2020 in accordance with Article 46 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council. Situation as at 31 December 2022.

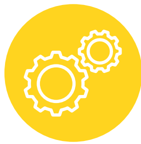
During the 2014-2020 programming period, guarantee financial instruments also provided the basis for the SME Initiative which was a joint financial instrument of the EC and the EIB Group created to stimulate SME financing by providing partial risk cover for SME loan portfolios of originating financial institutions. The SME Initiative consisted of two instruments products, ready-to-use for the Member States, one of which was an uncapped portfolio guarantee instrument. The InvestEU programme, which has succeeded the SME Initiative and other financing tools in the 2021-2027 programming period, includes similar guarantee instruments designed to enable continuing mobilisation of private sector resources to support SMEs and mid-caps across the EU.

InvestEU

The InvestEU Programme aims to provide long-term funding to companies and to support sustainable investment, innovation and job creation in the 2021-2027 programming period. It consists of three building blocks: The InvestEU Fund, the InvestEU Advisory Hub and the InvestEU Portal.

The InvestEU Fund is a new instrument replacing the diverse centrally managed financial instruments of the 2014-2020 programming period with one fund with a single set of requirements.

The InvestEU Fund supports four policy windows with a special focus on the green and digital transition, enhanced resilience and strengthened strategic value chains.



SUSTAINABLE INFRASTRUCTURE

RESEARCH, INNOVATION AND DIGITISATION

SMALL AND MEDIUM-SIZES COMPANIES

SOCIAL INVESTMENT AND SKILLS

The InvestEU Fund aims to mobilise at least EUR 372 billion in public and private investments through an EU budget guarantee of EUR 26.2 billion in support of investment focusing mainly on EU policy priorities and investments in EU value added, implemented by selected implementing partners. The main partner is the EIB Group, which has successfully implemented and managed the European Fund for Strategic Investments (EFSI) since its launch in 2015, and which is responsible to implement 75% of the EU Guarantee. The guarantee will increase the risk-bearing capacity of the implementing partners.

In addition, Member States have the opportunity to add funds to the EU guarantee's provisioning by voluntarily channelling a part of their Cohesion policy funds (via a partnership agreement or programme amendment and subsequently a contribution agreement with the EC) or of their Recovery and Resilience Facility (RRF) funds to the Member State compartment for each policy area.

Source: investeu.europa.eu.

03 Guarantee financial instruments: a market perspective

3.1 Debt financing in the real economy

Debt financing through banks is the most important external financing source for SMEs in all Member States, despite differences between the banking sector across the EU. The lending capacity of the EU banking sector to SMEs can be affected by a number of factors. One of such factors in the recent past was for instance the introduction of higher capital requirements for the banking system in line with the Basel III reforms, implemented in the EU through the Capital Requirements Regulation and Directive[4].

In this context, guarantee financial instruments, through their loss protection mechanisms, may provide capital relief to banks, thereby improving their lending capacity as well. In countries or regions, where the economy has a relatively important focus on certain new sectors, fine-tuned financial instruments providing debt financing in those sectors can be of great relevance.

From the demand side, smaller and younger SMEs generally face more difficulties in accessing debt financing, due to the lack of credit history and shortage of personnel assigned to acquire financing. Innovative SMEs, in particular, often face also greater difficulties because they have very limited tangible assets that could be offered as collateral for the debt financing. The same is true for SMEs developing in new sectors such as circular economy, social economy, and/or the cultural and creative sector.

Guarantee instruments can address both medium and long-term needs for investments, mainly for investments in infrastructure or fixed assets and short-term needs for working capital. Their effectiveness as a tool to mobilise financing was illustrated in several Member States during the COVID-19 pandemic when guarantee instruments were repurposed and expanded to support companies affected by the crisis as part of the European Commission's Coronavirus Response Investment Initiative (CRII) and CRII Plus.

4 Directive 2013/36/EU (CRD IV) and Regulation (EU) 575/2013.

The SIH Anti-Corona Guarantee

The Slovak Investment Holding (SIH) Anti-Corona Guarantee was launched in Slovakia in the second part of 2020. The purpose of the instrument was to provide favourable-term bridging loans to SMEs impacted by the COVID-19 crisis.

The guarantee was one of the first products introduced in the EU after the COVID-19 outbreak. It was funded by the Operational Programme 'Integrated Infrastructure' with ESIF resources co-financed by the national budget of the Slovak Republic.

The financial instrument consisted of two components. First, a first loss portfolio guarantee with 80% guarantee coverage on individual loans a 50% guaranttee cap rate at the level of the portfolio. Secondly, an interest rate subsidy of up to 4% for those enterprises that manage to preserve existing jobs.

Factsheet – Responding to the COVID-19 crisis through financial instruments: SIH Anti-Corona Guarantee | fi-compass.

The high level of liquidity and low interest rates, that characterised the supply side of the banking sector in the recent years, have resulted in generally very favourable financing conditions to SMEs. Nevertheless, such favourable conditions, as demonstrated by the increased interest rate environment since 2021/2022, can change and flexible financial instruments co-financed by EU resources are important means to mitigate the effects of such changes.

3.2 Guarantee instruments vs equity

Debt financing and equity financing are two fundamentally different approaches to support businesses. These instruments differ significantly in their terms, structures and implications. The table below compares the different features of the two product types.

Debt instruments	Equity instruments
Short- to long-term finance.	Medium- to long-term finance.
Investors do not take a share of ownership in the company. They provide risk-taking (e.g. guarantees or credit enhancements).	Investor takes a share of ownership in the company.
Commitment subject to compliance with loan terms.	Committed until 'exit', subject to investor participation on the company's Board.
Interest payable regardless of results.	No interest is paid, return on investment through a capital gain on sale of shares.
Provides a source of finance to meet short or longer term needs of the company.	Provides a flexible, capital base to meet a company's future growth plans.

Requires stable good cash flow to service interest and capital repayments.	Good for cash flow, as no capital or interest payments.
The returns are not directly linked to the business's performance. They are generally based on fees or premiums.	The returns to the private equity investor depend on the business' growth and success – the more successful the company, the better the returns of investors.
Security can vary depending on the specific terms and conditions of the debt financing. Guarantee financial instruments often require the reduction of collateral.	No security is given to investors. If the business fails, equity investors will rank alongside other shareholders, after the banks and other lenders, and stand to lose their investment.
Investors usually do not take an active role in the company's management. They offer financial support but do not provide hands-on advice or managerial expertise as equity investors do.	A business partner, sharing business risks and rewards, with hands-on advice and managerial expertise to assist business growth and sustainability.

Debt financing involves borrowing funds, typically with the obligation to pay interest and repay the principal amount, regardless of the company's performance. As opposed to equity instruments, debt products can preserve the equity of final recipients, since there is normally no claim on the ownership of the enterprise. Instead, they play a risk-mitigating role. In contrast, equity financing allows investors to become partial owners of the business. It involves a long-term commitment and a share in the company's profits and losses. Equity investors typically do not expect regular interest payments, and their returns are tied to the company's success. They often take an active role in business management, offering strategic advice and expertise to drive growth. Such transfer of business know-how to final recipients does not take place in debt instruments. Also, whereas equity focuses mainly on supporting SMEs with high growth potential, the scope of ERDF guarantees is broader in terms of target final recipients.

3.3 Guarantee instruments vs loan products

Across the different debt instruments, all product categories have advantages and disadvantages compared to each other. For example, guarantee products usually have higher leverage rate than funded products, due to the multiplier effect. This also means that the instrument can be launched with relatively small contribution from the managing authorities. On the other hand, the reflows are slower for guarantees than for loan instruments, therefore the re-use of funds would take longer. The guarantee represents a risk reserve for the lender and does not provide liquidity. Consequently, if banks require higher levels of liquidity, loan instruments would be a more suitable choice to address the market's needs.

For further information on the pros and cons of each financial product, see fi-compass: 'Financial Instrument Products'.

Figure 6: Comparison of financial products

	Loan product	Guarantee products		
	Portfolio Risk-Sharing Loan	**Capped Guarantee**	**Uncapped Guarantee**	**Individual Guarantee**
Portfolio	Financial Intermediary; Risk sharing	Financial Intermediary; Expected loss	Financial Intermediary; Expected loss	N/A
Leverage	Low	Highest	Depending on other investors	High
Risk profile	Low	High	Higher	High
Transfer of benefit	Highest	High	Depending on the guarantee fee	High
Reflows	Fast	Slowest	Slowest	Slow

Among the possible ways of financial instrument implementation, the choice of the financial product and the investment strategy to pursue depend on various factors, including the managing authority's goals (for example, whether liquidity or rather leverage is the main requirement) the portfolio profile and the risk appetite in the market.

For example, guarantee instruments can be useful means of financing when the collateral requirements by commercial banks are high, where there is risk-aversion to finance riskier projects in the market or a tightening of lending conditions stemming from regulatory requirements.

FMFIB – Strategic use of guarantees and loan financial instruments for SMEs

The Fund Manager of Financial Instruments in Bulgaria (FMFIB) is a Holding Fund that manages EU shared management resources through 13 different financial instruments on behalf of five Bulgarian managing authorities.

This case study highlights how FMFIB initially set up several targeted loan financial instruments under the ERDF 'Innovation and Competitiveness' Operational Programmes to complement the large guarantee programme being delivered under the SME Initiative.

Later further guarantee financial instruments were developed as part of the response to the COVID-19 crisis to mobilise significant additional finance to support Bulgarian businesses.

FMFIB: Fund Manager of Financial Instruments in Bulgaria – a multi-sector fund of funds | fi-compass.

3.4 Debt market analysis – market conditions in EU macro regions

The debt financing gap for SMEs (estimated at EU level at EUR 176.7 billion) remains high despite the provision of support from both EU centrally managed instruments as well as those using national programme resources. Within the Member States, the highest debt / GDP ratio was measured in Greece (7.7%) and Cyprus (6%), followed by Estonia (5.5%) and Croatia (4.7%). In absolute terms, the study found that the largest EU counties have the highest debt financing gap: Italy (EUR 24.9 million), France (EUR 21.1 million) and Germany (EUR 20.3 million)[5]. The results for the specific EU macro regions or group of countries are set out below.

South-European Member States: Cyprus, Greece, Italy, Malta, Portugal and Spain

Greece's financial situation within the EU is unique, characterised by challenges in SMEs' access to finance and the banking sector. The country faces the largest debt financing gaps to GDP ratios (7.7%), primarily rooted in difficulties arising from the 2008-2009 economic and financial crisis and subsequent public debt crises. Although Greece's banking sector is gradually recovering, it has historically struggled to fund the economy, especially SMEs. This was a result of both the banks' inability to access international markets for funds and government-imposed restrictions on the auctioning of real estate assets held as collateral, hindering new financing opportunities. Furthermore, capital controls implemented in 2015 have further limited access to liquidity.

Italy's debt gap is the largest among all EU Member States in absolute terms, amounting to EUR 24.9 billion. This figure significantly surpasses Spain's and Greece's (EUR 14 billion each) and Portugal's (EUR 7.5 billion) gaps. It's important to note that Italy's gap is likely influenced by its even greater number of SMEs, particularly micro-enterprises with fewer than 9 employees, which stands at 3.7 million SMEs, in contrast to Spain's 2.7 million, for example.

Cyprus and Malta, with 'debt financing gap to GDP ratios' of 6% and 4.3%, respectively also show unique characteristics with percentages of viable but unsuccessful SMEs at 9.4% (Cyprus) and 7.6% (Malta), compared to the EU average of 4.3%. These figures indicate particular difficulties for SMEs in these countries.

Central and Eastern European Member States: Bulgaria, Croatia, Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia

In the Central and Eastern European Member States, Poland stands out as the sole country with a 'debt financing gap to GDP ratio' below the EU average, specifically at 0.9% compared to 1.1%. Poland provides an interesting perspective, given its remarkably low percentage of viable but unsuccessful SMEs, which stands at 1.6% - the second lowest within the EU-27. This phenomenon can be partly attributed to the diverse financing landscape for SMEs, which includes not only commercial banks but also cooperative banks and non-bank entities like savings unions and foundations. This diversity suggests that certain SMEs, which may not meet the financial viability criteria of the banking system, still have access to financing through these alternative sources.

In contrast, the macro-region's highest 'debt financing gap to GDP ratios' were observed in Estonia (5.5%), Croatia (4.7%) and Bulgaria (3.7%). Notably, Bulgaria shares an identical 'debt financing gap to GDP ratio' with Portugal, but their characteristics differ significantly. While Bulgaria has a mere 4.8% of viable but unsuccessful SMEs (far fewer than the 6.7% in Portugal) but has 2.6 times fewer SMEs than Portugal and possesses a GDP that is 3.7 times smaller than that of Portugal.

5 fi-compass (2020): Gap analysis for SME financing in the European Union.

The comparison between Czechia and Slovakia provides also valuable insights. Slovakia presents a notably lower percentage of viable but unsuccessful SMEs in comparison to Czechia (2.5% versus 3.2%). It is home to a smaller nominal count of SMEs (472 000 versus Czechia's 1.0 million) and indicates a lower average loan amounts requested (EUR 179 000 as opposed to EUR 219 000 in Czechia). This divergence indicates two different SME markets and potentially various needs from SMEs to be addressed, and consequently different potential supports to be provided via financial instruments.

Western European Member States: Austria, Belgium, France, Germany, Ireland, Luxembourg and the Netherlands

Within the Western European Member States, the Netherlands stands as the sole country where the 'debt financing gap to GDP ratio' surpasses the EU average. Their relatively high ratio of 1.5% is attributed to the country's well-structured banking sector, featuring some of the largest EU-wide banking groups. Dutch banks typically show a willingness to engage with new and more risky sectors, such as the circular economy. The Netherlands presents a comparatively low percentage of viable but unsuccessful SMEs (3.6%), in contrast to the EU average. This can be explained by a relatively high average loan size (EUR 285 000) and a substantial number of SMEs in the country (1.2 million).

Conversely, France presents a 'debt financing gap to GDP ratio' below the EU average, registering at 0.9%. This is noteworthy, considering it possesses the second-largest debt financing gap in the EU, totalling EUR 21 billion and a relatively high percentage of viable but unsuccessful SMEs (5.3% in comparison to 4.3% at EU level). Despite the low gap to GDP ratio, it's important to recognise that some French SMEs still continue to face challenges when it comes to accessing debt finance. This is particularly true considering that the average loan amount requested by French SMEs is EUR 144 000, one of the lowest in the EU. As a result, French SMEs may encounter difficulties in securing financing, even for relatively low amounts.

Nordic Member States: Denmark, Finland and Sweden

Within the Nordic macro-region, the 'debt financing gap to GDP ratio' closely mirrors the EU-27 average, with Sweden slightly surpassing it at 1.2%. In contrast, Denmark (0.9%) and Finland (0.8%) both demonstrate values below the EU-27 average. Notably, Finland's exceptionally low ratio can be attributed primarily to its limited percentage of viable but unsuccessful SMEs (3.1%), a relatively modest count of SMEs in the country (235 000), and a comparatively high GDP of EUR 232 billion.

04

Guarantee financial instruments: key market features

4.1 The portfolio guarantee model

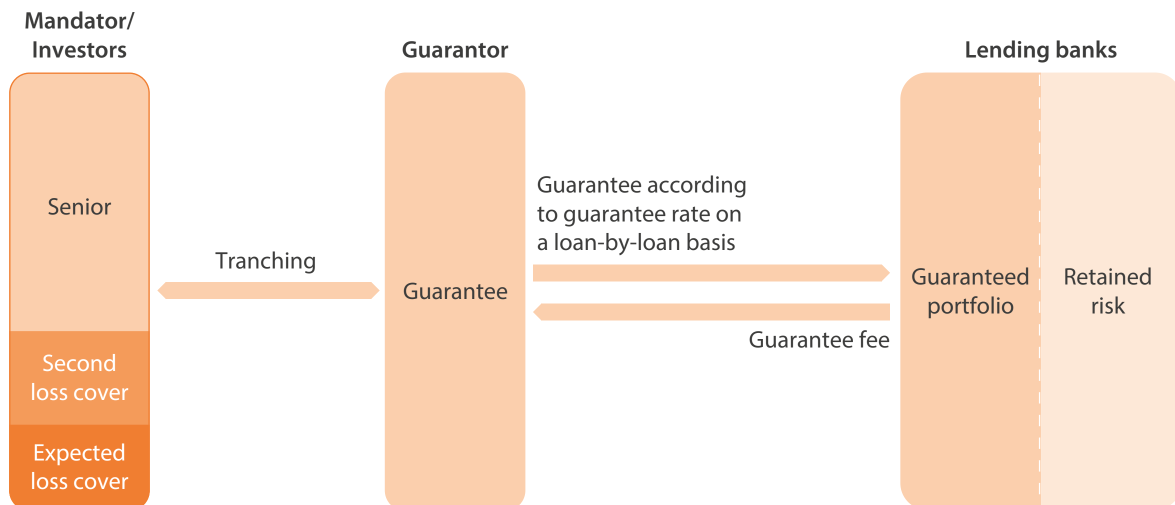
In a portfolio guarantee model, the guarantee may be provided by a single guarantor or several different investors.

Where there are a number of investors, the risk coverage is split between the mandators/investors via tranching mechanisms, differentiating the junior, mezzanine and senior risk-takers. The junior tranche is the riskiest layer of the guarantee, absorbing losses before and claiming recoveries after both the senior and mezzanine tranches. In contrast, the senior tranche is the first layer of the guarantee, covering the most secure and least risky portion of the portfolio. Senior tranches have the highest claim on recoveries in case of default.

The lending banks, while building up their portfolio of loans, would benefit from a portion of the portfolio secured by the guarantee in accordance with the guarantee rate. At the same time, the lending banks retain the risk with respect to the remaining portion of the portfolio.

The guarantee fee (risk premium), if applicable, is a function of capital structure and pricing of each risk taker. However, there are structures (typically in case of first loss portfolio guarantees) where the guarantee can be provided free of charge.

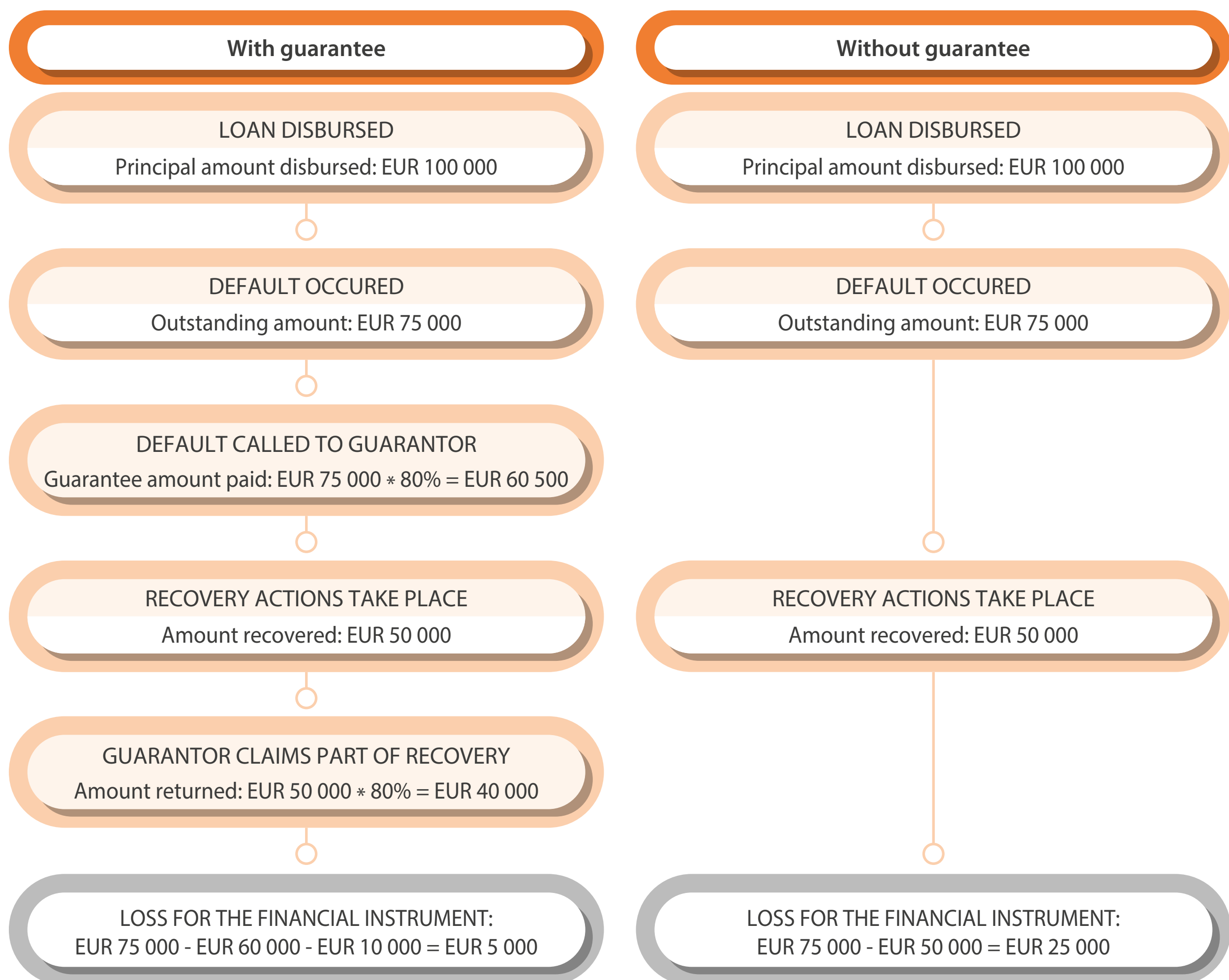
Figure 7: Portfolio guarantee model



After the deadline agreed with the lending banks for guarantees to be called for defaulted loan transactions, the banks should return the part of the contributions that are not intended to cover possible guarantee calls to the guarantor.

In case defaults occur at the level of final recipients, the loss to be borne by the lending banks can be significantly reduced as a result of the guarantee called from the guarantor. The below example shows what happens in case of a default with and without the guarantee. The example assumes a guarantee rate of 80% a principal amount of EUR 100 000 disbursed to the final recipient and EUR 75 000 of which is outstanding at the time it defaulted. Due to the recovery actions, the bank was able to recover EUR 50 000.

Figure 8: Example of the consequences of default with and without guarantee

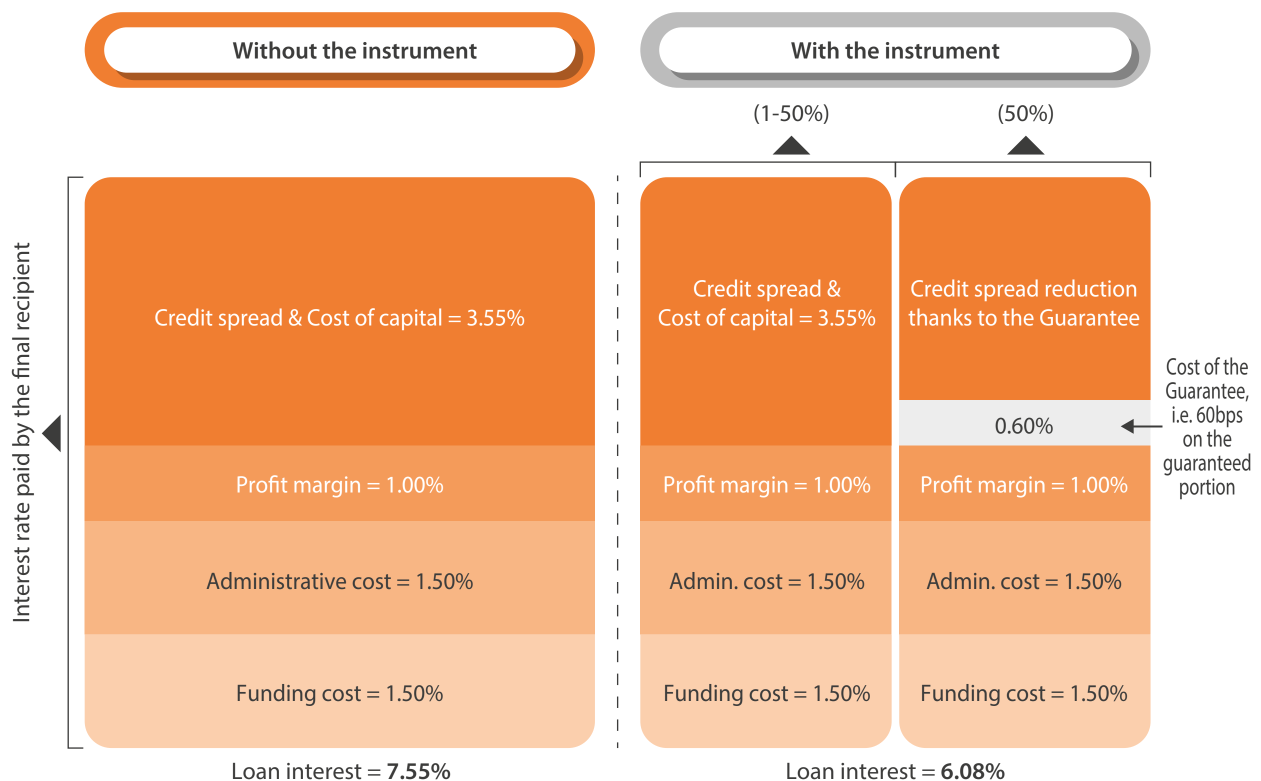


4.2 Transfer of benefit in case of guarantees

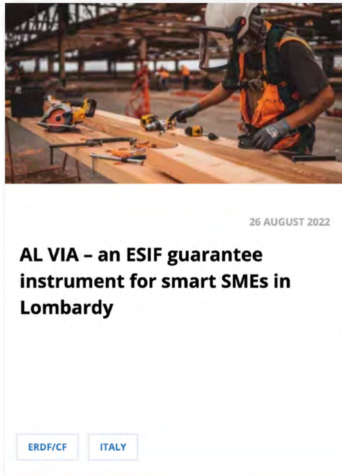
Where a guarantee is in place, financial institutions providing the underlying loans can provide loans to final recipients on better terms and conditions compared to standard debt financing which is not covered by the guarantee. Such better financing conditions can take the form of lower interest rates, lower collateral requirements, longer maturities, reduced transaction fees or a combination of these (in line with the transfer of benefit requirements imposed on the lending banks).

The mechanism to reduce interest rates operates to treat the guarantee as a credit enhancement, mitigating the perceived risk associated with the loans, and consequently leading to a reduction in the credit spread. The credit spread reflects the risk premium added to the interest rate to account for the borrower's creditworthiness. Higher-risk borrowers typically face a higher credit spread. The guarantee alleviates the risk linked to the guaranteed portion of the loan, resulting in the decrease in the credit spread and ultimately in the overall loan interest compared to the standard market rates (see Figure 9 below explaining the mechanism via an illustrative example).

Figure 9: Mechanism of interest rate reduction as a result of the transfer of benefit



AL VIA – an ESIF guarantee instrument for Smart SMEs in Lombardy, Italy



Founded in 2017, the Italian region of Lombardy's AL VIA programme has taken important steps to help revive the regional economy in the wake of the financial crisis. The AL VIA financial instrument provides mid- to long-term assistance to small and medium-sized businesses in the form of loans and guarantees, releasing up to EUR 370 million of financing.

The long- and medium-term loans provide between 85% and 95% of an investment, with guarantees covering 70%. Grants, made available through the Lombardy ERDF ROP, can be used to cover 5%-15% of the agreed investment.

The initiative has mobilised EUR 262 million for loans backed by EUR 65 million guarantee from the Lombardy ERDF ROP 2014-2020, and a further EUR 43.4 million was committed as grants from the Lombardy ERDF ROP 2014-2020.

AL VIA – an ESIF guarantee instrument for smart SMEs in Lombardy | fi-compass.

4.3 Guarantees in combination with grants

Guarantee instruments can be provided on a stand-alone basis or in combination with grants. This could be related to the same investment operation and – subject to applicable State aid rules – also cover the same expenditure items, as long as the sum of both types of support does not exceed the total amount of the expenditure items concerned. The combination can be implemented also in a way that the two types of funding would be split between the revenue-generating part of the project and the part that does not generate revenues for the final recipient.

Under Article 58(5) of the Common Provisions Regulation 2021/1060 (CPR), grants can be combined with financial instruments in a single operation, enabling the body implementing financial instrument to deploy the grant alongside the guarantee, with the rules relating to financial instruments applying to the eligibility and reporting of the grant component.

Combination of financial instrument and grants

The fi-compass factsheet, published in May 2021, explores the different possibilities for combining grant with loan, equity and guarantee financial instruments.

The factsheet describes how a number of different types of grant support including interest rate subsidies, technical assistance, investment grant and capital rebates can be combined with loan, guarantee and equity financial instruments in a single operation. Governed by financial instrument rules, combined financial instrument-grant operations are expected to play an important part in scaling up the use of financial instruments to support Cohesion policy in the 2021-2027 period. The factsheet describes the options available under the regulations and gives practical examples of how the flexibilities can be applied in practice.

Combination of financial instruments and grants.

Grants can be combined with guarantee financial instruments to meet a number of different types of needs of final recipients, allowing the product to be tailored to the local market. Typically, these include:

- **Interest rate subsidies** – as Figure 9 shows, the benefit of the guarantee can enable a reduced interest rate to be offered to the final recipient. This can be further reduced by offering an interest rate subsidy to cover some or all of the price payable in respect of the portion of the loan not funded from ERDF programme resources;
- **Technical support grant** – the body implementing the financial instrument may pay grant to a final recipient (or to another body for the benefit of the final recipient) to meet the cost of project preparation and/or implementation costs;
- **Capital grant** – where the body implementing a financial instrument provides the final recipient with a grant to meet part of the investment cost, for example where a proportion of the project is non-revenue generating.
- **Capital rebate** – where the grant is used to repay early/write off part of the principal. This mechanism is often linked to the achievement of a specified target (for example regarding the energy performance of the new project).

The need for grants must be identified and justified as part of the market failure assessment at programme level and be analysed in detail in the financial instrument's investment strategy. Managing authorities will then sign one funding agreement with the body implementing the instrument covering the contributions to both the loan and grant components.

Energy Efficiency and Renewable Energy Malta

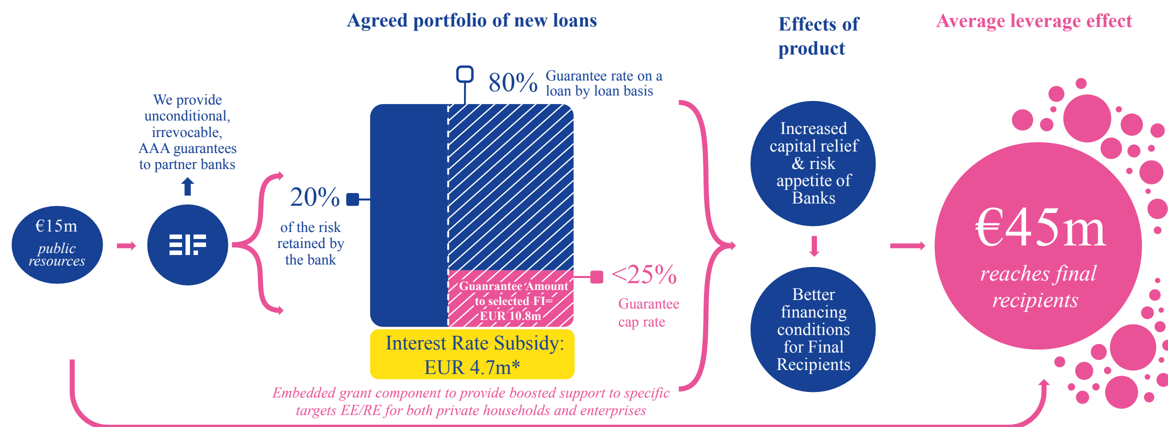
In 2018, the Maltese authorities decided to commit EUR 15 million from its Operational Programme I – 'Fostering a competitive and sustainable economy to meet our challenges' (EUR 12 million from ERDF and EUR 3 million from national resources) to the EIF to set up a fund of funds for projects of energy efficiency and renewable energy.

The financial instrument is an EIF-backed portfolio guarantee, with 80% guarantee rate and 25% guarantee cap rate. The guarantee is provided by the EIF to two selected financial institutions to cover part of their risks for newly originated loans provided to households and enterprises (entrepreneurs, SMEs, mid-caps) in relation to EE and RE investments in Malta. The guarantee is expected to leverage financing of EUR 45 million to final recipients.

The financial instrument includes a grant component in the form of interest rate subsidies of up to 2.5%[6] p.a. for 10 years. The subsidy is managed and monitored by the selected banks and apply on top of any interest rate reductions enforced thanks to the transfer of benefit mechanisms of the guarantee. The overall contribution of the grant component is EUR 4.7 million.

In addition, a support package has been set up by EIB Advisory for financial institutions, which consists of an automatised webtool for eligibility check and reporting and tailored bilateral support to financial institutions (coaching, pipeline building, project development, eligibility assessment, project reporting).

Figure 10: The delivery mechanism of the combined financial instrument in Malta



Source: EIF, see fi-compass presentation.

Eligible investments supported by the instrument include investments related to the building envelope (insulation, windows and doors and other measures with impact on thermal performance), investments related to the building system (space heating, domestic hot water, ventilation system, cooling, lighting, building and energy management system, connection to energy supplies, integrated renewable energy investment, charging station for electric vehicles) and investments related to renewable energies (e.g. photovoltaic systems), not connected to buildings.

6 Increased to 5.15% p.a. on 15 February 2023.

4.4 Implementation of guarantee financial instruments

Guarantee financial instruments can be implemented either directly by the managing authority or indirectly through a body implementing the financial instrument that is selected (or directly appointed in case of the EIB Group or NPBIs) by the managing authority.

The relevance and adequacy of the proposed financial instruments should be justified by an ex-ante assessment drawn under the responsibility of the managing authority. In the programming period 2014-2020 these were separate from the ex-ante evaluations carried out with respect to the overall programmes in the beginning of the period. In the 2021-2027 programming period, the ex-ante assessments related to financial instruments are better integrated into the programming and implementation process from the outset. It means that the market assessment and the justification for the forms of support, indicating the planned use of financial instruments for each specific objective, should be carried out in parallel with the finalisation of the programme document.

Market testing carried out before the finalisation of the product structure is also important to verify the assumptions (e.g. proposed volumes, target groups, eligibility, etc.) and market interest on the ground. It is also essential in order to avoid crowding-out the instrument by other/similar products already on the market. Clear definition of the scope of the product and the eligibility criteria based on the results of the market testing can help to prevent the potential cannibalisation of the instrument by other sources of finance.

Finding the appropriate governance structure for the instrument is crucial for the success of the instrument. That includes a body implementing the financial instrument (guarantor) with the relevant track record, financial institutions (lender banks) providing the underlying loans with the sufficient capacity and product offering and a well-regulated monitoring committee or governance board to help the managing authorities setting up the financial instrument, including defining the terms of reference for the selection of financial institutions, to monitor the implementation and intervene with amendments to the investment strategy when needed.

Strong partnership and collaboration among the stakeholders is essential throughout the entire life cycle of the financial instrument, that is from market testing all the way until the termination of the instrument. This can be achieved by early involvement of all parties in the discussions regarding product design and constant communication during product deployment regarding operational aspects of the implementation.

A funding agreement is established between a managing authority and the body that implements the holding fund or between a managing authority or the body that implements the holding fund and the body that implements the specific fund. The funding agreement is the contract governing the terms and conditions for programme contributions to the financial instrument. It defines the roles and responsibilities of the parties. It also sets out the proposed investment strategy with the amount of programme contribution and expected leverage, the financial product, target final recipients and expected contributions to the specific objectives. Regarding the latter, it is important that the investment strategy is defined in a relatively flexible way, so that the focus can be adjusted quickly to potentially changing circumstances.

According to the CPR, the selection of the implementing bodies can be carried out via direct award by the managing authority in case the implementing body for instance the EIB Group, an IFI or an NPBI. In some cases, the body implementing the guarantee may provide guarantees to underlying banks without the need for a public procurement (the 'non-public procurement approach'). The non-public procurement approach can be applied also when the managing authority provides the guarantee directly, or in case of individual guarantees that are provided to final recipients getting financing from a bank. In case of open public procurement procedures, the application process must comply with the relevant public procurement rules.

fi-compass Knowledge Hub – Selection of financial intermediaries

The Note of Workshop published after the fi-compass Knowledge Hub on Selection captures the key topic discussed by participants. This includes a discussion on the non-procurement approach and how it can be used in conjunction with ERDF guarantee financial instruments.

Other topics covered in the note include the use of the accelerated procedure, amendment of contracts under Article 72 of the Public Procurement Directive and the competitive procedure with negotiation and competitive dialogue processes.

For further information on the procurement rules related to financial instruments, including guarantees, see: fi-compass Knowledge Hub - Selection of financial intermediaries.

In case of individual guarantees, the decision to provide a guarantee is assessed on an individual basis for each loan. The final recipient would have to apply for both the loan (to the lending bank) and the guarantee (to the guarantor). In many cases, the application for the guarantee is also submitted via the lending bank and approval of the loan application is pending the processing and approval of the guarantee by the guarantor. If assessed positively, the guarantee is provided to both the bank and the final recipient. The contrasts with portfolio guarantees, where the guarantee is committed to the banks by the guarantor, prior to origination of the loans. The banks assess the loan applications submitted by the final recipients, in view of the terms and conditions (including eligibility criteria) defined in the guarantee agreement signed with the guarantor.

The managing authorities should comply with the reporting requirements defined in the CPR. Compared to the period 2014-2020, the programming period 2021-2027 shows important simplifications with fewer reporting requirements and less data on financial instruments[7] being collected during implementation. The data should be transmitted twice per year (by 31 January and 31 July). Under its monitoring responsibilities, the managing authority should carry out management verifications at the level of the bodies implementing the financial instrument (except if it is the EIB or other international financial institutions in which a Member State is a shareholder) and at the level of the banks providing the loans to the final recipients.

Audits of EU shared management financial instruments (either by the Commission or the audit authorities) should be done in a way to avoid duplication of audits and management verifications and with the objective of minimising the cost of the audits as well as the administrative burden on beneficiaries (i.e. single audit principle). The bodies carrying out the audits shall first rely on the information and records stored by the managing authority including the results of management verifications, and only request additional documents from the beneficiaries, where the above-mentioned audit evidence is not sufficient. Under the CPR for the 2021-2027 period, no audit activity will be undertaken at the level of the banks providing the underlying loans unless certain conditions are met which prevent accurate reporting information being accessed through the managing authority.

7 Article 42 (3) CPR.

05

Guarantee financial instruments: an ERDF perspective

5.1 Policy framework for ERDF guarantee financial instruments

For the 2021-2027 period, more than EUR 370 billion has been allocated to economic, social and territorial cohesion policies in the EU. To facilitate further the uptake of financial instruments in all policy areas, the Commission has simplified the rules related to financial instruments and introduced enhanced flexibility, broader eligibility and increased opportunity for combination with grants.

The ERDF Regulation[8] for the 2021-2027 period defined the following specific Policy Objectives (PO) for the ERDF and CF:

- **PO1:** a more competitive and smarter Europe by promoting innovative and smart economic transformation and regional ICT connectivity;
- **PO2:** a greener, low-carbon transitioning towards a net zero carbon economy and resilient Europe by promoting clean and fair energy transition, green and blue investment, the circular economy, climate change mitigation and adaptation, risk prevention and management, and sustainable urban mobility;
- **PO3:** a more connected Europe by enhancing mobility;
- **PO4:** a more social and inclusive Europe implementing the European Pillar of Social Rights;
- **PO5:** a Europe closer to citizens by fostering the sustainable and integrated development of all types of territories and local initiatives.

Financial instruments co-funded by the ERDF can be used to support a wide range of projects. The majority of the investments supported by financial instruments are expected to target the first two priority areas.

Face Verticale – SME benefiting from ERDF guarantee support

The FOSTER TPE-PME guarantee financial instrument supported a loan to the company Face Verticale which was created by three high-altitude mountain guides who had a vision to offer a graduate training programme for rope access technicians. The investment was used for the rehabilitation and transformation of an old water tower into a training place. This allows the company to welcome bigger groups and to recreate specific working environment such as an industrial chimney for instance.

fi-compass Showcase 2019 submission – watch four video stories from France: FOSTER TPE-PME | fi-compass

8 Regulation EU 2021/1058.

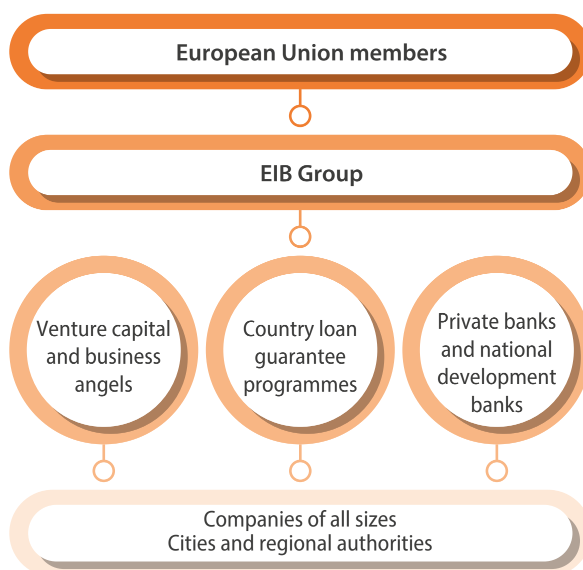
The new CPR allows the implementation of a single operation covering both a grant element and the financial instrument under a single funding agreement and with both types of support provided by the same financial institution (for instance through a 'one-stop-shop' for final recipients). In case of such single operation, the grant should be directly linked and necessary for the investment supported by the financial instrument and the rules related to financial instrument would guide the implementation of both types of support. The grant element can be provided in the form of e.g. interest-rate subsidies, guarantee fee subsidies or capital rebate (the latter is introduced as a new element in the next programming period). As financial instrument rules apply in this case for both forms of support, the financial instrument and the grant element, an important advantage is that the resources of both forms of support can be received upfront by the final recipient.

5.2 ERDF guarantees supporting SME access to finance

Due to their ability to unlock bank lending, guarantee financial instruments are expected to continue to be used to support lending in the SME sector. In the 2014-2020 period, thanks to the high multiplier effect of guarantees, an estimated 365 000 final recipients benefited from finance supported by ERDF backed guarantees. This represents approximately 65% of the total number of final recipients supported by ERDF financial instruments, a strong performance as only approximately 26% of programme resources were committed to guarantee instruments.

This strong performance was further confirmed by the reported leverage rates. According to data for the period ending 2020, 89 guarantee financial instruments achieved a median leverage rate (or multiplier) of 5.2 compared to the rate of 1.3 for loans and 2.0 for equity. Thus guarantee financial instruments will continue to provide a powerful vehicle for investment of EU resources to support businesses, both at an EU level, through products such as the European Guarantee Fund and at Member State level through financial instruments supported by shared management Funds

The European Guarantee Fund (EGF)



The European Guarantee Fund (EGF), also called the Pan-European Guarantee Fund, is implemented by the EIB Group and aims to help businesses recover from the COVID-19 pandemic, hire employees and grow by absorbing market risk so that banks could lend more and funds invest further. The EGF has a volume of EUR 25 billion and is expected to generate up to EUR 200 billion for the economy. It provides guarantees to free up capital for NPBIs, local banks and other financial institutions in order to make more financing available for SMEs, mid-caps and corporates to address their short-term liquidity needs on their road to recovery and provide incentives to continue their growth and development in the medium to long-term.

The EGF includes a number of equity, debt funds and guarantee products deployed in cooperation with selected financial institutions. The guarantees cover losses that may occur in the EGF operations of the EIB Group. Within the guarantee products, it provides both capped and uncapped (counter)-guarantees.

Due to their straightforward and market orientated nature, guarantee financial instruments offer a well-established mechanism to mobilise finance from participating banks to support access to finance for SMEs. This risk-sharing arrangement makes financial institutions more willing to provide loans, even to businesses or individuals with a higher perceived risk profile. This enables banks to diversify their client portfolio by reaching potentially untapped or new target groups. The guarantees open doors to a broader spectrum of borrowers, including those with limited access to traditional financing. This diversification helps banks spread their lending risk across various sectors and clients, enhancing the stability of their overall portfolio.

Slovak Investment Holding – multi-sector financial instruments in Slovakia

The Slovak Investment Holding (SIH) was created by the Slovak Government in 2014 to manage the holding fund of EU shared management financial instruments. SIH manages over EUR 1 billion of EU shared management fund programme resources, through a number of loan, guarantee and equity financial instruments.

A portfolio risk-sharing loan instrument has been implemented via SZRB (Slovak Guarantee and Development Bank) with a contribution of EUR 34.2 million. Two first-loss portfolio guarantee instruments have been deployed via selected financial intermediaries (UniCredit Bank and Slovenská sporiteľňa), one standard and another targeting RDI projects with a total net allocation of EUR 5.6 million for the former and EUR 3.78 million for the latter.

In 2020 SIH developed the Anti-Corona Guarantee which eventually mobilised over EUR 900 million to support businesses during the pandemic.

Slovak Investment Holding – Multi-sector financial instruments in Slovakia.

5.3 ERDF guarantees supporting the green transition

Guarantee financial instruments support the green transition across a range of sectors including SME support and energy efficiency in residential buildings.

Given their importance in the SME sector, ERDF guarantee financial instruments can be adapted to support investment in green infrastructure, energy efficiency and renewable energy measures developed by SME final recipients. Typically, an investment strategy for an SME guarantee instrument may include a requirement that a minimum percentage of investments shall be targeted at green investments. Combination with grant may be included in such measures to reduce the cost of borrowing through an interest rate subsidy or meet part of the investment cost.

Biznesmax – ERDF guarantee supporting SMEs in Poland

This video case study explains how the ERDF-powered Biznesmax with a simple first-loss portfolio guarantee is supporting the development of innovative entrepreneurs in SMEs in Poland. The instrument is combined with an interest rate subsidy. It was able to quickly adapt to changing circumstances by extending its eligible investments to include green projects promoted by SMEs.

Biznesmax ERDF guarantee supporting SMEs in Poland | fi-compass

Due to their ability to leverage private sector investment through the multiplier effect, guarantee financial instruments are expected to play an increasing role in financing energy efficiency improvements to buildings, both residential and public/commercial. The RePowerEU Plan and the European Green Deal programme has identified saving energy through improved energy efficiency as a priority to secure the EU's energy security and resilience in the future. In 2020, the European Commission published its strategy, 'A Renovation Wave for Europe – Greening our buildings, creating jobs, improving lives'[9] which included an action plan with the aim of doubling the annual energy renovation rate by 2030.

Residential energy efficiency financial instruments in Lithuania

Financial instruments in combination with grants have been used by Lithuania's Ministry of Finance and Ministry of Environment to fund loans to support investment in energy efficiency in apartment block buildings in Lithuania.

A number of different financial instruments have supported the development of a single product for homeowners known as the 'Modernisation Loan' which forms the centrepiece of the Lithuanian government's programme to improve energy efficiency in residential properties. This included a first loss portfolio guarantee instrument designed to attract significant additional private sector investment.

Residential energy efficiency financial instruments in Lithuania | fi-compass.

9 COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS A Renovation Wave for Europe - greening our buildings, creating jobs, improving lives COM/2020/662 final.

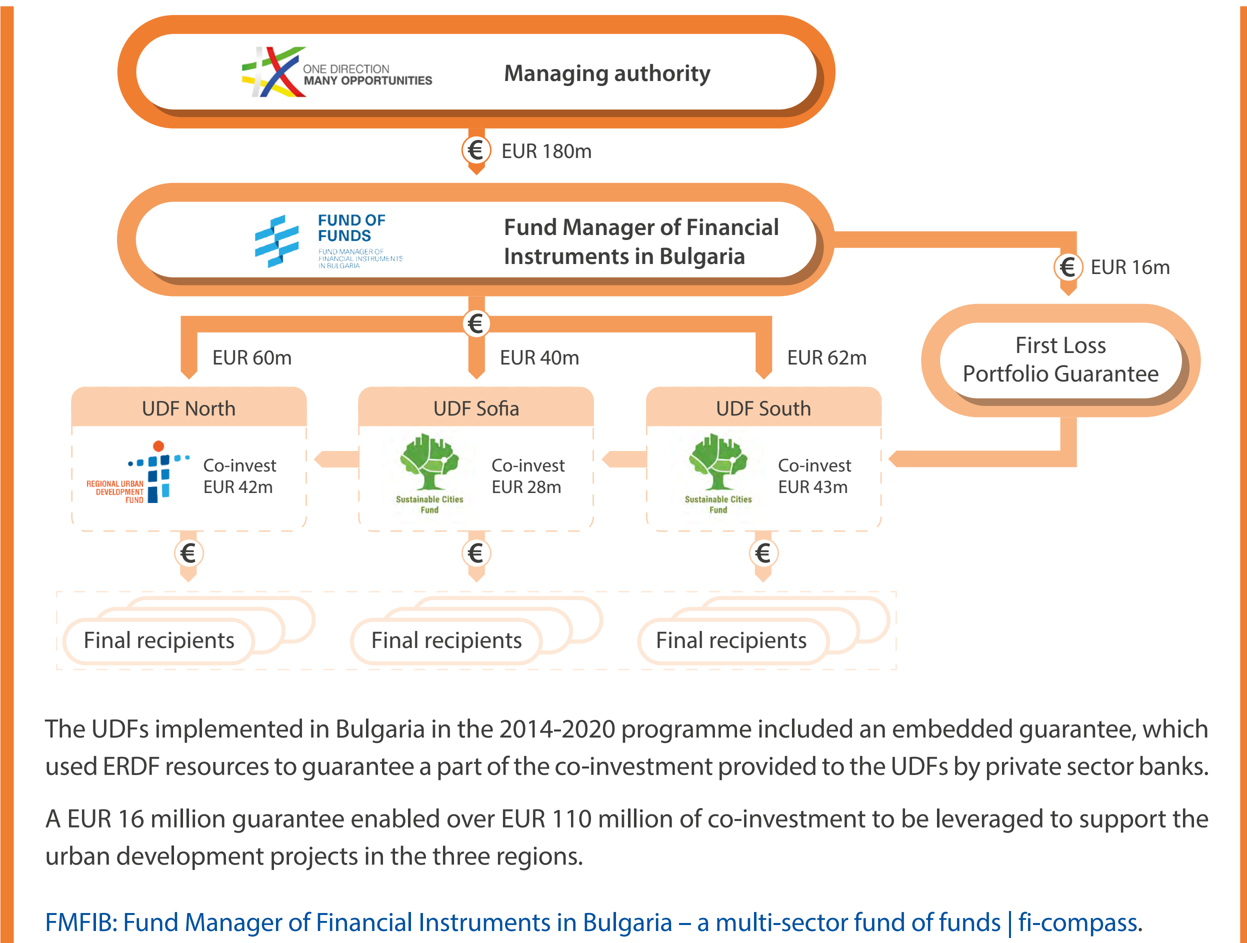
In the renewable energy sector, guarantee financial instruments may play an increased role in the future to support investment in less established renewable energy sources, such as geothermal, solar thermal, ocean energy, and biofuels, as they are associated with significantly higher risks due to less tested business models and technologies. At the same time, they are generally characterised by capital intensity and uncertain return on investment. Therefore, private financing is rather limited in these sub-sectors, which creates market opportunities for financial instruments such as guarantees.

5.4 ERDF guarantees supporting other sectors

The relevance of guarantee instruments in other sectors targeted by the above-mentioned priority objectives are described briefly in the following paragraphs. For further information, see 'Stocktaking study on financial instruments by sector'.

There are some examples of guarantee support being developed to support urban development (see for example IFRRU 2020[10]), although in general, the risk sharing loan has proved to be more successful at this stage. A novel approach was taken in Bulgaria[11] in the 2014-2020 programming period where a guarantee product was used to support private co-investment into an urban development fund (UDF).

The Regions in Growth UDFs with embedded guarantee



The UDFs implemented in Bulgaria in the 2014-2020 programme included an embedded guarantee, which used ERDF resources to guarantee a part of the co-investment provided to the UDFs by private sector banks.

A EUR 16 million guarantee enabled over EUR 110 million of co-investment to be leveraged to support the urban development projects in the three regions.

FMFIB: Fund Manager of Financial Instruments in Bulgaria – a multi-sector fund of funds | fi-compass.

10 Financial instruments for urban development in Portugal – IFRRU 2020 case study.
11 FMFIB: Fund Manager of Financial Instruments in Bulgaria – a multi-sector fund of funds.

Within the **environment sector**, investment areas related to municipalities, such as water services, waste treatment, air quality and flood risk prevention, do not generate direct streams of revenues and generally need to wait many years to break even. Under such circumstances, guarantees providing long-term debt financing with preferential conditions could offer a solution, potentially in combination with a grant component that could cover the infrastructure connection costs in smaller municipalities in remote areas. Moreover, as the CPR now permits the combination of financial instruments with capital rebate in a single operation, a product may be developed whereby the municipalities could receive a type of bonus at the end of the investment's timeline if the project meets certain financial and environmental criteria defined on the outset.

In the **ICT sector**, broadband infrastructure projects in sparsely populated areas are characterised by high investment costs per capita. Financial instruments can help make these projects more bankable and address the high risks with these investments. Similar to environment infrastructure interventions, a combination with grant can provide a solution. The grant component would be used to connect the sparsely populated areas to the infrastructure, while the guarantee can allow the final recipients to receive long-term debt with preferential terms to finance the other services once the connection is established.

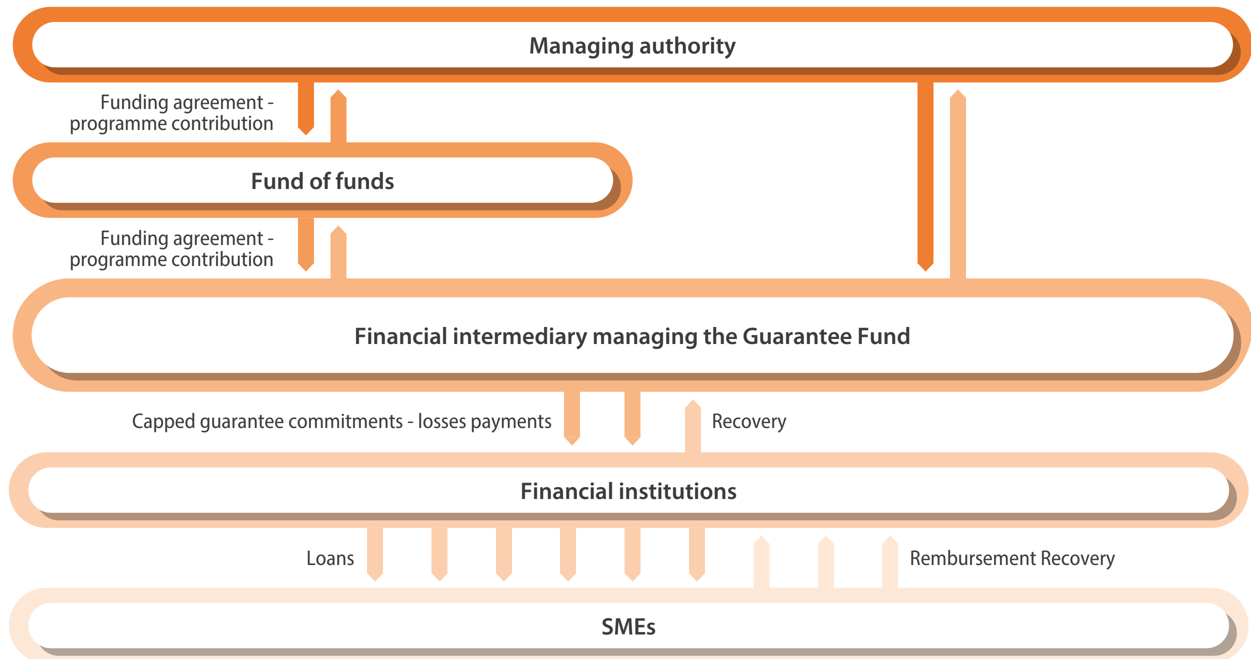
In the **transport sector**, financial instruments could provide the critical mass for smaller municipalities by aggregating their projects that would not be able to receive the necessary financing in acceptable conditions on their own. This way, via guarantee financial instruments, these municipalities can receive loans with improved financing conditions, with longer maturity and lower interest rates. The financing can be combined with grants to both address viability issues and provide additional project development and implementation capacity.

The financing needs as well as the scope for public intervention related to **RDI projects** in the SME sector depends on the development stage of the company and of the project. Grants represent the main source of support during the initial phase, when the project does not generate revenues. Financial instruments become relevant when an innovative project reaches its commercialisation phase. ERDF-funded guarantee products providing risk protection to the banks can unlock access to private sector financing to support the delivery of the new product to the market. Such intervention is deemed reasonable as long as the RDI project has not reached its market maturity, when it can already be fully financed by the private sector without incentives from the public sector.

5.5 The 'off-the-shelf' capped portfolio guarantee model

In 2014, the European Commission published its first suite of 'off-the-shelf' model financial instruments[12]. The model remains a useful reference point for practitioners seeking to design a guarantee financial instrument for the first time.

Figure 11: the 'off-the-shelf' capped portfolio guarantee for SMEs



For the implementation of any financial instrument, standard terms and conditions should be established that would be set out in the funding agreement.

The capped portfolio guarantee provides credit risk coverage for financial institutions with a guarantee rate of up to 80% on a loan-by-loan basis up to a maximum amount, calculated based on a maximum cap rate. The financial institutions shall build up a portfolio of new loans for which the guarantee partially cover the losses in case of default.

12 COMMISSION IMPLEMENTING REGULATION (EU) No 964/2014 of 11 September 2014 laying down rules for the application of Regulation (EU) No 1303/2013 of the European Parliament and of the Council as regards standard terms and conditions for financial instruments.

The financial institutions are required to fully pass on the financial benefit of the public contribution to the final recipients. The transfer of benefit can be evidenced in the form of reduced interest rates and/or lower collateral requirements.

The facility is designed as a State aid free instrument at the level of the bodies implementing the financial instrument. At the level of the final recipients, the guaranteed loan shall comply with the *de minimis rules*, meaning that the total amount of aid calculated with the Gross Grant Equivalent (GGE) cannot be above EUR 300 000 over a 3 years fiscal period[13].

Table 1: 'Off-the-shelf' capped portfolio guarantee key characteristics

Loan amount	Max. EUR 1 500 000 for the guaranteed part of the loan
Guarantee rate	Max. 80% of each loan, may cover expected and unexpected losses
Guarantee cap rate	Max. 25% as determined in the ex-ante risk assessment
Guarantee fee	Free of charge
Maturity of the guarantee	Min. 1 year; max. 10 years
Multiplier	Min. 5x, based on the ex-ante risk assessment
Eligible final recipients	SMEs, as defined in the Commission Recommendation 2003/361/EC
Eligible operations	a. Investments in tangible and intangible assets including transfer of proprietary rights in enterprises provided that such transfer takes place between independent investors; b. Working capital related to development or expansion activities that are ancillary (and linked) to activities referred to in (a) above (which ancillary nature shall be evidenced, inter alia, by the business plan of the final recipient and the amount of the financing).

13 Updated ceiling through Regulation (EU) 2023/2831 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis aid*.

Further information

Set out below is a list of fi-compass resources that can be found on our fi-compass website (www.fi-compass.eu) and provide additional information on guarantee financial instruments established with EU shared management funds.

Factsheets, brochures and studies

Implementing Energy Efficiency projects via Energy Performance Contracting with support from ERDF financial instruments in Poland

fi-compass Knowledge Hub - Implementation of grants and financial instruments combined in a single operation

fi-compass Knowledge Hub - Implementation of financial instruments across consecutive programming periods

fi-compass Knowledge Hub - Audit and control of financial instruments 2014-2020

fi-compass Knowledge Hub - Audit of financial instruments in the 2021-2027 programming period

fi-compass Knowledge Hub - Combination of financial instruments and grants under shared management funds in the 2021-2027 programming period

fi-compass Knowledge Hub - Selection of financial intermediaries

fi-compass Knowledge Hub - State aid

fi-compass Knowledge Hub - fi-compass Funding Agreement

The potential for investment in energy efficiency through financial instruments in the European Union

European, Structural and Investment Funds (ESIF) and Energy Performance Contracting (EPC)

Stocktaking study on financial instruments by sector - Executive summary

Stocktaking study on financial instruments by sector - The use of financial instruments in the 'Environment' sector

Stocktaking study on financial instruments by sector - The use of financial instruments in the 'Information and Communication Technologies infrastructure' sector

Stocktaking study on financial instruments by sector - Final report

Stocktaking study on financial instruments by sector - The use of financial instruments in the 'urban development and transport' sector

Stocktaking study on financial instruments by sector - The use of financial instruments in the 'Research, Development and Innovation in Small and Medium-sized Enterprises' sector

Stocktaking study on financial instruments by sector - The use of financial instruments in the 'Renewable Energy' sector

Gap analysis for small and medium sized enterprises financing in the European Union

Financial instrument products

Case studies

Biznesmax – ERDF guarantee supporting SMEs in Poland

Slovak Investment Holding – multi-sector financial instruments in Slovakia

FMFIB: Fund Manager of Financial Instruments in Bulgaria – a multi-sector fund of funds

Residential energy efficiency financial instruments in Lithuania

Responding to the COVID-19 crisis through financial instruments: SIH Anti-Corona Guarantee

FOSTER TPE-PME-AGRI a new generation multi-sector fund of funds, Occitanie, France

Financial instruments for urban development in Portugal – IFRRU 2020 case study

Loans and guarantees for SMEs - The JEREMIE Initiative in Cyprus

Financial Engineering Instruments for SMEs, Slovenia

The First Loss Portfolio Guarantee instrument in Malta

Financial instruments for innovative firms

First Loss Portfolio Guarantee

Videos

Interview with Slovak Investment Holding

Biznesmax ERDF guarantee supporting SMEs in Poland

Fund Manager of Financial Instruments in Bulgaria

ERDF financial instruments in action: Urban Development in Bulgaria

Combination of financial instruments and grant

Energy efficiency in housing

Financial instruments for urban development in Portugal – IFRRU 2020 video case study

Energy efficiency loans for Lithuanian homes

Blogs and podcasts

Huras: a rising star in challenging times

AL VIA – an ESIF guarantee instrument for smart SMEs in Lombardy

Episode 2: The SIH Anti-Corona Guarantee in Slovakia

Episode 12: Financial instruments in changing times

Episode 15: Financing RePowerEU – shared management financial instruments combined with grants

Showcase videos

NRB: Supporting innovation and SMEs in Czechia

Puglia Sviluppo: Minibonds for Sustainability

fi-compass Showcase 2019 submission – watch a video story from Italy: Gomedia Satcom

fi-compass Showcase 2019 submission – watch four video stories from France: FOSTER TPE-PME

Table of figures

Figure 1: A typical capped portfolio guarantee 6
Figure 2: Structure of a guarantee instrument 11
Figure 3: Portfolio guarantee models 13
Figure 4: Structure of an individual guarantee 14
Figure 5: ERDF and CF committed by TO and financial product 17
Figure 6: Comparison of financial products 23
Figure 7: Portfolio guarantee model 27
Figure 8: Example of the consequences of default with and without guarantee 28
Figure 9: Mechanism of interest rate reduction as a result of the transfer of benefit 29
Figure 10: The delivery mechanism of the combined financial instrument in Malta 32
Figure 11: the 'off-the-shelf' capped portfolio guarantee for SMEs 42

Table of tables

Table 1: 'Off-the-shelf' capped portfolio guarantee key characteristics 43

Notes

Notes

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