Financial instruments in 2014-20:
learning from 2007-13 and adapting to the new environment

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Abstract

The 2007-13 planning period saw a new and significant emphasis on the use of so-called 'financial instruments' as measures to implement Cohesion policy. This was justified on the basis that such instruments are sustainable (because funds are recycled to be spent again in the same region), that they generate better quality projects (because funds have to be repaid and commercial expertise can enhance project selection) and that they are a more efficient use of public funds (because private sector monies are leveraged in to supplement public spending). In 2014-20, the emphasis on financial instruments is reinforced: they can be used for any thematic objective and there are incentives for programmes to dedicate an entire priority axis to financial instruments. At the same time, there are important changes to the regulatory framework affecting how financial instruments can be implemented in practice. Against the background of these changes, it is important to ask how much is known about the experience with financial instruments in 2007-13. What lessons have been learned? How far have these been incorporated into the new context? What are the key changes implied by the new rules and to what extent do these constrain or enable the effective use of financial instruments in the new period?

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1 Introduction

The role of financial instruments (FI) has increased significantly over successive Cohesion policy planning periods. Rising from an estimated investment in FI of €0.6 billion in 1994-99 to some €1.3 billion in 2000-6,[1] the most recent Commission report notes Operational Programme (OP) commitments to FI totalling over €17 billion.[2]

The 2007-13 planning period saw a new and significant emphasis on the use of so-called 'financial instruments' as measures to implement Cohesion policy. This was justified on the basis that such instruments are sustainable (because funds are recycled to be spent again in the same region), that they generate better quality projects (because funds have to be repaid and commercial expertise can enhance project selection) and that they are a more efficient use of public funds (because private sector monies are leveraged in to supplement public spending). Thus, the overarching rationale for the use of financial instruments in the context of Cohesion policy is that facilitating access to finance through the use of repayable instruments contributes to sustainable regional economic growth and employment.[3] Underpinning this are three largely distinct premises for intervention.

First, FIs are designed to **address market imperfections in the availability of capital**. Publicly funded FIs are justified on the basis of two main types of market imperfection. One is information asymmetry; that certain types of project – such as start-ups and new firms in high technology sectors - lack sufficient track records or other information for potential investors to be able to assess risks. Another is that commercial assessments of returns in investment do not necessarily capture all positive externalities or wider social benefits. For example, lack of access to finance may constrain investment in R&D and innovation, leading to suboptimal investment in new technologies that would benefit society more widely; similarly, urban development or energy efficiency projects offer longer-term societal gains that justify public intervention, but would not attract commercial funding. More prosaically, the assessment of very small projects requiring microfinance may incur disproportionate transaction costs for investors, leading to a dearth of funds for initiatives that could have a positive impact on reintegrating individuals into the labour market or supporting disadvantaged groups.

Second, policymakers may consider that repayable instruments **improve the quality of investments** (compared to those in receipt of grant funding) owing to the obligation to repay the investment and the due diligence involved in assessing investment proposals, often supported by private sector expertise. This rationale is partly founded on the notion that the level of deadweight involved in such instruments is lower than for grants; there is also a psychological dimension insofar as the investee, as well as the investor, shares some

[1] CSES (2007) *Comparative Study of Venture Capital and Loan Funds Supported by the Structural Funds,* report to European Commission.

[2] European Commission (2014) *Summary of data on the progress made in financing and implementing financial engineering instruments*, Programming period 2007-13, situation as at 31 December 2013, September 2014.

[3] European Commission (2012) *Financial Instruments in Cohesion Policy*, Commission Staff Working Document, SWD(2012)36 final, Brussels 27 February 2012.

of the risk, though how this is distributed will depend on the precise design of the instrument. In addition, the use of FIs is influenced by the perception that the involvement of private sector expertise in conducting due diligence or assessment of business plans improves the viability of projects compared to grants.

Third, policymakers may reason that the use of FIs will **increase the cost-effectiveness of public funds** since repayments, including interest and dividends (or the 'non-draw-down' of a guarantee) create a revolving legacy that can be reinvested and that financial instruments create mechanisms for drawing in private sector finance. This argument has become particularly prominent in the context of the financial crisis which has affected not only public spending, but also the willingness of the private sector to lend and invest. Crucially, however, the scale of returns depends not only on the presence of sufficient numbers and scale of viable projects that are not commercially funded and the scope for timely exits and repayments, but also on the level of costs involved in running repayable funds and the need for losses and fees not to erode returns.

Against the background of the growing priority attached to using FI in 2007-13, and reinforced in 2014-20, it is appropriate to ask how much is known about the experience with financial instruments in 2007-13. More specifically, what lessons have been learned and how far have these been incorporated into the new context? What are the key changes implied by the new rules and to what extent do these constrain or enable the effective use of financial instruments in the new period? Last, can anything be said about the validity of the rationales underlying the use of FI and what do we still need to know?

2 Taking stock – the scale of FI

Although it is widely-known that the use of FI has increased significantly in successive Cohesion policy planning periods, a clear assessment of their scale in 2007-13 was initially hampered by the lack of systematic reporting. At the start of the 2007-13 planning period, reporting on FIs was not obligatory;[4] the Commission only began to require data collection and reporting annually part way through the 2007-13 programmes.[5] Successive reports have progressively improved the quality and completeness of reporting, though gaps and inconsistencies remain. In spite of these lacunae, it is possible to gain considerable insight into the variations in the use of cofinanced FI across the EU.

2.1 EU perspectives

At the EU level, the 2014 Commission Summary Report notes that by end 2013:

- 25 Member States had established cofinanced FIs (only Ireland, Luxembourg and Croatia had not)
- A total of 941 cofinanced FIs (69 holding funds – HF; and 872 specific funds – SF) were operating by end 2013

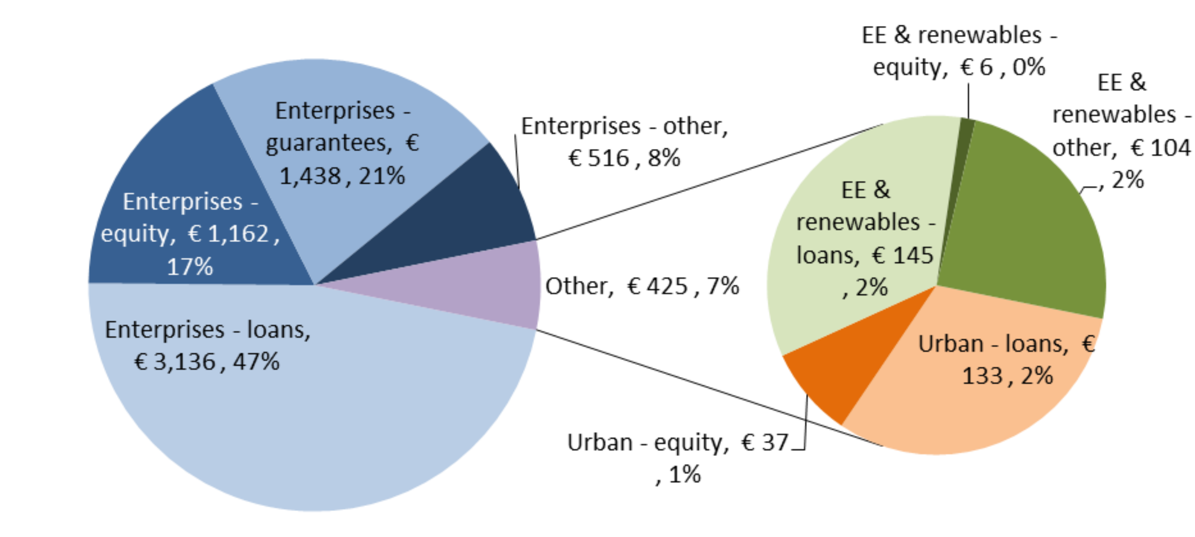
[4] An amendment to Council Regulation (EC) No 1083/2006 obliged Member States to report on FIs in the Annual Implementation Report.

[5] For first summary report see: http://ec.europa.eu/regional_policy/thefunds/doc/instruments/financial/financial_engineering_report_2012.pdf

- Of these, 91 percent of instruments were aimed at business development (ie. enterprises – typically SMEs); 6 percent at urban development projects; and 3 percent at energy efficiency and renewables; in terms of sums reaching final recipients, however, the proportion is even higher, with 93 percent of funding accounted for by support for enterprises – see Figure 1.
- FI principally take the form of loans and guarantees with a small proportion in the form of equity finance. In terms of *number* of transactions, around 48 percent take the form of guarantees, but in terms of *amounts* disbursed to final recipients, over 51 percent take the form of loans (and just 21 percent in the form of guarantees).
- Some €17 billion in OP contributions were committed to FI, of which over €14 billion had been paid into holding funds or specific funds by end 2013, *although less than €6.7 billion had actually reached final recipients* – meaning that only just over one-third of the sums committed had actually reached their intended target by the end of 2013.

Importantly, however, as will be seen, these headline figures conceal considerable variation between countries.

Figure 1: Sums disbursed to final recipients by type of FI and target (€m and % of total)



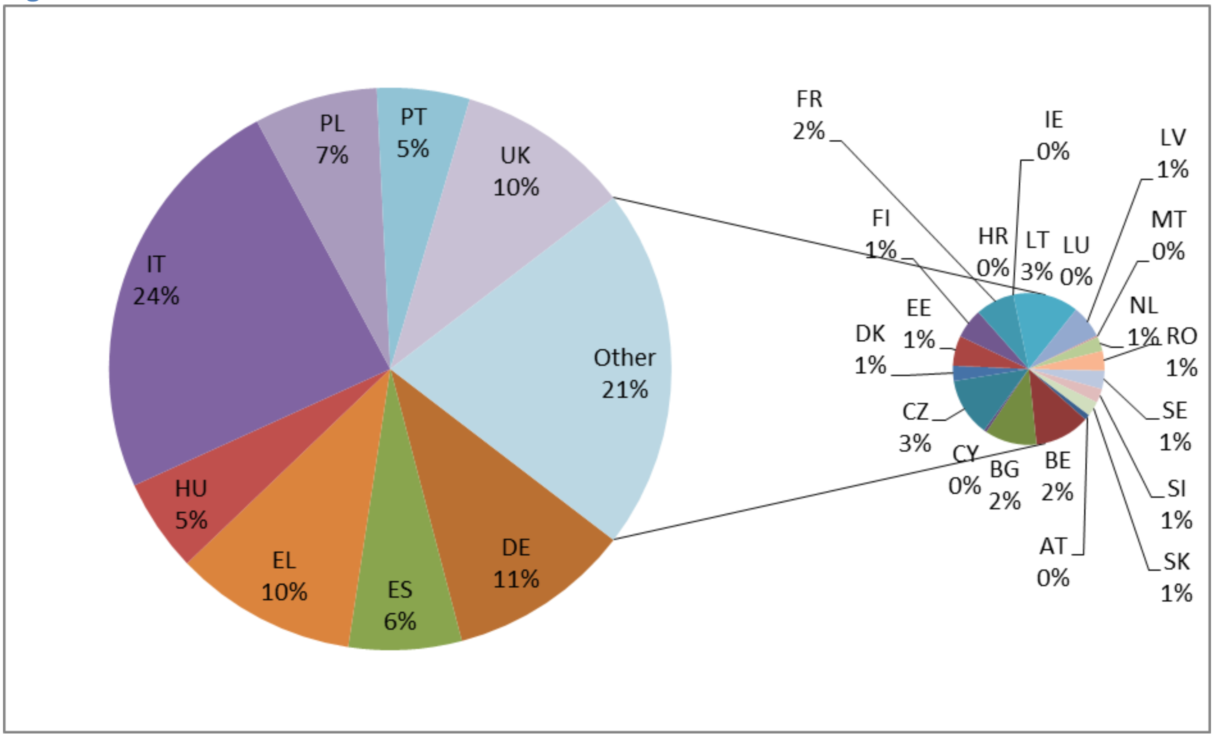
Source: Own calculations from European Commission Summary Report 2014.

2.2 National variations

2.2.1 Scale and significance of OP commitments to FI

The amount of Structural Funds committed to financial instruments varies widely between Member States. As Figure 2 shows, four Member States (IT, DE, EL, UK) account for 55 percent of OP contributions committed to FI in 2007-13. Among these, Italy alone accounts for almost a quarter of the total.

Figure 2: National Shares of OP Contributions Committed to FI



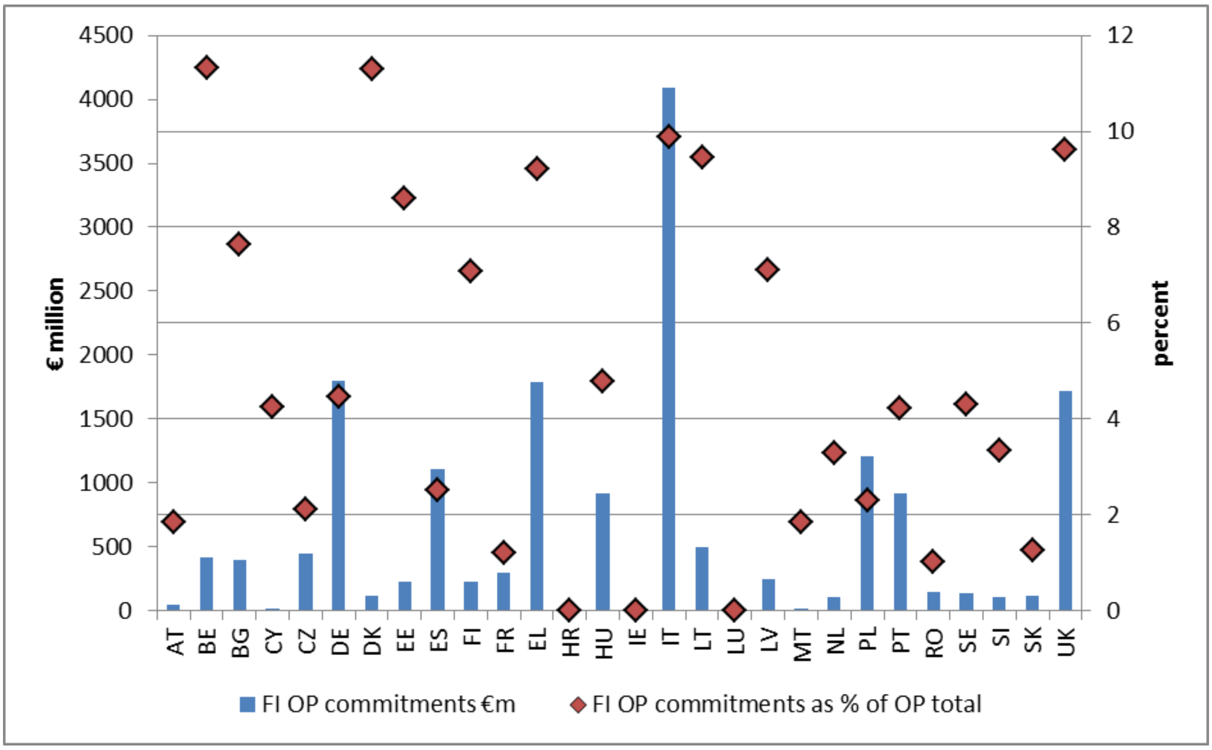
Source: Own calculations from European Commission (2014).

The differences between countries are partly a function of country size and the overall scale of Cohesion policy funding (which itself complicates direct comparisons), but are also a reflection of policy choice and of existing domestic practice. As a result, there is arguably no consistent pattern of spend on FI cofinanced through Cohesion policy. For example:

- The UK and France receive broadly similar Structural Fund (ERDF and ESF) allocations, but the UK committed almost six times as much as France to FIs in the OPs.
- Portugal and Greece have similar ERDF and ESF allocations, but Greece committed twice as much as Portugal to FI in the OPs.
- Romania receives almost three times as much as Bulgaria in ERDF and ESF allocations, but Bulgaria has committed more than two and a half times as much to FI as Romania.

In line with Figure 2, Figure 3 shows the highest levels of OP commitments to FI in Italy, Greece, Germany and the United Kingdom. Perhaps more interesting, however, is the *relative* importance of those commitments. Figure 3 suggests that in Belgium and Denmark more than 11 percent of OP commitments are made to FI; a second group, Estonia, Greece, Italy, Lithuania and the United Kingdom also commit comparatively large amounts to FI – of the order of 8 to 10 percent of OP allocations.

Figure 3: Absolute and relative OP commitments to FI



Source: Own calculations from European Commission (2014) and DG Regio data available at: http://ec.europa.eu/regional_policy/impact/evaluation/data_en.cfm

Significantly, widespread use of FI in *domestic* policy is not necessarily reflected in the scale of OP commitments to FI. This may be because, given the complexities of Structural Fund administration, the programme is too small to justify the setting up of specific instruments, and this is left to domestic policy(as in Flanders – all FI commitments in Belgium are accounted for by Brussels and Wallonia) or because policymakers opt to focus Structural Fund spending on particular types of project that are perceived to be less amenable to the use of FI, even though repayable support is an established part of domestic economic development policy (as in Austria)

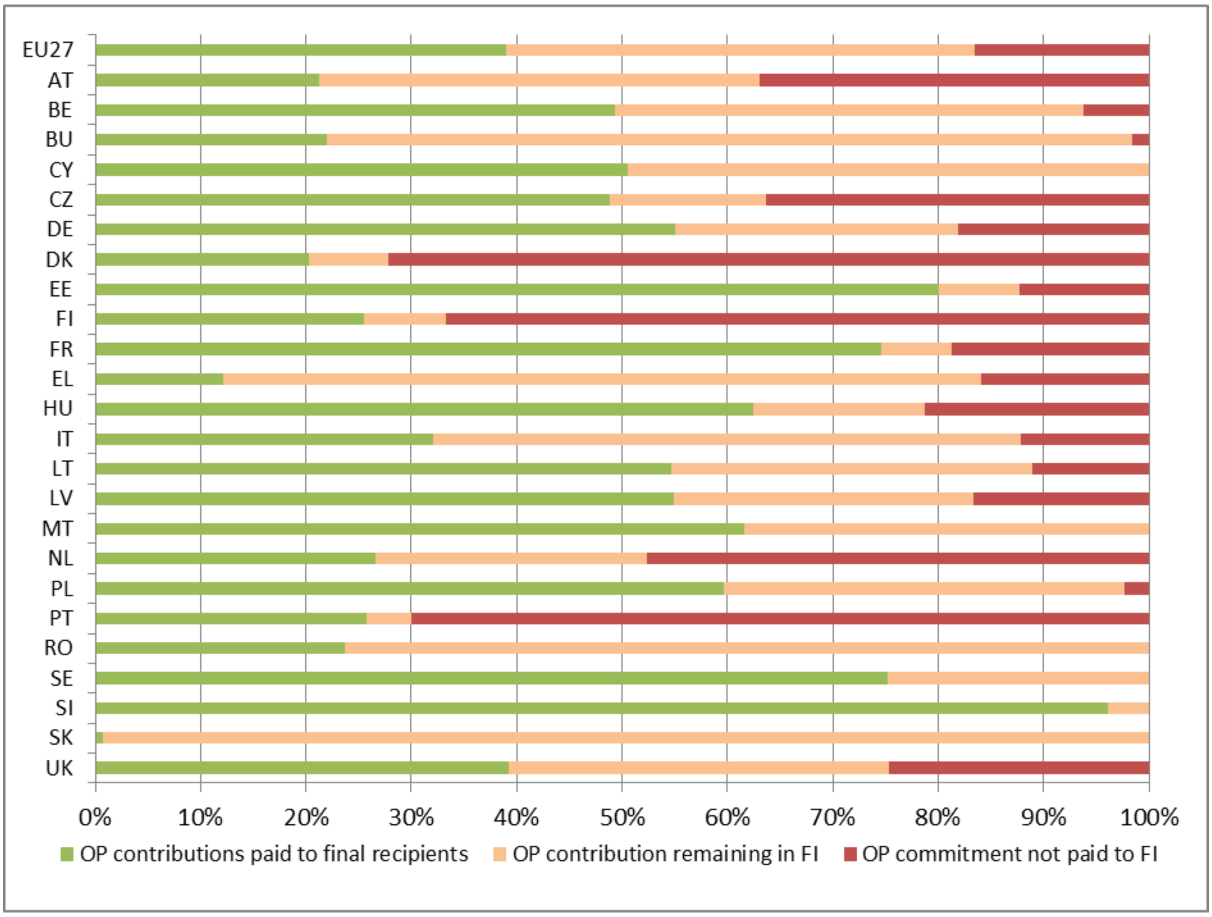
2.2.2 OP commitments, payments to funds and investment in final recipients

In considering 'spend' on FI it is important to distinguish between commitments made at the level of the OP, payments to funds (HF or SF) and monies actually reaching final recipients. The data in Figure 3 are concerned with OP commitments – in principle an indicator of policymaker intent regarding the scale of FI spend. There is, however, evidence that OP commitments to FI have sometimes been 'artificially' inflated by the impact of the N+2/3 decommitment rules, since the rules enabled these contributions to be treated as committed, therefore escaping, or at least postponing, potential decommitment.[6] This tendency is reflected in the extent to which OP commitments to FI have reached either the funds (ie. a holding fund or specific fund) or final recipients, which is illustrated in Figure 4.

[6] Michie R and Wishlade F (2011) *Between Scylla and Charybdis. Navigating Financial Engineering Instruments through Structural Funds and State Aid Requirements*, IQ-Net Thematic Paper 29(2), European Policies Research Centre, University of Strathclyde, Glasgow.

The data in Figure 4 are striking. Across all countries operating cofinanced FIs, by end 2013 – - less than 40 percent of the funds committed to FI in OPs had actually reached final recipients (ie. individual firms or urban development projects, for example) and most of the funding committed actually remained with holding funds or specific funds (though a substantial proportion had not been paid to funds either). The data should be treated with some caution and the Commission notes that some of the entries are implausible; also, many entries are incomplete, so the final picture may be more positive. However, in some countries (AT, DK, FI, EL, NL, PT, RO, SK) less than 30 percent of commitments had reached final recipients, with the figure for Slovakia especially noteworthy since just €0.85 million from a commitment of over €110 million seems actually to have been invested by the end of 2013. At the opposite end of the spectrum Sweden, Slovenia, France and Estonia appear to have achieved a utilisation rate exceeding 70 percent of OP commitments.

Figure 4: OP Commitments reaching funds and final recipients (%)



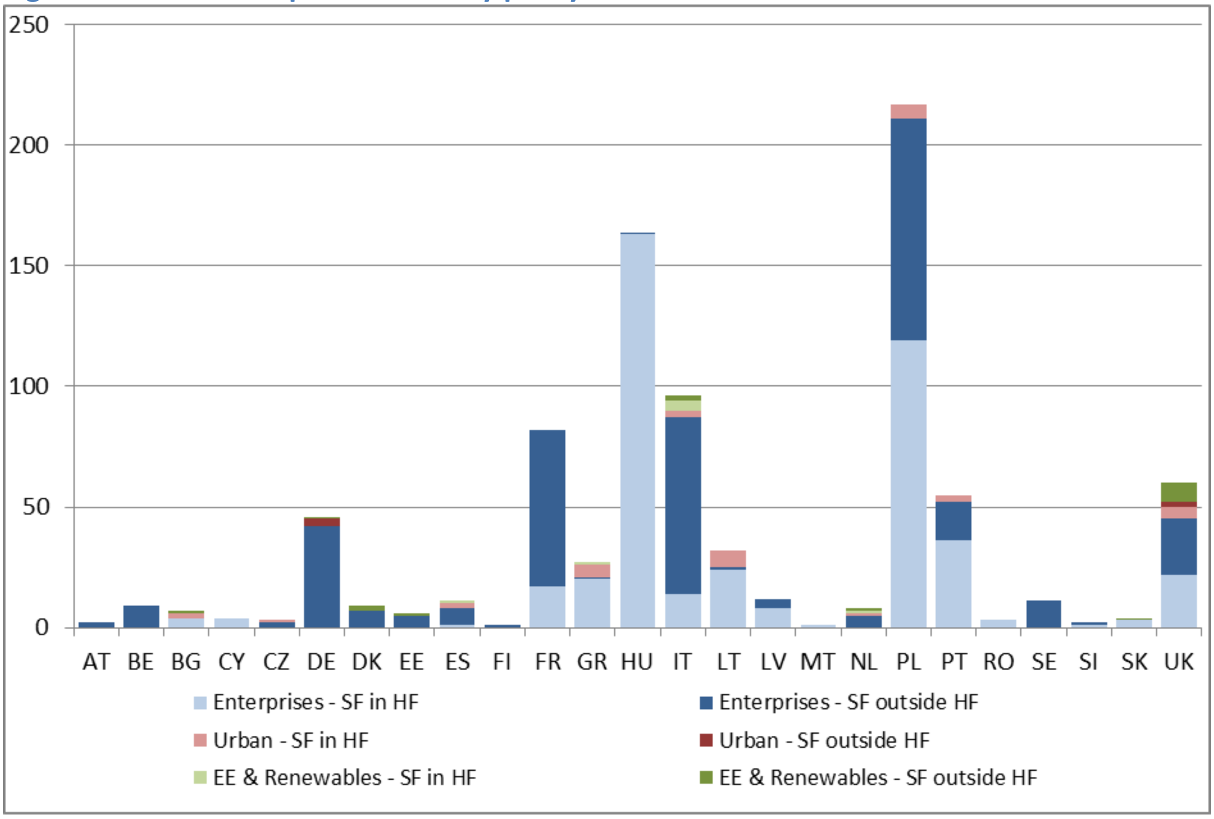
Note: Spain is excluded from this chart since the data reported includes some returns rendering the data unreliable.
Source: Own calculations from European Commission (2014).

2.2.3 Funds and fund size

The number and type of instruments operated varies widely between countries. Leaving aside holding fund structures, there are some 872 specific funds, the vast majority of which are, as noted above, focused on support for enterprises.

As Figure 5 shows, 25 countries (i.e. excluding IE, LU, HR) provide FI to enterprises, but only 11 support urban development with FI and 12 use FI for energy efficiency and renewables. The number of specific funds operated in a given country ranges from one (MT, FI) to 217 in the case of Poland; there is no clear relationship between the number of funds, country size, or spending commitments – for example, Poland and Hungary alone account for 44 percent of all specific funds (in terms of number of funds), but only around 12 percent of OP commitments to FI; France has 82 instruments, almost double the number in Germany, but OP commitments to FI run at about one-sixth of those in Germany.

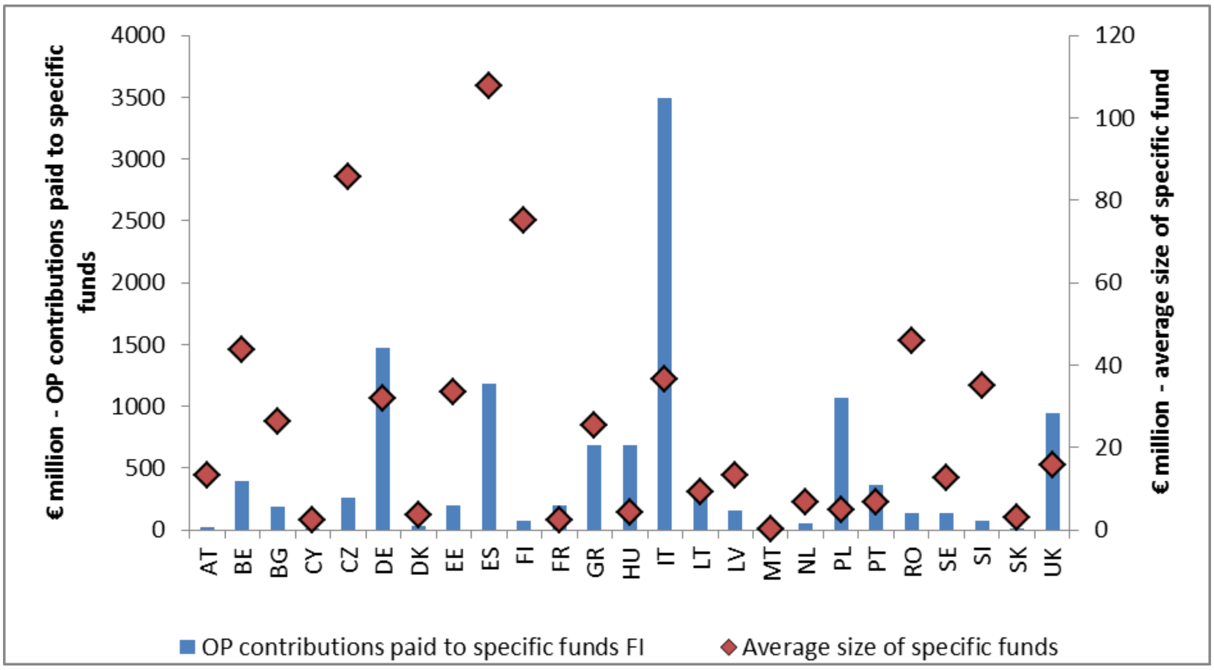
Figure 5: Number of specific funds by policy focus



Source: European Commission (2014).

Reflecting this, *average* fund size varies considerably between countries, as illustrated in Figure 6. This suggests that in around half of Member States, the average fund size is less than €20 million, though in the Czech Republic and Spain it exceeds €80 million, partly owing to the prominence of nationwide funds.

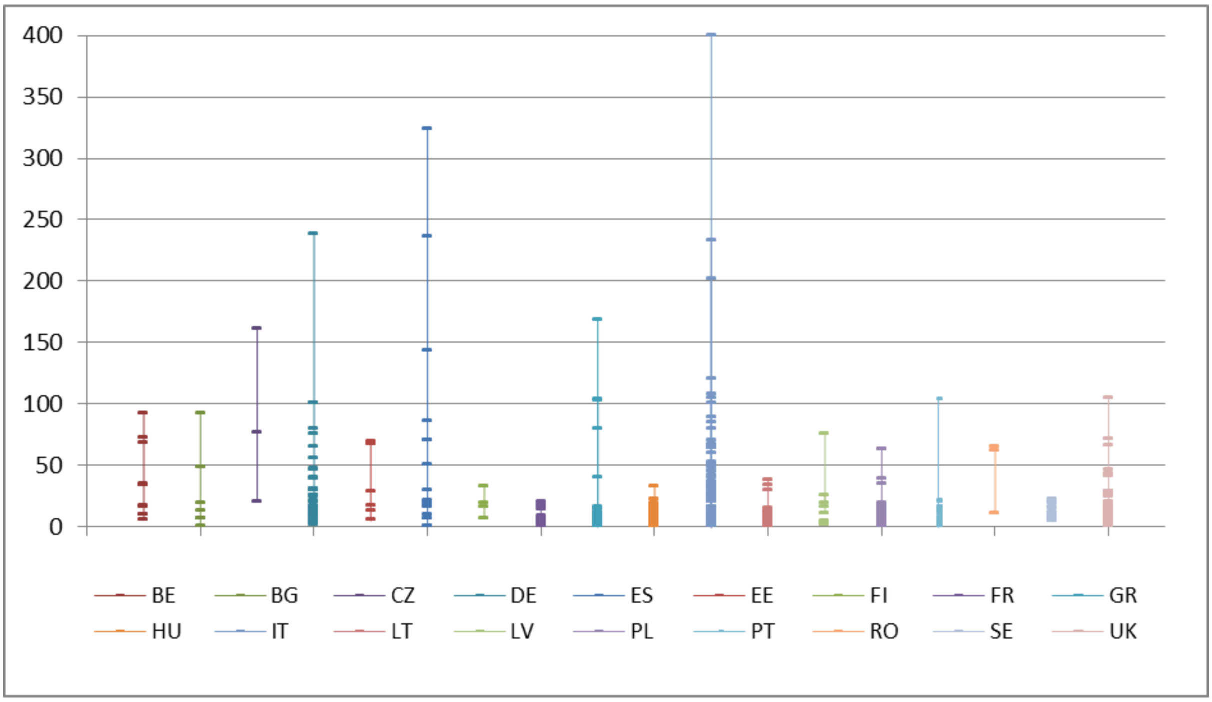
Figure 6: OP contributions paid to specific funds and average fund size



Note: This chart shows OP contributions actually paid to specific funds; this is different (and may be less than) OP contributions committed to FI, depending on the extent to which funds remain in holding funds or have not been paid out to funds at all.
Source: Calculated from European Commission (2014).

Fund size also varies considerably *within* countries partly owing to the presence of substantial multiregional funds as in Spain and Italy, but also contingent on choices and priorities at the subnational level.

Figure 7: Fund size - contributions paid to specific funds (€ million)



Source: European Commission (2014).

Although fund size is partly a reflection of country and region size, there is no consistent pattern and some countries are characterised by a large number of very small funds, whereas for others the reverse applies. For example:

- In *France*, the single largest fund is €30 million (Languedoc-Roussillon) and the most significant as a proportion of the OP is in Auvergne, but the amounts paid to FIs account for just 6 percent of OP commitments. In general, France is characterised by a large number of specific funds (82), many of them totalling less than €1million.
- *Poland* is characterised by the presence of a number of holding funds (9), most of which are significant in size (typically greater than €40 million), and a large number of specific funds (211). The largest holding fund (Wielkopolska) runs to over €120 million and amounts to almost 8 percent of OP commitments, but many of the specific instruments operating in Poland are, as in France, small in scale with a large number involving less than €2 million.
- Conversely, the *Czech Republic,* for example, operates few funds, but they are relatively significant in absolute size.

A final observation concerning size concerns the relative importance of FI within OPs. In the majority of cases the OP contribution paid to FI is a small proportion of the overall OP commitment –typically less than five percent of the OP total. However, there are also a number of substantial FI – the two multiregional schemes in Spain and Italy mentioned earlier have involved payments to FI of over €300 million (over 15 percent of OP commitments) and €400 million (almost 10 percent of the OP), respectively. These measures are therefore significant both in terms of absolute size and their role in the relevant OP. In addition, there are a number of examples of FI playing a significant role within OPs that are comparatively modest in size – such as the Walloon region Convergence OP where payments to FI account for 36 percent of OP commitments and the Regional Competitiveness and Employment programme for Stockholm where amounts paid to FI account for over 20 percent of OP commitments.

3 Experience from 2007-13: setting up and implementing financial instruments

3.1 Setting up financial instruments

Managing authorities were strongly encouraged by the European Commission to consider introducing financial instruments within their 2007-13 Structural Fund programmes. As discussed above, most did so and the most popular policy target was enterprise support, and in particular support for small and medium sized enterprises (SMEs). The main stated rationale for this was the gap in the availability of finance for SMEs, since SME support was a high priority in virtually all Cohesion policy programmes in 2007-13.[7] To the extent that the gap was formally quantified, in some cases it was assessed in existing studies, but in others specially-commissioned gap analyses were carried out by the European Investment Fund (EIF). Early in the 2007-13 programme period, the EIF was tasked by the European Commission to undertake 55 gap analyses in 19 EU Member States, but most were

[7] Michie R and Wishlade F (2011) *op cit*

conducted in Spain, France and Poland.[8] The gap analyses took a standardised approach as recommended by the European Parliament,[9] with a single template methodology for all studies developed by the EIF. All except one (which used a SME survey) were based on secondary data, sometimes complemented with stakeholder interviews.[10]

The gap analyses, which were 'a combination of an analysis of existing macro-economic and/or regional data, an inventory of existing structures and initiatives, and an analysis of statistical material on the SME situation',[11] were valued by managing authorities as providing an experienced 'objective view' and were intended to differ from existing studies by going beyond an analysis of existing gaps to include an assessment of possible financial instruments 'from a portfolio perspective'.

The fact that the gap analyses were funded by the EIF and the European Commission played a significant role in managing authority decisions to undertake them and then to proceed with establishing a fund.[12] The costs of the gap analyses varied widely, from several thousand Euros to several hundred thousand Euros, and most managing authorities would have been unwilling to fund the analyses themselves, particularly when they were unconvinced of the feasibility of using FI. Where studies were carried out, the financial contribution was considered to be highly significant, especially in smaller Member States.[13]

While the process was valued by managing authorities, it was also problematic in some cases. Issues included substantial delays, taking up to two years of a seven year programme period, and a range of approaches being taken despite the common template - from quite general statistical analyses to very detailed descriptions of the different actors at regional levels involved, types of instruments proposed and overlaps.[14]

Feasibility studies were also carried out for FI to support urban regeneration (JESSICA). By the end of 2011, around 65 JESSICA feasibility studies in 21 Member States had been conducted with the support of the European Investment Bank. Of the publically available studies, all but one (the study for Finland) recommended setting up urban development funds and concluded that such funds would provide considerable advantages and added value. Most of the studies highlighted continuous and increasing demand for urban development activities, and many identified project pipelines at various stages of investment-readiness. Only one study (Liguria, Italy) highlighted that it would be difficult for the region to formulate project proposals which met cofinancing requirements, although several others (Greece, Spain, and South Poland) raised eligibility issues. The number of

[8] European Court of Auditors (2012) Financial instruments for SMEs co-financed by the European Regional Development Fund, Special report no. 2. DG REGIO of the European Commission financed 85 percent of the studies' cost and the EIF the remaining 15 percent.

[9] European Parliament (2012) Overview of Financial instruments used in the EU Multiannual Financial Framework period 2007-2013 and the Commission's proposals for 2014-2020. Analytical Study. DG for Internal Policies, Policy Department D: Budgetary Affairs, Brussels.

[10] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and Atkinson S (2013) Financial Instruments. A Stocktaking Exercise in preparation for the 2014-2020 Programming Period. Final Report to European Investment Bank.

[11] Operations Evaluation/EIB Group (2011) Ex post evaluation of JEREMIE Evaluation Phase as it relates to the EIF, Synthesis Report, April 2011.

[12] Operations Evaluation/EIB Group (2011) *Op cit.*

[13] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and Atkinson S (2013) *Op cit*.

[14] Operations Evaluation/EIB Group (2011) *Op cit.*

suitable projects was generally expected to increase over time as awareness and experience of such instruments increased.[15]

The delays experienced in the gap analysis process were to become a recurring theme. Although some Structural Fund managing authorities had experience of implementing financial instruments under their 2000-06 programmes, the expansion of their use in 2007-13 imposed a significant and steep learning curve. Their complexity meant that the setting-up process in many cases took longer than managing authorities had expected, especially for urban development FI, which were relatively new.[16] The Structural Fund regulations for 2007-13 were somewhat vague and incomplete in terms of their coverage of financial instruments and managing authorities had to seek clarification on many issues from the European Commission during the design, set-up and launch phases. This lengthy set-up period was problematic, especially where instruments were being launched to provide a rapid response to the economic crisis and to help businesses lacking access to finance.

Implementation delays in FIs for SMEs have been attributed to factors such as the time taken to structure FIs and to negotiate them with the Commission; obtaining private sector contributions; negotiation of management costs; agreeing the governance arrangements; uncertainty over the eligibility of working capital; and other administrative issues.[17] For urban development FIs, delays were attributed to uncertainty surrounding a number of issues, including: how the initiatives would work in practice; the need to go through a learning process; difficulties in using land as co-financing; problems convincing private sector fund managers to engage with contracts involving the Structural Funds; and issues with State aid.[18] However, according to the European Commission, such delays could in most cases be explained by the novelty of the instruments and by State aid-related issues.[19]

State aid rules were indeed identified as a key source of frustration and anxiety. For FIs offering SME support, many managing authorities addressed State aid compliance by using the ‘no aid’ option, for example by offering loans on a *de minimis* basis or at market rates, and structuring equity such that private and public contributions are *pari passu*, or providing it on a *de minimis* basis. The main justification for using the *de minimis* facility was ease of use, however, disadvantages included the small size of sums available and onerous monitoring requirements. Some use was also made of instruments compliant with the General Block Exemption Regulation (GBER), and several managing authorities used the notification option, particularly for venture capital measures targeted at SMEs. Urban development FIs were found to present particular challenges in a State aid context - while the European Commission had a well-developed basis for dealing with SME support measures, there was no overarching framework setting out eligible expenditure types or projects for urban development measures. Thus assessing State aid compliance involved dealing with a fragmented approach, with the relevant constraints and parameters spread across a range of documents.[20]

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[15] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and Atkinson S (2013) *Op cit*.
[16] Michie R and Wishlade F (2011) *Op cit*.
[17] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and Atkinson S (2013) *Op cit*.
[18] Michie R and Wishlade F (2011) *Op cit*.
[19] European Court of Auditors (2012) *Op cit.*
[20] Michie R and Wishlade F (2011) *Op cit*.

The complexity of public procurement processes, in particular ensuring compatibility between national and EU approaches, was also a significant source of delay,[21] although those programmes which chose the EIF as holding fund manager were able to do this through a direct award, potentially resulting in fewer delays. This was also the case for some other institutions, for example the German *Länder*, since the direct award route could be used for the *Land* promotional banks which are owned by the *Land* governments. Capacity among managing authorities and European institutions themselves was also identified as a delay factor.[22]

3.2 Experience with implementation

As noted earlier, in 2007-13, financial instruments could be set up for three specific purposes: to invest in SMEs and enterprises; urban development; and energy efficiency and renewable energy in buildings. The majority of instruments were cofunded by the ERDF, but there were also some examples of European Social Fund (ESF) cofunded FIs (it was not possible to set up FIs using the Cohesion Fund in 2007-13).

When setting up a financial instrument, managing authorities had four basic options:

- to make a direct contribution to an instrument (without using a holding fund);
- to contribute to a holding fund, the management of which is put out to public tender;
- to contribute to a holding fund and contract the management to EIF/EIB; or
- to contribute to a holding fund and contract management to a national financial institution without tender under national law (if compatible with the Treaty).

Managing authorities also had to decide whether to establish a distinct legal entity for the instrument (including the holding fund) or whether to set up a separate block of finance within an existing institution. The choices made were largely context-driven, and most Member States using financial instruments used both organisational approaches (i.e. holding funds and direct contributions). In terms of the overall pattern of management, the holding funds were managed by either national financial institutions (42 percent), were put out to public tender (15 percent), or were managed by the EIF or EIB (43 percent).[23]

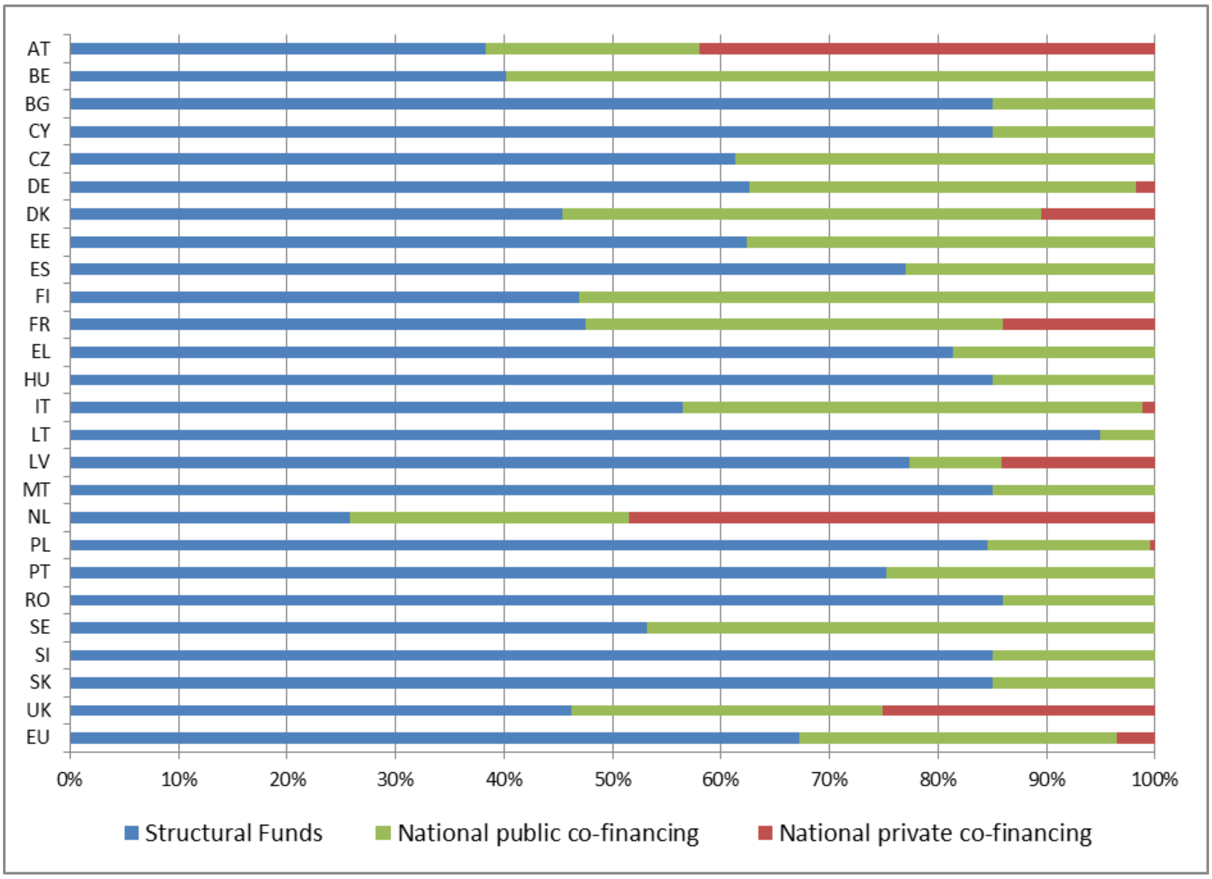
As discussed earlier, the rate of uptake under FIs has varied significantly across Member States and across different instruments. This is to be expected, given their different objectives and investment environments.[24] However, in addition to expected differences in project generation, the economic crisis has had a serious, primarily negative, effect on the implementation rate of FIs in many programmes.[25] This has been due to, for example, subdued demand, understaffing and difficulties finding co-investment partners.[26] The low uptake has been particularly severe in the case of FIs for urban development where there were early concerns around the length of time it takes to develop infrastructure projects

[21] Michie R and Wishlade F (2011) *Op cit*.
[22] Michie and Wishlade (2011) *Op cit*.; European Commission (2012) *Op cit*
[23] European Commission (2013) Summary of data on the progress made in financing and implementing financial engineering instruments co-financed by Structural Funds, September 2013.
[24] Centre For Strategy and Evaluation Services (CSES) (2007) Comparative Study of Venture Capital and Loan Funds Supported by the Structural Funds, Final Report, Brussels.
[25] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and Atkinson S (2013) *Op cit*.
[26] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and Atkinson S (2013) *Op cit*.

and the challenges involved in putting together packages of urban regeneration activity that would generate sufficient returns, as well as uncertainty over rules governing exit policies and the re-use of resources.[27]

It has, in many cases, been difficult to engage the private sector as participants in co-funded financial instruments in 2007-13. Encouraging additional co-investment from the private sector (thereby increasing the sums available for investment in programme priorities) is cited as one of the key benefits of using financial instruments in Structural Funds programmes in place of grants. This contribution may take place at the level of the holding fund (if there is one), the individual fund or the deal/final recipients. The European Court of Auditors noted the poor capacity of Structural Fund programmes to leverage in private investment in comparison with other EU SME programmes, an outcome which they attributed to a lack of fit between the Structural Fund regulations and the specific features of financial instruments, as well as weaknesses in the gap analyses carried out.[28]

Figure 8: OP contributions paid/committed to HF or SF by source



Source: Own calculations from European Commission (2014).

Clearly the proportion of national cofinancing illustrated in Figure 8 is partly a function of the rates applicable to different categories of country and region, but what is notable overall is the very low (zero in most countries) proportion of cofinancing provided by the private sector.

[27] Michie R and Wishlade F (2011) *Op cit*.
[28] European Court of Auditors (2012) *Op cit.*

4 Lessons learned

Many countries have a long domestic experience in operating FI and a number of lessons can be drawn from this.[29] In addition, however, the regulatory context for cofinanced FIs gives rise to a number of specificities. A notable issue to emerge from a number of programmes and instruments is that the design and implementation of FI is context specific. As the earlier discussion showed, national (and regional) practices and experiences differ widely in terms of the overall scale of FI, the types deployed, their relative importance in the context of the operational programme and their relationship with existing domestic structures and instruments: in practice, the only commonality between the many of the instruments catalogued in the Commission summary report may be the existence of Cohesion policy cofinancing.

4.1 Successful implementation of financial instruments is not just about disbursing funds

A key issue in the uptake of financial instruments is the presence of a pipeline of 'investor-ready' projects. The literature on publicly-backed venture capital suggests that, in disadvantaged regions especially, the problem is one of 'thin markets' – there are limited number of investors *and* a limited number of 'investable' opportunities.[30] Experience with FI in 2007-13 suggests that this applies more widely than in the context of equity investment and many policy makers have stressed the importance of providing mentoring, training and business advice as a precursor to the provision of finance through FI. In this context, some regions have developed sophisticated and intensive mechanisms to identify, develop and fund SME projects.

4.2 There is no 'one size fits all' – FI need to be designed for their context

A key lesson to emerge from a number of programmes was the importance of having a quality *ex ante* assessment of the market to provide an evidence base for the size and nature of the funding gap; as noted, such assessments were not obligatory in 2007-13 (but are for 2014-20). In many cases, the funds allocated to FI and the design of instruments seems not to have been based on specific studies, though often drew on the experience of existing financial institutions and their perceptions of market needs. In others, although assessments were undertaken, there were serious doubts about the quality of the analysis.[31]

Managing authorities have also noted the importance of factors such as the need for experts with a thorough understanding of the locality, able to take account of its specific characteristics and potential impact on market failures and the ability to provide a specialist analysis of the SME financing market. The analysis should also include a forward looking

[29] There is a substantial literature on the operation of specific types of instrument – for a recent overview of various types of instrument see Cowling, M (2012) *Financial engineering Literature Review – credit rationing, equity gaps and policy solutions for financing entrepreneurial businesses in Europe*, report to European Commission, DG Regio. This literature is, of course, highly relevant, but the principle focus of this paper is on how FI operate in a Cohesion Policy context.

[30] Nightingale, P. (2009) From funding gaps to thin markets: designing hybrid VC schemes for the 21st century, BVCA and NESTA.

[31] European Court of Auditors (2012) *Op cit*.

element to take account of changing economic conditions, as well as the potential for mid-term re-examination of the market, on the basis of which instruments could be adjusted.[32]

4.3 Coordination among stakeholders is key to sound implementation

An important lesson to emerge from 2007-13 experience is the importance of close coordination of the various actors involved from the outset. In this context policymakers have pointed to the importance of understanding of the market, as implied by an *ex ante* analysis, but also the motivations of different actors in the field and the need to ensure that interests and incentives are aligned. For example, funding agreements need to be made sufficiently attractive to fund managers, but they also need to be enforceable to ensure that the policy objectives are met. The strategy underpinning the use of the FI (and associated support) needs to be communicated effectively to potential recipients.

4.4 The flexibility to adapt to changing conditions is important

The impact of the crisis in the 2007-13 period and its implications for access to finance threw into sharp relief the need for FI to have the capacity to adapt to changing market conditions. As noted, a high quality initial *ex ante* assessment of market needs is considered essential as a starting point. In addition, but many policymakers have also emphasised the need to adjust the strategy during the course of implementation, drawing on evaluations, market research and monitoring data to recalibrate instruments to reflect market needs. In this context, the use of holding funds is widely considered to be useful since they facilitate switching allocations between different instruments according to needs.[33] Research also suggests that implementation of FIs was more challenging where investment strategies were focused too closely on specific target groups, especially where this was combined with geographical limitations.[34]

4.5 Guarding against 'objective drift'

Notwithstanding the requirement for flexibility, there is also a need to guard against 'objective drift' - recent research found that many FIs deviate from the investment strategy set out in their market assessment.[35] This may be justified by changing economic circumstances, but can be due to the political situation, financial risks, technical issues or administrative capacity. Importantly, the goals of the various parties involved in implementing FIs may not necessarily coincide. There is potential for tension between the complex range of managing authority goals and the profit-oriented focus of private sector fund managers. This may be seen for example in relation to attitudes towards risky or innovative projects, with managing authorities typically seeking to support innovative projects and private fund managers seeing these as potentially undermining profit. While the development of a regional SME base is a core objective for the managing authority, it is merely an incidental by-product to a profit-driven private investor.

[32] Michie, R, Wishlade, F and Gloazzo, C (2014) *Guidelines for the implementation of Financial Instruments: Building on FIN_EN – sharing methodologies on financial engineering for enterprises*, final report to Finlombarda SpA.
[33] Michie, R, Wishlade, F and Gloazzo, C (2014) *Op cit.*
[34] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and S Atkinson (2013) *Op cit.*
[35] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and S Atkinson (2013) *Op cit.*

4.6 Capacity building and mastery of the regulatory environment

The slow start to implementation in 2007-13 partly owed to the complex skill set required to establish financial instruments. The set-up and operation of financial instruments is administratively very complex, and requires detailed knowledge of Structural Funds regulations, State aid compliance and investment principles. In practice, 2007-13 experience suggests that the various parties involved often lacked expertise in more than one of the three policy spheres concerned.

5 Financial instruments in 2014-20 – opportunities and constraints?

The new planning period introduces a number of changes to the operation of financial instruments,[36] as well as emphasising their importance as mechanisms to implement policy. Regarding the latter, an important development is the extension of the use FI beyond the three areas targeted in 2007-13 (enterprises, urban development and energy efficiency and renewables) to include all of the Commission's thematic objectives for 2014-20, as well as a push towards using FI through the EAFRD and the EMFF, areas where use has hitherto been limited. In terms of *changes* to existing arrangements, a number of key areas can be highlighted.

5.1 *Ex ante* assessment

Arguably the most important change is the emphasis placed on the *ex ante* assessment of the need for FI. As discussed, the need for a high quality analysis of the finance gap is one of the key lessons to emerge from 2007-13, and this lesson is implemented through the obligation to undertake such analysis (for which detailed methodological requirements have been provided) before OP funds can be committed to FI.

5.2 Phased payments

A second important change concerns the phasing of payments to FIs. As mentioned, in 2007-13, there is some evidence of 'parking' of funds in order to avoid decommitment, which is at least in part responsible for the high levels of funds not invested in final recipients (other factors include the quality of the gap analysis and general implementation delays). While this change can be seen as important in delivering a more orderly and realistic draw down of funds, it may also have implications for flexibility in implementing FIs, especially if economic conditions change.

5.3 Management costs and fees

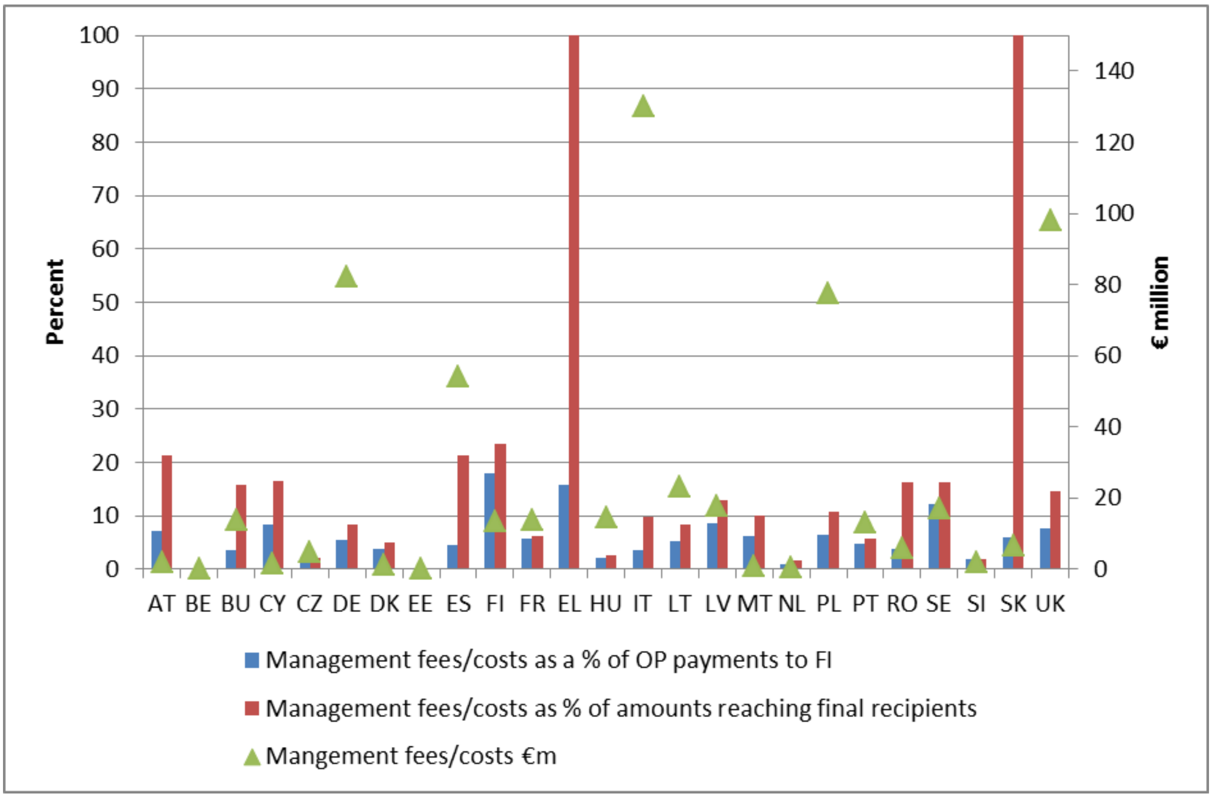
For 2014-20 there are more detailed provisions and stricter limits and the imposition of specific methodologies for establishing costs and fees that seem likely to lower management fees overall. In fact, it is currently very difficult to assess the full scale of management costs – for many funds no fees are explicitly reported and it is unclear whether or when such information might be available. The Commission Summary report[37] suggests that some of the data on costs is implausible, but it is not clear which. Nevertheless, Figure 9 indicates that there is cause for concern over management costs. In Greece and Slovakia, for example, fund management costs appear to exceed the amounts invested in final recipients.

[36] European Commission (2014a) Financial instruments in ESIF programmes 2014-2020. A short reference guide for managing authorities (Ref.. Ares (2014)401557 - 18/02/2014), http://ec.europa.eu/regional_policy/thefunds/fin_inst/pdf/fi_esif_2014_2020.pdf.

[37] European Commission (2014) *Op cit.*

Although the new rules on such costs are more stringent, this has to be balanced against the need to make fund management sufficiently attractive to the commercial sector otherwise none will tender to operate FI and bring the benefits of private sector expertise that FI are perceived to offer.

Figure 9: Management costs and fees



Note: GR is off the scale both in management costs as a proportion of amounts reaching final recipients (109 percent) and total management fees and costs (€238 million); Slovakia is off the scale in terms of management costs as a proportion of amounts reaching final recipients (over 700 percent). The Commission Summary report notes that some data is implausible and it may be that these are among them.
Source: Own calculations from European Commission (2014) *Op cit.*

5.4 State aid compliance

The relationship between financial instruments (FI) and the State aid rules was, as noted above, among the most troublesome aspects of implementing FI. Several factors explain this. First, some key aspects of the State aid rules lack clarity – not least the definition of what a State aid actually *is* – and the rules are perceived to be complex to apply in practice. Second, although the Treaty ban on State aid is tempered by a number of derogations, these tend to be cast in terms of *policy* objectives (e.g. R&D&I, SME) rather than the *form* of intervention, so several different texts may need to be considered in designing FI measures. Third, the State aid rules have seemed relatively ill-equipped to deal with the emphasis on FI under Cohesion policy, and domestic policymakers have often criticised the working relationship between DG REGIO, DG COMP and the EIB.

State aid control has undergone significant changes, some with direct implications for the deployment of FI in the new funding period. These flow from the European Commission's

State Aid Modernisation initiative (SAM)'[38] which sought to re-focus State aid control against the backdrop of Europe 2020, but it also regards State aid control as 'crucial in order to improve the efficiency and effectiveness of public spending'. A number of developments will affect the interface between the operation of FI and State aid compliance.

At a general level, State aid issues are among the *ex ante* conditionalities listed in the Common Provisions Regulation (CPR) which forms the basis for the operation of ESIF for 2014-20.[39] Of course, compatibility with the State aid rules has always been a requirement under the Structural Funds Regulations, but the *ex ante* conditionalities extend the criteria beyond compliance to include arrangements for training and dissemination of information and ensuring adequate administrative capacity for applying the rules. This is an important component of the Commission's so-called 'trust and verify' approach to State aid compliance, which is reflected in the new General Block Exemption Regulation (GBER).[40]

More specifically, the CPR provides for possible new structures for the implementation of FI in Cohesion policy which, among other things, aim to simplify or eliminate State aid compliance issues for Managing Authorities. At the same time, changes to the State aid rules concerning *de minimis* aid, the GBER and new rules on risk investment finance reshape the potential for using FI, especially in the context of SMEs but also for a new size category of firm in the State aid context, so-called midcaps. Overall, the new GBER significantly enlarges the scope to offer risk finance without recourse to notification. Some provision is also made for urban development FIs within assisted areas in the new GBER, but the scope of this is limited. As a result, State aid compliance is likely to remain an area of considerable complexity in the new period.

5.5 EU level instruments and 'off the shelf' instruments

The CPR provides for two new structures through which managing authorities can implement FI. First, contributions can be made to EU-level instruments which are managed directly or indirectly by the Commission.[41] Second, while remaining under the responsibility of the managing authority, FI can use pre-determined terms and conditions that, among other things, ensure State aid compliance – these have become known as 'off-the-shelf' instruments.[42]

Under the provisions for ***EU-level instruments*,** funds can be channelled to initiatives such as Horizon 2020 (equity and risk-sharing instruments), COSME (equity and guarantees), and the Connecting European Facility (e.g. project bonds). This relieves the managing authority of much of the administration associated with design, tendering, reporting and compliance issues, including ensuring State aid compatibility.

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[38] State aid modernisation, COM(2012) 0209 final, see: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0209:FIN:EN:PDF

[39] Article 19 and Annex XI of Regulation 1303/2013, the 'common provision regulation' (CPR): http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:347:0320:0469:EN:PDF

[40] The previous GBER is Commission Regulation 800/2008, OJEU L214/3: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:214:0003:0047:EN:PDF, which was extended to 30 June 2014. From 1 July 2014 Commission Regulation 651/2014, OJEU L187/1 applies, see: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0651&from=EN

[41] Article 38(1)(a), CPR.

[42] Article 38(3)(a), CPR.

Off-the-shelf instruments are designed to deal with a range of compliance issues. In the context of State aids, this involves structuring FI such that their terms and conditions either do not involve State aid at all, or do not require State aid notification and subsequent clearance from the European Commission.

It remains to be seen whether these new initiatives to reduce the administrative burden of operating FI are attractive to domestic policymakers. There may, for example, be concerns at the lack of flexibility and control for managing authorities in the EU-level instruments and questions over the added-value of simply channelling funds 'back up' to the EU level, through the complexities of EU financial circuitry. Moreover, the off-the-shelf templates would have been more valuable in 2007-13 – many managing authorities spent a large part of the last funding period gaining the experience and establishing the structures needed to operate financial instruments and have now mechanisms in place, many of which are likely to be capable of being rolled forward. In general, early indications are that the uptake of these provisions is likely to be rather poor.

5.6 Technical assistance

Another key area of development concerns technical assistance for FI. In 2007-13, the JEREMIE, JESSICA and JASMINE initiatives were launched by the Commission to provide support for managing authorities wishing to co-fund financial instruments under their Structural Funds programmes. Towards the end of the 2007-13 programme period, two studies funded by the EIB confirmed a strong demand from stakeholders for greater capacity building and technical assistance activity related to FIs in 2014-20, through all stages of the programme lifecycle and across thematic areas.[43] In response, a new technical assistance platform – recently launched as FI-Compass[44] - was developed for the 2014-20 period. FI-Compass will apply to all ESI Funds and is intended to provide common and fund-specific products related to FIs, covering the whole implementation cycle.

There will be two main strands to FI-Compass. The first is a horizontal strand, focusing on **advisory services for all Member States and types of FI** (e.g. exchange of best practice, networking, training, guidance on common themes such as *ex-ante* assessments, public procurement, State aid). This will be carried out by the EIB, and activities under this strand would be initiated through the definition of a horizontal work programme (top-down approach). Such activities would typically include the exchange of best practice and networking across Member States, as well as training sessions or methodological guidance on common themes such as *ex-ante* assessments, public procurement, regulatory aspects concerning Cohesion policy, State aid, etc. This could also include initiatives to promote the development of FIs in sectors with high potential but limited experience in the Cohesion policy framework, such as energy efficiency and renewable energies, research and innovation, social infrastructure and services.

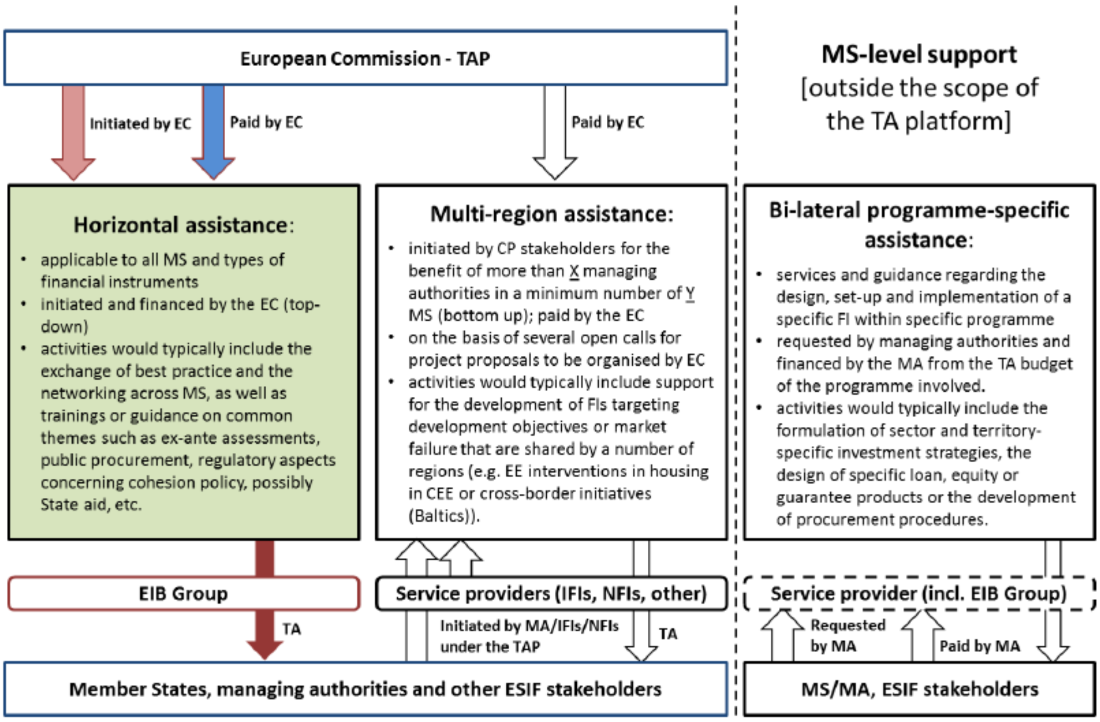
The second strand covers **multi-region assistance responding to stakeholder proposals.** This must benefit at least two managing authorities in at least two Member States. Such activities would typically include support for the development of FI targeting development objectives or market failures that are shared by a number of regions, such as energy

[43] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and S Atkinson (2013) *Op cit*; http://ec.europa.eu/regional_policy/thefunds/instruments/doc/20130621_ta_survey_en.pdf
[44] http://www.fi-compass.eu/

efficiency interventions in large housing estates in Central and Eastern Europe or support to cross-border initiatives aimed at reaching economies of scale and integration.

A further strand covers **bilateral assistance including ex-ante assessment for FIs**. Bilateral Assistance would typically support individual Member States and MAs intending to set up and implement FIs in their territory. However, Member States must use their own TA budgets for tasks such as the ex-ante assessment or hiring a specialised body to assist the setting up of a FI in their programme area.

Figure 10: Horizontal, multi-region and bilateral assistance under the Technical Assistance Platform



Source: Horizontal Advisory Services for the use of ESIF FIs in the 2014-20 Programming Period Terms of Reference

6 Concluding points

The aim of this paper has been to provide an overview of the Member State experiences with Structural Fund co-financed FI in 2007-13 and to consider the changes implied by the new regulations.

A review of the available data shows that Member State practices vary very widely, with further diversity at the subnational level. For some, FI are a key delivery mechanism for Cohesion policy, for others they are a minor adjunct. Direct comparisons between countries are complicated by the very varied policy contexts. Many Member States have longstanding traditions of providing finance through business development banks, sometimes with the result that Cohesion policy brings little added value – especially if Cohesion policy allocations are small - given the complexity of cofinancing policy. Elsewhere, Cohesion policy provides a substantial complement to existing domestic policy, or indeed provides support of a type that did not exist before.

Partly as a consequence of this variety, it can be argued that there is limited commonality of interest and experience leading to lesson-drawing beyond the broad themes highlighted such as the importance of tailoring support to the context, *ex ante* assessments, coordination, flexibility, capacity building, and so on. Some lessons learned from 2007-13 clearly have fed into the 2014-20 reforms. However, surprisingly little seems to be known about the extent to which FI deliver on the rationales underpinning them:

- Sustainability: no data seems to be available on repayments or the full extent of management costs for operating FI; what returns can be expected and over what timescale?
- Project quality: what evidence is there that projects funded with repayable support are superior to grant-aided projects? What role has private sector expertise played in project selection?
- Efficiency: the scale of private sector capital levered in is limited, but how much is known about the impact of FI on private finance?

In short, the experience of 2007-13 has yielded much about how Cohesion policy funded FIs work, but rather little about whether they do.