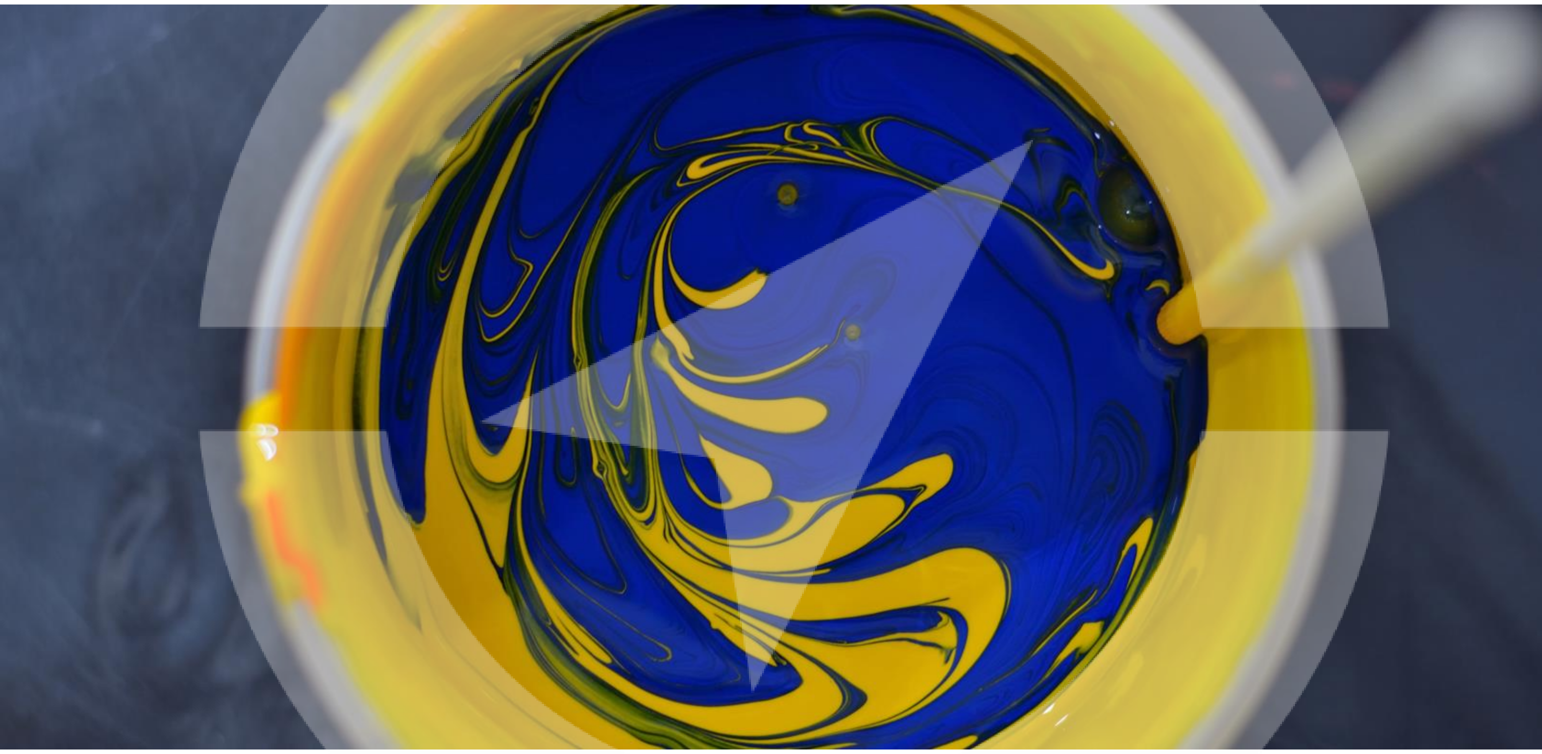

fi-compass Knowledge Hub

Combination of financial instruments with grants

Notes of workshop

The Knowledge Hub has been developed to meet the growing need amongst experienced practitioners for events and materials that provide a more in-depth look into topics affecting financial instruments. Its format utilises email exchanges to promote a longer term engagement between participants together with traditional face to face workshops to allow experienced practitioners to work together to explore the subject matter through peer to peer exchange and expert-led sessions.

In order to encourage openness between the parties the discussions are undertaken under the Chatham House Rule which states: 'When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.'

In particular, the representatives of the European Commission, namely DG REGIO have participated in the Knowledge Hub to receive feedback from the Member States concerning the combination of financial instruments with grants. The participation of the representatives of DG REGIO and the European Investment Bank should not be interpreted as an official endorsement of any of the suggestions that may be discussed and/or described during the Knowledge Hub.

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1. Introduction

The *fi-compass* Knowledge Hub – Combination took place between June - July 2020. Expert practitioners came together with specialists from the European Commission, DG REGIO and *fi-compass* to consider a number of topics related to the combination of financial instruments with grants using EU shared management funds.

The discussions considered Article 52(5) of the draft 2021-2027 Common Provisions Regulation[1] (2021-2027 CPR) which foresees new flexibilities to combine grants and financial instruments in a single financial instrument operation. It provides as follows:

> *'Financial instruments may be combined with programme support in the form of grants in a single financial instrument operation, within a single funding agreement, where both distinct forms of support shall be provided by the body implementing the financial instrument. In such case the rules applicable to financial instruments shall apply to that single financial instrument operation. The programme support in the form of grants shall be directly linked and necessary for the financial instrument and shall not exceed the value of the investments supported by the financial product.'*

In total, two online discussions were held to discuss (i) how the new flexibilities can be used to increase the use of financial instruments in the next programming period as well as (ii) the potential to use financial instruments in combination with grants to support the priority sectors of Research Development and Innovation (RDI) and Energy Efficiency (EE).

This note captures the experiences shared between the participants and highlights topics of interest that may be of use to practitioners implementing financial instruments in the future. The note does not constitute definitive guidance in relation to the combination of financial instruments and grants. This account of the discussions does not constitute official endorsement of the points set out in this note.

[1] Proposal for a Regulation of the European Parliament and of the Council laying down Common Provisions on the European Regional Development Fund, the European Social Fund Plus, the Cohesion Fund, and the European Maritime and Fisheries Fund and financial rules for those and for the Asylum and Migration Fund, the Internal Security Fund and the Border Management and Visa Instrument COM/2018/375 final - 2018/0196 (COD)

2. Key notes

In the 2021-2027 period there will be greater flexibility to combine grants and financial instruments in a single operation.

The possibility to combine a wider spectrum of grant types (on top of the interest rate/guarantee fee subsidies and technical support) – provided they are necessary and directly linked with financial instruments - in a single operation and according to financial instruments rules was highlighted as one of the most useful major evolutions of the 2021-27 CPR. **Three different types** of combined financial instruments have initially been identified as potentially being attractive to managing authorities. The non-exhaustive list includes:

- A continuation of the combination options available under the 2014-2020 programme period (with some added flexibility), i.e. **interest rate/guarantee fee subsidies and technical support**;
- The combination of financial instruments with **investment grants**; and
- The combination of financial instruments with **performance based grants**

Grants combined with a financial instrument in one operation under the 2021-2027 CPR benefit from the more flexible financial instrument regulatory framework.

The positive implications for operating **grants under the financial instrument regulatory framework** that were identified in the discussion included simplifications in relation to the **application process for financial support** and project assessment. The **disbursement of funds, which can be made in advance** by the body implementing the financial instrument, possibly directly to final recipients (instead of only for their benefit), is another key benefit. Financial instrument rules also apply to **co-financing, audit, control and reporting** of the operation.

The combination of grants with financial instruments can be used to extend the range of projects and sectors that can be supported by financial instruments.

The new flexibilities are aimed to allow financial instrument/grant combinations in one operation to support projects that **do not generate sufficient returns or savings** to be economically viable. Additionally it is expected that the use of 'combined financial instruments' will be used to **stimulate investment demand**, pursue **wider policy objectives** and **attract private financing** to projects/programmes.

The ex-ante assessment should identify and analyse the need for grant to be used in combination within the financial instrument.

The proposed combination with grant should be envisaged at programme level and specified in the ex-ante assessment. Where an existing ex-ante assessment is being updated, the need for grant and type of grant to be combined in one operation shall be detailed and justified in the update.

3. Combination of grant and financial instruments in the 2021-2027 period

3.1 Overview

The combination of financial instruments and grants under shared management funds is already important in delivering cohesion policy objectives and addressing market failures linked to the **design, viability and access to finance** of potential investment projects. It is needed where investments do not generate sufficient economic returns to be viable without additional support. It may also stimulate the pipeline of investment-ready projects, helping achieve upper policy targets and attract private financing.

In the next programming period, the combination of financial instruments and grants is expected to become a critical tool for managing authorities, **capitalising on new flexibilities** under the 2021-2027 CPR. The new rules extend existing types of combinations of financial instruments and grants in one operation enabling grant payments to final recipients in addition to the current scope of technical support, interest rate and guarantee fee subsidies. It also retains the option for combination in two operations.

Importantly, the new CPR **simplifies and enlarges** the possible options to combine financial instruments and grants in one operation where, '*the programme support in the form of grants shall be directly linked and necessary for the financial instrument and shall not exceed the value of the investments supported by the financial product*'.

In practice, **new types of grants** such as investment grants or performance-based grants (e.g. capital rebate) will be able to be combined with financial instruments in one operation and be fully implemented under financial instrument rules. Hence, the new CPR gives more leeway to managing authorities to set-up streamlined and tailored hybrid financing solutions in the form of financial instrument-grant combinations in various sectors, such as SMEs and innovation, energy efficiency and renewable energies, sustainable infrastructure or social economy, thus supporting an **increased financial instrument uptake**.

3.2 Grants for interest rate/guarantee subsidy or technical support in the 2021-2027 programming period

The 2021-2027 CPR provides for the continuation of the option to **combine interest rate/guarantee fee subsidies with financial instruments** in a single operation. The new CPR includes **additional flexibilities** with regard to technical support, which should enable financial intermediaries, i) to provide support to potential **final recipients directly** (not only for their benefit), and ii) **without requiring** that they all subsequently access a financial instrument product, provided CPR conditions are fulfilled at financial instrument level.

In the 2021-2027 period, the programme support in the form of technical support grants must be directly linked and necessary to the financial instrument and shall not exceed **at the level of the financial instrument** the total value of the investments supported by the financial product. This would allow more **flexibility at a project level** to provide technical support to pre-commercial projects.

Practitioners considered potential tools available to incentivise financial intermediaries to implement interest rate / guarantee fee subsidies including their remuneration from this part of the operation. It was clarified that since grant support would fall under the financial instruments' regulatory framework, the volume of such grants would be included in the calculation of management fees for the financial intermediaries. This would include cases where management fees are capped by regulation such as where implementation of financial instruments are **entrusted directly** to entities.

3.3 Combination of investment grants and financial instruments

The use of investment grants to support e.g. non-revenue generating elements of projects, otherwise supported by financial instruments was considered. In this scenario a financial intermediary would evaluate a proposal and, where a **financial viability gap** was identified, **could potentially use grant** to fund the gap, with the financial instrument product supporting the rest of the operation.

During the session practitioners considered whether it was necessary for the grant to be used specifically for a 'non-revenue generating' element of the project. It was confirmed that this was not the case. For example, investment grants could be used to lower the burden of the repayable part on the projects' cash flows or to decrease the final costs of the supported investments to be financed by users.

Under the 2021-2027 CPR it is also made clear that grants and financial instrument support can be used in respect of distinct parts of the same expenditure item (on a 'pro rata' basis).

3.4 Performance based grant support in combination of financial instruments

A performance based grant can come in several forms including **forgivable loans, recoverable grants and convertible grants**. The mechanics for each form was presented during the session and a discussion was held on how they could be deployed to support RDI.

It is recognised that there may be challenges for some financial intermediaries with mechanisms, which repay or forgive parts of long term loan facilities. Whilst this is an issue that will need to be explored with institutions in each Member State there are also potential incentives for financial intermediaries participating in such operations, including accessing new markets, enhancing investment projects' quality and attracting new customers.

Performance based grants have been used in the past, for example in relation to energy efficiency instruments in the form of capital rebates. These mechanisms have also been used in the past using national resources in other sectors such as RDI or social economy.

3.5 Benefits to implementing grants within combined financial instruments under financial instrument rules

Under the 2021-2027 CPR, combined financial instruments and grants in one operation are implemented solely under the regulatory framework for financial instruments provided they comply with Art. 52(5) requirements.

This provides a number of **potential benefits for grants** under combined instruments as compared to stand-alone grant schemes. A number of potential benefits of implementing grants under financial instrument rules were identified including:

- **Payment** to final recipients possibly **'up front'**. Unlike traditional grant operations where the grant is paid following defrayal of expenditure, in the case of financial instruments, the programme support precedes the investment (by the final recipient) by providing the means of financing for the investment. This is often cited as a key advantage of financial instrument support for SMEs. Under combined financial instruments, the grant part may be also be paid to final recipients in advance of expenditure (depending on the managing authority's choice), providing a significant advantage over the traditional grant approach;
- **Co-financing** of the operation must be demonstrated at the **level of the combined operation**, without distinguishing between the grant and financial product components of the combination. This additional flexibility may provide managing authorities with greater flexibility to deploy resources across their programme.
- **Audit, control and reporting** also take place at the **level of the combined grant/financial instrument operation**. As a result the audit requirements focus on the beneficiary level (i.e. the body that implements the holding fund or, where there is no holding fund structure, the body that implements the specific fund or MA in case of direct implementation), and in case of a guarantee instrument, at the level of the bodies granting the underlying loans. In general, final recipients should not be audited in relation to the financial instrument. The audit trail has to be maintained in line with financial instruments rules.

4. Financing research, innovation and SMEs

4.1 Application of combined financial instruments

The use of grant in combination with a financial instrument can help secure the financial viability of a greater number of investment projects ensuring the successful delivery of the **financial instrument at scale**.

The combination of financial instrument support and grant is particularly relevant for research development and innovation (RDI) given the **uncertainty of project outcomes**. Research infrastructure also tends to have significant viability gaps that can be bridged only by covering part of the capital investment with a grant. SMEs investing in innovative products, services, processes or willing to expand into new markets may also need grant support to mitigate financial risks related to projects' uncertain future cash flow.

The different funding needs of SMEs engaged in innovative projects depends on the development stage as follows:

- Creation (start-up) and early growth phase: **until proof of concept stage**, it is generally necessary to finance innovative projects with grants. For well-established SMEs bringing innovations to the market, repayable forms of finance (e.g. venture capital) through financial instruments may however be combined with grants;
- Commercialisation phase: once the proof of concept stage has been successfully reached, some **potential for revenue generation can be assessed** but the risks associated with bringing innovation to the market remain significant. At this stage, projects may need a combination of grants, equity financing and/or senior/subordinated loans; and
- Scale-up phase: in this phase, to scale up business activities and to enter new markets, SMEs need **access to equity and to debt financing** with preferential conditions. For risky projects, grants can be usefully combined with equity or debt support to help meet funding requirements.

4.2 Cohesion policy support for RDI through combined financial instruments

In the next programming period, support for RDI will be under **Policy Objective 1: smarter Europe**, which targets RDI, digitalisation, SME competitiveness, skills and job creation. The potential to use combinations of grant and different types of financial instruments in one operation during the life cycle of innovative SMEs was considered by practitioners.

Practitioners identified the potential to support growing businesses **initially** with a high level of grant, **reducing** to more market orientated repayable forms of support as the company matures. At the later stages of the innovation process, grants may still be needed to support individual technologies or components requiring research at lower technology readiness levels or commercialisation and market development.

The range of financial instruments that were considered by practitioners included:

- A **risk-sharing loan for innovative SMEs** providing longer maturities than the market, with lower collateral requirement and a lower interest rate. The risk profile of the final recipients would be moderate; and

- A **guarantee instrument for companies with highly innovative projects**, which financial institutions are ready to finance only with a substantial guarantee on project by project basis.
- **Equity instrument for early stage projects/companies** including technology transfer, start-up and/or VC compartment. This instrument should be combined with a support programme for projects in the development stage having not reached the proof of concept stage yet (such as a grant scheme); and
- A **quasi-equity instrument for more mature SMEs**, which could be coupled with the early stage instrument described above. The latter would be provided at the start-up and growth phases in the form of subordinated loans and convertible bonds to support the capital structure of innovative SME and mid-caps (bullet repayment, no collateral, interest rate partly linked to the companies' performance).

4.3 Examples of combination of financial instruments and grant to support RDI

Several examples were shared during the event of current financial instruments that combine investment with grant support. In one case, a combined operation supports **research by established SMEs** with a strong track record in RDI through a **partially reimbursable loan** funded with central State budget resources. It combines a grant and a loan by offering loans to cover 75% to 85% of the cost of the research project, of which 10% to 33% can be rebated by grant.

Another example combines ERDF co-financed **non-repayable grants and subsidised loans** which are offered to SMEs depending on the innovation phase of their project. Grants of up to EUR 3 million per project can be provided in the industrial research phase, for process and organisational innovation and for feasibility studies. Research institutions can also be supported with a grant for the phases of industrial research and experimental development. The subsequent phases of experimental development and market preparation/launch can be supported by low-interest loans to the SME concerned. Loan support is up to EUR 3m per project. Loans and grants can be combined and cover up to 100% of the eligible expenses. In the 2021-27 programming period, such a financial instrument could be implemented through the combination of a capital grant and a loan in one operation.

Another financial instrument that was considered provides financial support to start-ups and mature SMEs active in the **circular economy, mobility and renewable energy sectors**. Subordinated loans (EUR 1-3 million) are combined with a **technical support subsidy** for investment preparation. This grant can go up to EUR 100k per company. The Fund has a EUR 40.5m size and a dedicated technical support envelope of EUR 2.5m.

5. Financing energy efficiency through combination of financial instruments and grant

5.1 Meeting the objectives of the EU Renovation Wave

The policy framework for support for energy efficiency in residential housing is within **Policy Objective 2 – a Greener, carbon free Europe**. The revised Multiannual Financial Framework (MFF) proposed by the European Commission in May 2020 increased ERDF & cohesion fund to EUR 321bn over 2021 – 2027 with a focus on climate related investments and energy efficiency.

The Knowledge Hub considered how grants may be used in support of energy efficiency projects. Potential uses include using ERDF grant to fund **technical support** measures to help prepare and administer projects and for activities such as energy audits. **Interest rate subsidies and investment grants** can also be used to help to extend the use of financial instruments to lower income households. **Capital rebates and investment grants** are also well suited to energy efficiency programmes, where they can be used to reward achievement of higher energy savings targets.

Since the Knowledge Hub took place, the European Commission launched its **Renovation Wave strategy** in October 2020. As part of the European Green Deal it aims to at least double renovation rates of buildings in the next ten years and make sure renovations lead to higher energy and resource efficiency. This will provide a wider policy context within which ERDF resources will be applied to mobilise finance to help meet the objectives of the strategy, supported by other measures under the EU Renovation Wave including new regulatory measures and standards, capacity building and the development of new design and construction products and solutions.

The experience shared during the Knowledge Hub highlighted how the new flexibilities to combine grant with financial instruments will be an important tool in the design and implementation of programmes to finance the work.

5.2 Deploying grant in combination with financial instruments

Energy efficiency investments are usually structured in such a way that financing costs are (at least partially) covered by **savings on energy expenses**. In practice, grants are often necessary for funding parts of energy efficiency projects, particularly those which have very **low or negative** internal rates of return, or, if needed, for **social reasons** or **deep renovation** purposes. Hence, in the energy efficiency sector, grants may be combined with financial instrument to:

- **achieve ambitious energy saving targets** within an acceptable timeframe. Grants can provide incentives for final recipients to engage in deeper renovation projects with higher energy saving impact than they otherwise would if only using financial instrument financing through capital grants or as loan capital rebates depending on EE objectives achieved;
- **reduce the cost and burden of financial instrument financing**. Grants may be used as interest rate subsidies to incentivise meeting EE objectives; and
- **decrease the perceived level of risks of specific market sub-segments**, such as homeowner associations, lower income individuals or energy efficiency projects involving SMEs and/or ESCOs.

5.3 The scope of Technical Support grants

The Knowledge Hub considered what activities can be funded by Technical Support grants which are often described as being 'to finance project preparation costs'. There are a number of activities that would be suitable for Technical Support that **extend into the project implementation and post-implementation phases**. Examples include energy audits, monitoring and verification of energy savings but also specific consultancy such as marketing, IT, legal, HR or financial management consultancy.

It was acknowledged that whilst Technical Support grant may be conceived as a way of preparing projects for implementation, there is no reason why costs during the implementation period cannot be supported by grant. The general criteria under Art 52(5) must be respected (for example the direct link to the use of the financial instrument) in relation to such combined instruments, although it is easy to see how activities such as the energy audits would be directly linked to the financing.

Examples were shared by practitioners of how Technical Support grants are used for awareness raising, project preparation, administration of projects and carrying out of energy audits. The experience demonstrates how grant support of this type has been critical in developing a pipeline of investment ready projects.

5.4 Supporting wider investments

In many residential energy efficiency projects there are often other works to be undertaken (and financed) at the same time which do not directly contribute to an improvement in a building's energy efficiency. The classical example of such situations is in relation to the replacement of a lift in a multi-block residential apartment building. Other examples identified by participants include the installation of replacement rainwater management systems and the construction of water pipelines and sewerage in difficult ground conditions. In these cases, the additional works may (if not supported by grant) render the scheme unviable and therefore combined financial instruments would have an important part to play in supporting such integrated projects.

The meeting considered the extent to which a combined financial instrument could support such costs, noting the requirement under Art 52(5) that grant support must be directly linked and necessary for the financial instrument.

It was first suggested that the new flexibility in the 2021-2027 CPR that the overall framework for different investments to be supported by grant and financial instruments under a combined instrument is managed at financial instruments level. Therefore, this would provide managing authorities with scope to apply flexibility in relation to the composition of individual investments. Further, managing authorities and their partners should follow an economic rationale and apply a common sense approach when classifying an integrated project as being for energy efficiency improvement. Where one or more elements of an integrated scheme are not strictly related to energy performance on their own, they may still be legitimately classified as part of an integrated scheme that has an overall objective to improve a building's energy efficiency. Ultimately managing authorities and their partners would have to consider these issues on a case by case basis.

Furthermore, concerns about eligibility of expenditure can also be addressed by developing integrated energy efficiency/urban development combined financial instruments. There are already good examples of financial instruments that have an Investment Strategy that targets both objectives and in such cases there would be even greater flexibility to support a full range of investments.

Overall, while the 2021-2027 CPR would allow for the combined financial instrument and grant to support integrated investment, it is equally necessary to ensure that elements of such integrated investment also meet eligibility criteria of the Programme and comply with related national eligibility rules.

5.5 Examples of combination of financial instruments and grant to support Energy Efficiency projects

A successful programme of investment implemented by a Member State was highlighted at the event. This programme uses **grants to support technical assistance, interest rates subsidies and capital rebates**. Because of the limitations in the current CPR the overall programme is implemented using a mix of ERDF resources and national funds across several aligned but separate operations. The greater flexibility under the 2021-2027 CPR would allow this type of support to be streamlined into a single operation.

A number of successful projects have benefited from the establishment of a **'centre of excellence'** within the Member State to promote and support the initiative. Typically an **existing or newly established agency** can provide a range of services such as the promotion of the scheme to residents, supporting the development of projects through Technical Support, undertaking or commissioning energy audits and managing the grant programme (e.g. for capital rebates). In the future, practitioners discussed how a model may develop under which a more streamlined combined financial instrument could allow the financial intermediary to manage the grant/capital rebate alongside the loan made to the final recipients. This would allow the agency to focus on Technical Support related activities.

Another example shared during the event was of a combined financial instrument and grant operation under which **grant is combined with a separate guarantee instrument** which together are provided to participating banks. The resources are then used by the financial intermediaries to support final recipients with funding, typically 50/50 proportion between grant part and loan part. In addition, a separate funded loan financial instrument is used in parts of the Member State where a lack of collateral stemming from lower land values creates difficulties with securing bank financing.

The model allows grant to be paid during the implementation process, which has been helpful in promoting the scheme as opposed to the previous structure where grant was paid in arrears.

The session closed with several other practitioners sharing their experience. The discussion highlighted how the use of grant to provide technical support in combination with a loan financial instrument can **significantly increase demand/take-up** for the financial instrument. In the case mentioned, the financial instrument with the grant support has proved to be the most successful of the managing authority's portfolio of instruments.

The potential to use grant in a combined financial instrument was highlighted as a way to **extend the range** of existing successful urban development/energy efficiency financial instruments to support additional types of final recipients. For example, a model that has been orientated to support development projects could be extended with a grant element to support measures to improve energy efficiency in areas such as **social and affordable housing**.

Another example was given of how grants can be used to **incentivise 'over achievement'** of baseline targets for energy efficiency. In a case mentioned a grant scheme had a top up element that was payable where a project met criteria including higher energy efficiency targets (over and above the 'business as usual' target), as well as social needs and designated regeneration areas. A similar model could be repurposed to apply to a financial instrument combined with a capital rebate grant.

6. Final comments – meeting the EU challenge

The experience shared during the session illustrated how important grant can be in supporting the implementation of financial instruments, in particular in sectors which target investment in projects where there is a ‘viability gap’, the risks are perceived as higher and/or where affordability is a key barrier to take up of support.

The new flexibilities under the 2021-2027 CPR reflect lessons learned under the current programming period and will significantly reduce barriers to the development of combinations of financial instruments and grant operations. This in turn provides managing authorities with the opportunity to extend the application of financial instruments across their Programmes. As a result managing authorities can explore how to use grant to maximise the power of financial instruments to leverage private sector investment and scale up the programmes of investment in their priority areas.

The European Commission’s 2021-2027 budget and recovery plan aims to mobilise Regional policy resources alongside the NextGeneration EU to support the recovery of the EU following the Covid-19 outbreak. The Commission’s vision is to secure through the recovery a greener, more digital and more resilient Europe.

As the discussions in this Knowledge Hub have shown, combination of financial instruments and grants in one operation could be well placed to support priority activities such as investment in RDI and Energy Efficiency in both residential and public/commercial buildings. In this way managing authorities are expected to take full advantage of the new flexibilities to mobilise public and private finance in support of their Programmes.

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