Financial Instruments: making funding go further

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EU rural development funding provides significant benefits for EU citizens and even more benefits are possible by using Financial Instruments (FIs) to recycle funding and thereby make the money go further.

Rural Development Programmes (RDPs) can use a combination of grants and FIs to support projects and schemes. Grants distribute funds that do not need to be repaid by beneficiaries. FIs provide RDP funding for investments that are repaid by beneficiaries through loans and micro-finance, guarantees, equity, interest rate subsidies, or other risk-bearing instruments.

These so-called 'revolving' RDP funding tools are useful for improving beneficiaries' access to rural development finance. A farmer for example can use a combination of grant, loan, and bank guarantee from their RDP. Together, this package of RDP support would cover a much larger proportion of the costs involved in realising development projects. RDP FIs can now also cover working capital and this further increases their potential usefulness.

Furthermore, rural businesses may prefer the fact that the revolving funds do not use retrospective repayments for projects and capital is provided 'up-front' at the start of a project. Applications for the money in FIs can normally be made all year round and not restricted to call periods.

Project developers benefit from these conditions which mean funding decisions can be made quicker and this makes FIs an attractive source of RDP support for commercial ventures, such as those in the agri-food, forestry, rural tourism, high-tech and other business sectors.

Market intervention

RDP-funded FIs cannot use public funds to undermine private sector financial institutions, and RDPs can only intervene in cases of demonstrated market failure or service gaps. These RDP interventions can actually be beneficial for private sector financial institutions because, by following the success of RDP instruments, the private lenders see that demand exists for particular services that they too could provide profitably.

In such cases, the indirect RDP outcomes from FIs may hold the potential to encourage regional financial markets to function better through more favourable conditions. Synergy like this can make an entire rural economy more competitive and cohesive.

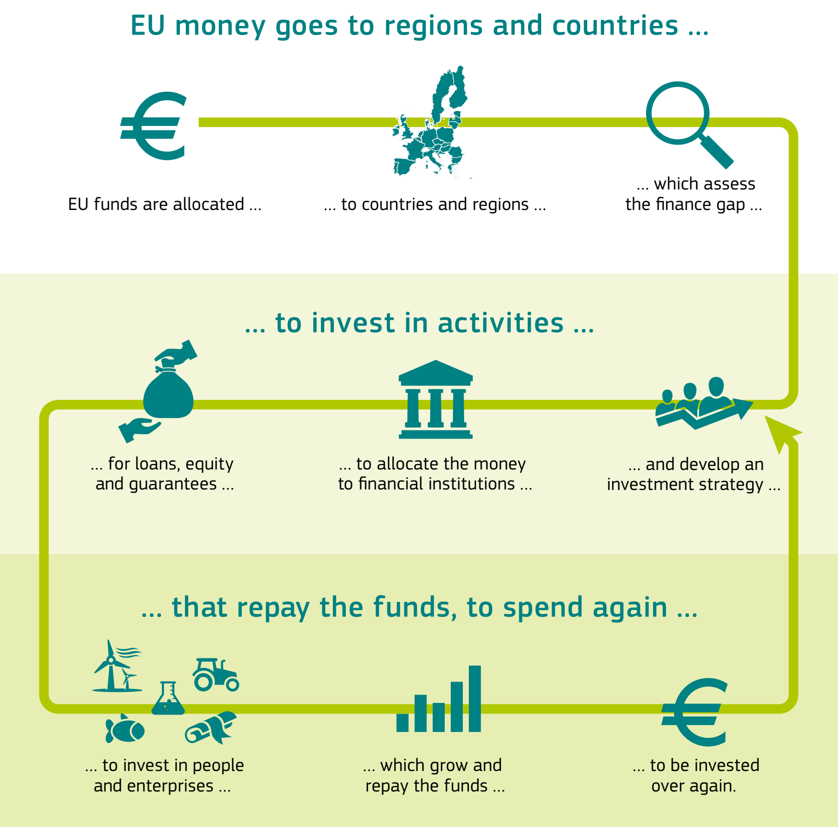
From an efficiency perspective, FIs also tend to involve less bureaucracy for funding applicants than grants. This is because each business using a FI will claim its funds from, and report to, an intermediary Fund (but not directly to the RDP). Intermediary Funds can be run within a Managing Authority or Ministry of Finance, as well as by external entities such as specialised agricultural banks or development organisations.

For these reasons, Member States are being encouraged by the European Commission to double the volume of RDP funding that is allocated to FIs during 2014-2020 than was for the previous programming period. However, gaps in experience, capacity and confidence among some RDP authorities may still inhibit the uptake of opportunities offered by FIs.

KEY OBSERVATIONS BY THE EUROPEAN COURT OF AUDITORS CONCERNING SUCCESSFUL USE OF FINANCIAL INSTRUMENTS IN RDPs INCLUDE[23]:

- Use ex-ante assessments and technical expertise to avoid risks of over-capitalisation (see the box below on essential ex-ante requirements for RDP FIs).
- Establish leverage and revolving effects as key performance indicators.
- Implement the new legal provisions in such a way as to ensure the greatest level of flexibility, for instance by establishing a single FI (e.g. providing both loans and guarantees) that is capable of addressing the development needs of the target sector(s).
- Pay particular attention to potential risks of deadweight or displacement effects when assessing applications for funding by applying appropriate indicators. Where such risks apply, RDP support from a FI could become the preferred option.
- Examine how grants and FIs can be combined to provide the best value for money, by optimising leverage/revolving effects.
- Set aside a certain share of the available EAFRD budget for FIs and make these instruments more attractive than grants in clearly defined circumstances.

How do Financial Instruments work?



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Financial advice

Fortunately, a great deal of new assistance is available to support RDP stakeholders with their plans to establish successful FIs. For example, lessons from previous RDP 'Financial Engineering' experiences have been learned and addressed in the current EU regulations governing rural development policy. These contain comprehensive programming information[24] to help RDPs get FIs going.

Specialised and wide-reaching support is also now available for RDP authorities through the EU's new fi-compass initiative (www.fi-compass.eu), which draws on decades of EU funding experiences with revolving instruments by the European Commission and European Investment Bank (EIB). Their collective expertise provides RDP authorities with free access to a significant knowledge base about good practices in planning, running, and controlling FIs.

(23) http://www.eca.europa.eu/Lists/ECADocuments/SR15_05/SR15_05_EN.pdf
(24) See Title IV of Regulation (EU) No 1303/2013: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32013R1303

Importantly, fi-compass has dedicated assistance for rural development purposes. This includes factsheets, step-by-step guides, handbooks, and off-the-shelf models for different RDP FIs. A useful programme of capacity building events and training sessions about RDP revolving funds are also organised by fi-compass. These take place in every Member State and details about the raft of on-going fi-compass events can be found on their website.

The new range of support to help RDPs use FIs should help change attitudes by showing Member States and Regions that revolving funds can be quite feasibly used by every RDP.

RDP Technical Assistance (TA) budgets are able to fund the groundwork required for getting a FI going. This is useful because many RDP managers do not yet have specialist skills in using these types of funding tools.

ADVANTAGES OF FINANCIAL INSTRUMENTS FOR RDP AUTHORITIES INCLUDE:

- Greater access to a wider spectrum of financial tools for policy delivery.
- Improved private sector involvement, expertise and financing for policy delivery.
- Leveraging resources, leading to increased impact of RDPs.
- Efficiency and effectiveness due to revolving characteristics of funds, which stay in the programme area for future use for similar objectives.
- Better beneficiary commitment to project quality because investments must be repaid.
- Simplified administration requirements for funding beneficiaries, reducing error risks.
- Improved RDP targeting because ex-ante evaluations confirm needs from specific target groups for loans, guarantees, equity, etc.

FI experts with experience of lending for development purposes[25] can be contracted to explore, design, and even help implement a RDP FI (running costs however are normally covered by standard fees charged during the lending process).

Using a specialist contractor can be particularly useful during negotiations between RDP authorities and financial bodies that might be involved as commercial partners in a FI. Contracting external advisors here will help RDPs to 'speak the same language' as bankers, venture capitalists, and equity investors etc. RDP authorities can learn a lot from specialists, and TA contracts could include knowledge transfer or institutional capacity building in this field for both Managing Authorities and Paying Agencies.

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(25) These include the EIB Group's services that can be used by RDP authorities to carry out ex-ante studies or other preparatory and management actions.

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Delivery mechanisms

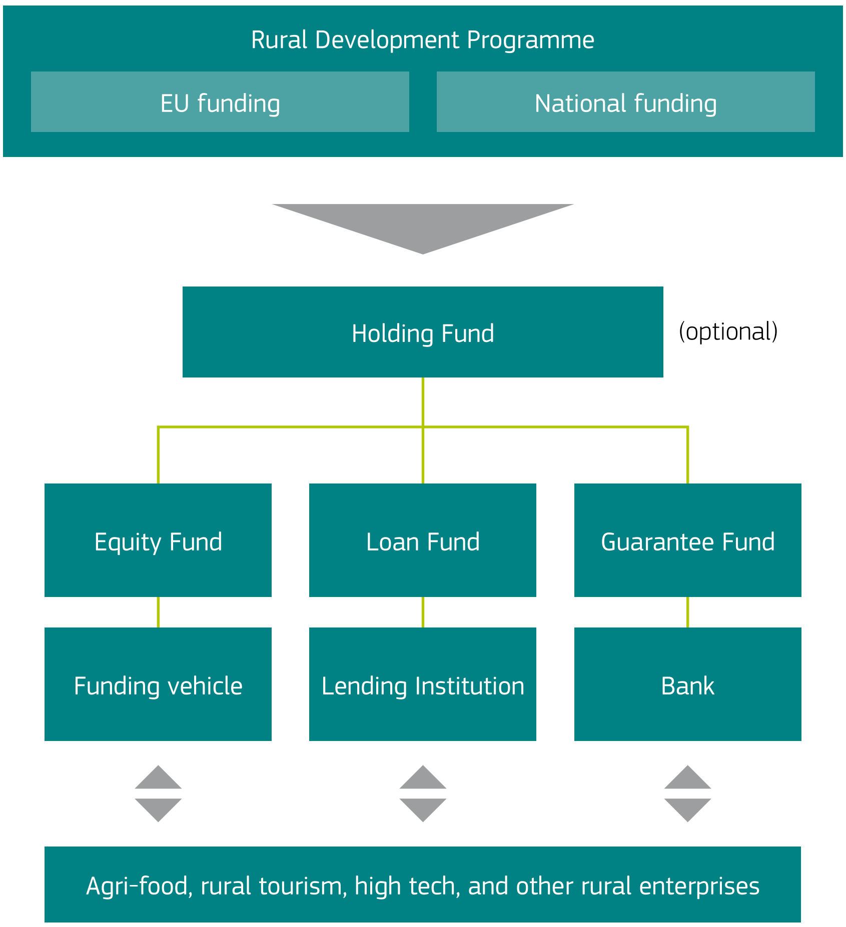
A valuable skill that RDP authorities will learn and develop relates to the selection of delivery mechanisms for revolving funds. Holding Funds for instance at national level (such as those used by Slovakia[26] and other countries) are useful 'umbrella' structures for channelling coordinated packages of financial support. Efficiency gains result from centralised management and expertise, which can also ensure the implementation of streamlined development support strategies that avoid funding overlaps or duplication of effort.

Choice of commercial partners for Holding Funds (and FIs in general) is critical to their overall effectiveness. EIB Vice President, Wilhelm Molteres, echoes this advice stressing, "It is important to have a professional counterpart that knows the sector well."

Good practice for RDP authorities thus involves working with financial institutions that have reliable knowledge and understanding about rural (particularly agricultural) business cash-flows. Partners who understand the influence of relevant legislation, like environmental protection or food safety standards, are also advantageous.

EIB advice about choosing the ideal lending partner for RDPs recommends using "one that won't run away from an unknown risk and that knows that working capital extends over a 12-month period and that businesses may only receive income a few times each year e.g. after harvest time."

Figure 3. Flow of funds from Financial Instruments to RDP beneficiaries



(26) http://www.fi-compass.eu/sites/all/themes/ficompass/files/Martin%20Polonyi.pdf

ESSENTIAL EX-ANTE REQUIREMENTS FOR RDP FIs INVOLVE[27]:

- Analysis of market failures, suboptimal investment situations, and investment needs for policy areas and thematic objectives or investment priorities. This demand analysis must use proven good practice methodologies.
- Assessment of the FI's added value compared with other forms of public intervention addressing the same market, as well as possible State Aid implications, the proportionality of the planned intervention, and measures to minimise market distortion.
- Estimates of expected leverage effect[28] (additional public and private resources to be potentially raised - down to the level of the final recipient), including as appropriate an assessment of the need for, and level of, preferential remuneration to attract co-finance from private investors and/or a description of the mechanisms which will be used to establish the need for, and extent of, such preferential remuneration, such as a competitive or appropriately independent assessment process.
- Consideration of lessons learnt from similar instruments and ex-ante assessments carried out by the Member State or other countries in the past, and how such lessons will be applied in the future.
- Details for the proposed investment strategy, including an examination of options for implementation arrangements, financial products to be offered, final recipients targeted and any options for combinations with grant support as appropriate.
- Specification of the expected results and how the FI will contribute to the relevant priority's objectives and indicator targets.
- Provisions for the ex-ante assessment to be reviewed and updated as required if the Managing Authority considers that the ex-ante assessment may no longer accurately represent the market conditions existing at the time of implementation.

Effective Ex-antes

Ex-ante analysis of each RDP FI should confirm the suitability of its intended partners. Much advisory work on ex-ante requirements for RDP FIs has been carried out and this is available from fi-compass. A summary of the main content for ex-antes is presented in the following box. It highlights the importance of starting from a well-informed position and making only evidence-based decisions about how best to use FIs.

Detailed ex-ante requirements (available from fi-compass) will influence the size of each individual FI and better economies of scale may result from larger overall FI budgets. This can also apply to FIs implementing micro-finance support.

Precision programming

Timing for the introduction of FIs is an important issue that RDP authorities have to consider. Most advantages are gained by including reference to FIs in the first validated version of an RDP. This allows the Managing Authority to gain from higher intervention rates (+10%) that are available for FIs, because these higher rates can be approved at the start in an RDP's financing decision.

It will be possible to modify RDPs and accommodate new FIs later on that still adopt the higher intervention rates. However, integrating and balancing these higher intervention rates at a later date will have an impact on intervention rates for other measures. Furthermore, introducing FIs after the programme is launched will normally need to be done as part of 'Strategic Amendment'. Only three of these are possible during the programme period and they may

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(27) Adapted from fi-compass guidance on ex-ante preparations
http://www.fi-compass.eu/sites/all/themes/ficompass/files/fi-compass_Ex_ante_quick_reference_guide_2015_final.pdf

(28) Diagrams explaining how to calculate leverage examples of different FI types (Loans, Equity, Guarantee) are in Annex II of the ECA Special Report No 2/2012 — Financial instruments for SMEs co-financed by the European Regional Development Fund
http://www.eca.europa.eu/Lists/ECADocuments/SR12_02/SR12_02_EN.PDF

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need to be reserved for making more comprehensive tactical changes to RDPs (compared to simply adding technical adjustments).

Including FI calculations in the scope of the original RDP's financing decision therefore offers the flexibility to introduce FIs when they are ready (e.g. following a positive ex-ante analysis and agreed confirmation of full implementation strategy).

Other timing considerations for FIs relate to the new payment framework that controls RDP revolving funds. Reimbursements now need to reflect performance and transfers will only be phased. RDP financial planners have to take account of this expenditure profile matter and ex-ante work should provide the required data.

More advice and guidance about these FI decision-making factors is available for RDP stakeholders from the Luxembourg-based fi-compass. This includes information about the possibilities for FIs to cover more than one RDP(29), as well as the very useful European Court of Auditors' recommendations(30) describing how RDPs can improve their use of FIs during the 2014-2020 period.

Evaluation advantages

Reporting on RDP evaluations will begin in 2017 when Member States will, for the first time, include major evaluation findings on the progress in achieving RDP results in their Annual Implementation Reports. Outcome data from beneficiaries is not likely to have started emerging in sufficient numbers by then to enable an accurate evaluation of the effects of FIs. Hence, a considerable proportion of the evaluations reported in 2017 could be used to assess the success of RDP implementation processes – including the use of FIs as delivery mechanisms.

This could be a useful opportunity to plan evaluations that explore the advantages and disadvantages of using combinations of grants and FIs in different circumstances. "Findings from this analysis will be useful for assessing outcomes, such as RDP influence on business competitiveness," observes the European Evaluation Helpdesk for Rural Development (because FIs should not normally involve risks of 'dead weight' support).

Comparing effects of different funding tools should also identify possible improvements to the overall cost-effectiveness of RDP operations and pave the way to assess their impact in the evaluations reported in 2019 and at the ex-post stage. The relatively early timing of the evaluations reported in 2017 will be particularly useful and allow improvements to be introduced sooner, thereby helping the RDPs' FI toolkits to create more and better benefits for EU citizens over a longer term.

(29) http://ec.europa.eu/regional_policy/sources/tender/doc/propositions/2015_16_bgt_001/qa_guide.pdf
(30) http://www.eca.europa.eu/Lists/ECADocuments/SR15_05/SR15_05_EN.pdf