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Guidelines for the Implementation of Financial Instruments: Building on FIN-EN – sharing methodologies on FINancial ENgineering for enterprises

FIN-EN
Sharing Methodologies on Financial Engineering for Enterprises

Final Report to Finlombarda SpA

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PREFACE

The FIN-EN project has supported the exchange of experience on a cross-section of 2007-13 financial instruments in both Convergence and Competitiveness regions, providing a comprehensive picture of the strengths and weaknesses of their implementation. The FIN-EN partners' experiences have been brought together in these Guidelines, along with an overview of the changes expected in the 2014-20 programme period. In considering the evidence and results presented in the Guidelines, it is important to stress the need for capacity building, continuity and flexibility, as well as caution concerning leverage, timing and certification:

- **Capacity building.** In terms of the ability of public institutions to evaluate and address crucial questions related to policy choices and implementation methods, the 2007-13 experience of setting up and managing financial instruments was the first such attempt for most of the project partners, as only a few had previous experience in this field. It is clear that all the partners recognise that the 2007-13 programme period has entailed the development of expertise through 'learning by doing'. Public sector staff had to incorporate a new perspective, working to support territorial development over the seven-year period, while also guaranteeing revenues for the future, and moving away from a 'grant' culture. Even if mistakes were made, they resulted in useful experience for the future.

  At the same time, the global economic crisis affected economic development in Europe, and influenced the performance of financial instruments. In consequence, and looking towards 2014-20, there is a need to move away from an 'aggregating approach' (viewing programmes as simply the sum of different actions) to a 'matrix approach', where each action is required to generate added value not only directly (to final recipients) but also indirectly (i.e. 'horizontally'). This can create positive externalities. In the context of financial instruments, this is reflected in the support for final recipients provided by Managing Authorities (as public bodies) which, through fund managers and financial intermediaries, also produces indirect positive effects. In this context, Structural Funds can provide a strong incentive to public bodies to combine spillover effects and efficiency with the proactive involvement of local and regional stakeholders. This is fundamental to exploiting the benefits of financial instruments, especially in the case of tailor-made instruments.

- **Continuity.** This refers to continued use of existing tailor-made instruments, renewed on the basis of an ex ante assessment for 2014-20, but exploiting the know-how and experience gained in 2007-13; building on this experience may be the most appropriate solution for partners. The Commission's off-the-shelf models are perceived as helpful for organisations

without experience of managing financial instruments. However, where instruments have performed well, it is better for stakeholders and final recipients alike, who are already accustomed to the various products and procedures, if the same measures are continued. Of course, in the interests of simplification, continuity must not be confused with 'inflexibility' as there is an ongoing requirement to reduce the administrative burden on recipients. Continuity also offers other benefits in terms of reducing 'Time to Market', i.e. the period of time between a financial instrument being designed and resources committed and it becoming available to final recipients. The experience gained through procedures which have already been tested (even if they need refining) should reduce the incidence of bottlenecks. The value of continuity is also evident in terms of effects, since policy stability can result in greater overall impact.

- **Flexibility.** This concept has been discussed frequently at FIN-EN project meetings and in FIN-EN reports. In 2007-13, the concept was not clearly explained in the regulatory framework and has been interpreted differently. There are two main types of flexibility in financial instruments – flexibility in composition and flexibility referring to adaptability to change.

  Flexibility in composition – as financial instruments are intended to address a gap identified by an ex ante assessment of demand and supply in the relevant territory, the nature and scale of a financial instrument is the result of a complex evaluation. Thus, the opportunity to combine instruments, (e.g. grants and revolving instruments) was appreciated and found suitable by the majority of FIN-EN project partners.

  The need to adapt general instruments to local specificities is important to bear in mind in the context of tailor-made instruments. Fortunately, in 2014-20, the Financial Regulation (art.139) and General Regulation (art.37.7) support the option of combining financial instruments as follows: '*Financial instruments may be combined with grants, interest rate subsidies and guarantee fee subsidies. Where support from ESI Funds is provided by means of financial instruments and combined in a single operation, with other forms of support directly related to financial instruments targeting the same final recipients, including technical support, interest rate subsidies and guarantee fee subsidies, the provisions applicable to financial instruments shall apply to all forms of support within that operation'.*

  What is not expressly described, but is valuable evidence from the FIN-EN analysis, is the added value that can be generated by financial instruments that combine funding and training. Final recipients can benefit not only from financial support but also from management and administrative assistance; this is often needed by start-up companies which may have strong technical know-how but lack business experience.

  Flexibility in changes – the use of financial instruments must already be indicated in Operational Programmes and an ex ante assessment must be carried out prior to funds being committed. Experience in 2007-13 suggests that both 'need' and 'economic context' could change in the framework of a seven-year period and so, consequently, should the financial instrument. It is therefore advisable not to be too specific in the Operational Programme on the financial instruments to be used, indicating that further detail will be developed in the ex-

ante assessment. This will help prevent the need for modification of the OP, which requires the approval of the EC.

Concerning the compulsory ex ante assessment, minimum requirements are specified in the General Regulation and guidelines, but, if the context or territorial needs change, it can be updated and modified. A potentially critical issue is that, even if the ex ante assessment is a compulsory document and must be submitted to the monitoring committee, it is not formally approved. This means that the document could be always called into question by the EC.

- **Leverage.** During the 2007-13 period, the concept of leverage was strongly used to push for the use of financial instruments instead of traditional grants. The idea of 'multiplying' the amount available to final recipients thanks to co-financing with private stakeholders was one of the key innovative elements, together with the revolving effect introduced by financial instruments.

  As the period progressed, it became evident that 'leverage' should not be an overriding priority. The analysis suggests that in some cases (e.g. innovation, start-up companies, etc.) the design of a financial instrument need not envisage significant leverage, but should focus on achieving the policy objective. In this regard, the 'Ex ante assessment methodology for financial instrument in the 2014-2020 programming period' – Volume I', which provides a guide to how to develop ex ante assessment and how to quantify the value added of a financial instrument, describes leverage as the non-EU financial contribution by third parties to the financial instrument; in other words, the national contribution is included in the contribution by third parties. This means that all financial instruments have a leverage effect, even if there is no other co-financing. This interpretation of leverage means that leverage does not need to be artificially high, but can be evaluated from time to time and the priority of a financial instrument can be stated differently.

- **Timing.** The evaluation of time taken to set up and run financial instruments was one of the critical issues emerging in the FIN-EN analysis. The 2007-13 period was focused on setting up new instruments and there were a number of new issues related to implementation to be addressed. In consequence, although many instruments were set up, the length of the process affected their effectiveness.

  In 2014-20, public bodies must control the phasing of FI implementation more tightly than in 2007-13, since the certification of OP spending depends on effective expenditure of the FI. It is therefore crucial that each phase of the instrument life cycle reflects the most appropriate solution, including speed of disbursement. This can be ensured in the design phase, for example, by renewing an already existent financial instrument, and in the implementation phase, for example, by using a quick method to select financial intermediaries. Managing Authorities should introduce 'time' as an evaluation criterion to select managing bodies and financial intermediaries, in order to manage the overall 'time to market' of the instrument.

  Another consideration is that the timetable of financial instruments does not sit easily with that of the Structural Funds. Given that it is already possible to set up an OP priority axis entirely

dedicated to FIs, could it also be possible to consider a 'dedicated' management approach to FIs which would also take account of their different schedules?

- **Certification.** The new 2014-20 regulations present a completely different method of certification of expenses for financial instruments. In 2007-13, the entire amount devoted to the instrument could be considered as certified from the start, with a cross check at the end of the programme period, providing considerable management freedom. In contrast, under the new rules the programme contribution paid to the financial instrument included in applications for interim payments cannot exceed 25 percent; moreover, this is dependent on reaching a minimum expenditure threshold. This means that, whereas in 2007-13 the performance trend of the instrument was not relevant until the end of the programme period, for example where a financial instrument could not spend very much in the first years but gained ground in later years, this is not feasible in 2014-20. If finance does not reach the final recipient, the expenditure cannot be certified and, in any case, certification cannot exceed 25 percent of the total amount of the instrument. In consequence, the ex ante assessment must also consider whether the forecast expenditure trend is compatible and appropriate for EU co-funding.

Finlombarda S.p.A., FIN-EN Lead Partner

1. INTRODUCTION

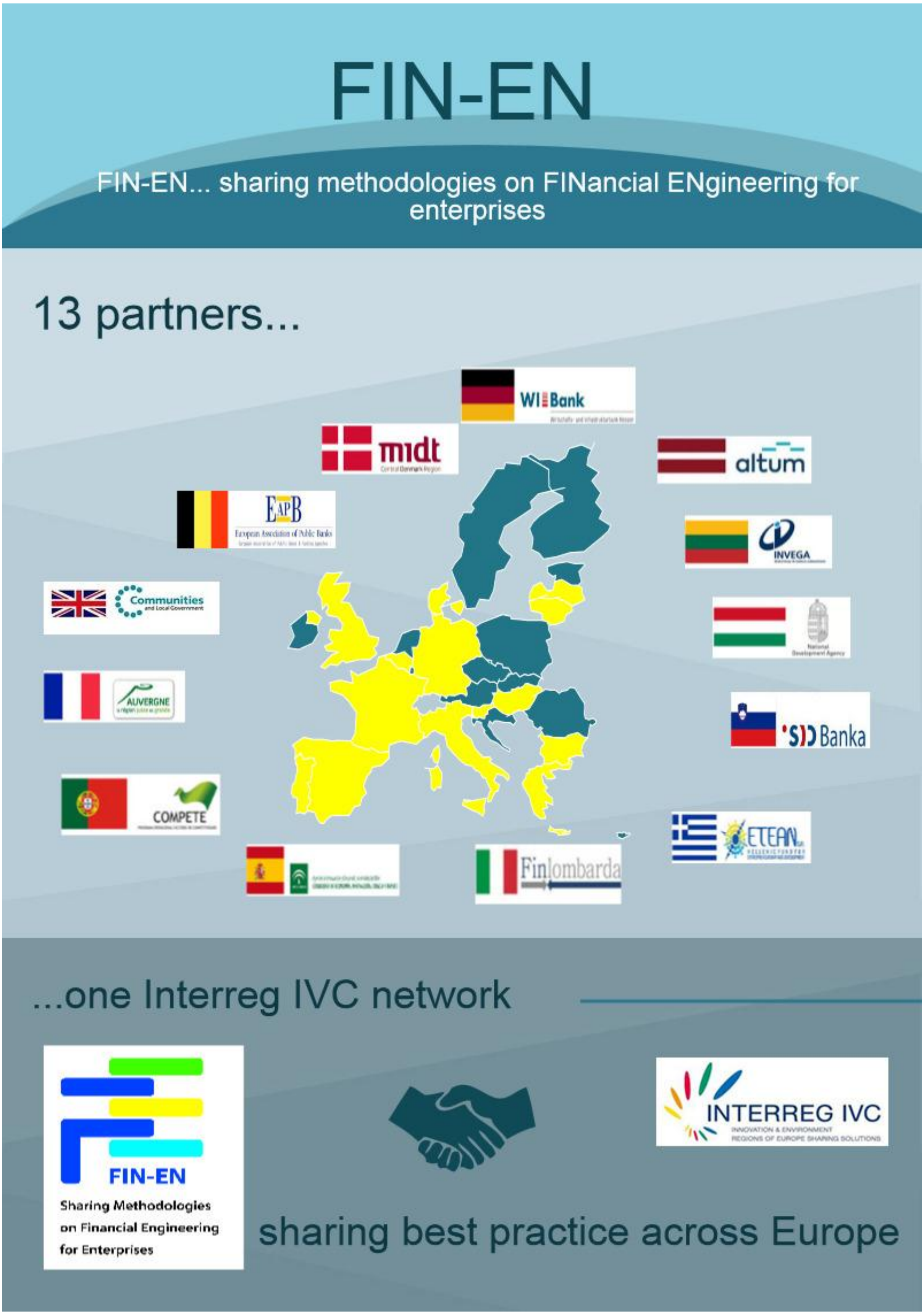
The FIN-EN project - sharing methodologies on FINancial ENgineering for enterprises - is financed by the European Regional Development Fund (ERDF) under INTERREG IVC. The aim of the project is to enhance cooperation between regional and national authorities across Europe on the methodologies and instruments used for implementing financial instruments in the framework of EU Structural Funds, in order to find concrete solutions to common problems and promote a more efficient and effective use of financial instruments in the future. FIN-EN is a wide and stable network of 13 regional and national institutions from 13 different EU Member States, managing 45 financial instruments under 2007-13 Structural Funds programmes, worth a total budget of circa €3.5 billion, without the support of the European Investment Fund (EIF).

FIN-EN comprises partners from across the EU, including both Convergence and Competitiveness regions, which have accrued substantial experience with the use of financial instruments in 2007-13:

- Finlombarda SpA. (Italy) – Lead Partner
- European Association of Public Banks A.I.S.B.L.
- Agencia IDEA - Agencia de Innovación y Desarrollo de Andalucia (Agency for Innovation and Development of Andalucía, IDEA) (Spain)
- Ministry for National Economy, Deputy State Secretariat Responsible for Implementing Economic Development Programs, Managing Authority (previously the National Development Agency, Operational Programme for Economic Development Managing Authority) (Hungary)
- Regional Council of Auvergne (France)
- SID – Slovenska izvozna in razvojna banka, d.d. (SID Bank) (Slovenia)
- VAS Latvijas Attīstības finanšu institūcija Altum (Latvian Development Finance Institution)
- UAB Investiciju ir verslo garantijos (INVEGA) (Lithuania)
- Central Denmark Region
- Wirtschafts- und Infrastrukturbank Hessen (WIBank) (Germany)
- Hellenic Fund for Entrepreneurship and Development SA (ETEAN SA) (Greece) (until July 2013)
- Autoridade de Gestão do COMPETE, Programa Operacional Factores de Competitividade (Portugal)
- North West Competitiveness Operational Programme, Department for Communities and Local Government (England, UK)

The following institutions were involved as Observers:

- Bulgarian Development Bank (BDB) (Bulgaria)
- Investitionsbank Berlin (IBB) (Germany)
- Bank of Valletta plc (Malta)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INVEGA
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AUVERGNE
SID Banka
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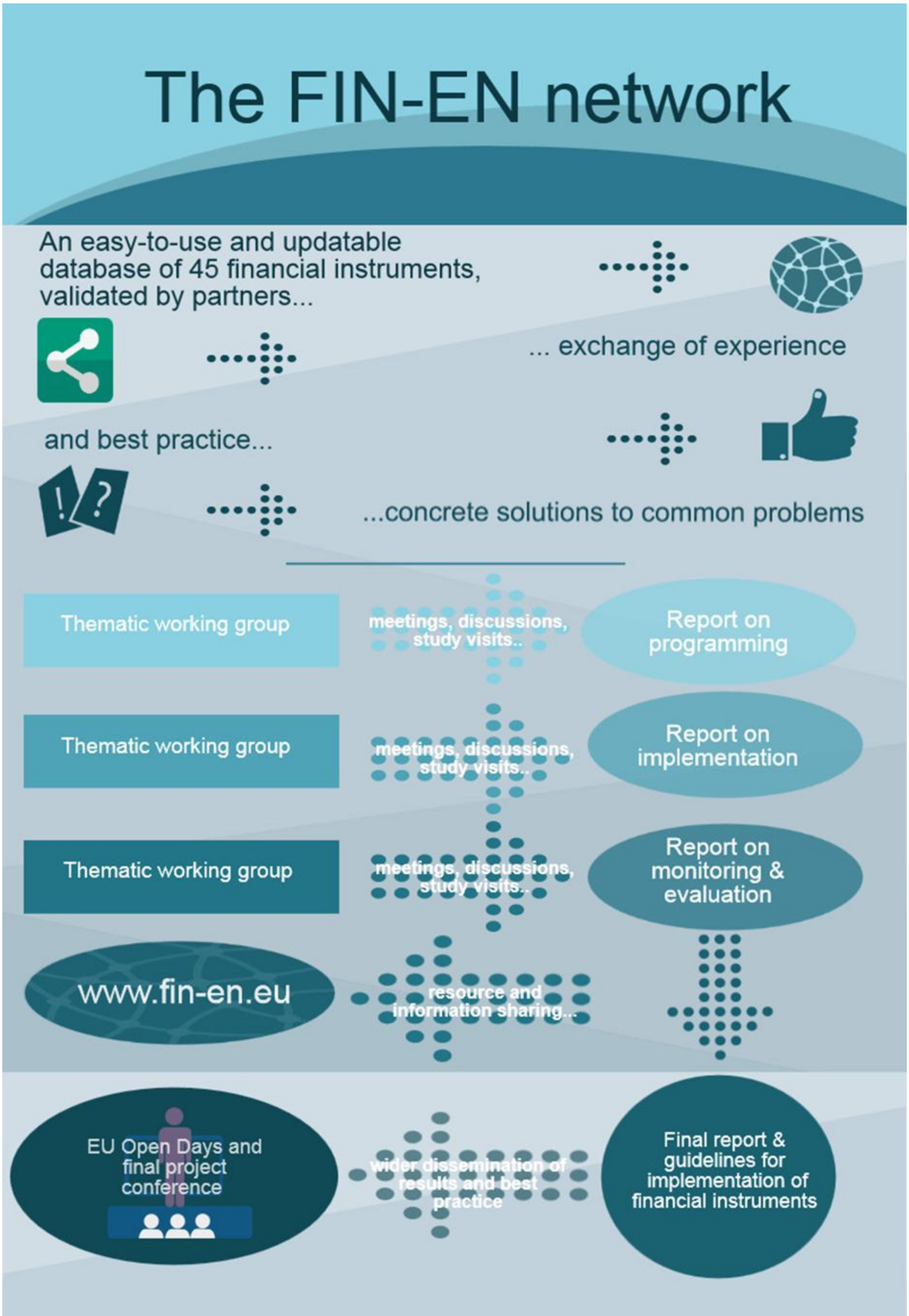
ETEAN
Finlombarda
...one Interreg IVC network
FIN-EN
Sharing Methodologies on Financial Engineering for Enterprises
INTERREG IVC
sharing best practice across Europe

Since the launch of the network in 2012, a series of networking and exchange of information activities has taken place. As a first step, a comprehensive database of information on the 45 financial instruments operated by the partners was developed. The updatable database describes the main quantitative and qualitative characteristics of the instruments which represent the basis for the exchange of experience between partners. Three Thematic Working Groups were set up to examine and report on the programming, implementation and monitoring phases of operating FIs, identifying the main problems and related good practices. In addition, study visits have been held in Lisbon, Auvergne and North-West England, and the mid-term conference took place in Auvergne (December 2013). The final conference is planned for November 2014. More information is available on the project website, at http://www.fin-en.eu/.

The 'Guidelines for the Implementation of Financial Instruments: Building on FIN-EN – sharing methodologies on FINancial ENgineering for enterprises' are the final project output, and are intended to be a useful tool for regional and national authorities planning to implement financial instruments in the 2014-20 programme period. The Guidelines illustrate the main findings of FIN-EN networking activity: the first part considers the 'lifecycle' of financial instruments and deals with aspects of programming, implementation and monitoring which are essentially common to all financial instruments; the second part reviews each type of financial instrument in turn, considering issues that are specific to that form of intervention. Each section has been structured to consider: the 2007-13 context; the experience of FIN-EN partners, with particular reference to good practices identified; and the new rules and regulations for 2014-20.


The FIN-EN network
An easy-to-use and updatable database of 45 financial instruments, validated by partners...
... exchange of experience
and best practice...
...concrete solutions to common problems
Thematic working group
meetings, discussions, study visits..
Report on programming
Thematic working group
meetings, discussions, study visits..
Report on implementation
Thematic working group
meetings, discussions, study visits..
Report on monitoring & evaluation
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resource and information sharing...
EU Open Days and final project conference
wider dissemination of results and best practice
Final report & guidelines for implementation of financial instruments

2. FINANCIAL INSTRUMENTS LIFECYCLE

This part of the report addresses issues that are common to all financial instruments operating in the context of Cohesion policy in 2007-13. It is structured in three main sections – **programming** (2.1), **implementation** (2.2) and **monitoring and reporting** (2.3), broadly reflecting not only the chronology of the FI lifecycle, but also the structure of the Thematic Working Groups, referred to in Section **Error! Reference source not found.**.

2.1 Programming Financial Instruments

This section focuses on the preparatory phase of incorporating financial instruments into Cohesion policy programmes. It draws, in particular, on the work of the FIN-EN Thematic Working Group 1,[1] and focuses on the analysis of the **need for financial instruments**, the **investment strategy**, the **incorporation of financial instruments in the operational programmes,** and the management of **financial flows**.

2.1.1 Analysis of the need for financial instruments

(i) Context

A crucial issue in considering the role for financial instruments (FI) in economic development is whether there is a need for public policy intervention or whether the market is already providing the requisite finance of an appropriate type and scale. There may be market failure or a sub-optimal investment situation due to the high risk of the sector involved (e.g. R&D&I), expectations of low profitability, high costs associated with available funding sources or the 'space' and 'place' effects of an uneven geography of finance.[2] For the 2007-13 programme period there was no explicit requirement for an ex ante evaluation or assessment to be carried out specific to financial instruments. Nevertheless, the usefulness of such analysis was recognised by the Commission, which co-financed so-called 'gap assessments' with the European Investment Fund (EIF) at the request of Member States or regions; these were provided free-of-charge.

(ii) Lessons from FIN-EN

FIN-EN partners took different approaches to determining the 'need' for financial instruments in 2007-13. For many FIN-EN partners, a gap assessment/analysis was undertaken by the EIF, while others opted to undertake the analysis themselves. For both these approaches, three main shortcomings were identified by TWG1: not enough involvement of local actors; insufficiently comprehensive or

[1] FIN-EN Thematic Working Group 1 "Programming" report (hereafter TWG1), see: http://www.fin-en.eu/files/5213/8121/6839/FIN-EN_TWG1_Programming_Report.pdf (accessed May 2014)

[2] European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period. General methodology covering all thematic objectives, Quick reference guide http://ec.europa.eu/regional_policy/thefunds/fin_inst/pdf/ex_ante_vol0.pdf (accessed July 2014); Mason C, Michie R and Wishlade F (2012) Access to finance in Europe's disadvantaged regions: Can 'new' financial instruments fill the gap? EoRPA Regional Research Consortium Paper 12/6, European Policies Research Centre, University of Strathclyde, Glasgow. http://www.eprc.strath.ac.uk/eorpa/Documents/EoRPA_12_Public/EoRPA%20Paper%2012-6%20Financial%20Instruments.pdf (accessed July 2014).

detailed analysis of the market situation leading to, for example, under or over-allocations of funds to FIs; and failure to anticipate economic change. As a result, a number of key lessons emerge:

- the need for a **thorough understanding of the locality** in order to take account of the specific characteristics of a region and their impact on market failures and potential
- **specialist analysis of the SME financing market** improves the reliability of the overall assessment
- **involvement of public and private stakeholders** facilitates the analysis and helps to ensure a balanced perspective
- while the analysis focuses on the ability of the existing market to fulfil funding needs, it must also take account of the **capacity of the stakeholders** within that particular territory to set up and run appropriate instruments
- the overall **investment strategy should be based on an in-depth analysis** that takes account of strategic objectives, funding sources (including proportion of private co-funding), options for fund structure and management, financial and legal aspects
- the analysis should include **a forward looking element** to take account of changing economic conditions and the funding needs of firms
- there is a case for a **mid-term re-evaluation of the market** on which basis instruments could be readjusted (although it is important to note that while a mid-term re-evaluation might, for example, recommend additional funding, this does not mean that funding will still be available from the operational programme to allocate to FIs).

Case study: internal ex ante evaluation WIBank Hessen

Land Hessen entrusted the gap analysis to WIBank, a public institution with an economic development remit, and its subsidiary, BM H. The analysis drew not only on their knowledge of the local market, but also expertise in private equity and market failures in SME access to finance. Carrying out the task internally, as opposed to through the EIF, facilitated a swift turnaround.[3]

The lessons and concerns raised by FIN-EN partners are consistent with the observations made by the European Court of Auditors, which was highly critical of many of the gap assessments in their sample of FIs studies.[4] Moreover, a recent EIF working paper echoes many of these lessons.[5]

(iii) Implications of ESIF 2014-20 and adaptation to the new regime

The ex ante analysis for FI is one of several key areas of change in ESIF 2014-20. The new Common Provisions Regulation (CPR) requires that support for financial instruments be:[6]

[3] Other FIN-EN partners note, however, that there may be drawbacks to internally-conducted ex ante evaluation studies, such as a potential lack of objectivity.

[4] ECA (2012) Financial instruments for SMEs co-financed by the European Regional Development Fund, Special report no. 2, see: http://www.eca.europa.eu/Lists/ECADocuments/SR12_02/SR12_02_EN.PDF (accessed May 2014).

[5] Kraemer-Eis, H and Lang, G (2014) Guidelines for SME Access to Finance Assessments (GAFMA), EIF working paper 2014/22, see: http://www.eif.org/news_centre/publications/eif_wp_22_gafma_april14_fv.pdf (accessed May 2014).

[6] Article 37(2), Regulation 1303/2013.

> "…based on an ex ante assessment which has established evidence of market failures or suboptimal investment situations, and the estimated level and scope of public investment needs, including type of financial instruments to be supported…"

Importantly, this ex ante *assessment* is specifically related to FIs and is distinct from the ex ante *evaluation* which must be undertaken for the operational programme. The ex ante assessment for FI must be done before the managing authority decides to make programme contributions to an FI and should include the following elements:

a) An analysis of market failures and investment needs.
b) An assessment of the value added of the FI under consideration, their consistency with other interventions, State aid implications and proportionality.
c) Estimates of the potential leverage effect and the potential need for preferential remuneration of counterpart investors.
d) An assessment of lessons learned from past practice.
e) An examination of implementation options, reflecting the additional opportunities outlined in the CPR,[7] the types of product to be offered, final recipients targeted etc.
f) A specification of the expected results and how the FI is expected to contribute to the specific objectives set out in the relevant priority.
g) Scope for the ex ante assessment to be reviewed and updated in line with changes in market conditions.

Many of these requirements are in line with the lessons from FIN-EN. Importantly, however, a number of additional elements are specified, partly reflecting the so-called 'results orientation' of ESIF 2014-20, but also the need to learn from past experience and to explore the additional implementation options provided for in the new period. Member States have sought more detailed guidance from the European Commission on what is required in terms of ex ante assessment. This is now available from DG Regio.[8]

2.1.2 Investment strategy

(i) Context

The investment strategy forms a key link between the assessment of a market gap and the financial instruments put in place to address that gap. However, the 2007-13 regulations said little about what an investment strategy should contain; they simply stated that an investment strategy should be part of the funding agreement between the managing authority/Member State and representative of a financial instrument. Following criticism from the European Court of Auditors,[9] a COCOF note elaborated on this and included mention of an 'underlying' and 'coherent' investment strategy.[10]

[7] Article 38, Regulation 1303/2013.

[8] The guidance covers both general and specific (thematic) aspects and is available here: http://ec.europa.eu/regional_policy/thefunds/fin_inst/index_en.cfm (accessed July 2014).

[9] ECA (2012) *Op cit.*

[10] COCOF_10-0014-04 (21/02/2011) Guidance note on Financial Engineering Instruments under Article 44 of Council regulation (EC) No 1083/2006 (Guidance Note 3).

(ii) Lessons from FIN-EN

A number of key lessons emerge from FIN-EN relating to the formulation of an investment strategy:

- the investment strategy should be **flexible** and able to be adapted to the changing economic context and changing needs of companies when appropriate (considering the use of holding funds may be helpful in this regard)
- related to the need to adapt to the changing environment, and the potentially changing needs of recipients, **the investment strategy should be kept up to date** as a consequence of updating the ex ante assessment
- the managing authority/fund manager should maintain a close relationship with final recipients, and **follow-up** with them to ensure the quality of investments made.

The need for flexibility in the investment strategy is emphasised by recent research which found that in around half of cases studied where a market assessment had been undertaken, the FIs set up deviated from the strategy set out in the market assessment.[11] In one-third of cases, this was due to issues caused by the political situation, financial risks, technical issues or administrative capacity, but in the remaining two-thirds, changes to the strategy were caused by a change in market demand due to the economic and financial crisis. In the majority (66 percent) of the cases where the market conditions changed, this led to different products being introduced as part of the portfolio of FIs.

The report also found that challenges were experienced in implementation of FIs where investment strategies were focused too closely on specific target groups, especially where this was combined with geographical limitations. Flexibility was identified as being important to adapt to changing economic circumstances and consequent changing requirements for finance; including the possibility to change products or broaden investment criteria.

[11] Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and S Atkinson (2013) Financial Instruments. A Stocktaking Exercise in preparation for the 2014-2020 Programming Period. Final Report. Report for European Investment Bank. http://ec.europa.eu/regional_policy/thefunds/instruments/doc/fls_stocktaking_final.pdf (accessed July 2014).

Case study: ensuring flexibility - JEREMIE Fondo Multiinstrumento (Andalucia)

JEREMIE Fondo Multiinstrumento (Andalucia) offers flexibility by using a variety of financial instruments (equity capital, mezzanine funding, loans, convertible loans, guarantees) which enables it to offer a tailor-made solution to nearly all situations of early stage expansion companies. The financial solutions usually consist of a combination of two instruments according to the needs of the company. The (strategic) flexibility of the Multi-instrument makes relatively easy to refine the financial conditions, even after having signed the contract. In contrast, if a single instrument does not perform, it is very difficult to adjust after contracting.

Case study: ensuring flexibility and follow up - Midtjysk Iværksætterfond (Denmark)

As the gap analysis detected potential for acting on both loan and investment markets, Central Denmark Region introduced Midtjysk Iværksætterfond, a fund (without a holding fund), which is notable for its flexibility: the fund manager decides on a case-by-case basis whether to use a loan or investment (or a combination of the two) as capital. This decision is made after the companies have completed a 6 month qualifying accelerator programme supervised by the fund manager. As well as a development opportunity, the programme serves as a due diligence test of a company's capacity to implement the 12-18 month growth plan that is part of the capital bundle offered by the fund. The companies that receive capital are followed closely by the fund manager who works actively with them at least once a week during the growth plan implementation period.

(iii) Implications of ESIF 2014-20 and adaptation to the new regime

For the 2014-20 period, the now mandatory ex ante assessment must include an examination of the proposed investment strategy (Article 37(2)(e)). The regulations specify that this must cover:

- the options for implementation arrangements (within the meaning of Article 38)
- financial products to be offered
- financial recipients targeted
- envisaged combination with grant support if appropriate.

In this regard, the FIN-EN suggested list of **elements to be included in the investment strategy** is helpful as a basis. This includes:

- the type of FIs to be set up
- the implementation structure
- governance and management arrangements
- the degree of private sector participation to be sought and at what stage
- type of company and sector targeted
- company development stage targeted
- the amounts needed
- the investment period and timetable
- performance indicators and objectives.

Two additional points could usefully be added to this list in future:

- the **level of legacy funds expected to be created**, and plans for their future use, in reference to Court of Auditors recommendations, and

- a **discussion of any envisaged combination with grant support**, as required in the regulatory provisions.

2.1.3 *Incorporation in the operational programmes*

(i) Context

Operational programmes (OP) are agreed with the European Commission and set out how Structural and Cohesion Funds resources will be allocated across eligible territorial areas and in line with priority objectives. In 2007-13, financial instruments could be set up for three specific purposes: to invest in SMEs and enterprises (Article 44a), urban development (Article 44b), and energy efficiency and renewable energy in buildings (Article 44c). The majority of instruments were co-funded by the ERDF, but there were also some examples of European Social Fund (ESF) co-funded FIs. It was not possible to set up FIs under the Cohesion Fund in 2007-13.

Member States or managing authorities had to indicate in their OPs plans to use FIs to contribute to the achievement of programme goals. The use of FIs had to form part of the implementation strategy for the OP, and be agreed between the Member State and the Commission. However, the decision on specific instruments to be used fell entirely within the competences of the Member State/managing authority concerned. Member States/managing authorities could also decide whether to devote an entire priority to FI, or whether to deploy FI as measures under one or more priorities. FIN-EN partners were divided fairly evenly between these two approaches. The partners who chose to consider FI as separate priority in their OP had several reasons:

- the amount of funding allocated was such that it required a separate priority in the OP
- it provided a clearer differentiation to grant support, the rules for which were different
- it helped emphasise the priority being given nationally to FI measures, and guaranteed public funding.

Those partners who chose to introduce FIs as a measure under a wider priority tended to view FIs as just one tool among a wider range of measures helping improve SMEs access to finance (e.g. along with grant support) and did not aim to prioritise FIs over other forms of support.

(ii) Lessons from FIN-EN

A number of key lessons emerge from FIN-EN relating to the incorporation of FIs into OPs:

- It is important to **think ahead about any regulatory changes that will be required** at national and regional level to facilitate implementation of FIs, as regulatory modifications have proved to be a lengthy and difficult process. Related, it is important to **gain expertise in the relevant regulations,** and to **resolve regulatory problems as soon as possible,** as this saves time in later stages.

Case study: anticipating regulatory changes at national level –Slovenia

In the *Programme for financing of technological projects 2011–13*, the provision to set up FIs was included in the operational programme. At the same time, the national Public Finance Act, which governs the annual budget, provided for rules on financial engineering. Changing the national law saved considerable time in setting-up the initiative and created a safe legal environment, avoiding mistakes.

- When incorporating FIs into the OP, **aim for clarity and simplicity** as this helps prevent problems arising over interpretation.

Case study: describing FI plans in the OP - KMU-Fonds Berlin (SME-Fund Berlin)/Berlin Kapital, Germany

Land Berlin provided for FIs in the operational programme. A deliberate strategy to limit the detail in the OP was made so the measures could be more open to changes in market demand. The OP simply noted the target group, the objectives, a total amount of resources and result indicators. This broad-brush approach facilitated changes such as those related to the economic crisis, by redirecting the investment strategy, and altering the allocation of financial resources by instrument and/or target.

- More generally, partners recommended **looking for opportunities to use FIs beyond ERDF**, as other Structural Funds can also be used successfully.

Case studies: going beyond ERDF…

ENALIO Fund Greece, co-financed by the Fisheries Fund

This fund uses two financial engineering instruments: a Loan Fund and a Guarantee Fund. However, it was initially decided to start only with the formation of the "Enalio Guarantee Fund". The Enalio Guarantee Fund will provide guarantees to bank loans, which are part of business plans approved in the Greek Fisheries OP.

JEREMIE ESF, Lombardia, Italy

This pilot initiative by Finlombarda is considered to be innovative in terms of objectives (fighting social exclusion) and beneficiaries (individuals, rather than firms). Financial intermediaries selected through public procurement offer micro-credits to final beneficiaries (which are the members and often the workers of cooperatives). The micro-loans are used to subscribe shares of the company, contributing to the capitalisation of the cooperative.

The European Court of Auditors recommended that Member States should aim to include all co-financed FIs within a single OP per Member State in order to rationalise the planning process and remove one of the key delaying factors.[12] The importance of close links between the ex ante assessment process and the OP was also emphasised, as it was recognized that the contents of the OP can constrain how FIs are implemented (e.g. allocation between different types of instruments, territorial constraints, monitoring and reporting requirements). The OP monitoring requirements in particular can be challenging, since, in 2007-13, OP indicators did not distinguish between FIs and grants. This meant that some indicators were unhelpful in assessing the progress of FIs.[13]

[12] ECA (2012) *Op cit*. The report specifically covered the ERDF co-financing of FIs for SMEs.

[13] ECA (2012) *Op cit*.; Michie R and Wishlade F (2011) 'Between Scylla and Charybdis: Navigating financial engineering instruments through Structural Fund and State aid requirements', *IQ-Net Thematic Paper No. 29(2)*, European Policies Research Centre, University of Strathclyde, Glasgow, see:

(iii) Implications of ESIF 2014-20 and adaptation to the new regime

The CPR for 2014-20 specifies that any financial instrument supported by ESIF must comply with the relevant OP objectives, priorities, eligibility rules, expenditure-related provisions, co-financing elements, monitoring and reporting requirements. The regulation requires each priority axis to include a description of actions … 'and the planned use of financial instruments'. It should therefore be indicated at priority axis level where there is consideration of FIs (this can take the form of ‘broad text’), on the basis of the ex ante evaluation of the OP and with reference to the thematic objectives selected in the Member State’s Partnership Agreement. This may be supplemented by the information available from any on-going ex ante assessment(s). At a minimum, the managing authority should mention that it envisages the use of FIs. The aim is to achieve a balance between providing sufficient information and avoiding the need for a later programme modification by not being too specific.

The OP need not identify the specific FIs to be used. Indeed, this can only be decided after the ex ante assessment is carried out, and this can take place after the programme is adopted. However, where managing authorities decide to devote an entire OP priority to FIs, and benefit from the incentive of a 10 percent top-up for the priority, or where they decide to dedicate a whole priority to support an EU-level FI, and apply a 100 percent co-financing rate to that priority, the European Commission would seek more detailed information in the OP (or a later programme modification).

The scope for FI use is being expanded and enlarged in 2014-20 to cover all funds (including the Cohesion Fund) as well as all thematic objectives and priorities in the OPs. The new regulations are non-prescriptive with regard to sectors, beneficiaries, types of projects and activities to be supported. Although experience with using Funds other than ERDF to co-fund FIs has generally been limited in 2007-13,[14] there is useful experience among FIN-EN partners that could support those wishing to explore FIs under ESF in particular.

2.1.4 Managing financial flows from the OP

(i) Context

In the 2007-13 period, funds were slow to reach final recipients from many FIs set up under Structural Funds. By the end of 2012, of the €5,957 million of OP contributions paid to holding funds, under half (€2,812 million) had been subsequently transferred to specific funds for enterprises, meaning that €3,145 million of OP contributions (including €2,340 of Structural Funds and €801 million of national co-financing) still remained at the level of holding funds. In addition, €6,601 million of OP contributions, with €4,050 million of Structural Funds and €2,551 million of national co-financing had been paid directly from managing authorities to specific funds set up without a holding fund. The amounts paid to specific funds set up without a holding fund at the end of 2012 represent 62 percent of the amount committed in legal agreements.

http://www.eprc.strath.ac.uk/iqnet/downloads/IQ-Net_Reports(Public)/ThematicPaper29(2)Final.pdf (accessed May 2014).

[14] Michie and Wishlade (2011) *Op cit*.

In total, €9,413 million of OP contributions (including €6,024 million of Structural Funds) reached specific funds and was available to support final recipients. At the end of the reporting period, only 37 percent of this amount (i.e. €4,684 million) had been invested in final recipients. [15]

(ii) Lessons from FIN-EN

There have been no major lessons emerging from FIN-EN partners, largely owing to the lack of precedent in terms of managing financial flows from operational programmes to holding funds and FIs, and then ensuring onward progressing to final recipients.[16] The quality of gap analyses may also have contributed to difficulties knowing the appropriate level of funds that should be allocated to FIs at the start of the period. There were few constraints posed by the Structural Funds regulations on how financial flows should take place, and this was an issue that was subject to criticism by the European Court of Auditors, specifically that Member States that had implemented holding funds were not subject to automatic decommitment during the life of the operational programme when holding fund disbursements had not taken place.[17]

(iii) Implications of ESIF 2014-20 and adaptation

Important changes are taking place in 2014-20, with the introduction of staged payments linked to disbursements to final recipients and new restrictions on 'parking' funds to avoid decommitment. The new regulations provide that:

- each application for interim payment shall not exceed 25 percent of the total programme contributions committed to a FI
- each interim payment can also include up to 25 percent of the national co-financing expected to be paid to the FI or final recipient, ensuring that the whole amount of ESIF contributions to a FI will be reimbursed even when national co-financing is provided at a later stage (before the end of the eligibility period)
- the second application for interim payment can only be submitted once 60 percent of the amount included in the first interim payment has been spent as eligible expenditure (disbursed to final recipients/ committed for guarantee contracts/ paid as management costs and fees etc.).
- the third and subsequent applications for interim payment can only be submitted once 85 percent of the amounts included in the previous applications for payment have been spent as eligible expenditure.[18]

[15] European Commission (2013) *Op cit.*

[16] Nevertheless, it should be noted that the Hungarian FIN-EN partner has developed a system for loans where funding is provided in tranches. If a financial intermediary doesn't use its tranche for a long period of time, it may be asked to pay it back. Transfer of funds is therefore already based on the real funding needs of financial intermediaries and final recipients.

[17] ECA (2012) *Op cit*. While the ECA report specifically refers to holding funds, this was also the case for FIs that had been implemented without a holding fund.

[18] European Commission (2014) 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 (accessed July 2014).

2.2 Implementing Financial Instruments

This section focuses on the implementation phase of FIs in Cohesion policy, including decisions about implementation **structures**, selecting **fund managers and financial intermediaries**, issues related to **management fees**, **co-financing and leverage**, **communication strategies** and **closure**. It draws, in particular, on the work of the FIN-EN Thematic Working Group 2.[19]

2.2.1 Implementation structures and options

(i) Context

In 2007-13, when choosing to set 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.

By the end of 2012, most Member States using financial instruments to support enterprises were using both organisational approaches (i.e. holding funds and direct contributions, with just over half - 445 funds out of 816 - having been set up using holding funds).[20] In terms of the overall pattern of management, the majority of holding funds were managed by either national financial institutions or were put out to public tender (384 out of a total of 487), rather than being managed by the EIF or EIB.

(ii) Lessons from FIN-EN

Among the FIN-EN partners, the use of holding funds predominates with nine partners having established 11 holding funds between them; these holding funds account for 35 of the 45 FIs operated by the partners. Seven of the holding funds are operated as separate blocks of finance while the remaining four are established as independent legal entities. Among the 10 FIs that operate without a holding fund, three are established as separate legal entities and seven as separate blocks of finance within a financial institution. Half of the FIN-EN partners (seven out of 14) used the European Commission/European Investment Bank JEREMIE technical assistance initiative.

The choices made by the FIN-EN partners are largely context driven, so that the scope for lesson-drawing from this aspect of FI implementation may be limited. Nevertheless, the FIN-EN experience suggests that:

[19] FIN-EN Thematic Working Group 2 "Implementation" report (hereafter TWG2). Not yet publicly available – provided to EPRC by Finlombarda.

[20] European Commission (2013) *Summary of data on the progress made in financing and implementing financial engineering instruments co-financed by Structural Funds*, September 2013, see: http://ec.europa.eu/regional_policy/thefunds/instruments/doc/summary_data_fei_2012.pdf (accessed July 2014).

- using a separate block of finance within an existing institution may facilitate **rapid implementation**
- holding fund structures **increase flexibility**, since funds may be switched between instruments, depending on their performance.

More generally, a number of advantages to the use of holding funds to manage financial instruments can be identified. In particular:

- **Overall scale**: holding funds can help to achieve funding on an adequate scale; critical mass is an important element.
- **Flexibility**: holding funds increase the scope for flexible management of the funds over the period of operation - i.e. the possibility of moving allocations between funds within the holding fund and the corresponding FIs depending on demand and/or performance of the FI in question (at least for a certain period of time, depending on the national legislation governing each fund).
- **Portfolio approach**: holding funds facilitate the use of a portfolio approach – this enables a mix of instruments to be used if appropriate, diversifying risk and expected returns.
- **Strategic investment**: holding fund managers can take a more holistic view of the investment strategy than if instruments are managed independently.
- **Leverage and match funding**: match funding can be secured at holding fund level, and at sufficient scale to attract European Investment Bank (EIB) funding. Holding funds in theory enable the 'triple leveraging' of the ERDF contribution: at the holding fund level; at the financial instrument level and at the level of the individual 'deals' (i.e. investment in final beneficiaries). Funds can be pre-matched at national or sub-national levels.
- **External expertise**: managing authorities can delegate some of the tasks required to implement financial instruments to outside professionals (e.g. design of financial products and the procurement of fund managers).
- **Rationalisation**: audit, reporting and other administration costs are pooled at holding fund level; and the holding fund management should have the capacity to manage ERDF reporting requirements.
- **Experience**: holding fund structures can be particularly appropriate in regions with weak or no risk capital financing capacity, which are unlikely to be able to set up financial instruments with other public and private sector partners without support.

In 2007-13, one of the most beneficial aspects for managing authorities has been the **flexibility** gained by making allocations from the OP into a holding fund, which provides time to decide what specific funds to establish and subsequent scope to move allocations between funds depending on demand and performance. Importantly, however, the Commission's proposals for 2014–20 provide for stricter discipline with the introduction of phased payments by managing authorities, which must pay programme contributions to financial instruments in at least four tranches, and subsequent payments on the basis of investment rates in relation to programme contributions. This follows criticism from the European Court of Auditors, which noted that under the current Structural Funds regulations, Member States that have implemented holding funds are not subject to automatic decommitment during the life of the OP when holding fund disbursements have not taken place.

A less positive aspect has been that holding funds have been found to involve **extra indirect costs**, with overheads costs being relatively high compared to other models. These may arise from

additional monitoring and scrutiny need to mitigate 'objective drift', as well as the additional layer of management fees, since each financial instrument within the holding fund sets its own management costs, in addition to those of the holding fund. Additional layers may also impede transparency.

Regarding **leverage**, the claims made for the holding fund model are not supported by the ECA report, which did not find significant leverage from the private sector at the level of the holding fund in either the 2000-06 or 2007-13 programme periods. The ECA report found that typically, no explicit leverage requirements were specified in the funding agreements between managing authorities and financial intermediaries, except for certain equity funds in the United Kingdom, which had binding leverage requirements for private co-investors.[21]

(iii) Implications of ESIF 2014-20 and adaptation

In 2007-13 managing authorities could only set up tailor-made FIs at national or regional level. By contrast, for 2014-20, the options include tailor-made FIs at national, regional, transnational or cross-border level: with or without holding funds (termed 'fund of funds' in 2014-20), and two new options. First, contributions can be made to EU-level instruments which are managed directly or indirectly by the European Commission.[22] Second, while remaining under the responsibility of the managing authority, FI can use pre-determined terms and conditions or templates for implementation; these have become known as 'off-the-shelf' (OTS) instruments.[23]

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 Europe 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.

Off-the-shelf instruments are designed to deal with a range of compliance issues, such as those pertaining to State aid. By mid-2014, draft terms and conditions were available for three of these:

- **Risk-sharing loan:** loans with subsidised interest rates for SMEs.
- **Capped portfolio guarantee for SMEs:** credit-risk protection up to a maximum loss amount.
- **Renovation loan:** loans for energy efficiency and renewables in the residential sector.

Another two instruments are envisaged or at an earlier stage of development (draft terms and conditions not yet available):

- **Equity investment fund for SMEs:** co-investment equity fund.
- **Loan for sustainable urban development:** an off-the-shelf measure for urban development funds is also under preparation.

It remains to be seen whether these new initiatives to reduce the administrative burden of operating FIs are attractive to domestic policymakers – early indications, from the FIN-EN partners and

[21] Among FIN-EN partners, experience has been that even where leverage requirements were introduced in funding agreements, penalties were not set for expected leverage amounts not being reached.

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

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

elsewhere, are that they may hold limited appeal.[24] 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.

Managing authorities also have the option of designing their own FIs from scratch or using existing instruments independently of EU-level instruments or templates, as is the case under domestic policy.

2.2.2 Selecting fund managers and financial intermediaries

(i) Context

Managers of holding funds and/or the financial instruments themselves play a key role in the operation of FIs. In 2007-13, fund managers could be public or private institutions. There were several possibilities for selecting holding fund managers, either:

- the award of a public contract through public procurement; or
- the award of a direct financial contribution to the EIB or to the EIF, or
- to a financial institution without a public procurement process, subject to national law compatible with the Treaty.

For financial instruments themselves, financial intermediaries can be appointed with or without a procurement process, depending on national legislation.[25]

With regard to possible State aid implications, as far as fund managers (and financial intermediaries) are concerned, there is a presumption of no aid if the management company is chosen through an open and transparent public tender procedure and if they do not receive any other advantages.

A notable finding from the stocktaking report carried out for the EIB was that in 2007-13, negotiation of funding agreements was a major source of delay and deviation from implementation plans for FIs. This was both at the level of holding fund manager and at the level of fund manager for specific instruments. Negotiation of funding agreements frequently took longer than expected, for example, regarding the practicalities of proposed conditions, uncertainty over terms and negotiation of terms, and legal work. However, on a positive note, the lengthy discussions were, with hindsight, seen to have paved the way for faster implementation of remaining processes.[26]

[24] Michie R (2014) 'Managing the demands of two programme periods - state of play of the 2014-20 and 2007-13 programmes' *IQ-Net Review Paper 34 (1)*, European Policies Research Centre, University of Strathclyde, Glasgow (not yet publically available).

[25] Regulation 1083/2006 Article 44(b)(ii).

[26] Van Ginkel et al (2013) *Op cit*.

(ii) Lessons from FIN-EN

Within the FIN-EN network, selected fund managers and financial intermediaries are typically existing financial institutions (not always banks) or entities under state control, with previous experience in similar fields (such as other financial instruments, mortgages, public financial services, etc.) Only three FIN-EN partners chose private sector fund managers (and one of these was a joint public/private group – see Auvergne case study below). FIN-EN partners note that there is no predominant or most suitable method to appoint fund managers or financial intermediaries, although some processes (especially the competitive dialogue process) seem to suit many. Among selection criteria, predominant criteria relate to technical and financial capacity, proposed leverage and price. Most partners found regulation (especially public procurement regulation compliance) to be the main difficulty with regard to the selection of fund managers/intermediaries. For risk capital, sometimes this was even found to be a barrier to the selection of the best candidate.

Recommendations from the partnership include:

- devoting **sufficient time and effort** to the selection of financial intermediaries and fund managers, because a sound process is crucial
- ensuring funding agreements are **attractive to intermediaries, easy to enforce and flexible** (and provide exit/closure options)
- adopting **standardized selection criteria** (especially for equity funds, selection criteria should be adjusted for loans and guarantees).

Case study: simplifying the selection of financial intermediaries, FRIM ERDF Lombardia

In the case of FRIM (Fondo di Rotazione per l'Imprenditorialità) ERDF in Lombardia, instead of selecting financial intermediaries through a public tender, a document fully describing the role, activities, remuneration and deadlines to be respected by the financial intermediary was produced. Accordingly, financial intermediaries willing to participate did not have to submit an offer, they just had to sign the document. This reduced the time needed in the selection process of financial intermediaries.

The experience of FIN-EN partners suggests that the selection criteria for holding fund managers should include:

- **track record**
- team expertise and skills, especially on the **technical aspects of financial instruments** co-financed by Structural Funds
- **local presence**, with a strong understanding of regional, national and European financial and banking networks and knowledge of local financial needs
- **flexibility** and creative approaches
- **understanding of the policy challenges** and the capacity to develop ad hoc solutions
- **administrative capacity**, and
- ability to **add value**.

Case study: public procurement of holding fund manager (Auvergne)

Following a public procurement procedure, two bids were received, one of which fully met the criteria: a joint tender by the multiregional private management firm, SOFIMAC PARTNERS, together with the Auvergne Region Chamber of Commerce and Industry (CCIA). The public/private partnership is considered an innovative approach to covering all requirements, benefitting from the expertise and skills of each of the structures involved. SOFIMAC PARTNERS manages the holding fund and oversees follow-up of the venture capital investment portfolio and mezzanine debt portfolio and CCIA manages the loan fund portfolio.

When fund managers/ financial intermediaries have been selected, a funding agreement is drawn up which sets out the terms and conditions for contributions from the OP to the FI. FIN-EN partners recommend public law expertise being available at this stage, the importance of creating a working team which combines legal and operational specialists, and the need to foster dialogue with the relevant authorities to adapt regulations and settle differences in interpretation.

(iii) Implications of ESIF 2014-20 and adaptation

Under the CPR for 2014-20, managing authorities again have a number of options regarding implementation:[27]

a) invest in the capital of existing or newly created legal entities, including those financed from other ESI Funds, dedicated to implementing financial instruments consistent with the objectives of the respective ESI Funds, which will undertake implementation tasks;
b) entrust implementation tasks to:
    (i) the EIB;
    (ii) international financial institutions in which a Member State is a shareholder, or financial institutions established in a Member State aiming at the achievement of public interest under the control of a public authority;
    (iii) a body governed by public or private law; or
c) undertake implementation tasks directly (loans and guarantees only).

Where part of the implementation is entrusted to entities other than the EIB, (ie. a), b)(ii) and b)(iii) above) certain minimum requirements must be met. These are specified in the Commission Delegated Regulation:[28]

- entitlement to carry out relevant implementation tasks under EU and national law
- adequate economic and financial viability
- adequate capacity to implement the financial instrument, including organisational structure and governance framework providing the necessary assurance to the managing authority
- existence of an effective and efficient internal control system
- use of an accounting system providing accurate, complete and reliable information in a timely manner, and
- agreement to be audited by Member State audit bodies, the Commission and the European Court of Auditors.

[27] Article 38(4) CPR.
[28] Article 7, Commission Delegated Regulation (CDR) 480/2014, OJ L 138/ of 13 May 2014.

The managing authority should take into account the nature of the financial instrument to be implemented, the body's experience with the implementation of similar financial instruments, the expertise and experience of proposed team members, and the body's operational and financial capacity. The selection criteria should include:

- robustness and credibility of the methodology for identifying and appraising financial intermediaries or final recipients as applicable;
- the level of management costs and fees for the implementation of the financial instrument and the methodology proposed for their calculation;
- terms and conditions applied in relation to support provided to final recipients, including pricing;
- the ability to raise resources for investments in final recipients additional to programme contributions;
- the ability to demonstrate additional activity in comparison to present activity;
- in cases where the body implementing the financial instrument allocates its own financial resources to the financial instrument or shares the risk, proposed measures to align interests and to mitigate possible conflicts of interest.

Where the entities selected (again see a) and b) above) are implementing funds of funds, they may further entrust part of the implementation to financial intermediaries. Financial intermediaries must be selected on the basis of open, transparent, proportionate and non-discriminatory procedures, avoiding conflicts of interest,[29] as well as meeting the criteria above.

2.2.3 Management costs and fees

(i) Context

The Implementing Regulation for 2007-13 included some guidance on management costs and fees (Article 43), but during the period concerns were raised about transparency and the lack of clarity over whether management costs were based on fund size, investment size or tied to financial performance of the investments.[30] In 2010, amendments to the General Regulation clarified the need to keep management fees in line with market practices.[31] Commission data on management costs and fees gathered for their summary reports has been somewhat patchy, but is improving.

(ii) Lessons from FIN-EN

A number of recommendations can be drawn from the FIN-EN partners:

- design a flexible and adjustable scheme for management fees
- ensure that the design of the remuneration schemes is consistent with the investment strategy

[29] Article 38(5) CPR.

[30] Van Ginkel et al (2013) *Op cit*, CSES (2007) *Comparative Study of Venture Capital and Loan Funds Supported by the Structural Funds, Final Report*, August 2007. http://ec.europa.eu/regional_policy/sources/docgener/studies/pdf/2007_venture.pdf (accessed July 2014).

[31] European Commission (2012), *Commission Staff working document. Financial Instruments in Cohesion Policy*. SWD (2012) 36 final. 27.2.2012, Brussels; European Commission (2012*) Factsheet: Financial instruments in Cohesion Policy 2014-2020*, DG Regional Policy, Brussels.

- balancing the different components of a remuneration scheme is key to delivering the desired behaviour.

(iii) Implications of ESIF 2014-20 and adaptation

For 2014-20 the regulatory provisions set out more detailed rules on management costs and fees. Management costs comprise direct or indirect cost items reimbursed against evidence of expenditure, while management fees refer to an agreed price for services rendered established through a competitive market process, where applicable. Management costs and fees are to be based on a performance-based calculation methodology.[32] According to the Delegated Act, a performance-based approach should take into account:[33]

- the disbursement of contributions provided by the ESI Funds programme
- the resources paid back from investment or from the release of resources that had been committed to guarantees
- the quality of investment support measures to final recipients
- the contribution of the financial instrument to the objectives and outputs of the programme.

The methodology for setting management fees should be included in the funding agreement and advised to the monitoring committee, who should also receive annual reports on the management costs and fees paid.

The Delegated Act also sets thresholds for management costs and fees.[34] These distinguish the maximum rates payable for the management of funds of funds and for the management of specific types of instruments. For specific types of instruments, the Delegated Act provides for a maximum base remuneration related to the scale of the programme contributions to the instrument and a performance-related component. In addition, the Act caps the aggregate amount of management fees and costs over the eligibility period. These are expressed as a percentage of total programme contributions made and vary between funds of funds and between instruments.

2.2.4 Co-financing and leverage

(i) Context

Co-financing refers to the public contribution to a financial instrument from the Member State/regional level, and also any private sector contribution (at the level of the OP). All Structural Fund resources are required to be co-financed by other public or private resources for managing authorities to be able to spend Structural Funds.

One of the perceived benefits of FIs is their capacity to attract private contributions, thereby increasing the sums available for investment in SMEs. This contribution may take place at the level of the holding fund (if there is one), the individual fund or the deal/final recipients.[35] This mobilisation of

[32] Article 42(5) CPR.

[33] Article 12 CDR.

[34] Article 13 CDR.

[35] Contributions (co-financing) at this level are distinct from the co-financing of the OP, the rate of which is determined in the General Regulation by country and policy objective.

private resources is known as leverage, and this leverage effect has been one of the main elements of added value reported by managing authorities using FIs in 2007-13.[36] In the European Commission's summary report (which covers the period up to the end of 2012), Member States (providing optional information on additional resources paid to financial instruments outside the OPs), reported additional public/private resources paid which represented an additional 25 percent on top of the OP contributions paid to financial instruments in those Member States. The additional private sector resources alone are not reported.[37]

While attracting private sector participation is one of the main areas where added value can be identified, it has been difficult to do, particularly during the economic crisis. The European Court of Auditors noted a poor ability to leverage in private investment compared to other EU SME programmes, which they attributed to a lack of fit between the Structural Funds regulations and the specific features of financial instruments, as well as weaknesses in the gap analyses carried out.[38] This is likely to continue to be challenging in 2014-20, with public sector budget cuts in many Member States; the EIB stocktaking report in 2012 highlighted that many managing authorities and fund managers felt that there will be a growing need to attract the required co-financing as well as attracting additional co-investors from the private sector, and that this is likely to be challenging.[39]

(ii) Lessons from FIN-EN

FIN-EN partners have generally found it challenging to attract private co-financing at all levels. Reported difficulties have related to: the type of instrument used; the strategy (e.g. targeting innovative sectors, non-profit oriented, high-risk profile, too lengthy investments, etc.); regional characteristics (e.g. size); the market targeted (e.g. newly established enterprises); and the availability of suitable actors. This has been exacerbated by the economic crisis and the current situation of financial markets, and in general, the conditions have been more complex than envisaged when designing the current strategies and instruments.

In some cases, maximizing leverage is not recommended as it can hinder effectiveness, e.g. where co-financing can become a constraint for the achievement of the pursued objectives. For example, in cases of severe market gaps where no private money is available (e.g. very early stage funding), trying to reach a certain level of leverage may cause funds to be underutilised.

One cautious conclusion from the FIN-EN partners is that co-funding at the fund level has been easier to achieve than co-investment at the level of each deal. They have found that this avoids having to secure private leverage on every deal, making it easier and quicker to invest the funds in businesses.

A number of lessons have been learned on **maximising leverage at fund and investment** levels. In general, **forming partnerships with Community institutions** such as the EIB / EIF is found to be very advantageous in terms of maximizing leverage, as these are public entities but their funds are considered 'private money'. In addition, the regulatory constraints for them are low in comparison with government and arm-length bodies (e.g. relating to procurement).

[36] Van Ginkel et al (2013) *Op cit*.
[37] European Commission (2013) *Op cit.*
[38] ECA (2012) *Op cit*.
[39] Van Ginkel et al (2013) *Op cit*.

Case study: EIB as a private co-investor (North West of England, UK)

After obtaining €102 million in ERDF co-funding, the North West Fund (a holding fund) required an equivalent amount from the European Investment Bank in the form of a reimbursable loan. A financing agreement was signed between the region and the EIB, clearly mentioning that the loan taken out must be reimbursed as a priority. It included an obligation for the holding fund to keep separate accounts between the funds from the ERDF and those from the EIB.

In general, to optimise co-financing, it is recommended ensuring that strategy, fund and portfolio design is **attractive for a private investor**, potentially by involving potential co-funders in the design and implementation of funds and instruments. This can include providing clear incentives for investment.

Additional recommendations are: to **partner with state-controlled private financial institutions;** to **include private leverage in the criteria** for FI selection; **engage a respected professional fund manager**, preferably one with a wide network of potential investors; **organise deal flow through partners** (business angels, investment funds, incubators, etc.) so that the deals come 'prequalified' and with a previous decision of private investment; **use a consortium** of co-financing partners for each project facilitating subsequent rounds without public participation; **allow public and private investors to act independently** (e.g. to exit or to stay), and minimize the public co-investment to the minimum amount of risk sharing that the private participants require.

Case study: Providing clear incentives for private investment (New Hungary Venture Capital Programme)

Hungary is encouraging private investors to provide capital to SMEs during early and expansion lifecycle that due to the level of risk currently do not receive capital from the market. In order to make venture capital calls attractive for private investors in the JEREMIE programme, the Hungarian government introduced *yield restriction* and *loss mitigation* clauses:

- Yield restriction: where the fund is liquidated and has a positive yield, the yield due to the State may be capped to a pre-defined sum and any surplus paid to private investors
- Loss mitigation: if the fund has a negative yield, a percentage of loss equal to the highest subscribed capital of the fund is absorbed by the JEREMIE (state owned) part of the fund. The remaining loss is shared between the State and the private investors in proportion to their contribution.

Case study: including private co-investors as a selection criteria for fund managers, Midtjysk Iværksætterfond, Denmark

The identification of co-financiers was a selection criterion of the call for tenders launched to select the fund manager in Central Denmark Region. The tenderers had to bring in co-investors whose contribution would be equivalent to the ERDF financing (1:1). Having had previous experience of investing in start-ups, the investors understood the difficulties and risks, but were convinced that this initiative, with the Accelerator coaching model built in, would give the participating companies a greater chance of success, and was therefore more likely to generate a return for them. The region considers that this worked well because of the fund manager’s strong relationship with the private sector investors, and also the fund’s focus on elite start-ups with a very high potential for growth – a broader target group would be less likely to attract the interest of private investors.

At European Commission level, the partners expressed the wish for common provisions to be drafted to calculate leverage effect. A common leverage standard at the EU level, in accordance with generally recognised standards of business practice, providing clear rules, criteria, etc. for calculating leverage for each type of financial instrument, and thus allowing safe and reliable benchmarking and comparisons between the regions, would be welcomed.

(iii) Implications of ESIF 2014-20 and adaptation

For 2014-20, significant additional flexibility has been introduced whereby national public and private co-financing contributions may be provided at the level of the financial instrument (fund of funds or financial intermediary) or at the level of the final recipient (including in-kind contributions where relevant, except for the EAFRD). National co-financing does not have to be paid to the financial instrument upfront but may be provided at later stages of financial instrument implementation. It has to be provided before the end of the eligibility period. However, the provisions on payments allow for the full reimbursement of ESI Fund contributions even when material co-financing is provided at a later stage.[40] The expected leverage effect should be assessed by the ex ante appraisal.

2.2.5 Communicating the strategy and publicising instruments

(i) Context

Communication activity can serve two main purposes: creating a general awareness of the financial instruments and publicising the policy approach, specific activity linked to attracting potential recipients and improving deal flow. Among FIN-EN partners, communication and other marketing activities have not been given very high priority in 2007-13. The activity that has taken place has tended to be carried out mostly by managing authorities and holding fund managers, through the use of advertising, events and networking. These activities were mostly carried out to create deal flow and raise general awareness. There has been some uncertainty over communication obligations where there is a potential conflict between the obligations deriving from the use of Structural Funds and, for example, the preference for confidentiality on the part of the final recipient.

(ii) Lessons from FIN-EN

FIN-EN partners suggest that activities such as seminars, events and networking seem to be the most effective approach for improving deal flow, in particular for equity and combined instruments. Qualified investors and other actors can act as good deal flow generators, and building strong networks (for example, through business schools, innovation networks and incubators) can help secure a continuous flow of good projects.

[40] Article 41(1)(b) CPR.

Case study: Communication and promotion – INVEGA fund, Guarantee fund and Entrepreneurship Promotion Fund, Lithuania

A range of complementary measures are used by INVEGA to publicise their funds, including information and project visit trips for journalists, annual events, press releases, press conferences, radio and TV programmes, items in major news portals, participation in various events and fairs, communication in social media, joint activities with government, social, economic and media partners, and the websites **www.invega.lt** and **www.esparama.lt**. One of the most innovative and successful activities has been a media campaign implemented in March-July 2013. The media campaign **Business Spike** was launched in the largest Lithuanian internet news portal in December 2012 with articles and short video clips illustrating 13 business success stories. This was then built on in March 2013 by targeting Lithuania's second biggest news portal and using additional communication measures, including interactive banners promoting financial instruments. Two 'business heroes' were introduced to discuss their business situations and solutions to problems. This campaign also included radio shows and TV reports about business success stories, how EU support and different financial instruments helped them to start and expand their business. In two months, 29 'stories' were presented. The campaign also featured a 'business expert' who had supported start-ups and small firms. Short video stories were added and a YouTube channel was launched. As a result of this campaign and other measures, the visitor flow to the INVEGA website (especially new visitors) and general awareness about financial engineering measures for business visibly increased.

(iii) Implications of ESIF 2014-20 and adaptation

The EIB stocktaking report identified that there may be a need to build 'soft' skills, particularly in the area of communications, as desk officers, managing authorities and fund managers have had to, and will continue to have to, communicate with wide range of partners on a fairly new and highly complex topic.[41] In 2007-13, the EIB Group played a significant role in providing support and promoting financial instruments. The Commission has also produced guides aimed at managing authorities.[42] For 2014-20, to encourage information dissemination and communication over the use of financial instruments over a wider range of funds and sectors, the Commission has asked the EIB to set up, implement and manage the Financial Instruments Technical Advisory Platform for ESI Funds (FI-TAP), which will play a role in preparing methodological guidance, developing and delivering capacity building services, designing and delivering awareness raising campaigns and disseminating information through a variety of delivery channels (see Annex 2).

2.2.6 Closure and exit

(i) Context

Closure of a financial instrument takes place at the end of its lifetime, or before, if it is underperforming. FIN-EN partners have identified a number of required processes including the tasks necessary to stop the operation, liquidation of assets, ownership transfer, transferring of funds, ensuring eligibility of expenditure, etc. Exits, on the other hand, refer to the termination of specific deals (e.g. when a loan is repaid in full (or is defaulted on), or when the stock in an equity investment

[41] Van Ginkel et al (2013) *Op cit*.

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

is sold). Important topics related to the exits identified by FIN-EN partners include the criteria for exits and expected outcomes (rules, time, returns, default rate, etc.), and the process (tasks necessary for exit, destination of funds, vehicles for exits, etc.).

The 2012 European Parliament report identified room for improvement in the areas of setting up clear exit strategies and winding-up provisions.[43] The lack of clarity and lack of experience have been noted by FIN-EN partners.

(ii) Lessons from FIN-EN

So far, there is limited experience, knowledge and few lessons learned available in the regions for both closing of a FI (especially extraordinary closure) and exits out of an investment (equity disinvestment, loan full repayment, defaults, etc.). However, a few recommendations from FIN-EN partners related to closure and exit can be identified:

- It is important to consider the whole life-cycle of each FI and each transaction at planning stage, and to **incorporate information on processes and rules for exit and closure policy in funding agreements**. Due to underperformance, for example, because of the impact of the economic crisis, some regions have faced the need for an extraordinary closure of certain FIs, which in general was not envisaged in the design and implementation of the instruments, so the rules and procedures have not been clear. This emphasises the need to **specify clear rules/criteria in case of underperformance and defaults** of the FI and extraordinary exits out of the FI, in the instrument design.
- Related, at EU level there is a need for greater certainty in EU rules and procedures for the 2014-20 programme period.

Case study: minimising disruption from fund manager performance – North-West Fund, England, UK

In North-West England UK, the appointment of fund managers to the holding fund followed a two-stage procurement process in the EU Official Journal: first, appointment to a Framework Panel then a mini-competition round to select the fund managers for the different funds from the Framework Panel. The fund management contracts that are in place are standard for the market with the option of contract termination for any serious breach of contract. Due to changes in one of the fund manager's investment activity in the UK, it was agreed with the holding fund to hand over the management of the fund to a new fund manager. The panel approach used by the holding fund to select the fund manager was beneficial, in that it enabled the holding fund to appoint a fund manager for the new mezzanine fund arrangement without having to restart a full procurement process in the Official Journal.

[43] 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, see: http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=73151 (accessed July 2014).

(iii) Implications of ESIF 2014-20 and adaptation

The new regulations provide more detailed guidance on closure, namely regarding eligible expenditure, notably in relation to eligible expenditure and management costs and fees. In addition, Annex IV of the CPR states that funding agreements should include conditions for a possible total or partial withdrawal of programme contributions from programmes to financial instruments, including the fund of funds where applicable.[44]

[44] Annex IV 1(k), CPR.

2.3 Monitoring and Reporting Financial Instruments

This section focuses on the **monitoring and reporting phase** of FI in Cohesion policy. It deals in particular with internal issues for tracking progress as well as the verifications and checks required by the Commission. It draws, in particular, on the work of the FIN-EN Thematic Working Group 3.[45]

2.3.1 Internal monitoring and reporting

(i) Context

Effective monitoring of the implementation of FIs is required both for the internal assurance of probity and effectiveness as well as to ensure that the required reporting to national government and the European Commission is accurate and based on the best possible data. Article 44 of the 2007-13 General Regulation requires that holding funds report to Member States or managing authorities and monitor the implementation of investments in accordance with applicable rules. This requires effective methods for monitoring at the level of the final recipients of funding, with data being provided to the FI or holding fund manager. This data then needs to be aggregated for reporting to the managing authority or European Commission. Additional authorities may also require the reporting of all or selected data depending on the country-specific governance systems.

(ii) Lessons from FIN-EN

All of the FIN-EN partners have had to establish monitoring and reporting systems in order to meet the administrative requirements of the funding, although the nature of these systems varies according to the institutional context and the reporting requirements of partners. Good practices therefore have to be placed within these contexts, and relate more to the design and management of monitoring procedures rather than the specific contents of data collected.

At the outset, the MAs **should identify all actors in the reporting system and map which forms of data need to be collected and reported** to each of the actors. Different reports may be needed at different levels of frequency and the management of this data flow is a key element in the design of the monitoring and reporting system. So, for example, in Central Denmark region, the FI manager identified a range of partners who need to receive regular reports. It is important that the monitoring and reporting system functions well at the level of the implementing bodies (financial intermediaries, FI and holding fund managers, managing authorities) to avoid increasing the administrative burden on final recipients. Even though shared systems among all the actors may not be possible, it is important that there is frequent (daily) communication between the different systems in order to be able to have up-to-date information on every stage of the implementation process.

The data collected should make it possible for Member States/managing authorities to **carry out in-depth analyses** and **provide a global assessment on the performance of FIs**. In addition, monitoring data and information (including results of evaluations, surveys, etc.) on FIs **could be made public to a larger extent**.

[45] FIN-EN Thematic Working Group 3 “Monitoring and reporting” report (hereafter TWG3). Not yet publicly available – provided to EPRC by Finlombarda.

The timing of reporting is also diverse with reporting periods varying from annual to monthly or even daily in some situations, in addition to ad hoc reports. This demands that **effective monitoring and reporting systems are established that gather data on a timely and regular basis**, and hold that data in a **flexible format that permits reporting at different points in time** and for different periods.

Case study: using a software tool for monitoring investment processes and reporting (JEREMIE North West England)

The UK has a number of procedures in place to effectively monitor the JEREMIE Fund in North West England. The reporting requirements are a condition of the grant funding agreement and the holding fund manager (HFM) must adhere to them strictly. The HFM must supply reports to the managing authority on a quarterly basis and this will include information on the investments made, default rate and the progress made in the quarter to the achievement of outputs. Apart from the day to day monitoring of the fund a number of formal audits are carried out, covering topics such as procurement, State aid and eligibility. Through the regular and in-depth monitoring, the managing authority has been able to identify issues and perform corrective measures, and has been able to identify a number of irregularities before Article16 audits which has meant that they have not been included in the error rate. This monitoring also means that the managing authority has up to date information on all the funds and is able to keep various stakeholders and committee members informed.

The CRM system used by the Holding Fund Manager is a custom-made software tool for monitoring investment processes and reporting, and it has been highly beneficial in the monitoring process, as it provides the managing authority with reliable and up to date information. The Microsoft CRM system was selected after researching the market and was tailored to meet management and reporting requirements at the Holding Fund and Fund Manager level. Applications to the Fund come through the website and go directly to the CRM system. They are automatically allocated to the most relevant Fund Manager. The Fund Manager updates progress of the application on the CRM system and can link this to their emails, so when they send an email to applicants a copy can be attached to the CRM record. The Fund Manager can also put reminders on records of when monitoring and output information is due.

The CRM system has improved the effectiveness and efficiency of monitoring the investment process and reporting. The Holding Fund can see at any time how many applications have been received, where from, source of referrals etc. and have designed reports within the system which enable them to run progress monitoring reports quickly and accurately. The system has also been beneficial in providing assurances to the MA that the data they receive from the Holding Fund is reliable, up to date and with an ability to respond to information requests quickly.

Standard templates should be used to collect data on a consistent basis, ideally through a web-based data entry system. Templates may be revised over time in response to new needs, but changes should be minimized and implemented in major revisions rather than incrementally.

An ideal approach to developing a monitoring system is to develop it in conjunction with a **web-based data input and management system**, so that all those involved in the project have to enter data in real time and only need to enter data once. In this way monitoring data is always available on a real-time basis.

Case study: FRIM ERDF web-based system (Lombardia)

The FRIM (Fondo di Rotazione per l'Imprenditorialità) ERDF instrument developed in Lombardia is a web-based data management system, through which data is collected from the first application throughout the project. The system allows operators belonging to different institutions involved to make queries at any time and receive updated information. There is also an integrated reporting tool (report template) used by the FI manager to report to the managing authority which summarizes results every six months. This has simplified reporting duties and significantly reduced the time needed to assemble reports and ensures that data is timely and accurate.

(iii) Implications of ESIF 2014-20 and adaptation to the new regime

For 2014-20, the Commission stresses the importance of reporting in order to assess FI performance. Monitoring committees are charged with a specific responsibility to examine FIs, and should be supplied with specific information of the type supplied to the European Commission as an Annex to the Annual Implementation Report. The information to be provided has been expanded in 2014-20 to include elements such as leverage and performance, and also now includes the Cohesion Fund, EAFRD and EMFF, where appropriate.

2.3.2 Reporting to the Commission

(i) Context

The first reporting exercise on FIs set-up in the 2007-13 period was carried out on a voluntary basis by managing authorities in 2011. The data provided by the Member States in various formats was collected and aggregated by the European Commission in the synthesis report first published in December 2011. At the end of 2011, the General Regulation[46] was amended to introduce an obligation for Member States to formally report on FIs within the Annual Implementation Reports by 30 June. Article 67 of the amended Regulation introduces some compulsory elements that must be reported and a number of optional data categories. 2012 was therefore the first year when MAs formally reported on FIs on this basis.

The Commission published a summary of the data; however, this had many omissions and inaccuracies, so the Commission invited managing authorities to verify the information they had submitted. An updated report was then published by the European Commission.[47] The second formal reporting exercise took place in 2013, when the Commission prepared and presented to the Member States updated guidance on FI reporting.[48] While improved, the data is still problematic.

(ii) Lessons from FIN-EN

FIs use a range of indicators, with great variation in the number produced, some producing a significantly greater number than others. FIN-EN partners recommend that the indicators measuring

[46] Council Regulation (EC) No 1083/2006.

[47] European Commission (2013) Summary of data on the progress made in financing and implementing financial engineering instruments co-financed by Structural Funds, September 2013, http://ec.europa.eu/regional_policy/thefunds/instruments/doc/summary_data_fei_2012.pdf (accessed July 2014).

[48] http://ec.europa.eu/employment_social/sfc2007/quick-guides/sfc2007_reporting%20instruction_fei_air_updated_version.pdf (accessed July 2014).

FI performance should be clearly identified, and that a broad range of indicators should be provided for the Annual Implementation Report to the Commission to encompass operational indicators, output indicators and results indicators. Care should be taken to ensure that all data required by the Commission has been collected and is available in the reports.

The identification of suitable indicators for FIs has been problematic. Indeed, as early as 2007, an evaluation of co-financed FIs raised questions over monitoring, and the usefulness/appropriateness of the indicators being used. For example, the evaluation pointed out the potential mismatch between funds investing in technology-based businesses designed to provide long-term returns and high-quality jobs, and ERDF measures on job creation during the programme period.[49] Another report found that managing authorities noted the difficulty of reconciling FIs with the targets and indicators set out in the OPs. Some managing authorities have been investigating more suitable indicators to use with FIs in 2014-20.[50]

The majority of FIs within the FIN-EN group have received an audit from the Commission. There appears to be no common problem as a wide variety of issues was identified. These included missing data and information, weaknesses in verification procedures, weaknesses in the evaluation plans, and changes to the approach of the funds from that which was agreed. In order to reduce these issues, FIs should invest in better monitoring data, verification processes and evaluation plans as a minimum. Linked to the internal reporting requirements discussed above, monitoring systems should be able to collect data in a form which is convenient for a swift elaboration of annual reports.

(iii) Implications of ESIF 2014-20 and adaptation

Building on the reporting requirements in 2007-13, the new framework requires managing authorities to send to the Commission a specific report on operations comprising FIs as an Annex to the Annual Implementation Report. Based on the reports submitted, the Commission will provide summaries of data collected.

The specific report referred to must include the following information for each FI:

(a) identification of the programme and of the priority or measure from which support from the ESI Funds is provided;

(b) description of the financial instrument and implementation arrangements;

(c) identification of the bodies implementing financial instruments, the bodies implementing funds of funds where applicable, and the financial intermediaries;

(d) total amount of programme contributions by priority or measure paid to the financial instrument;

(e) total amount of support paid to the final recipients or to the benefit of final recipients, or committed in guarantee contracts by the financial instrument for investments in final recipients, as well as management costs incurred or management fees paid, by programme and priority or measure;

[49] CSES (2007) *Op. cit.*

[50] Michie and Wishlade (2011) *Op cit*.

(f) the performance of the financial instrument including progress in its set-up and in selection of bodies implementing the financial instrument, including the body implementing a fund of funds;

(g) interest and other gains generated by support from the ESI Funds to the financial instrument and programme resources paid back to financial instruments from investments;

(h) progress in achieving the expected leverage effect of investments made by the financial instrument and value of investments and participations;

(i) the value of equity investments, with respect to previous years;

(j) contribution of the financial instrument to the achievement of the indicators of the priority or measure concerned.

Templates for reporting are provided on the Commission's SFC system.[51]

2.3.3 Checks and verification

(i) Context

Verification is the internal system of checks to ensure that projects selected for funding by the FI are in accordance with the criteria applied by the fund, the operational programme and national and EU regulations. Verification checks may include:

- document-based checks
- on-the-spot checks (sometimes for all projects, for example where there are relatively few final recipients)
- sampling among projects, sometime using risk analysis (where there are a high number of final recipients)
- 'extraordinary' or ad hoc checks.

Thematic Working Group Report 3 identifies two models of verification checks among the FIN-EN partners:

- the 'cascade model', in which typically only the level directly below the certain entity is checked but not the further levels lower in the hierarchy;
- the 'ladder model' in which typically the entity checks all lower levels below in the hierarchy.

[51] http://ec.europa.eu/employment_social/sfc2007/quick-guides/index_en.htm (accessed July 2014).

Cascade model

Actor who performs the check	Entities checked			
	HFM	**FEI Manager**	**Financial intermediary**	**Final recipient**
Managing Authority	X	(X)		
HFM			X	
FEI Manager			X	(X)
Financial intermediary				X
Final recipient				

Ladder model

Actor who performs the check	Entities checked			
	HFM	**FEI Manager**	**Financial intermediary**	**Final recipient**
Managing Authority	X	X	X	X
HFM		(X)	X	X
FEI Manager			X	X
Financial intermediary				X
Final recipient				

(ii) Lessons from FIN-EN

FIN-EN partners present diverse practices in terms of verification checks, however many common features could be found and a number of general recommendations made:

- Verification processes are usually undertaken internally within the fund and may be undertaken at different points in the process and at different levels in the organisation. However it is good practice if the verification process is a **regular, planned element as part of wider administrative procedures**.
- As verification is a preventive action it is important to **create procedures for verification at all levels** that play a role in FI implementation (i.e. financial intermediaries, FI manager, holding fund manager, managing authority).[52]

[52] Note that verification should only be carried out at the level of the final recipient where there is insufficient documentation/verification at the level of the managing authority or financial instrument.

  - On-the spot visits should take place for every level of the implementation system.
  - HFM/FI managers should visit contracted partners to check the documentation of funded projects, comparing data received through the IT system.
  - The MA should carry out its verification duties visiting the HFM/FI managers in order to examine specific topics, processes related to a certain product, etc.
- If using a sampling approach, **investigation of the relevance of using risk analysis** instead of random sampling to better address potential risks is recommended.
- **Central (national/regional) databases of public subsidies should be developed** to limit the possibility of approving public financing over defined thresholds.

Case study: Procedures to carry out verifications (Portugal COMPETE)

COMPETE has predefined guidelines, instructions and checklists for management verifications, developed and improved through experience and through contributions from the national audit and certification authorities.

COMPETE has an **annual verification plan for on-the-spot checks**. The verification plan is based on a sample of FI operations managed by the HF and FI managers. The sample is defined randomly, after excluding certain groups, e.g.: (i) operations already audited by COMPETE or other entities; and (ii) operations not yet in a phase that justifies verification. The exclusion criteria are redefined every year in the planning of the on-the-spot checks. The sampling method includes around 10 percent of equity operations and 3 percent of guarantees, if they have more than 1,000 final recipients; for equity the rate agreed with the National Audit Authority was 5 percent, but in 2012 and 2013 it was decided to double the sample so that a larger number of operations could be checked.

Administrative (or document based) checks are performed for each operation by the FI in final recipients:

(a) whenever additional funding is requested for the operation; or

(b) during the analysis of the quarterly report of the HF / FI manager.

The practice is considered a success as the fact that the monitoring procedures are implemented and known by all the stakeholders helps prevent problems, resulting in a low rate of irregularities. The key success factor is to make all the stakeholders of the process aware of the monitoring procedures from the start of implementation.

(iii) Implications of ESIF 2014-20 and adaptation

Adequate management verification is a key requirement of the management and control system in 2014-20. Several implementing acts are envisaged to deal with different aspects of monitoring, verification and control, but at the time of writing, these have not been published.[53] MAs must submit a proposed methodology for carrying out on-the-spot checks if the Commission does not do so.

2.3.4 Evaluation

(i) Context

Evaluation of FIs is usually a part of the overall evaluation of operational programmes, given the scale of the FIs within such programmes. Whilst such evaluations vary in format and objectives, the scale and nature of FIs suggests that evaluations should be undertaken *within* the FI to ensure effective and efficient implementation and to ensure that the FIs are correctly targeted. Evaluations can be

[53] See: http://ec.europa.eu/regional_policy/what/future/pdf/preparation/implementing_acts_summary_inforegio_180614.pdf (accessed July 2014).

expected to provide feedback on operational, performance and absorption issues also in view of future programming.

Among FIN-EN partners, the majority have plans for qualitative and quantitative interim and ex-post evaluations of FIs. Planned evaluation activity varies in frequency:

- In the case of the Spanish FIs there are evaluations on a monthly and an annual basis.
- In France, the MA evaluates the FI once a year.
- In Hungary, typically one interim and one ex post evaluation is planned for FIs.

In some cases the evaluation is not specific to the FI but is part of a complex evaluation project. For example in the case of the Portuguese FIs, the evaluation is planned and included in a broader performance evaluation of the OP, while in the case of Hessen Kapital I GmbH and Mittelhessenfonds GmbH the evaluation is part of the regular report to the relevant Ministry.

(ii) Lessons from FIN-EN

Evaluation plans should be drawn up at the outset as part of the effective management of FIs, both to ensure that the effective use of public funds can be accounted for, but also to help with the management and targeting of the funds on an ongoing basis, as well as to provide guidance on future needs and funding strategies. FEIs should be assessed through, as a minimum, ex ante, interim and ex post evaluations with these evaluations feeding into programme-wide evaluations where applicable.

Interim evaluations should be undertaken after an initial tranche of deals so that processes and policies can be assessed, and corrective measures can be put in place as early as possible, if needed. This can also serve to verify whether context conditions have changed and whether the policy and FIs need to be readdressed.

The evaluation should involve external and independent reviewers but the involvement of fund managers in the process is also advantageous to ensure that lessons are embedded.

Case study: Internal review (North-West England, UK)

In the case of the North-West Fund in England, an internal review of the fund was undertaken in 2012 to determine if the strategic rationale was still relevant and whether the outputs and targets could be met. The review involved the HFM, the fund managers and the MA, and involved interviews with relevant stakeholders. The review suggested areas of improvement to increase efficiency and ensure that the fund is fully invested by 2015.

Regular updates of needs or gap analysis should be undertaken alongside evaluation to ensure that the FI continues to be targeted on needs. In addition, satisfaction surveys can be used to provide fresh feedback of final recipients' needs and on specific tools implemented.

Case study: SME survey (IBB, Berlin)

IBB works in partnership with a local credit research company which conducts interviews with 1,000 SMEs in Berlin each year. These interviews assess the ease of access to debt finance and the extent to which companies use public finance. The results of this survey are then used to evaluate, improve or adjust the financial instruments.

(iii) Implications of ESIF 2014-20 and adaptation

In 2014-20, regulatory provisions have been strengthened in terms of the monitoring of FIs. The managing authority must report annually to the Commission on the operations comprising FIs as an annex to the Annual Implementation Report. Provisions are also made in the regulations for the ex ante evaluation and evaluation of Cohesion policy programmes during the programme period. Specifically, an evaluation should be carried out for each priority at least once during the period to assess how support from the ESI Funds has contributed to its objectives. It is worth noting also the Commission's emphasis in 2014-20 on the assessment of the *impact* of Cohesion policy programmes. The strengthened monitoring and data gathering should assist greatly in future evaluation of the impact of FIs under Cohesion policy programmes.

3. SPECIFIC FINANCIAL INSTRUMENTS

Financial instruments under Cohesion policy can take three principal forms:

- **Loans** (sometimes referred to as debt) – where the capital is loaned to the borrower and must be repaid.
- **Guarantees** – where capital is wholly or partially secured in the case of a default.
- **Equity** – where a holding or share is taken in the capital of a firm.

Financial instruments may also be offered in **combination**, for example, different programme contributions and different funds in one financial instrument, as well as combination of financial instruments and grants and other forms of assistance. This section highlights lessons from the FIN-EN partners which relate specifically to certain types of financial instrument, although most lessons are horizontal in nature and have been described in the earlier sections of this report.

Academic and policy literature generally argues that there is no ideal model to be established based on particular existing conditions, but the choice of specific models must stem from the market gap analysis, or, in the 2014-20 programme period specifically, the ex ante assessment.

3.1 Equity

(i) Context

A comprehensive set of definitions and guidance on the implementation of FIs was not available until 2011, four years after the start of the 2007-13 programme period and approval of the General Regulations. The guidance states that:

> "*Equity is the (ordinary) share capital of an enterprise. Typical features of equity capital include an entitlement to the profits of the enterprise, a proportionate share of the proceeds upon liquidation and subordination to creditors*."
>
> while equity investment: "*refers to the acquisition of an equity participation (ownership) in an enterprise (or a start-up enterprise)".*[54]

Although the co-funding of equity instruments by the public sector has gained a higher profile in recent years, equity instruments have been less widely used than other forms of FI under Structural Funds programmes. Equity investment represented a comparatively small proportion of co-financed FIs in 2007-13. By the end of 2012, in terms of *numbers* of final recipients, just 2,024 had been supported through equity, out of a total of 158,520. They accounted for around €790 million of investments, just under 17 percent of the total for all specific funds. However, the average equity investment (at around €370,000) was much higher than the average loan (at around €52,000). By the end of 2012, there were 124 funds providing equity finance, suggesting that the average number of operations per fund was relatively small. [55]

[54] Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006 COCOF_10-0014-04-EN, 21/02/2011.

[55] European Commission (2013) *Op cit*.

In 2007-13, equity funds were being used more in EU15 countries than in the EU12. In general, equity financing tends to be used to support innovative firms and business start-ups with high growth potential, but which are subject to a relatively high degree of uncertainty, and therefore risk, in respect of the return on investment and how long it will take to come through.[56]

The frequently regional character and relatively small size of the co-funded equity instruments set up in 2007-13 has been criticised.[57] Also problematic have been issues related to follow-on investments and exits. Among other things, the State aid rules have constrained the capacity for follow-on investments. At the same time, the economic climate has reduced the scope for exits from investment, while a more general concern has been the difficulty of reconciling the lifespan of equity funds with the programme period duration, especially in the context of often lengthy delays in the setting-up process.

(ii) Lessons from FIN-EN

The table below highlights equity instruments used by FIN-EN partners in 2007-13.

MS/REGION	PARTNER	TITLE	H. FUND	BUDGET (M€)	
			YES/ NO	EU	TOTAL
DE (Hessen)	WIBank	Hessen Kapital I GmbH	N	19.0	38.0
		Mittelhessenfonds GmbH	N	5.0	10.0
ES (Andalusia)	Agency for Innovation & Development of Andalusia	JEREMIE Andalucia Fondo de Capital Riesgo	Y	40.0	75.0
FR (Auvergne)	Regional Council of Auvergne	FCPR Jeremie Innovation 1	Y	10.3	14.4
		FCPR Jeremie Mezzanine 1	Y	2.6	3.7
HU	Ministry for National Economy (formerly National Development Agency)	New Hungary Venture Capital Programmes	Y	147.6	233.4
HU (excluding Central-Hungarian region)	Ministry for National Economy (formerly National Development Agency)	New Szechenyi Venture Capital Programmes - Joint Seed Fund sub-programme	Y	0	0
		New Szechenyi Venture Capital Programmes - Joint Growth Fund Sub-programme	Y	0	0
UK (North West England)	Department for Communities & Local Government (DCLG)	Biomedical Fund	Y	13.7	27.5
		Development Capital Fund	Y	24.7	49.5
		Energy & Environmental Fund	Y	11.0	22.0
		Digital & Creative Fund	Y	8.2	16.5
		Venture Capital Fund	Y	16.5	33.0

Distinct from FIN-EN loan and guarantee products, equity instruments offered by the partners vary widely in terms of purpose and are differentiated by, for example, sectoral focus or maturity of the

[56] Ward T (2012) *Expert evaluation network 2012. The use of the ERDF to support Financial Engineering Instruments. A report to the European Commission Directorate-General for Regional Policy*. See: http://ec.europa.eu/regional_policy/sources/docgener/evaluation/pdf/eval2007/expert_innovation/2012_evalnet_fei_synthesis_final.pdf (accessed 23 July 2014).

[57] Tykvová T, Borell M and Kroencke TA (2012) *Potential of Venture Capital in the European Union*, European Parliament, Directorate-General for Internal Policies, Policy Department A, Economic and Scientific Policy.

target market. Most FIN-EN equity FIs are regional in scope. A large proportion of private actors, or a public-private mix of actors, are involved in implementation, as the involvement of actors with specific experience of venture capital markets is sought. Few constraints of the kinds of investment financed are specified. The minimum and maximum amount of investment varies according to targeted size of companies. The rate of required own resources varies widely and the majority do not require any own resources from the final recipient at all. The picture is mixed in terms of State aid compliance, and includes exemption based on the GBER, individual notifications and exemption based on *de minimis*. Most FIN-EN equity FIs have some share of private co-financing. Performance is found to vary widely.[58]

FIN-EN partners have identified a number of lessons specific to equity instruments:

- Equity instruments have been characterised in an analysis by the network partners as being of **low efficiency and high efficacy** (where efficiency describes the extent to which time, effort or cost are well used for the intended task or purpose, and efficacy is the capacity to produce an effect).
- Equity can be more appropriate than debt instruments where there is a risk of substitution for bank lending.
- Taking into consideration the 45 financial instruments implemented by FIN-EN partners, the **lowest levels of leverage** have been achieved in equity instruments. This has been found to be the case especially for seed and early stage instruments. In general, leverage maximization in equity is found to be difficult to achieve, especially because when ERDF funding is included, the entire fund must comply with ERDF regulations, whether the ERDF share is 10 percent or 90 percent of the fund total.
- Equity instruments have involved a **relatively standard pattern of remuneration**, based on the established market standard for private equity (combination of fixed management fee plus carried interest).
- Investment in projects where equity is a suitable instrument, but where the private sector is unwilling to invest alone, **will involve an element of risk**.
- It is recommended that **standardised selection criteria** be used for the selection of financial intermediaries for equity instruments. Selection criteria should include:
    - Investment strategy
    - Track record
    - Minimum experience
    - Ability to attract private capital
    - Distribution cascade – determination of timing of returns
    - Management fees.

Some further key **advantages** of equity have been identified in the literature:[59]

[58] FIN-EN Summary report on the mapping of FEIs, Version 2.2, February 2014.

[59] Michie R, Wishlade F and Granqvist K (2013) Financial Instruments for Business Development in EU Cohesion Policy: National Experiences, Issues and Options. Report to Lombardy Region on the 2007-13 Operational Programme, European Policies Research Centre, Glasgow; Schneidewind P, Radzyner A, Hahn M, Gaspari E, Michie R and Wishlade F (2013) *Financial Engineering Instruments in Cohesion policy*, Report to the European Parliament, Directorate General for Internal Policies, Policy Directorate B, Structural and Cohesion Policies,

- Equity instruments have been shown to create economic value added when designed appropriately and used in a relevant context.[60]
- Equity finance is primarily suited to firms that have high growth potential but lack the cash-flow necessary to borrow from conventional sources. From the perspective of the managing authority or investor, equity investment has the **potential to generate substantial returns** through what may turn out to be investment in high-growth enterprises.
- The **capital input may be very substantial**, and it does not have to be repaid (although an entrepreneur may ultimately opt to buy-out an investor in order to regain total control of the firm).
- The investor **may also bring considerable skills**, experience and contacts that can support the development of the firm.
- For public investors, an equity-type instrument can provide a **higher level of management control**, through higher involvement of the fund in project management or the management of target companies.
- Mezzanine finance may be attractive to small firms which are resistant to pure equity.

The literature also highlights some potential **disadvantages** of the use of equity instruments:

- Equity investment is a **highly specialised form of finance and is only appropriate for a very small minority** of firms.[61]
- Equity investors are purchasing part ownership, so there will be **partial loss of management contro**l of the firm. (However, although this may be a disadvantage for an entrepreneur, it could potentially be an advantage for the public investor.)
- The main issues to arise in the design of equity instruments using ESI Funds relate to their **complexity**:[62]
    - Difficult State aid issues may arise depending on the type and scale of investment targeted.
    - Management costs may be high, partly owing to the due diligence to be carried out.
    - It may prove difficult to lever in private sector investment.
    - Returns are unpredictable both in terms of scale and timing and depend on the capacity to exit the investment.
- These instruments are **less successful in regions and countries where the innovation infrastructure and ecosystem is not developed enough** to support and sustain the creation of knowledge that can be commercialised.[63]
- Access to venture capital is **very dependent on proximity** of venture capital firms and urban centres.[64]

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http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/495870/IPOL-REGI_ET%282013%29495870_EN.pdf (accessed July 2014).

[60] Cowling M (2012) "Credit rationing, equity gaps and policy solutions for financing entrepreneurial business in Europe: Theory, tests, evidence and the design and effectiveness of policy instruments." Expert Evaluation Network delivering policy analysis on the performance of Cohesion policy 2007-13 Year 2 – 2012, Task 1: Financial engineering Literature Review. Report to DG REGIO of the European Commission.

[61] Cowling (2012) *Ibid.*

[62] Michie R, Wishlade F and Granqvist K (2013) *Op cit*.

[63] Cowling (2012) *Ibid*.

[64] Rigby J and Ramlogan R (2013) Access to Finance: Impacts of Publicly Supported Venture Capital and Loan Guarantees, NESTA Working Paper No. 13/02.

- There is **evidence of poor performance** where funds are geographically constrained.[65]

Case study: IN2:BA – Business Angels Co-investment schemes (Portugal COMPETE)

Two Business Angel (BA) co-investment schemes, managed by the Portuguese Competitiveness OP managing authority (COMPETE) were designed to address market failure and sub-optimal investment situations for early stage businesses. These are two similar schemes, with differing asymmetric models for distribution of results, and with different budget allocation models. For both schemes, the investment is split 65:35 between the public investor (COMPETE) and participating BA societies (which are the financial intermediaries of the instrument). In the first model, the budget was allocated to BA societies at the start of the process (initial portfolio approval). In the second model, selection of investors is done on a deal-by-deal basis (on-going single operation approval). This approach, and the asymmetric distribution of earnings, has proved popular within the BA community. The distribution of earnings is carried out in three phases:

In Phase A, all earnings received by the BA society are distributed as follows – 80 percent to the BA societies and 20 percent to COMPETE (i.e. to the holding fund and re-invested). The distribution of earnings in Phase A is the same for both models. Phase A ends when the BA societies' investment is repaid.

For Phase B, the asymmetric distribution of earnings starts. For Instrument 1, the returns are split 50:50 between the BA societies and the public investor (COMPETE). For Instrument 2, the returns are split 80 percent to COMPETE and 20 percent to the BA societies. Phase 2 finishes when COMPETE's investment is repaid.

When both private and public investment has been reimbursed, Phase C starts, and profits are distributed to both partners. For Instrument 1, this is at the rate of 80 percent to the BA societies and 20 percent to COMPETE; for Instrument 2, this is at the rate of 50:50 between the BA societies and COMPETE.

(iii) Implications of ESIF 2014-20 and adaptation

For 2014-20, the main definitions applying to FIs can be found in different legal bases: the Financial Regulation and its Implementing Rules, the CPR, the ESI Fund-specific regulations, and the applicable State aid framework. In the Financial Regulation setting the rules applicable to the EU budget for 2014-20, two different definitions are set, one for "equity investment" and the other for "quasi-equity investment", the former meaning: *"the provision of capital to a firm, invested directly or indirectly in return for total or partial ownership of that firm and where the equity investor may assume some management control of the firm and may share the firm's profits";* whereas the latter concerns *"a type of financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity. Quasi-equity investments can be structured as debt, typically unsecured and subordinated and in some cases convertible into equity, or as preferred equity"*. [66]

The role of equity instruments in different OPs will be determined by the outcomes of the ex ante assessment, which will assess to what extent they can be designed to fill a gap in the market. The ex ante assessment methodology for FIs in 2014-20 developed for the European Commission and European Investment Bank by PWC identifies a series of advantages and disadvantages for each type of instrument. For quasi-equity/mezzanine finance these are outlined below.

[65] Rigby and Ramlogan (2013) *Ibid*.

[66] Regulation (EU, EURATOM) no 966/2012 of the European Parliament and of the Council of 25 October 2012 on the financial rules applicable to the general budget of the Union and repealing Council Regulation (EC, Euratom) No 1605/2002 in EUJ L298/1 issued 26.10.2012.

Advantages	Disadvantages	Key considerations
Allows bridging the equity gap needed for leveraging additional loans. Reduced exposure to loss in case of insolvency (compared to equity).	High risk borne by the financial intermediary (but lower than equity). No active role in the project management or the management of the target companies. High transaction costs related to the complexity of the products.	Silent participations and other forms of mezzanine loans require a very detailed due diligence, an ad hoc contract and a very specific scheme for the exit phase. One of the opportunities lies in an upside ('equity kicker') participation, which could be agreed upon by the fund.[67]

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, General methodology covering all thematic objectives, Volume I (Version 1.2, April 2014) (with minor adaptation by EPRC).

For equity and venture capital the key issues are set out below:

Advantages	Disadvantages	Key considerations
Active role in project management and access to shareholder's information. Allows high impact per € invested (projects with sufficient level of equity are able to gather other types of finance).	High risk borne by the financial intermediary (full insolvency risk for the invested capital in the target companies). Venture capital (early stage) investments are time-consuming and cost intensive (due diligence is carried out for several potential business plans before investment).	High involvement of the fund in the project management or the management of the target companies. The due diligence already includes considerations on it.

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, General methodology covering all thematic objectives, Volume I (Version 1.2, April 2014) (with minor adaptation by EPRC).

It is worth noting that early drafts of European Commission proposals for 'off-the-shelf' instruments envisaged an equity investment fund for SMEs and starter companies based on a co-investment model (co-investments facility), although this has not been included in later drafts. Off-the-shelf instruments are designed to deal with a range of compliance issues, including ensuring State aid compatibility. However, interviews with the FIN-EN partners suggest limited interest in such templates; largely owing to the experience and expertise built-up in 2007-13, such templates were generally considered 'too little, too late'.

Notwithstanding the availability of off-the-shelf instruments, the ESIF 2014-20 regulations imply some specific changes for equity-based instruments, including special provisions with regard to eligible expenditure (Article 42 of the CPR), while maximum thresholds for fees and costs are set out in the Delegated Act. A further key area of change concerns State aid compliance, where there are more changes in respect of equity than for other types of instrument (see Annex 1).

[67] Also known as an 'equity sweetener'. An option to buy equity, often used in mezzanine financing transactions where the lender receives equity interests in the borrower as an additional financial reward for making loans. (Thomsons Reuters Practical Law, http://uk.practicallaw.com/7-382-3440)

3.2 Loans

(i) Context

Loans are the most widely used form of finance by SMEs. The provision of loans (and the accompanying loan guarantees) by the public sector to fill an identified market gap has been a well-established policy option in a number of Member States and such FIs have been in operation for several decades in countries such as Austria, Germany, Finland and Sweden.[68] The use of micro-finance is also widespread, often with a social inclusion aspect, with a focus on the long-term unemployed and on disadvantaged areas. Within Structural Funds programmes, FIs offering loan finance have been co-funded over several programme periods and a great deal of experience has been built up in some programme areas.

According to the Commission's summary report for 2013, the number of co-financed loans offered up to the end of 2012 was 38,501, accounting for 47 percent of the value of OP funds committed. By the end of 2012, there were 351 specific funds supported by the Structural Funds offering loans; the average loan being for just over €50,000.[69]

(ii) Lessons from FIN-EN

In total, 7 FIN-EN partners operate loan-type FIs. In an analysis carried out by the FIN-EN network, loan instruments were characterised by high efficiency and low efficacy (where efficiency describes the extent to which time, effort or cost are well used for the intended task or purpose and efficacy is the capacity to produce an effect). The main reported burdens for beneficiaries are red tape and the collateral required. The table below shows loan instruments used by FIN-EN partners in 2007-13.

MS/REGION	PARTNER	TITLE	HF	BUDGET (M€)	
			Y/ N	EU	TOT
FR (Auvergne)	Regional Council of Auvergne	Réseau Entreprendre Auvergne + Initiative Auvergne	Y	3.9	5.4
HU	Ministry for National Economy (formerly National Development Agency)	New Széchenyi Loan Programme	Y	181.2	229.4
		New Hungary SME Loan Programme	Y	15.2	35.8
		New Hungary Working Capital Loan Programme	Y	12.6	28.6
LT	Invega	Small credits	Y	27.5	27.5
		Open Credit Fund	Y	43.4	57.9
IT (Lombardia)	Finlombarda SpA	Fondo di Rotazione per l'Imprenditorialità FESR	N	13.9	35.0
LV	(Hipoteku banka) Altum banka	ERDF Promotional Programme for improvement of Competitiveness of Entrepreneurs (Nr.X399/2009)	N	54.6	83.2
SI	SID Bank, Slovenia	The development-promotional programme for financing of technological projects 2011 - 2013	N	N/A	150.0
UK (North West England)	Department for Communities and Local Government (DCLG)	Business Loans Fund	Y	19.2	38.5

[68] It should be noted that 'double financing' is not permitted by the European Commission, who considers that if a loan financed by ESI Funds is also backed by guarantees financed by ESI Funds, the same expenditure has been financed twice which is not acceptable.

[69] European Commission (2013) *Op cit*.

Loan-type FIs offered by FIN-EN partners mainly aim to provide access to credit for micro and SMEs, with several particularly targeting RD&I. The geographical coverage of loans offered is mixed, with only the larger countries with more powerful and/or established regions tending to launch FIs at regional level (e.g. UK, France, Italy). Most have public FI managers and banks are the most popular type of financial intermediary operating FIN-EN loans. The loan-type FIs typically finance expansion of business activities and investments; working capital or current asset financing were mentioned frequently as an auxiliary-type activity, and innovation and/or R&D-type activities were also covered. A very wide range of loan sizes is offered. In terms of the amounts of own resources required from final recipients, on average the FIN-EN loan-type FIs operate with zero to moderate own resources requirements and so leverage triggered by final recipients is quite limited. With respect to State aid, all FIN-EN loan-type FIs were exempted from State aid either on the basis of the *de minimis* regulation (seven cases) or the General Block Exemption Regulation (GBER) (four cases) (and, in one case, both). The partnership found that loan-type FIs were relatively simple to launch early and quickly compared to other types of instrument, and the market uptake of these products is also quicker than for other types of FI.[70]

The literature identifies a number of **advantages** to loan instruments:[71]

- Firms may prefer debt to equity due to the lower information and dilution costs.[72]
- There is no loss of control over how the business is managed.
- The amount of capital and interest are known amounts that can be factored into business planning.
- The interest rate offered can incorporate a subsidised element so that the loan is offered below market rates.
- For MAs and intermediaries, loans are relatively straightforward to administer and the assessment of State aid compatibility is straightforward if a subsidy element is incorporated.
- Returns to the fund should be quite predictable.

Disadvantages have also been identified:[73]

- Loans may lack flexibility; they must be repaid on a fixed timescale and the burden of repayments may affect cash flow and/or the capacity of the firm to expand.
- Changes in market conditions can affect the ability of the firm to repay the loan.
- Collateral might be required, this can involve debt being secured on property or guarantees, for which payment is required.
- For MAs and intermediaries, the key disadvantages are:
    - a capital outlay is required at the outset
    - returns may be unpredictable.
- Loans funded through Cohesion policy may be either crowding-out private investment or investing in projects which the private sector has, for sound reasons, rejected.
- In some countries, there have also been administrative issues surrounding the use of loan repayments and how these are managed in practice.

[70] FIN-EN Summary report on the mapping of FEIs, Version 2.2, February 2014.
[71] Michie R, Wishlade F and Granqvist K (2013) *Op cit*; Schneidewind *et al*. (2013) *Op cit*.
[72] Rigby and Ramlogan (2013) *Op cit*.
[73] Michie R, Wishlade F and Granqvist K (2013) *Op cit.*

Case study: KMU-Fonds Berlin (SME-Fund Berlin) / Berlin Kapital
The Investitionsbank Berlin (IBB) recommends combining small and high volume loans. The SME loan fund offers microcredit and loans of up to €5m where a return is expected. This combination of high volume loans and microcredit which does not cover costs ensures that the FI as a whole covers costs, while still also meeting social/development objectives.

Case study: Fonds JEREMIE AUVERGNE
Under Jeremie Auvergne, loans are managed through a network of 14 small 'loan on trust' associations spread throughout the region. These associations know their territory well, and loans are provided to the entrepreneurs rather than to the companies, so that the loan amount can be brought in to the capital of the company. The loans on trust do not require any guarantee or personal liability and are interest-free. Administration and coordination is carried out by the regional Chamber of Commerce, which has oversight over the network of loan associations.

(iii) Implications of ESIF 2014-20 and adaptation

As noted elsewhere, the role for loans in the implementation of the various OPs will be decided on the basis of the ex ante assessment. The ex ante assessment methodology for FIs in 2014-20 developed for the European Commission and European Investment Bank by PWC identifies a series of advantages and disadvantages for each type of instrument. For loans these are outlined below.

Advantages	**Disadvantages**	**Key considerations**
Addresses specific liquidity and risk capacity constraints in a given market segment. Limited management cost (yet higher than guarantees) in cases where the due diligence of the financial intermediary receiving the guarantee can be accepted as a delegated process – so no own diligence is necessary.	Funded products such as loans require more initial support than unfunded products such as guarantees. As loans assume part of the risk and provide liquidity at the same time, there are no uncovered liabilities. When a grant scheme is transformed into a loan scheme, particular efforts are needed to establish a realistic PD (Probability of Default) and LGD (Loss Given Default) ratio. Once assessed, these values of should be monitored carefully during the implementation phase.	Key issues are the definition of the terms of the loan (e.g. soft loan in a revolving fund) and its eligibility, the required interest rates and potential losses from insolvency risk of final recipients.

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, General methodology covering all thematic objectives, Volume I (Version 1.2, April 2014) (with minor adaptation by EPRC).

The European Commission proposals for 'off-the-shelf' instruments include a risk-sharing loan with subsidised rates for SMEs. This falls within the *de minimis* ceilings for beneficiaries and provides no aid for intermediaries, provided certain conditions are met (including market rate remuneration and *pari passu* risk sharing). However, as noted earlier, it remains to be seen whether the off-the-shelf instruments will hold any appeal for managing authorities that have already run OPs with financial instruments within them.

Notwithstanding the availability of off-the-shelf instruments, the ESIF 2014-20 regulations imply some limited changes for loan instruments, with specific management fees and cost maxima outlined in the Delegated Regulation.

3.3 Guarantees

(i) Context

Guarantee funds provide support to companies unable to obtain finance, typically debt finance, due to a lack of collateral. Guarantee funds (and cross or counter-guarantee funds that provide support to intermediaries providing guarantee funds) are an important source of support for new businesses.

The most common form of co-financed FI is the guarantee, with 96,989 having been committed for disbursed loans and other risk-bearing instruments by the end of 2012. The average commitment per guarantee for one loan disbursed to the final recipient is €20,000. Note that guarantees funds are only disbursed when there is a default on the associated loan. By the end of 2012, there were 128 Structural Funds-supported funds offering guarantees.[74]

(ii) Lessons from FIN-EN

Only four FIN-EN partners reported using guarantee instruments in 2007-13.

MS/REGION	PARTNER	TITLE	H F	BUDGET (M€)	
			Y/N	EU	TOTAL
BG (through EAPB)	Bulgarian Development Bank	First Loss Portfolio Guarantee Financial Instrument	Y	66.6	78.4
HU	Ministry for National Economy (formerly National Development Agency)	New Széchenyi Credit Guarantee	Y	40.0	47.1
		New Széchenyi Counter-Guarantee Programme	Y	161.2	189.6
IT (Lombardy)	Finlombarda SpA	Joint European Resources for Micro to Medium Enterprises	Y	7.9	24.0
		Made in Lombardy	N	13.1	33.0
LT	Invega	Guarantee Fund	N	37.4	37.4

Guarantee instruments offered by FIN-EN partners typically aim to improve access to finance for SMEs (although one example is a counter-guarantee instrument, which secures guarantees rather than loans (the New Széchenyi Counter-Guarantee Programme in Hungary) and the Made in Lombardy instrument includes large companies beyond SMEs among final recipients). Most of the guarantee-type FEIs are national in scope, with only two regionally-focused guarantee schemes (in Lombardia, Italy). No private FI managers are involved in the implementation of FIN-EN partner guarantees, and commercial banks are the most frequently reported financial intermediaries. Reported projects include investments in fixed and current assets, infrastructure development, business expansion, industrial research, experimental development, technology innovation and company organisational development, which are financed primarily through a loan supported by the

[74] European Commission (2013) *Op cit*.

guarantee schemes. All guarantee-type FIs among FIN-EN partners use the *de minimis* regulation. Co-financing is marginal as the budget covers the losses of defaulting loans.[75]

In an analysis by the FIN-EN network partners, guarantee instruments were characterised by high efficiency and low efficacy (where efficiency describes the extent to which time, effort or cost are well used for the intended task or purpose and efficacy is the capacity to produce an effect). There were some doubts expressed about the effectiveness of guarantees, and it was not considered to be clear that guarantees alter the investment decision, rather they may just lower the risk to the lender. Also, in the context of the economic crisis, guarantees have been found to be of limited use because of the lack of liquidity. However, the highest levels of leverage have been achieved in guarantee instruments.[76]

The literature finds a number of **advantages** to using guarantees:[77]

- They are relatively simple to design and administer and typically require that investment appraisal is conducted on a commercial basis, minimising deadweight.[78]
- They have the most potential for high and positive effects in countries and regions where collateral-based lending is the norm and where the entrepreneurial population is not asset-rich.[79]
- They provide access to finance that would not be available otherwise; in some cases, finance may also be available more cheaply as a result of the guarantee (because the lender is taking less risk, so charges less interest).
- For managing authorities and financial intermediaries, guarantees require less capital outlay. In addition, State aid clearance is relatively easy, especially if the country concerned has a notified and approved formula for calculating the aid equivalent.
- Guarantees can also be useful in addressing credit rationing, for example: where the banking sector is highly concentrated and there is a lack of 'relationship' banking; where commercial loans require assets to be placed as security; where there is a diverse entrepreneurial population (poor as well as rich entrepreneurs); where there is substantial diversity in the quality of lending institutions; and where access to loans is conditional on factors not related to project quality.
- Evidence suggests that access to credit is of greater concern to firms than the cost of credit, implying that loan guarantees might be a more appropriate policy instrument than soft loans.
- An evaluation of the Small Firms Loan Guarantee Scheme in the United Kingdom in 2010 (now the Enterprise Finance Guarantee, EFG) found that the Loan Guarantee Scheme, which is distributed by participating banks in the UK, appeared to be a particularly cost effective way of creating additional employment.[80]

[75] FIN-EN Summary report on the mapping of FEIs, Version 2.2, February 2014.

[76] TWG2 reports some concerns that this data may be misleading, due to the above-mentioned questions of whether guarantees just lower the risk to the lender rather than alter the investment decision.

[77] Michie R, Wishlade F and Granqvist K (2013) *Op cit*.

[78] Cowling (2012) *Op cit*.

[79] Cowling (2012) *Ibid*.

[80] Cowling M (2010) *Economic Evaluation of the Small Firms Loan Guarantee (SFLG) Scheme*, Report to BIS, Department for Business, Innovation and Skills.

- Easing access to finance for credit-constrained SMEs, through schemes such as loan guarantees, provides support for important agents in the regeneration of deprived areas and businesses who are employers of under-represented groups in the labour market.[81]

Assessing the need for loan guarantee schemes

Critical indicators of the need for loan guarantee schemes identified by Cowling (2012) include:

- a highly concentrated banking sector (few large banks)
- less dense local branch networks and a general lack of relationship banking
- low levels of housing or general (tangible) asset ownership
- most commercial loans require assets to be placed as security
- falling asset values
- a diverse entrepreneurial and latent entrepreneur population (poor as well as rich potential entrepreneurs)
- access to loans is conditional on criteria not related to the quality of the entrepreneur of their investment proposal (e.g. collateral availability)
- the spread of interest rates on bank loans is narrow (indicating rationing is favoured over risk-adjusted lending)
- there is substantial diversity in the relative quality of lending institutions.

Source: Cowling M (2012) "Credit rationing, equity gaps and policy solutions for financing entrepreneurial business in Europe: Theory, tests, evidence and the design and effectiveness of policy instruments." Expert Evaluation Network delivering policy analysis on the performance of Cohesion policy 2007-13 Year 2 – 2012, Task 1: Financial engineering Literature Review. Report to DG REGIO of the European Commission.

A number of **disadvantages** have also been highlighted:[82]

- Guarantees may be costly and there may be no reduction in interest rates in relation to the market rate.
- The disadvantages of loans also apply to guarantees.
- For MAs/intermediaries, the 'additionality' of guarantees may be difficult to determine – it may be that guarantees are providing cover for bank loans that lenders would have offered anyway. One study takes this further by outlining a framework of Type 1 and Type 2 errors: if a loan guarantee scheme secures a loan for a firm that subsequently fails, this represents a Type 1 error, indicating that banks made the correct decision in the first instance not to lend to the firm in the absence of a loan guarantee scheme, whereas government-backed loans which are successfully repaid would, in the absence of a guarantee scheme, represent a missed opportunity for the bank. This would be termed a Type 2 error'[83] It is also impossible to measure the counterfactual.[84]
- The use of guarantees requires clarity of objectives – is it to encourage lending to riskier projects, which would entail higher levels of default? Who should assess the level of risk?

[81] Cowling (2010) *Op cit*.

[82] Michie R, Wishlade F and Granqvist K (2013) *Op cit*.

[83] Astebro T and Bernhardt E (2003) The winners curse of human capital. Small Business Economics, 24. 1-16, cited in Cowling (2012) *Op cit*.

[84] Rigby and Ramlogan (2013) *Op cit*.

- From a Structural Funds financial management perspective, a further disadvantage is the unpredictability of claims on the guarantee, making the full costs difficult to determine.[85]
- The relationship between loan guarantees and innovation is opaque and the literature is divided on whether publically funded loan guarantee schemes are effective instruments for promoting lending to SMEs.[86]

Case study: INVEGA Guarantee Fund (Lithuania)

In Lithuania, INVEGA, the national guarantee agency, manages the Guarantee Fund. The fund, co-financed by ERDF, is a public fund and operates as a scheme of counter-guaranteeing of losses in INVEGA's guarantee portfolio. All credit institutions/leasing companies which operate in Lithuania and which have signed a cooperation agreement with INVEGA can apply for INVEGA's guarantees. SMEs then apply to the intermediary for the loan or leasing, after which the intermediary applies to INVEGA for the guarantee. INVEGA evaluates the project and makes a decision whether or not to issue the guarantee. After the guarantee is issued, INVEGA takes a decision on including that guarantee in the Guarantee Fund portfolio. Only guarantees which comply with additional criteria can be included in the Guarantee Fund portfolio. If the SME defaults, the intermediary asks INVEGA to guarantee payment, and, if the guarantee was included in the Guarantee Fund portfolio, the guarantee payment is made from Guarantee Fund resources.

Using the Guarantee Fund scheme, INVEGA can apply a significantly lower guarantee fee to be paid by the final beneficiary, i.e. SME, as compared to a guarantee fee established according to safe harbour principles. Thus, the INVEGA Guarantee reduces SME business financing costs and facilitates SME access to finance. Furthermore, with its payments being reimbursed, INVEGA is able to provide credit institutions with more individual guarantees, thus promoting SME development.

(iii) Implications of ESIF 2014-20 and adaptation

As for other instruments, the future role of guarantees in any given OP will be determined by the ex ante assessment. The ex ante assessment methodology for FIs in 2014-20 developed for the European Commission and European Investment Bank by PWC identifies a series of advantages and disadvantages for guarantees. These are outlined below.

[85] For other forms of FI, there must be a capital outlay at the start and funds can be allocated until they are exhausted; for guarantees, a claim is only made on the funds if there is a default on the loan, making it more difficult to assess whether the budget limit is likely to be reached and potentially less likely that the entire amount allocated is actually spent.

[86] Rigby and Ramlogan (2013) *Op cit*.

Advantages	Disadvantages	Key considerations
Addresses specific risk capacity constraints in a given market segment. Actual disbursement takes place only in case of default. Allows consolidation of the financing structure of a large number of projects with relatively few resources. Allows reduction of the risk premium for request of further financing.	The main problem of all unfunded instruments is the control of potential liabilities. This can be mitigated by a prudent analysis of the risk and measures to limit potential liabilities. Proving the incentive effect of FIs using this type of financial product might be more complex than that of others. Assessing the value added needs more effort.	It is crucial to define an appropriate and prudent multiplier ratio between the OP contributions set aside to cover expected and unexpected losses and the corresponding loans or other risk-sharing instruments covered by the guarantees.

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, General methodology covering all thematic objectives, Volume I (Version 1.2, April 2014) (with minor adaptation by EPRC).

The ex ante assessment guidelines provide more detailed recommendations with regard to guarantees. As mentioned in the table, these relate to the need to estimate in advance expected and unexpected losses, the need to put a cap on liability of the funds and the likely premium that will be required by a financial intermediary to accept such a cap on liabilities. Additional costs to financial intermediaries of operating unfunded instruments can include (possibly substantial) administration costs and the amount of capital underpinning required by the relevant regulations. Several further suggestions are made:

- financial intermediaries should retain at least 20 percent of the risk to align their interest with those of the managing authority; and
- a specific risk assessment for guarantees in addition to the general ex-ante assessment should be carried out to assess the leverage of the funded products.

The ex ante assessment guidelines suggest that a prudent approach to risk assessment will result in unfunded instruments such as guarantees not showing advantages over funded instruments such as loans, and a careful check of whether a funded product could deliver the same objective instead is recommended. If not, the managing authority should set a maximum amount of the guarantees significantly smaller than the total volume of the FI, and identify possible partners such as financial institutions with relevant own risk-bearing capacities such as commercial or promotional banks or private mezzanine and loan funds.

The European Commission proposals for off-the-shelf instruments include a guarantee fund for SMEs (capped portfolio guarantee). From a State aid perspective, this falls within the *de minimis* ceiling for beneficiaries and offers no aid to financial intermediaries, provided certain conditions are met.

The off-the-shelf instrument aside, the new regulations imply some specific changes in respect of guarantees. In particular, the Delegated Act 480/2014 includes specific requirements with regard to guarantees:

- an appropriate multiplier ratio shall be achieved between the amount of the programme contribution set aside to cover expected and unexpected losses from new loans or other risk-

sharing instruments to be covered by the guarantees and the value of corresponding disbursed new loans or other risk-sharing instruments;

- the multiplier ratio shall be established through a prudent ex ante risk assessment for the specific guarantee product to be offered, taking into account the specific market conditions, the investment strategy of the financial instrument, and the principles of economy and efficiency. The ex ante risk assessment may be reviewed where it is justified by subsequent market conditions;
- the programme contribution committed to honour guarantees shall reflect that ex ante risk assessment;
- if the financial intermediary or the entity benefiting from the guarantees has not disbursed the planned amount of new loans or other risk-sharing instruments to final recipients, the eligible expenditure shall be reduced proportionally.

3.4 Combined Financial Instruments

(i) Context

Combined FIs are the most popular type of financial instrument among FIN-EN partners. Altogether 16 combined instruments were reported by 10 partners. This covers a wide range of combinations, not only of FIs with grants, but more commonly different types of FIs together (equity and quasi equity, loans and guarantees, as well as guarantee fee and interest rate subsidies, equity and loans and FIs with 'soft support' such as training and consultancy).

The use of such 'combined' financial instruments was discussed at the JEREMIE Networking Platform in Brussels in May 2011, where several participants outlined their rationales for complementing repayable forms of support with grant support: [87]

- it can be used to tailor support to beneficiaries' needs, particularly taking into account the effects of the economic crisis
- the mix of grant and repayable financial instruments can be modulated according to different typologies and recipients e.g. higher aid intensities for more innovative projects in sectors of regional interest with more difficulty accessing traditional finance
- it enables a 'smooth shift towards more innovative forms of finance to sustain the development of sectors which have traditionally benefited from 'non repayable' forms of finance
- it makes financial engineering mechanisms more attractive to SMEs
- it allows a balance to be found between meeting beneficiaries' needs and increasing the financial resources available, and

[87] Finlombarda (2011) *Designing schemes which combine grants and repayable financial instruments in Lombardia*, presentation to JEREMIE Networking Platform, Brussels 20 May 2011; Asselberghs R (DG REGIO) (2011) *Combination of repayable financial instruments with grants*, presentation to JEREMIE Networking Platform, Brussels 20 May 2011.

- it helps ensure that public sector funds are being spent in line with their strategic objectives.

(ii) Lessons from FIN-EN

Among FIN-EN partners, combined instruments are found to be very attractive, but complex to implement due to regulatory and operational issues, and their State aid status is often unclear. Loan and grant procedures can be difficult to coordinate. The table below illustrates the combined instruments used by FIN-EN partners in 2007-13.

MS/REGION	PARTNER	TITLE	HF	BUDGET (M€)	
			Y/N	EU	TOTAL
BG (through EAPB)	Bulgarian Development Bank	Risk Capital Fund(s) Financial Instrument	Y	17.8	30.0
		Growth Capital Fund Financial Instrument	Y	0	0
		Mezzanine Fund(s) Financial Instrument	Y	0	0
		Entrepreneurship, Acceleration and Seed Financing Instrument	Y	0	0
		JEREMIE funded financial instrument with an embedded risk sharing	Y	0	0
DE (Berlin through EAPB)	Investitionsbank (IBB), Berlin	KMU-Fonds Berlin (SME-Fund Berlin) / Berlin Kapital	N	50.0	100.0
DK (Central Denmark Region)	Central Denmark Region	Midtjysk Iværksætterfond	N	6.7	13.42
ES (Andalusia)	Agency for Innovation & Development of Andalusia	JEREMIE Fondo Multiinstrumento	Y	148.0	185.0
GR	ETEAN SA	Fund for entrepreneurship - loan fund, fund for entrepreneurship - guarantee fund	Y	386.5	1,060.0
HU	Ministry for National Economy (formerly National Development Agency)	Combined micro-credit	Y	60.7	78.5
IT (Lombardy)	Finlombarda SpA	Joint European Resources for Micro to Medium Enterprises	Y	8.5	37.5
LT	Invega	Entrepreneurship Promotion Fund	Y	14.5	15.8
LV	(Hipoteku banka) Altum banka	ESF programme "Support to Self-employment and Business Start-ups"	N	17.3	32.8
PT (North, Center, Alentejo)	MA Compete	Venture Capital Funds	Y	118.0	211.0
		Credit lines combined with Guarantees	Y	107.9	154.2
		Business Angels Program	Y	27.0	44.0

Combined instruments among FIN-EN partners are diverse and include: equity and quasi-equity (Bulgaria and Portugal); loans and guarantees (Bulgaria, Greece and Italy (Lombardia)); equity and loans (Bulgaria and Denmark (Central Denmark Region)); FIs with other loans and guarantees that are provided on a commercial basis (Spain); FIs with grants (Italy, Latvia and Hungary); and FIs with business consultancy and training (Latvia and Lithuania). The purposes of combined FIs are also diverse and wide-ranging. Of the total of 45 FIN-EN instruments, four are co-financed by ESF (rather than ERDF) and these are all combined FIs (Midtjysk Iværksætterfond in Denmark, ESF Programme ‘Support to Self-Employment and Business Start-ups’ in Latvia, the Entrepreneurship Promotion Fund in Lithuania and JEREMIE FSE in Lombardia, Italy). The combined FIs include both those which are national and regional in scope. The type of FEI manager and financial intermediary involved tends to reflect the profile of the individual FIs which have been combined. Minimum and maximum investment amounts also vary widely. In terms of State aid, just over half of the FIN-EN combined instruments are exempted based on the *de minimis* regulation. Several FIs are exempted based of the GBER, and two are not only exempted but also notified. Combined FEs have the largest financial allocation compared to other FI types and private co-financing is substantial. Financial progress of the combined

FIs has been slower than average, due in part to the late start of these instruments and their complexity.[88]

Combined instruments can be one way of trying to introduce flexibility to FI implementation. The need for flexibility during the programme period has been a key issue among FIN-EN partners and this is expected to continue to be the case in 2014-20. The changing economic environment during 2007-13 emphasised the importance of flexibility in FI design and implementation, including:

- the ability to reallocate funding between programme priorities/measures
- the ability to reallocate funding between financial instruments, changing the investment strategy
- the flexibility to adjust target groups/the focus of funds (e.g. type, sector, location or size of companies supported)
- the ability to offer tailored solutions for SMEs (FIs combined with grants and other kinds of 'soft' support), and
- the need for active monitoring of the market gap/conditions and consequent adjustments required in the products offered, changing, expanding or downsizing the products offered.

The EIB stocktaking report identified that in the majority (66 percent) of reported cases where market conditions changed this led to different products being introduced as part of the portfolio of FIs, for example, through the introduction of an equity scheme in addition to loan funds, or increases in the provision of both.[89]

Case study: Combined instruments (Hipoteku banka, Latvia)

The ESF Start Programme (ESF Programme "Support to Self-employment and Business Start-ups") in Latvia provides good practice for establishing an innovative FI comprising different tools (loans, grants and services). The financial intermediary is a bank, whose consultants evaluate businesses at an early stage. Then they give advice on requirements, and by means of a test/ interviews they assess the applicant's knowledge and practical experience. If necessary, additional training in particular modules, e.g., management, accounting and taxes, marketing etc. is made available. In later stages, consultancy on drafting a business plan and implementation of the project is provided. After submission of the business plan and related documentation, the loan officers examine applications according to selected criteria and select viable projects to be financed.

Case study: Combined instruments (New Szechenyi Combined Micro Loan programme, Hungary)

In Hungary, the New Szechenyi Combined Micro Loan programme combines reimbursable and non-reimbursable EU assistance, plus the applicant's own contribution. The applicant submits both the reimbursable loan application and the non-reimbursable grant application to a financial intermediary. The financial intermediary assesses the loan application, makes a decision about the loan element and forwards the grant application to the Intermediate Body (IB) of the relevant MA. The IB evaluates the grant application by checking all the acceptance criteria and carrying out eligibility and content checks of the application. One of the criteria they check is whether the loan decision is positive or negative. The application for the reimbursable EU assistance therefore acts as a filter.

[88] FIN-EN Summary report on the mapping of FEIs, Version 2.2, February 2014.
[89] Van Ginkel *et al* (2013) *Op cit*.

State aid approaches used for combined instruments among FIN-EN partners include: no aid (three out of 16); use of *de minimis* (nine out of 16); and use of GBER (four out of 16, two of which were not only exempted but also notified).

Case study: Central Denmark region: Strategic flexibility through a combined instrument (loan/equity plus a business development coaching programme)

Central Denmark Region has a combined FI (loans, equity) which was launched in 2012. Applications are accepted twice a year by the fund manager, who recommends 20-50 companies to a screening committee. The screening committee then selects up to 10 companies to join a 6-month ambitious and high quality Accelerator programme. The programme performs as a test for the entrepreneurs, who must complete an agreed action plan within 12-18 months. During the Accelerator programme, the fund manager's commercial development experts work closely with the companies to help them develop, and to get to know the participants, and their potential, very well. The companies completing the programme apply to obtain investment capital in 'Midtjysk Iværksætterfond'. Applicant companies are evaluated by an investment committee, and investments are made on the basis of the company's performance during the 6 month Accelerator programme and their attractiveness as an investment. The fund manager screens for potential syndicating private co-investors, who are typically business angels.

The model used for screening companies and selecting which companies are to be granted investment has so far proven to be not only very effective, but also very attractive among the target group. The effectiveness of the screening model has made the instrument attractive to business angels. The flexibility in the management company in being able to make ongoing selections on which instrument to use (loan or equity) for each case (as well as the possibility of making syndicated investments), has also proven to be very smooth and effective. On the other hand, the model used for screening companies and selecting which companies are to be granted investments is time-consuming and also demands significant economic resources, and in the long-term, thought needs to be given to ways of ensuring that the costs of the screening process and Accelerator programme do not erode the Fund.

(iii) Implications of ESIF 2014-20 and adaptation

The new regulations contain clear rules to enable better combination of financial instruments with other forms of support, in particular with grants. As the Commission's guide to FI for managing authorities states:

> "The CPR makes it clear that all types of combination will be possible: combination of different programme contributions and different funds in one financial instrument, combination of financial instruments and grants and other forms of assistance."[90]

The Commission's view is that combining funds from different sources in one FI can help achieve critical mass and economies of scale as well as cover a wider spectrum of policy objectives. For the combination of FIs with grants or other assistance from ESI Funds, there are two possibilities:

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

- certain types of grants (interest rate subsidy, guarantee fee subsidy or technical support as specified in the Delegated Act) and financial products can be combined within the same operation and can be treated as a financial instrument.
- the grant operation and financial instrument operation support can be combined to finance the same investment at the level of final recipient as separate operations.

The same expenditure cannot be declared twice to the Commission, and grants must not be used to reimburse support received from FIs, and FIs must not be used to pre-finance grants. Separate records must be maintained for each source of assistance.

Combining FIs with grants for specific Thematic Objectives

The ex ante assessment methodology guidelines find combining grants with FIs to be particularly relevant under Thematic Objectives 1 (RTDI) and 3 (SMEs). The uncertainty of RTDI project outcomes can prohibit generating a sound cash flow. Grants can be used, for example, to overcome the premium rates required by specialised suppliers to recompense the uncertain outcomes. Grants can also be useful to provide technical support for innovative start-ups and spin-offs e.g. to cover expenses to address property rights issues, to pay for preparation of a business plan or to provide capacity building and professionalisation of commercial research activities in academic spin-offs. Training and coaching can help raise awareness of existing financing opportunities, particularly for SMEs operating in sectors or regions where access to bank finance is relatively weak. The importance of coordination of the different forms of support (e.g. through a mapping exercise) is emphasised in the guidelines, to avoid issues of overlapping and duplication.

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, Strengthening research, technological development and innovation, (Thematic Objective 1), Volume II (Version 1.0, April 2014); European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, Enhancing the competitiveness of SME, including agriculture, microcredit and fisheries (Thematic Objective 3) Volume III, (Version 1.2, April 2014).

4. CONCLUSIONS

There is still considerable uncertainty among FIN-EN partners regarding their future plans for FI use in 2014-20. Many have not yet started the ex ante assessment process, and final decisions about the amount of funds to be allocated to financial instruments will depend on these and, in some cases, other political factors outside the control of managing authorities. Little interest has been noted so far in the Commission's off-the-shelf models, possibly as many managing authorities would prefer to build on the experience they have gained during the 2007-13 period. There is a strong desire for continuity where possible (and where this is justified by the ex ante assessment) in terms of instruments, and also in terms of management arrangements, using existing structures where these are already working well. Alongside this desire for stability and continuity, however, there are nevertheless plans to devote additional funding to FIs (including recycled funds from 2007-13), expand existing successful FIs, introduce new instruments (expanding into new thematic areas and using new ESI Funds), to introduce more effective monitoring and communication strategies and to draw on the experience of other FIN-EN partners where their practices in these areas are perceived to have been successful.

The new regulations introduce greater clarity and certainty on the use of FIs under Structural Funds programmes in 2014-20. Managing authorities, financial intermediaries and fund managers have built up considerable expertise over the last few years. However, challenges and areas of uncertainty remain. There are new provisions that must be adhered to in the regulations, particularly relating to monitoring and reporting, FIs must be adapted to the new State aid requirements, and there is increased pressure on all projects and instruments funded under ESI Funds to be able to demonstrate the impact they have achieved. FIN-EN partners have discussed many of these issues and shared possible solutions, such as how to ensure flexibility and the ability to adapt FIs to changing market conditions, how to combine different instruments to produce successful levels of outputs while still being able to address niche markets, combining instruments to ensure sustainability of the FI portfolio, effective means of monitoring, and how to communicate FI achievements to a wider audience.

Further challenges have been identified by partners - finding effective ways to incentivise fund managers while ensuring value for money, ensuring effective leverage and involving the private sector to a greater degree, and calculating the leverage effect. In this regard, the FIN-EN partners would welcome common provisions at EU level to calculate leverage effect, providing a common standard allowing reliable benchmarking and comparisons between regions. A further question, which may only be addressed towards the end of the 2014-20 period, is how the new off-the-shelf proposals will compare to the tailor-made instruments which have been in operation in 2007-13.

The continued need for support and Technical Assistance in the area of FI is clear. In recognition of this, the Commission has launched a new technical assistance platform (TAP) to provide common and fund-specific support related to FIs. Alongside this support, managing authorities may wish to allocate dedicated Technical Assistance to supporting FI design and implementation. As a capacity-building network, FIN-EN has been greatly valued by its partners since its inception in 2012, and discussions amongst peers has allowed learning, capacity building and exchange of ideas to take place. The TAP seems set to provide a useful mechanism for addressing many of the issues facing those implementing and managing FI. FIN-EN is a powerful and qualitative complement to this EU-wide initiative. Based on a comparatively small number of diverse partners who have come to know

one another well, FIN-EN provides the basis for more fine-grained analysis and learning and the transfer of best practice between partners and beyond.

Case study: benefits of participation in FIN-EN, Bulgarian Development Bank

Participation in FIN-EN study visits has provided valuable information and practical examples which have been useful in the preparation for the set-up of a new subsidiary of the Bulgarian Development Bank in 2014, engaged in equity financing. The experience gained during the FIN-EN meetings, including the one in England in early 2014, was subsequently transferred to the BDB’s working group on the creation of the Capital Investment Fund. The study visits allowed similar funds and structures to be viewed, and although the market for private equity is England is much more developed, the basic instruments and practices remain the same and this valuable experience will be used in the process of creation of the Capital Investment Fund in Bulgaria.

ANNEX I: FOCUS ON STATE AID

2014 heralds the start of a new era in both EU Cohesion policy planning and the State aid rules. Financial instruments are set to play a growing role in European Structural and Investment Funds (ESIF), though they proved to be one of the most challenging aspects of implementing policy in 2007-13, with State aid compliance a major factor.

The aim of this Annex is to set out the state of play in the relationship between financial instruments and State aid compliance. The annex is structured as follows: it begins by outlining the current context for change in State aid regulation; second, there is brief overview of 'State aid proof' instruments under ESIF, covering both EU-level and so-called 'off-the-shelf' instruments; third, the new State aid context for policymakers 'going it alone' on financial instruments is reviewed. As in 2007-13, this comprises three main options: to design 'no aid' instruments; to comply with the GBER; and to notify. Each of these options is considered in turn, focusing on the scope of the draft GBER and outlining the new possibilities provided for by the RFIG.

1. CONTEXT

In the 2007-13 Cohesion policy period, the relationship between financial instruments (FI) and the State aid rules was among the most troublesome aspects of implementing FI.[91] 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.

The 2014-20 European Structural and Investment Funds (ESIF) period sees a substantial reinforcement of the use of FI across a wider range of policy interventions. In parallel, 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),[92] adopted in 2012, which launched a review of almost all existing State aid rules. SAM seeks 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'. Added to the mix, the economic crisis and its aftermath continue to affect the availability of finance, especially for SMEs. Against the background of this changing policy and regulatory context, a number of developments will affect the interface between the operation of FI and State aid compliance.

[91] Michie, R and Wishlade, F (2011) *Between Scylla and Charybdis: Navigating Financial Engineering Instruments through Structural Funds and State Aid Requirements,* IQ-Net Paper No. 29(2), Aachen, Germany, 7-9 December: http://www.eprc.strath.ac.uk/iqnet/downloads/IQ-Net_Reports(Public)/ThematicPaper29(2)Final.pdf

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

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.[93] 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 General Block Exemption Regulation (GBER)[94] discussed below. The key principle here is that domestic authorities are exempt from notifying defined measures for prior Commission approval, but subject to a number of conditions.

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.

2. STATE AID 'PROOFING'? EU LEVEL INSTRUMENTS AND 'OFF-THE-SHELF' FINANCIAL 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.[95] 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.[96]

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.

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

[93] Article 19 and Annex XI of Regulation 1303/2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006, OJ L347/320 of 20 December 2013: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:347:0320:0469:EN:PDF, which are complemented by European Commission (2013) Draft guidance on *Ex ante* Conditionalities, Part II, 20 August 2013: http://ec.europa.eu/regional_policy/what/future/pdf/preparation/20092013_guidance_part_2.pdf

[94] 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

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

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

aid at all, or do not require State aid notification and subsequent clearance from the European Commission.

Under the most recent draft terms and conditions,[97] three measures are envisaged:

- **Risk-sharing loan:** loans with subsidised interest rates for SMEs. Falls within the *de minimis*[98] ceilings for beneficiaries; no aid for financial intermediaries provided certain conditions are met (including market rate remuneration, *pari passu* risk sharing).
- **Capped portfolio guarantee for SMEs:** credit-risk protection up to a maximum loss amount. Falls within the *de minimis* ceilings for beneficiaries; no aid for financial intermediaries, provided certain conditions are met (including minimum level of risk retained by intermediary and either the Guarantee Notice[99] is respected or any benefits are passed to the beneficiary).
- **Renovation loan:** loans for energy efficiency and renewables in the residential sector. Designed to be aid-free either on the basis of the *de minimis* Regulation, or the *de minimis* threshold for providers of Services of General Economic Interest (SGEI)[100] or as compatible aid in the form of public service compensation for SGEI in the context of social housing.[101]

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.

3. 'GOING IT ALONE' ON STATE AID COMPLIANCE

Managing Authorities also have the option of designing their own FI from scratch or using existing instruments independently of EU-level instruments or templates, as is the case under domestic policy. As now, there are three principal options regarding State aid compliance:

- to design measures so that no aid is involved;

[97] These are currently in draft form (dated 2014) and not yet publically available. Earlier draft versions also included a proposal for an equity investment fund for SMEs and a loan for sustainable urban development.

[98] Regulation 1407/2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid, OJ L352/1 of 24 December 2013: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:352:0001:0008:EN:PDF

[99] Commission notice on the application of Article 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJEU No C155/10 of 20 June 2008: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:155:0010:0022:en:PDF

[100] Regulation 360/2012 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid granted to undertakings providing services of general economic interest SGEI, OJ L114/8 of 26 April 2012: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:114:0008:0013:EN:PDF

[101] Commission Decision on the application of Article 106(2) of the Treaty on the Functioning of the European Union to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, OJ L7/3 of 11 January 2012: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:007:0003:0010:EN:PDF

- to design measures that fit within the parameters of the GBER so that measures can be implemented without prior Commission approval;
- to notify measures to the Commission and await approval prior to implementation.

Each of these has either been subject to change in recent months.

The 'no aid' route

An ongoing issue in State aid compliance is that the notion of State aid is not precisely defined in Article 107(1) TFEU and indeed continues to evolve. This can render the task of ensuring that a transaction does not involve aid rather complex. Nevertheless, Commission decisions and case law provide the main contours of what constitutes a State aid, and this has recently been complemented by a proposed Notice on the notion of State aid, which is currently the subject of public consultation.[102]

A major complication in assessing the State aid compliance of some FI is that aid may exist at one or more different levels – for example, in relation to the ultimate beneficiary (e.g. the firm in receipt of a loan), holding fund managers who are remunerated for investment management services and investors or lenders where loans are guaranteed or where the private and public contributions are asymmetric. In relation to *intermediaries*, aid can be excluded by ensuring that transactions take place on market terms – for instance, the public and private sector investing on a *pari passu* basis or the appointment of fund managers following an open and transparent tender procedure. In relation to ultimate *beneficiaries*, the main options under the 'no aid' route are also to ensure that transactions take place on market terms and there is accordingly no 'advantage' beyond that which the market would deliver (so that there is no aid) - or to ensure the intervention remains below *de minimis* levels (so that support falls outside the scope of Article 107(1)).

The *de minimis* Regulation adopted in December 2013[103] does not significantly change the scope of the existing provision – the general ceiling of €200,000 over three years, to a single undertaking remains in place. This is in effect a grant-equivalent amount, which also applies to public support in the form of equity. Also as now, guarantees are considered *de minimis* if they do not exceed 80 percent of loans of up to €1.5 million*.* A new provision is that loans are considered *de minimis* (even if their gross grant equivalent calculated on the basis of the reference interest rates exceeds the €200,000 threshold) if they are at least 50 percent secured by collateral and the loan is no more than €1m over five years or €500,000 over ten years.

Guarantees

The Commission has set out various criteria[104] which enable both individual guarantees and guarantee schemes *not* to involve State aid; in both cases a slightly simplified approach applies to SMEs. In the case of guarantee *schemes*, the key criteria are that:

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[102] See: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html. The consultation closed on 14 March 2014.

[103] Regulation 1407/2013, OJ L352/1 of 24 December 2013: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:352:0001:0008:EN:PDF

[104] Notice on State aid in the form of guarantees, OJEU C155/10 of 20 June 2008: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:155:0010:0022:EN:PDF, as corrected: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:244:0032:0032:EN:PDF

- borrowers should not be in difficulty;
- the guarantee should be linked to a specific transaction, for a maximum amount and limited in time; it should generally not cover more than 80 percent of the loan;
- premia should be such as to make the scheme self-financing, including normal risk, administrative costs and yearly remuneration of an adequate capital; premia should be reviewed annually;
- the eligibility criteria and terms for guarantees should be transparent for applicants;
- for SMEs, there is scope for either 'safe-harbour' premia or the use of a single yearly guarantee premium for all SMEs for amounts up to €2.5m.

Loans

Loans which are offered at market rates and terms do not involve State aid; whether market rates are offered is determined by the so-called 'reference rate'. The reference rate is based on the one-year inter-bank offered rate (IBOR) increased by margins ranging from 60 to 1000 basis points (i.e. 0.6 percentage points to 10 percentage points), depending on the creditworthiness of the company and the level of collateral offered. This approach is in line with the revised international capital framework introduced under the Basel II Accords. The base rates are published online[105] and the margins to be added are set out in a Commission communication.[106]

Risk capital

The situation for risk capital is more complex since, as confirmed in the Risk Finance Investment Guidelines (RFIG) adopted on 15 January 2014,[107] aid may be present at one or more levels – notably: investors, investment fund/vehicle and/or its managers, as well as in the firm in which the investment is made.

At the level of the *investor*, there is no State aid if the investment is effected on a *pari passu* basis between public and private investors. This means that both categories of investor must intervene simultaneously, on the same terms and conditions and the private investment must be 'significant'.[108] In this context, 30 percent independent private investment is considered 'significant' under the new RFIG; this is more flexible than the previous SARC Guidelines (which RFIG replaced from 1 July 2014), where 'normally' at least 50 percent of the funding has to come from private investors in order to fulfil the *pari passu* criterion.[109]

[105] See: http://ec.europa.eu/competition/state_aid/legislation/reference_rates.html
[106] Communication on the method for setting the reference and discount rates, OJEU C14/6 of 19 January 2008.: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:014:0006:0009:EN:PDF
[107] Guidelines on State aid to promote risk finance investments (RFIG), OJEU C19/4 of 21 January 2014: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2014:019:0004:0034:EN:PDF
[108] Para 34, RFIG.
[109] Para 3.2, Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (SARC), OJ C194/2 of 18 August 2006: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:194:0002:0021:EN:PDF

The Commission normally considers that an *investment fund* or vehicle is an intermediary vehicle for the transfers of funds to a firm, rather than a beneficiary of aid itself, unless the fund is managed by an entrusted entity which is co-investing, in which case aid may be present. As far as *fund managers* are concerned, there is a presumption of no aid if the management company is chosen through an open and transparent public tender procedure and if it does not receive any other advantages. Where the financial intermediary and its manager are public entities and there is no such tendering process, they will not be considered recipients of aid if the management fee is capped and the remuneration reflects market conditions and is linked to performance.[110]

Regarding *target firms,* if intervention is made on terms that would be acceptable to a private investor in a market economy, then no State aid is involved. Alternatively, if the measure provides public capital only up to the *de minimis* threshold (€200,000), then this falls outside the scope of Article 107(1).

Summary of main 'no aid' criteria for financial instruments

De minimis	▪ transparent support ▪ <€200,000 cash grant equivalent over 3 years ▪ 80% guarantees relating to loans <€1.5 million ▪ loans (at least 50% collateral secured) <€1m over 5 years or < €500,000 over 10 years
Guarantees	▪ maximum 80% of loan ▪ premia cover normal risks, costs and adequate capital ▪ premia within safe harbour limit *or* single SME premium rate for guaranteed amounts up to €2.5m
Loans	▪ interest at or over reference rates
Equity / risk capital	▪ *investors:* public sector invests on *pari passu* basis ▪ *funds/fund managers:* no specific transfers or benefits; manager selected by open tender ▪ *target firm:* investment on 'market economy investor principle' or public capital <€200,000

Note: There may also be scope for 'no aid' financial instruments under the provisions on State aid and services of general economic interest (SGEI), on the basis of the SGEI *de minimis* regulation (see: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:114:0008:0013:EN:PDF)

GBER compliant aid

Under the GBER, provided that a given measure meets the conditions set out in the Regulation, there is a *presumption* that the measure is compatible with the Treaty. The main purpose of the block exemption approach is to obviate the need for prior notification and approval of so-called 'good' aid – in recent years the Commission has facilitated the use of certain types of aid which it considers beneficial and in line with wider agendas such as Lisbon, Gothenburg or Europe 2020 (e.g. support for SMEs or R&D), while subjecting other forms of support (e.g. rescue and restructuring or investment aid to large firms – 'bad' aid) to increased scrutiny.

The reform of the GBER for 2014-20 was the subject of successive rounds of consultation. GBER 2014-20 widens the range of measures exempt from notification, but imposes new or additional conditions relating to evaluation, incentive effect, reporting and transparency, among other things.

In the context of financial instruments, there is both stability and change. On the one hand, for loans and guarantees to support investment projects, State aid compatibility issues remain broadly as now.

[110] Para 37-42, RFIG.

On the other hand, there are significant changes in respect of so-called 'risk finance' measures which both relax and extend the block exemption in relation to FI, as well as introducing new provisions on aid for start-ups, alternative trading platforms specialised in SMEs and aid for scouting costs.

For ***investment-related aid***, the grant-equivalent ceilings for guarantees and loans vary by firm size, type of expenditure (general investment, RD&I etc.) and in some cases according to whether the beneficiary is located in an assisted area. For SMEs, the absolute grant equivalent ceiling for investment aid under the GBER remains unchanged at €7.5 million per investment per project.[111] For projects located in assisted areas, higher rates of award apply than in the non-assisted areas, but the aid ceilings are, in general, lower from 1 July 2014 than in 2007-13; however, the precise scope of the assisted areas depends on the new maps being approved by the Commission on the basis of the 2014-20 Regional Aid Guidelines.[112]

As before, ***loans*** related to investment can be rendered GBER compliant by ensuring that the interest rates payable respect the grant-equivalent thresholds, taking account of the relevant reference rate, as described earlier. Similarly, schemes which comprise a ***guarantee*** element may be considered transparent if the Commission has accepted the methodology used to calculate the intensity of the guarantee. A number of countries have notified methodologies for calculating the grant-equivalent of measures.[113] These methodologies have been endorsed by the Commission, which effectively renders aid calculated according to these methods transparent.[114] This enables the Member State concerned to report schemes under the GBER that use the methodology to calculate aid values and increases the scope of the GBER to include measures that would otherwise lack the transparency for exemption.

Draft GBER proposals on access to finance for SMEs

The main FI-related changes proposed under GBER 2014-20 relate to what is now termed 'risk finance aid', a broader concept than that of risk capital measures provided for in the current GBER. In addition, there are specific provisions for aid for start-ups, for alternative trading platforms specialised in SMEs and for scouting costs.

GBER 2008-13 exempted risk capital measures in the form of participation in a private equity investment fund which, among other things, met the following criteria:[115]

- the tranches of investment made by the fund in any target SME should not exceed €1.5 million in any 12-month period;

[111] Article 4, GBER 2014-20.
[112] Guidelines on regional State aid for 2014-20 OJ C209/1 of 23 July 2013: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:209:0001:0045:EN:PDF
[113] For example, Commission Decision N 677b/2007 – *France: Méthode de calcul de l'équivalent subvention brut (ESB) pour les aides sous forme de garantie publique de prêts bancaires pour le financement d'investissements des entreprises*, 29 April 2009; Commission Decision N 197/2007 – *Germany: Method to calculate the aid element in guarantees*, 25 September 2007; Commission Decision N 185/2008 – *Austria: Methodology of AWS GmbH to calculate the aid element of guarantees*, 24 March 2009; Commission Decision no. SA.33022 (2011/N) – *Denmark: Calculation methodology for the State aid element in guarantees*, 4 August 2011; Commission Decision N 201/a/2007 – *Hungary: Method to calculate the aid element in guarantees (to be applied by Hitelgarancia Zrt.),* 12 November 2008; Commission Decision N 182/10 – *Italy: National method to calculate the aid element in guarantees for SMEs*, undated decision.
[114] Article 5, GBER 2014-20.
[115] Article 29, GBER 2008-13.

- at least 70 percent of the fund should be invested in SMEs in the form of equity or quasi-equity;
- for SMEs in assisted areas ('a' regions and 'c' areas) and small firms in any region, risk capital is available for seed capital, start-up and/or expansion capital; for medium-firms in non-assisted areas expansion capital is excluded from the scope of the GBER;
- at least 50 percent of the financing of the fund is provided by private investors - except where the fund exclusively targets SMEs in assisted areas, in which case the threshold is 30 percent.

Risk finance aid

GBER 2014-20 significantly increases in the scope of risk finance aid measures falling with the scope of the exemption and refers to FI more generally, rather than just in terms of risk capital. Moreover, the text refers explicitly to "risk finance aid to independent private investors",[116] which can include public and private intermediaries. Aid can take the form of equity, quasi-equity, financial endowments, or loans to finance investments directly or indirectly in eligible firms or guarantees to cover the losses from such investments. In addition, for natural persons (i.e. *not* undertakings) aid may also take the form of tax incentives. By contrast, GBER 2008-13 refers simply to 'participation into a profit driven private equity investment fund.'

GBER 2014-20 covers a larger part of the life cycle of new firms and a wider range of firms, irrespective of their location, higher levels of risk finance and include the potential for follow-on investment. More specifically, GBER 2014-20 provides for the following:

- the €1.5 million annual tranche approach is replaced by a ceiling of €15 million per eligible firm under any risk finance measure;[117]
- the minimum equity requirement of 70 percent is removed, facilitating the use of a wider range of instruments, including equity, quasi-equity, loans, guarantees or a mix thereof;
- there is no discrimination between assisted and non-assisted areas, nor in relation to firm size in relation to the stage for which risk finance is available; there is scope for follow-on investment;[118]
- the minimum private capital participation rate of 50 percent in non-assisted areas and 30 percent in assisted areas is abolished in favour of linking the minimum private participation to the risk level of the investment.[119] The levels proposed are:
  - 10 percent of the risk finance provided to firms prior to their first commercial sale on any market;
  - 40 percent in relation to firms operating on the market for less than seven years following their first commercial sale; and
  - 60 percent in the case of follow-on investment.

GBER 2014-20, like its predecessor, requires measures to be profit-driven,[120] but it also emphasises that financial intermediaries should undertake investments that would not have been carried out at all

[116] Article 21(2), GBER 2014-20.
[117] Article 21(9), GBER 2014-20.
[118] Article 21(6), GBER 2014-20.
[119] Article 21(10), GBER. 2014-20.

or in the same way without the aid,[121] and should be able to demonstrate that they operate mechanisms to ensure that all the advantages are passed on to the greatest extent to the final beneficiaries through higher volumes of financing, riskier portfolios, or lower collateral, guarantee premia or interest rates.

Aid for start-ups

GBER 2014-20 introduces new provisions on aid to start-ups[122] (up to five years from registration) in the form of soft loans, guarantees that do not conform to market conditions. The proposed amounts are:

- loans of up to €1 million (€1.5 million in 'c' areas and €2 million in 'a' regions) of up to 10 years duration;
- guarantees covering up to 80 percent of loan amounts of up to €1.5 million (€2.25 million in 'c' areas and €3 million in 'a' regions);
- other sources of support – including equity, quasi-equity, interest rate and guarantee premium reductions of up to €0.4 million gross grant equivalent (€0.6 million in 'c' areas and €0.8 million in 'a' regions);
- doubled maxima for small *and* innovative enterprises.

This provision effectively replaces and consolidates the previous exemptions for aid to newly-created enterprises in the assisted areas,[123] those established by female entrepreneurs,[124] and young innovative entreprises.[125] although in all of these cases aid could take the form of grants rather than involving only repayable instruments, as provided for under GBER 2014-20.

Aid to alternative trading platforms

GBER 2014-20 also exempts measures aimed at the development of alternative trading platforms specialised in SMEs.[126] Where the proposed operator is a small enterprise, it may be eligible for the measures for start-ups just described. Eligible costs are not specified, which implies that these would be determined primarily with reference to block-exempted SME or regional investment aid schemes.

Aid for scouting costs

Aid to cover up to 50 percent of so-called 'scouting' costs is also proposed.[127] This can take the form of a grant and would contribute towards initial screening and formal due diligence undertaken by managers of financial intermediaries or investors to identify eligible undertakings for the purposes of risk finance investment.

[120] Article 29(2), GBER 2008-13 and Article 21(14) GBER 2014-20.
[121] Article 21(16), GBER 2014-20.
[122] Article 22, GBER 2014-20.
[123] Article 14, GBER 2008-13.
[124] Article 16, GBER 2008-13.
[125] Article 35, GBER 2008-13.
[126] Article 23, GBER.2014-20.
[127] Article 24, GBER 2014-20.

Summary of main 'Draft GBER compliant' criteria for financial instruments

Guarantees	• Approved valuation methodology • Gross grant equivalent does not exceed SME aid, regional aid, R&D aid ceilings as appropriate
Loans	• Interest rate reduction does not exceed gross grant-equivalent ceilings for SME aid, regional aid, R&D aid ceilings as appropriate
Risk finance aid	• Target firms: up to €15m (in equity, quasi equity, loans, guarantees…) per eligible SME; covers period from first commercial sale to follow-on investment • Private investment: 10%-60% of risk finance, depending on development stage of target firm • Fund/fund managers: selected by open call or assigned to an entrusted entity commercially-managed, profit-driven, but additionality and aid benefits demonstrably transferred to target firms.
Aid for start-ups (<5 yrs from registration)	• Loans up to €1-2m (depending on area) and 10 years duration • Guarantees up to 80% of loans of €1-3m (depending on area) • Equity, quasi-equity, interest rate reduction etc. up to €0.4-8m (depending on area) • For small *and* innovative firms, these maxima are doubled
Aid for alternative trading platforms	• Terms not specified – assumes promoters are SMEs?
Aid for scouting costs	• Grants of up to 50% of due diligence and initial screening costs

Notifying financial instruments

The third option open to domestic policymakers is to notify the measures proposed and gain approval in advance of implementation. This may be necessary where it is uncertain whether a measure involves aid or when the GBER is not considered to offer sufficient scope to support a project in the way envisaged or at the level of intervention desired. The key benefit of notification is legal certainty; the main disadvantage tends to be the time taken for a decision.

Where a measure may constitute aid and does not fit within the GBER parameters, Member States are duty bound to gain authorisation from the Commission before the measure is implemented. A notified measure may fall to be assessed under one or more of a number of sets of guidelines or, it may be assessed directly against the Treaty provisions. In practice, most financial instruments notified to date have been assessed in relation to the SARC Guidelines, since replaced by the RFIG.

The Risk Finance Investment Guidelines (RFIG)

A major development is the adoption of the Risk Finance Investment Guidelines in January 2014 and applicable from 1 July 2014. Overall, the RFIG expand significantly on the scope for risk finance measures provided for in the SARC Guidelines. The RFIG need to be read alongside the GBER since they provide a framework for assessing measures that fall beyond the Exemption Regulation. These fall into three main categories:

- Risk finance measures which target undertakings that do not fulfil all the eligibility requirements in the GBER, including:[128]

[128] Para 47, RFIG.

- small mid-caps that exceed SME definition; broadly, small mid-caps are firms with fewer than 499 employees, and either annual turnover below €100 million or an annual balance sheet below €86 million;
- innovative mid-caps carrying out R&D and innovation activities; these are essentially firms with up to 1,500 employees whose R&D and innovation costs are at least 15 percent of operating costs in one of the three years preceding investment under the risk finance measure, or more than ten percent of operating costs in each of the three years preceding the investment;
- undertakings receiving initial risk finance investment more than seven years after their first commercial sale;
- undertakings requiring overall risk finance investment exceeding the cap set in the GBER (€15 million);
- alternative trading platforms not fulfilling the conditions in the GBER.

- Risk finance measures where the design parameters differ from those in the GBER, including:
  - private participation rates lower than provided for in the GBER;[129]
  - financial instruments other than guarantees where investors, fund managers or intermediaries are selected by giving preference to protection against potential losses;
  - fiscal incentives to corporate investors.

- Schemes which fall outside the GBER owing to their large budget.[130] The GBER provides that schemes which involve annual State expenditure exceeding €150 million should be subject an assessment plans before the Commission decides if the GBER can be extended to them beyond an initial six month period.[131] Presumably, if the Commission had doubts, a given measure would fall to be assessed under the RFIG.

Schemes that fall outside the ambit of the GBER are assessed on the basis of criteria set out in the RFIG[132] which are framed in terms of the 'common principles' for the compatibility of State aid with the called for under SAM.[133] The approach in the RFIG is consistent with the 'balancing test' in other areas of State aid.[134] In considering a notified measure, the Commission essentially seeks to analyse whether the positive impact of the measure in addressing an objective of common interest outweighs its potential negative effects on trade and competition. In doing so, the Commission will consider a range of criteria. The application of these criteria will depend heavily on the provision of *ex ante* assessments by the Member States. All of the following criteria must be met for the measure to be considered compatible under the balancing test.

a) **Contribution to a well-defined objective of common interest:[135]** for risk finance aid, the general policy objective is to improve the provision of finance to viable SMEs, from early-stage

[129] Para 48, RFIG.
[130] Para 49, RFIG.
[131] Article 1(2)(a), GBER 2014-20.
[132] Section 3, RFIG.
[133] European Commission (2012) EU State aid modernisation – SAM, COM(2012) 209 final, 8 May.
[134] See, for instance, Section 3, RAG 2014-20.
[135] Para 57-62, RFIG.

development through to growth, and in certain circumstances, small mid-caps and innovative mid-caps. Notified measures must define the specific policy objectives in view these general objectives, based on the *ex ante* assessment, which must also identify the relevant performance indicators (e.g. private sector investment, expected number of beneficiaries, jobs created, anticipated yields, etc.). The investment strategy of the financial intermediary must be in line with the policy objectives and there must be appropriate monitoring and reporting mechanisms in place.

b) Need for state intervention:[136] the proposed measure must be designed on the basis of an *ex ante* assessment demonstrating the existence of a funding gap. The nature of this assessment will vary according to the type of measure – for instance, the extension of measures to include mid-caps or funding for alternative trading platforms that go beyond the scope of the GBER. Where the measure is co-financed from the ESIF, the *ex ante* assessment required under the CPR[137] will be considered to meet the requirements of the RIFG, though the Commission reserves the right to question the validity of the data.

c) Appropriateness:[138] the proposed measure must be appropriate while being the least distortive to competition. This will include a consideration of whether the policy objectives can be met by other means – e.g. regulatory measures to improve the functioning of financial markets, investment-readiness schemes or public investment on market terms. The *ex ante* assessment must analyse existing and, where possible, envisaged national and EU measures targeting the same market failure, take into account the efficiency and effectiveness of other policy tools and must, among things, justify the specific form of FI proposed.

d) Incentive effect:[139] aid is only compatible if it alters the behaviour of the beneficiary. At the level of the final beneficiary, an incentive effect is present when the firms can raise finance that would otherwise not be available in the same form, amount or timescale. A risk finance measure is considered to have an incentive effect if it mobilises investment from market sources so that the total financing provided to eligible undertakings exceeds the budget of the measure. The assessment of the incentive effect is closely linked to the need for aid discussed above.

e) Proportionality:[140] In general, at the level of final beneficiaries, risk finance aid is considered proportionate if the total amount of syndicated funding (public and private) is limited to the size of the funding gap identified in the *ex ante* assessment. At the level of investors, aid must be limited to the minimum necessary to attract private capital in order to achieve the minimum leverage effect and bridge the funding gap. For financial instruments (as opposed to fiscal instruments of alternative trading platforms), the nature and value of the incentives to financial intermediaries must be determined through an open selection process among competing bids. Under the RFIG, if asymmetric risk-adjusted returns or loss-sharing is established in this way, then this is considered to reflect a fair rate of return (FRR) and the FI is considered proportionate. Where

[136] Para 63-88, RFIG.
[137] Article 37(2), CPR.
[138] Para 89-129, RFIG.
[139] Para 130-132, RFIG.
[140] Para 133-154, RFIG.

private investors are not selected through such a process, the FRR must be established by an independent expert.

f) **Avoidance of undue negative effects on competition and trade:**[141] the negative effects on trade and competition must be limited and outweighed by the contribution to the objective of common interest. For risk finance, this will be considered at three levels: the investors, the financial intermediaries and their managers and the final beneficiaries. Commission assessment will focus on a range of factors, including: issues of crowding-out in the risk finance market; the potential impact of aid measures on the market power of intermediaries; the viability of potential target investments (to avoid the situation in which risk finance amounts to a grant); the commercial management and profit orientation of investment decision-making; fund size, especially those with a limited regional focus, which are considered to have insufficient scope and to be less attractive to private investors; and the product market of the final beneficiaries, notably where the proposed measure has a sectoral orientation.

g) **Transparency:**[142] Member States must publish on a single website the text of notified measures, total Member State participation in the scheme, the identity of the entrusted entity and/or the names of selected financial intermediaries and specified information on beneficiaries.

A further innovation introduced in the new generation of State aid frameworks and present in the RFIG is the emphasis on evaluation. RFIG provides the possibility for the Commission to limit the duration of aid schemes and for an evaluation to be carried out.[143] The precise terms of any evaluation requirement would be defined in the approval decision on the aid measure. However, evaluations must be undertaken by experts independent from granting authorities and must be made public. The types of measure likely to be subject to evaluation include: large schemes; schemes with a regional or a narrow sectoral focus and schemes with novel characteristics.

[141] Para 155-165, RFIG.
[142] Para 166, RFIG.
[143] Para 170-172, RFIG

ANNEX II: FOCUS ON THE TECHNICAL ASSISTANCE PLATFORM FOR FINANCIAL INSTRUMENTS

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.[144]

Recognising this demand, a new technical assistance platform (TAP) was developed for the 2014-20 period. The TAP 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 of the TAP. 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.

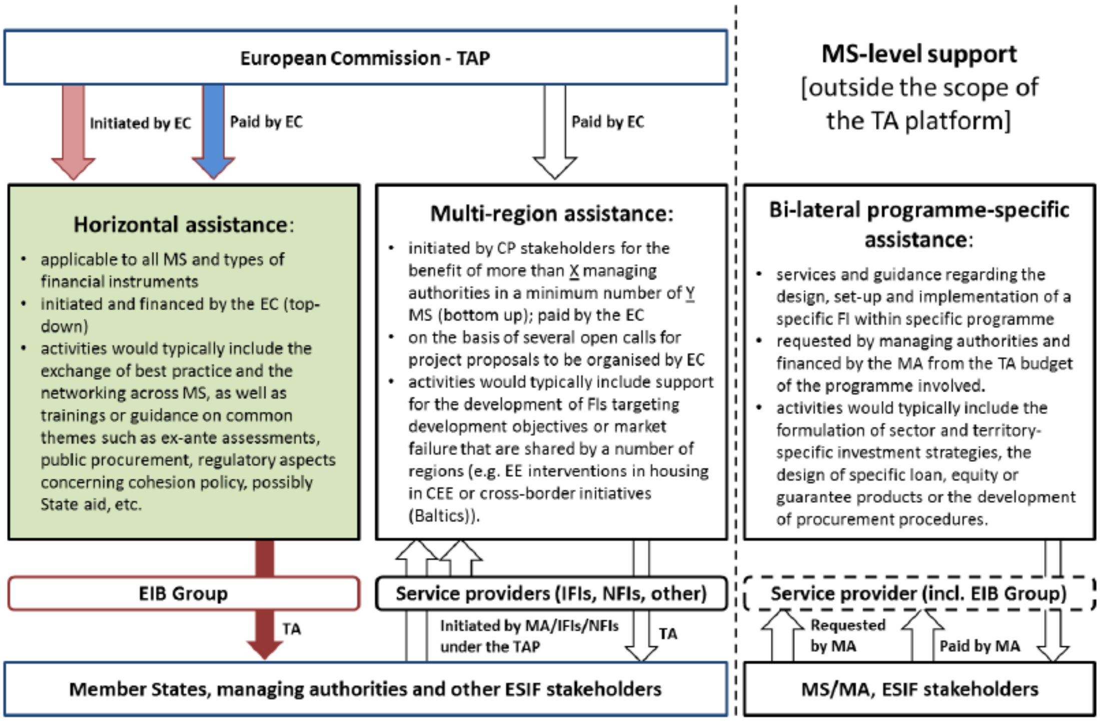
The second strand covers **multi-region assistance responding to stakeholder proposals.** This must benefit at least two managing authorities in at least two Member States. Such activities would typically include support for the development of FI targeting development objectives or market failures that are shared by a number of regions, such as energy 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 MSs and MAs intending to set up and implement FIs in their territory. However, this is strictly speaking outside the scope of the FI-TAP, and 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 1 summarises the areas of activity covered by the TAP and by Bilateral Assistance.

[144] http://ec.europa.eu/regional_policy/thefunds/instruments/doc/fls_stocktaking_final.pdf; http://ec.europa.eu/regional_policy/thefunds/instruments/doc/20130621_ta_survey_en.pdf

Figure 1: 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

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