

HIGH LEVEL GROUP REFLECTING ON FUTURE COHESION POLICY

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FINANCIAL INSTRUMENTS FOR ERDF AND COHESION FUND ¹

This document has been prepared by DG Regional Policy as the basis for a discussion with experts as part of a general reflection process on the future of cohesion policy. It does not prejudice in any way the final position of DG Regional Policy or the Commission on these questions.

1. INTRODUCTION

Non-grant financial instruments can bring significant added value, both in quantitative and qualitative terms, compared to investments financed by grants.

Besides the obvious advantages of recycling funds over the long-term and their capacity to attract additional funding from the financial sector and private investors, financial instruments attract additional sources of expertise and know-how, increasing therefore the efficiency and effectiveness of public resources.

Moreover, repayable financial support to investments provide enhanced incentives to better performance on the part of beneficiaries, including greater financial discipline at the level of supported projects.

This discussion document provides contextual information regarding the current use of financial instruments in Regional policy and sets out a number of considerations and questions for the possible future development of these instruments; namely:

- rationale and scope for financial instruments,
- minimum requirements and rules to be observed,
- incentives to support maximal use, blending and leverage,
- financial management and control issues,
- institutional questions.

2. IMPLEMENTATION OF FINANCIAL INSTRUMENTS

Since the mid-1990s national and regional programmes have allocated significant amounts of funding to risk capital, primarily for the benefit of SMEs. This trend was continued and expanded in the 2007-2013 programming period during which the efforts in this field intensified and expanded into new sectors, namely urban development and energy efficiency and renewable energy in buildings.

¹ For the purpose of this note, "financial instruments" shall mean repayable financial support schemes wholly or partially financed through Structural Funds programmes, to address Cohesion policy objectives, by way of loans, guarantees, equity or quasi-equity investments or participations.

These efforts have been supported with an extended body of regulatory and guidance provisions, stronger incentives to Member States and regions to use repayable forms of assistance, as opposed to a sole reliance on grants, and closer coordination and cooperation mechanisms with the EIB Group.

In the context of Cohesion policy, financial instruments offer a more sustainable alternative to the assistance that has traditionally been provided through grants. This being said, the two forms of assistance can be complementary, including through the combination of grants with repayable finance, allowing therefore for the design of tailored assistance schemes to meet the needs of Cohesion policy operations.

Currently, in almost all Member States operations have been set up in line with the specific provisions of the SF regulations applicable to financial instruments, even though some of them are not formally defined as such.

Recent discussions with representatives from Member States, regions and other stakeholders² show that there remains support for the continuation and possible expansion of the use of financial instruments in the current and future programming periods.

Q1: Should financial instruments be sustained and further strengthened vis-à-vis grant assistance?

3. SCOPE OF FINANCIAL INSTRUMENTS

Current scope of investments

In the current programming period financial instruments are used primarily to deliver repayable financial support for (1) SMEs, (2) integrated urban development and, following the recent modification of the regulations, (3) energy efficiency and renewable energy in buildings. These are typical sectors where the investments concerned can be expected to yield a revenue stream and financial returns to accommodate repayable support.

Typical areas of support include: creation of new business or strengthening of existing ones; access to investment and related working capital to implement business plans aiming to develop and expand business activity by enterprises, (particularly SMEs); business oriented research and development, technology transfer, innovation and entrepreneurship; technological modernisation of productive structures; urban regeneration and brown field development; improvement of energy efficiency, renewable energy and low carbon economy objectives.

Financial instruments have also been used in some regions, to support investment in environmental infrastructure including waste recycling. Moreover, in the current and previous programming periods some Member States have set up various atypical forms of repayable financial assistance, to implement various types of Cohesion policy operations going beyond those described by the current regulatory provisions on "financial engineering instruments".

² e.g. hearing of regional experts on financial engineering, JEREMIE and JESSICA networking platforms meetings.

Current types of financial instruments (and related financial products)

The typical forms of financial instruments through which investment has been supported or secured are as follows:

- loan funds providing SME loans, specialised in R&D and innovation, micro-credit for start-ups and micro-enterprises;
- risk capital funds, including seed capital and development capital, R&D innovation, co-investment funds, networks of business angels, etc;
- guarantee funds, including guarantees and counter-guarantees for any of the loan activities described above;
- urban development funds providing loans, equity and/or guarantees, to stimulate urban regeneration, integrated local development plans, rehabilitation of industrial sites etc.

Moreover, in the current programming period pure interest rate subsidies have been considered as not falling within the scope of financial instruments. Indeed, interest rate subsidies on their own are similar to grants, since they are not repaid as such, nor do they support risk-sharing. However, when combined with loan capital in a single package, interest rate subsidies have the potential of providing significant leverage and could thus be considered to form part of financial instruments.

Extending the thematic scope of investments and range of products

As indicated above, in the current and earlier programming periods, some Member States have used non-grant forms of support to implement Cohesion policy operations without formally including them under the existing regulatory provisions on "financial engineering instruments" typified by the SF regulations. Some Member States and regions have also accumulated experience in financing small environment infrastructure through financing instruments.

In order to increase clarity concerning the modalities for the use of non grant forms of support in the next programming period, more detailed provisions for such instruments could be laid down in the regulatory framework, e.g. as part of the rules governing financial instruments and related financing products.

Extending the scope of financial instruments in national and regional programmes- beyond current SME support, urban development and energy efficiency/renewable energy in building - to encompass new activities (e.g. research and development, small infrastructure investment by private and public authorities, etc.) could offer potentially significant benefits, contributing to more efficient investments and an overall higher effectiveness of the policy.

On the other hand, there is also a certain consensus that Cohesion policy support to private sector, particularly SME development should be done largely, even exclusively through financial instruments in the form of guarantees, loans, mezzanine finance, equity and other equivalent forms of investment.

Moreover, the satisfactory implementation of certain Cohesion policy operations may require a tailored assistance package, providing a well-structured combination of grants and repayable assistance from financial instruments.

Q2: Should the use of financial instruments be extended to the full range of eligible cohesion Policy interventions as part of the delivery options available to Managing Authorities?

Q3: Should Financial Instruments become the only option for supporting certain types of interventions (e.g. enterprise access to finance)?

Regulatory provisions

In the current programming period specific rules were set up for financial instruments under Article 44 of the General Regulation and Articles 43 to 46 of the Implementing Regulation. However, these rules have been specifically designed to cover investments in enterprises, primarily SMEs, urban development and regeneration, energy efficiency and renewable energy in buildings, organised through specific funds.

The regulations do not exclude the possibility to use other forms of financing instruments beyond those explicitly described in the current Articles, in which case the general rules applicable to grant assistance should apply. However, the general rules applicable to grants may not be well suited to non-grant forms of assistance.

On the other hand, the current specific rules applicable to financial instruments set out certain conditions which may render support provided under such instruments more restrictive than support provided through grants. Even though certain standards of good practices should be followed in all instances where financial instruments are used, it may be more appropriate that a single set of eligibility rules should apply, regardless of the nature of the financial support provided (grant or non-grant support).

Regarding however the basic requirements to be met for the setting, implementation, monitoring and audit of financial instruments, the nature of non-grant financial instruments is such that specific rules would need to be set for these instruments, in order to ensure sound and efficient management of the resources involved.

For the next programming period the Commission proposes therefore to give greater clarity and differentiation between rules governing grant-based assistance and rules governing repayable forms of assistance delivered through financial instruments and to set up a separate set of **implementation** rules. In terms of **eligibility** one set of rules should apply to both non-repayable grants and financial instruments.

Q4: Should one set of eligibility rules be applied to both for grants and financial instruments?

Q5: Should the regulatory framework for financial instruments contain a specific set of rules regarding setting up, implementation, monitoring and audit, which differentiates them from grants?

4. INCENTIVES PROVIDED BY FINANCIAL INSTRUMENTS

This section starts by referring to two technical issues which have been highlighted as posing obstacles in the current Structural Funds framework, and sets out potential solutions for consideration in the future framework. In general, removing this type of implementation obstacles may lead to increased performance of financial instruments or, going further, *existing or new incentives could encourage their increased use*. One should also give strong consideration on how to maximize the capacity of financial instruments to attract IFI financing (blending) or other forms of private sector funding (leverage)?

Removing obstacles and improving performance

Regarding venture capital it is acknowledged that disbursements can suffer from lack of demand from the enterprise sector (perhaps due to saturation), and are highly sensitive to expansion and contraction of financial markets and economic cycles. Regarding shortfalls in disbursements for venture capital operations, in the current programming period, flexibility has often been granted whereby transfers to other financial engineering operations (such as loans, or guarantees) have been accepted to the extent they fall under the same priority axis of the operational programme. The future implementing rules could explicitly allow for this.

Where EU support is granted to guarantee schemes, the amount of expenditure considered eligible at closure for EU support should flow from an obligation to provide an ex-ante risk assessment, aimed at assessing the resources that are genuinely at risk, which would be substantially less than 100 % of the overall loan portfolio being guaranteed. As such Managing Authorities benefit from a maximal leverage of public sector resources with private sector funds.

Incentivising increased use of financial instruments

As indicated earlier financial instruments help create revolving forms of finance derived from public resources, making them more sustainable over the longer term, contributing to increase resources for investment, especially in times of recession. Their implementation should therefore be incentivised to the maximum extent possible.

In addition to the advantages described in the previous section, use of financial instruments could bring following additional benefits:

- the revolving nature of financial instruments could potentially provide significant resources deriving from the initial Structural Funds investments to support longer term funding of specific policy areas (enterprise development, urban regeneration, energy efficiency/renewable energy, etc);
- the higher flexibility offered by financial instruments as the potential to accelerate absorption of Cohesion policy funding while ensuring better value for money for scarce public resources;
- use of financial instruments could be accompanied by increased implementation support to national and regional bodies aiming at strengthening their administrative capacity in dealing with new products.

Incentivising blending and leverage

Financial instruments should also engage other sources of finance outside Structural Funds, including the participation of the private sector, and thus should seek to maximise the leverage effect. Bringing in the expertise of international financial institutions (IFIs) should improve the quality of projects and bring new management capacity from experienced financial institutions into EU Cohesion policy.

Q6: What kind of existing or new incentives could encourage a wider use of financial instruments in the future, both for public and private sector partners?

Q7: What steps should be taken to attract additional private sector funding? What kind of role should be foreseen for international financial institutions (IFIs) and other relevant national and regional bodies?

5. FINANCIAL MANAGEMENT AND CONTROL ISSUES

Audit requirements need to strike the right balance between simplification and operational effectiveness. A particular issue that has arisen concerns the requirements regarding the retention of documents. This has been the case where auditors in practice have elected to cross-check the validity of information held at the level of the financial intermediaries with the end recipients, including very small business with limited administrative resources and capacity.

Specific audit rules in the implementing rules for financial instruments could be devised in order to clarify, for example:

- the various levels of audits according to the layer in implementing the financial instrument chain (holding fund/financial intermediary/final recipient). The audit trail should stop at the point when resources are effectively transferred to final recipients;
- the concept of "beneficiary" of the assistance (currently the financial instrument itself).

Moreover, financial instruments appear to be a natural candidate for "performance audits", whereby, on top of the issue of eligibility and regularity of expenditure, it is important to verify and assess the performance of the instrument against the objectives set.

Q8: Should specific audit rules be developed for financial instruments, including the strengthening of performance audits?

6. INSTITUTIONAL ISSUES

Implementation experiences from the current period have shown that the effectiveness and efficiency of financial instruments are subject to achieving appropriate economies of scale and rationalisation. In certain cases, financial instruments with a national scope (as opposed to a regional scope) are more likely to achieve the necessary critical mass in terms of operational efficiency and promotional impact against set development objectives. To date,

with a few exceptions, the majority of financial instruments are implemented within the territorial scope of the underlying Operational Programme.

In an effort to increase the effectiveness of financial instruments and to provide further flexibility to the Member States when it comes to assessing and deciding on the most appropriate geographical implementation level for these instruments, the possibility of combining resources from different Operational Programmes and priority axis for the delivery of financial instruments could be strengthened.

Q9: Which is the most appropriate geographical level for implementing financial instruments? Should flexibility be promoted with a view to achieve critical mass, economies of scale and rationalisation by strengthening the possibility of combining resources from different Operational Programmes and priority axis for the delivery of financial instruments?

7. IMPROVING QUALITY: DEVELOPMENT AND IMPLEMENTATION SUPPORT

Finally, it would appear that there is scope for strengthening national and regional capacity in regard to the design and management of financial instruments. Capitalising on the implementation experiences of the current programming period and the know-how generated by the joint initiatives of the Commission and the EIB Group, an assistance mechanism could be set up to support Managing Authorities and their partners in the design and subsequent implementation of financial instruments.

The range of optional support services could include initial evaluation, design of investment strategies and products, development of implementation structures, identification of potential co-financing partners and the operationalisation or management of the financial instrument on behalf of the Managing Authority.

Q10: Would a European technical support facility for the design and subsequent implementation of financial instruments be viewed as desirable and helpful?