BRIEFING

Financial instruments in cohesion policy

SUMMARY

Considered a resource-efficient way of using public funding, the use of financial instruments in cohesion policy is increasing. Financial instruments provide support for investment in the form of loans, guarantees, equity and other risk-sharing mechanisms. In the 2014-2020 programming period, financial instruments can be applied in all thematic areas and funds covered by cohesion policy, and they can be combined with grants. The amounts allocated are expected to double in comparison to the previous period.

The lessons learnt so far from the implementation of financial instruments show that they present both advantages and challenges. Their revolving nature can increase the efficiency and sustainability of public funds in the long term. The requirement to repay can stimulate better performance and quality of investment projects. They can improve access to finance, through targeting financially viable projects that have not been able to obtain sufficient funding from market sources. However, financial instruments can also entail high management costs and fees, as well as complex set-up procedures. Although financial instruments may be a beneficial way to optimise the use of the cohesion budget, in some situations grants can be more effective. It is also important to bear in mind that the primary goal of financial instruments is to support cohesion policy objectives, rather than just to generate financial returns. The new legislative proposals on the post-2020 cohesion policy framework have taken these considerations into account, simplifying the use of financial instruments.

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In this Briefing

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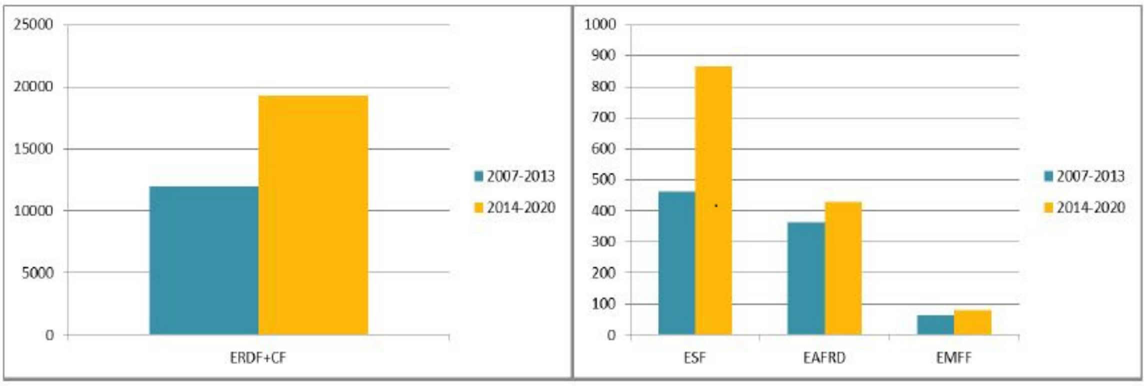
Background

Cohesion policy is the main EU investment policy, with an allocation of about one third of the total EU budget (€351.8 billion) in the 2014-2020 programming period. Its Treaty-based goal is to strengthen economic, social and territorial cohesion, as well as to reduce disparities between regions. In 2014-2020, cohesion policy investments target 11 thematic objectives, including small and medium-sized enterprises (SMEs) competitiveness, resource efficiency, research and innovation, sustainable transport, social inclusion, lifelong learning and efficient public administration. These objectives are aligned with the overarching EU strategy for sustainable, smart and inclusive growth (Europe 2020 strategy).

The forms of cohesion support have evolved over the years to include both grant-based assistance and financial instruments (such as loans, guarantees and equity capital). While some forms of revolving assistance were already available in the 1994-1999 programming period (mainly for SMEs), the use of financial instruments became significantly more widespread in 2007-2013.[1] The amounts allocated to financial instruments (FIs) within cohesion policy programmes grew from €0.57 billion in 1994-1999, to €1.3 billion in 2000-2006, to almost €12 billion in 2007-2013. The types of instruments, scope and amounts allocated to FIs have grown rapidly, and are applied on an even wider scale for all thematic objectives of cohesion policy in 2014-2020, with the final allocation amounts expected to double (see Figure 1).

Figure 1 – Amount of ESIF funding channelled via financial instruments in 2007-2013 and 2014-2020 (€ million)



Data source: European Commission, 2015.

The final report summarising data on **FI implementation in 2007-2013** was published in 2017. The results[2] show that FIs represented 5.4 % of all resources from the European Regional Development Fund (ERDF) and 0.7 % from the European Social Fund (ESF).[3] By the end of the reporting period (March 2017), a total of 1 058 financial instruments were set up in 25 Member States (all Member States except Croatia, Ireland and Luxembourg), receiving support from 192 operational programmes. The payments into FIs reached €16.4 billion (including 11.3 billion from ERDF and ESF). The thematic distribution of financial instruments was 89 % for enterprises, 7 % for urban-development projects and 4 % for funds for energy efficiency/renewable energies. The financial instruments co-financed from the ESF were implemented through 20 operational programmes and targeted specific populations such as the self-employed, long-term unemployed and women, mainly offering microcredits and guarantee funds for microcredits. In total, over 170 000 jobs were created. Table 1 presents the key figures on FI beneficiaries at the closure of the reporting period.

The report highlights generally positive developments, such as the increased use of FIs, steady progress in the absorption of the funds disbursed via FIs and keeping management fees within the thresholds. However, it also points out some discrepancies in the reporting of data, which were subsequently addressed in the regulations for the 2014-2020 period.

Table 1 – Key figures on FI beneficiaries in 2007-2013

Final recipients supported	314 000
Average support per recipient	€40 000 (of which €26 000 from ERDF and ESF)
Average loan size	€45 000 (including microfinance)
Average guarantee size	€16 000
Average equity participation	€410 000

Data source: European Commission, 2017.

The European Commission published three summary reports with preliminary data for **2014-2020**. The latest available report published in November 2018 shows that by the end of 2017, 24 Member States (except Cyprus, Denmark, Ireland and Luxembourg) had started implementation, with contributions committed to FIs via all European Structural and Investment Funds (ESIF) reaching €14.2 billion. The number of financial instruments stood at 459, which reflects a consolidation compared with the previous period (i.e. 1 058 for ERDF and ESF alone. The main areas include SME support (56 %); low-carbon economy, including energy efficiency (16 %), and research and development (16 %). Financial instruments represented about 7.9 % of ERDF and Cohesion Fund allocations. New reports with more advanced data on FI implementation in 2014-2020 will be issued every year, while the final report on FI implementation in 2014-2020 is expected in 2024.

Legal framework

Current rules 2014-2020

Article 2 of the Financial Regulation (No 966/2012) defines FIs as 'Union measures of financial support provided on a complementary basis from the budget in order to address one or more specific policy objectives of the Union. Such instruments may take the form of equity or quasi-equity investments, loans or guarantees, or other risk-sharing instruments, and may, where appropriate, be combined with grants.' This definition is also used in the cohesion policy context.

The general provisions on the use of financial instruments in cohesion policy are laid out in Articles 37-46 of the Common Provisions Regulation (No 1303/2013) for all ESIF).[4] These provisions establish rules related to implementation, management, control and reporting. More detailed provisions on the use of FIs in each ESI Fund are contained in the Fund-specific regulations, for instance regarding priorities, measures and co-financing. These sets of provisions can be complemented by delegated and implementing acts,[5] as well as guidance documents issued by the European Commission. In addition, the use of financial instruments must comply with state aid and public procurement laws.

In 2014-2020 several regulatory changes were introduced in response to the lessons learnt from the implementation of financial instruments in the previous programming period (2007-2013). These included the extension of FI support to all thematic objectives and all ESI funds. In the previous period, FIs were available only for support for enterprises, urban development, energy efficiency and renewable energies in the building sector. The key innovation in respect of implementation is the compulsory ex-ante assessment before the adoption of instruments (as opposed to the voluntary 'gap analysis' in the previous period). Moreover, new types of financial instruments have been introduced, covering a wider range of implementation options. Other changes included the introduction of phased payments linked to disbursements to final recipients (as opposed to the previous period, where 100 % of the amount paid to the fund had to be declared). Moreover, the legal basis has been significantly extended to include detailed provisions on management costs and fees, interest, resources returned, legacy and many other aspects. Lastly, reporting is now compulsory from the outset (in the previous period, reporting was from 2011 onwards only), with the use of a range of indicators.[6]

New proposals for 2021-2027

The new proposal for the 2021-2027 framework[7] published by the European Commission in May 2018 simplifies the use of financial instruments. The ex-ante assessment will be streamlined. Some implementation rules will be simplified, for instance the rules on management costs and fees, as well as rules on payments. Combination of resources will be possible under one set of rules and flexibility for combining grants with FIs will increase. Moreover, the eligibility rules have been clarified, while the specific rules for revenue generating investments will no longer apply. Fund recycling and combination of different resources (such as different funds or FIs and grants) have been codified in a simple way. The special procedure for major projects will also disappear and strategic projects will be followed by the monitoring committee. Instead of separate additional reporting on financial instruments, they will be included in the same reporting system as other forms of finance.

Financial instruments in practice

Types of financial instruments

Support offered under ESIF financial instruments can mainly take the form of a loan, guarantee or equity (see Table 2). Financial instruments can be offered as tailor-made or off-the-shelf (i.e. ready-made) instruments. Currently, Member States tend to prefer **tailor-made instruments**, as they allow them to better address specific market needs and reach targeted final recipients. However, they are more complicated to implement, due to the complexity of the applicable rules. **Off-the-shelf instruments** come with a pre-defined set of standard terms and conditions, compatible with ESI Funds regulations and state aid rules. While this enables faster set-up procedures, they do not always fit well with local market needs and the economic situation. Combined solutions are also possible, such as contributions from various programmes and different funds within one financial instrument, or combining financial instruments with grants and other forms of assistance. These combinations can facilitate the transition from a financial support model based on grants towards the use of FIs, and allow for bigger economies of scale. However, they require separate records for different types of assistance and splitting expenditure into sub-operations, which increases the complexity of the process.

Financial instruments under ESIF can be established at **regional, national, cross-border and transnational level** (under the responsibility of managing authorities), or involve a contribution to **EU-level instruments** managed by the European Commission (e.g. under Creative Europe, Horizon 2020, COSME, Life, Connecting Europe Facility, Erasmus+ and the Programme for Employment and Social Innovation).[8] EU-level FIs have several advantages, such as that no national co-financing is needed and the managing authorities can conclude contracts directly with the European Investment Bank (EIB) or European Investment Fund (EIF), which then selects financial intermediaries based on its internal procedures rather than a competitive process or public procurement. Despite such advantages, Member States still prefer to use national and regional FIs. Some of the reported reasons for this are the relatively high fees and rigid implementation conditions of the EIB/EIF.

Actors involved

The actors involved in the roll-out of financial instruments under ESIF are the **managing authorities** responsible for implementing ESIF (usually national, regional or local authorities), **holding funds** entrusted with the management of FIs (also referred to as 'funds of funds'), **financial intermediaries and final recipients**. While the managing authorities can implement FIs directly, it is more usual to entrust this task to a holding fund, i.e. a fund contributing support to several financial instruments.

Table 2 – Types of support available under ESIF financial instruments

Loan	Loans are funding advanced to a firm or individual that has to be repaid according to a pre-defined schedule. They are used where banks are unwilling to lend or to offer funding on better terms (e.g. a lower interest rate, a longer repayment period, or lower collateral requirements).
Guarantee	Guarantees provide assurance to a lender that their capital will be wholly or partially repaid if a borrower defaults on their loan. The provider of the guarantee will be liable to cover the shortfall or default on the borrower's debt.
Equity	Equity instruments involve investing capital in a firm in return for total or partial ownership of that firm; the equity investor may assume some management control of the firm and may share the firm's profits. The instruments include venture capital (sometimes called risk capital), seed capital and start-up capital. The return depends on the growth and profitability of the business. It is earned when the investor sells its share of the business to another investor ('exits'), or through an initial public offering (IPO).

Data source: fi-compass, 2015.

In the previous period, the holding funds were managed by the EIF or EIB (43 %), national financial institutions such as banks (42 %), or put out to public tender (15 %). The fund managers are responsible for the selection of financial intermediaries and implementing the financial instrument. Financial intermediaries tend to be banks or other public or private financial institutions as well as venture-capital companies (such as business angels). Final recipients may include individual citizens, entrepreneurs, SMEs/businesses and various recipients of public funding (such as urban development or energy efficiency projects).

Life-cycle of a financial instrument

The FI life-cycle includes the design and set up stage, and implementation and winding up (see Figure 2). At the strategic planning stage, the use of FIs can already be indicated in partnership agreements and operational programmes, which are the strategic planning documents outlining the ESI Fund spending at Member State level. The initial stages also involve choosing implementation modalities, the type of FIs and their thematic scope, possible combination with grants, cooperation with the EIB, selection of financial intermediaries and conducting an **ex-ante assessment**.[9] This assessment has to provide evidence for existing market failures or sub-optimal investment situations (e.g. insufficient bank lending or private investment). It also serves to determine the investment needs and the FI fit with cohesion policy objectives. The managing authorities must also assess whether a grant would be a better option, and seek synergies and complementarity with other EU or national instruments. At Member State request, the ex-ante assessment can be carried out by the EIB.

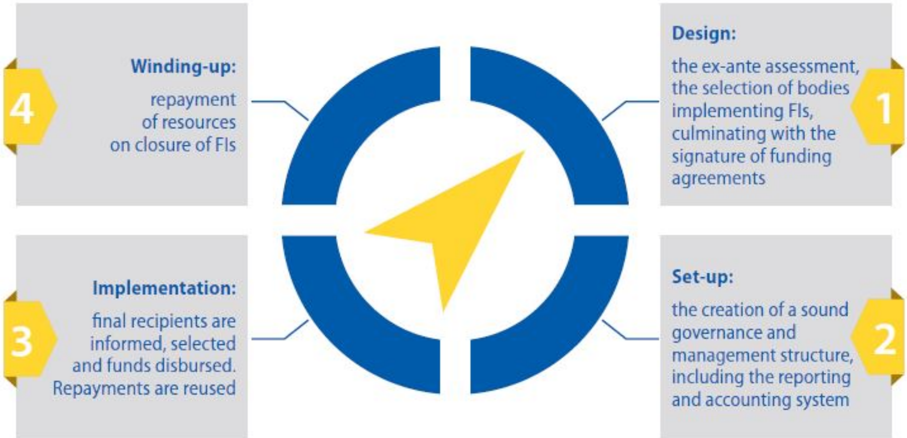
Fi-compass

An advisory service provided by the European Commission and the European Investment Bank Group, Fi-compass offers practical expertise and learning tools, such as methodological handbooks, factsheets and case studies, Commission regulatory guidance, training seminars and networking events. Services cover financial instruments under ESIF and microfinance under the Programme for Employment and Social Innovation (EaSI).

The implementation stage includes the selection of final recipients, disbursement of funds and re-use of repayments. Managing authorities are required to prepare a report on operations covered by FIs as an annex to the annual implementation report. On this basis, the European Commission prepares 'summaries of the data on the progress made in financing and implementing the financial instruments' since 2016. The Commission transmits these summaries to the European Parliament and the Council, and publishes them. Programme audits are carried out primarily at the level of managing authorities and entities implementing FIs, including holding funds, with audits among final recipients only under specific circumstances.

The resources repaid before the end of the eligibility period can be used for investments within the same FI, remuneration of investors or reimbursement of management fees and costs. After the exit of resources attributable to ESIF, the FI can complete its life-cycle and be liquidated (wound up), or can continue to operate.

Figure 2 – Life-cycle of financial instruments



Data source: fI-Compass, EIB, 2015.

Advantages and challenges

Advantages

The use of financial instruments in cohesion policy is encouraged for a variety of reasons. They are believed to increase the efficiency of public funding due to their revolving character, i.e. repayment and re-use. This also ensures the long-term sustainability of public investments, which is considered particularly beneficial in the context of post-crisis budgetary constraint. Financial instruments can help increase access to funding, as they focus on economically viable projects, which encounter difficulties in obtaining private market funding (such as commercial bank lending or equity investment). The fact that the funds need to be repaid is considered an incentive for better quality investment, better planning and greater financial discipline. Moreover, the FIs are expected to have a leverage effect, i.e. attract additional private or public funding. This is further strengthened by the accumulation of interest generated and dividends paid to the funds. ESIF-supported financial instruments can be particularly attractive for investors as they guarantee lower risk and the long-term nature of projects. From the point of view of final recipients, they offer more advantageous terms than standard commercial loans (e.g. lower collateral and longer repayment periods). From the point of view of managing authorities, financial instruments are a way to attract private-sector financing to public policy objectives. The participation of private-sector investors and the EIB Group also allows access to their financial expertise and skills in the areas of investment and financial management. The possibility to deliver cohesion support through grants or FIs provides additional flexibility for managing authorities to choose the best tools to address specific needs. Although they take longer to set up, they provide faster disbursement of funds than grants, and foster a move away from grant-dependency.

Challenges

The 2007-2013 period was the first in which FIs were introduced on a larger scale. A number of challenges, pointed out in various evaluations, have been addressed in the new period, but some challenges remain. The first feedback from Member States on the implementation of FIs under ESIF in 2014-2020 indicates some positive developments as well as challenges. The more detailed regulation for 2014-2020 compared with the previous period is seen as a step in the right direction, especially at the level of the basic act (Common Provisions Regulation), as it ensures greater legal certainty. However, there is a perception among Member States that there has been a move from under-regulation to over-regulation, especially when it comes to guidance documents and additional legal acts. This entails the risk of an 'audit freak', which may lead to inflexible and inefficient use of funds. Another challenge is the legislative gap between national FIs and those implemented by the EIB Group. The EIB/EIF are exempt from applying EU procurement rules, which enables a faster set-up and more flexibility if they manage an FI. Where FIs are set up at national level (currently the preferred option), the public procurement requirements for selection of financial intermediaries lengthens and complicates the process, which may decrease the efficiency of implementation. Member States suggest exploring the alternative of open calls. The obligatory ex-ante assessment of FIs is considered a useful tool to ensure proper justification of their use, to ensure they are used only when necessary and improving the quality of FI planning. However, it is time-consuming and complex, due to the variety of aspects to be covered, which suggests the need for simplification in the future. Need for simplification of other administrative procedures, such as the extensive and complex reporting requirements is also mentioned. The new proposals for the post-2020 cohesion policy framework address some of these issues.

The tailor-made instruments seem to be Member States' currently preferred choice, but they can prove to be quite complex to use in terms of sometimes inconsistent applicable rules (cohesion policy, state aid and public procurement). Off-the-shelf products provide standard terms and conditions compatible with ESI Funds regulations and state aid rules, but do not always fit with market needs. Another important challenge related to FIs in cohesion policy is the need for expertise, skills and administrative capacity, both in the area of financial and banking knowledge as well as cohesion policy regulations. A 2015 European Policies Research Centre (EPRC) study showed that the instruments can be burdensome and difficult for regional authorities to manage, and are perceived as less useful in small projects and in certain areas. Another issue mentioned was that the fees and costs can be high, while local and regional authorities sometimes struggle with co-financing their part of an FI. Moreover, financial instruments constitute very complex funding tools with significant risks if they lack adequate planning and delivery mechanisms. They also entail ordinary risks, such as risk of default on a loan and unjustified profits for financial intermediaries. The European Court of Auditors report on the lessons learnt from 2007-2013 shows the need for more in-depth evaluation of the impact of FIs, exploring ways to attract more private capital and seek greater economies of scale. Moreover, in some cases grants may be more appropriate than FIs, for instance in under-developed areas or in situations where financial returns are not realistic or limited. Therefore, the effectiveness and impact requires further thorough research and evaluation.

European Parliament

While negotiating the 2014-2020 cohesion framework, the European Parliament endorsed the use of revolving FIs, and their extension to appropriate areas eligible for funding. Together with the Council of the EU, it also pushed for greater legal certainty compared to the previous period and to include more detailed provisions in the basic act, instead of in secondary legislation. The Parliament was also successful in requesting that the European Commission publish and transmit summaries of progress in implementing FIs to the co-legislators on an annual basis.

For the currently negotiated post-2020 framework, Parliament proposed amendments to the Commission proposal in its March 2019 legislative resolution. These focus on: clarification of rules regarding the direct award of contracts; limiting reporting requirements on the use of FI for their intended purposes to managing authorities and financial intermediaries; use of interests and further gains for further investments in final recipients or coverage of losses under certain conditions; preventing cost savings from energy efficiency measures from resulting in operating subsidy reduction; and highlighting the principle of sound financial management.

In its 2015 resolution on 'Investment for jobs and growth: promoting economic, social and territorial cohesion in the Union', the Parliament highlighted 'the role of financial instruments in mobilising additional public or private co-investments in order to address market failures in line with the Europe 2020 strategy and with cohesion policy priorities'. It also emphasised the need to ensure transparency, accountability and scrutiny of FIs. It expressed concern about the low rates of disbursement of FIs to beneficiaries, and encouraged the use of technical assistance tools, such as fi-compass. It also supported extending the use of FIs in ESIF.

In its 2017 resolution on 'The right funding mix for Europe's regions: balancing financial instruments and grants in EU cohesion policy', Parliament recognised that both grants and FIs have their advantages and limitations. It insisted that the mix of grants and FIs should be defined by the requirements of particular interventions. Rather than being an end in itself, FIs should address territorial development needs, sectoral needs or market needs. While it noted that Member States and regions should continue to take consider the most appropriate option, it also highlighted significant differences across the EU regarding the penetration of FIs. Moreover, Parliament called on the Commission to further simplify the rules and extend technical support to authorities and recipients.

In its resolution of 13 June 2017, on building blocks for a post-2020 EU cohesion policy, the Parliament welcomed the increasing role of financial instruments, while also recommending treating them as complementary to grants, which should remain the basis of the financing of cohesion policy. It also recalled that these instruments are not suitable for all types of interventions under cohesion policy and advocated that their use be based on an appropriate ex-ante assessment and clearly demonstrated added value (for instance a strong leverage effect). Parliament also called for voluntary use of FIs responding to the needs of diverse regions, opposed any binding quantitative targets and warned against linking the use of FIs to a reduction in the EU budget. On the other hand, it stressed the importance of assisting local and regional authorities on using the innovative FIs through platforms such as fi-compass or by providing incentives for beneficiaries.

European Committee of the Regions

At its plenary session in October 2015, the European Committee of the Regions adopted an opinion on 'Financial instruments in support of territorial development'. It stressed that structural funds interventions should be implemented in accordance with the cohesion policy goals outlined in Article 174 of the Treaty on the Functioning of the European Union (i.e. strengthening economic, social and territorial cohesion, and reducing disparities between regions). It highlighted that 'the use of financial instruments must always be based on in-depth analysis and maximising public utility' and 'solve specific social, economic or environmental problems'. It called for reinforced cooperation between representatives of regions, the European Commission, EIB and businesses as regards the interpretation of provisions and implementation of FIs. It also highlighted the complementarity of FIs and subsidies in addressing various territorial situations, and warned against crowding subsidies out from FIs, as well as excessive reduction of the subsidies system.

Outlook

The increasing use of financial instruments is strongly supported in the multiannual financial framework (the multiannual EU budget), the ESI Funds policy framework and the European Fund for Strategic Investments. This is because this type of revolving support is perceived as a resource-efficient way to use public spending. The Commission has been pushing for extended use of FIs in ESIF and achieving greater economies of scale through a consolidation of resources into national or supra-regional instruments, rather than a multiplication of small instruments at regional and local level.

However, for FIs to be highly effective and more widespread, the current challenges need to be addressed. The implementation of FIs under ESIF in the 2014-2020 programming period is ongoing, while feedback from Member States indicates both positive developments and practical challenges. The perceived 'over-regulation' compared to the previous period might stimulate a better balance in future provisions between regulatory flexibility and legal certainty. The experiences gathered so far also suggest the need to simplify some administrative procedures, for instance related to public procurement in the selection of financial intermediaries at national level, ex-ante assessment and reporting obligations. Regarding the tailor-made instruments, which are currently the Member States' preferred choice, there is a need for better harmonisation of the applicable rules on cohesion policy, state aid and public procurement. Off-the-shelf instruments, on the other hand, require more versatility to cover a wider range of situations. The successful implementation of financial instruments also requires stronger administrative capacities at national level, particularly a combination of expertise on the cohesion policy regulations, financial products, state aid and public procurement. In addition to properly trained human resources, there is a need to keep the fees and costs of financial instruments at a reasonable level. The future of recycled funds is also becoming an important topic, as the re-usable resources from FIs established under the previous period become available for reinvestment. The impact of financial instruments and grant financing requires more future research to identify the cases where each kind of assistance is most effective.

Current discussions on the post-2020 cohesion policy framework provide an opportunity to consider these issues, in order to increase the effectiveness of FIs in the future. The new proposals for 2021-2027 provide significant simplification of FI implementation rules and demonstrate that many findings from previous evaluations and Member States' feedback have been taken into account. The new Common Provisions Regulation, with provisions on FIs, is currently under negotiation between the co-legislators and expected to be adopted in 2020.

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ENDNOTES

1 Financial instruments were referred to in the 2007-2013 programming period as 'financial engineering instruments' (FEI).

2 The final report presents the situation at closure of the reporting period, i.e. 31 March 2017. Data submitted by the managing authorities to the European Commission at that time covered 99 % of the operational programmes using financial instruments. To overcome data collection limitations, the final report also uses complementary data from other sources, such as the 2016 ECA Special Report on implementing financial instruments and the ex-post evaluation of cohesion policy programmes 2007-2013.

3 The Commission final report does not include data on financial instruments in the Cohesion Fund. The 2014-2020 summary reports on FIs include data reporting for all European Structural and Investment Funds – see footnote 5.

4 European Structural and Investment Funds include the European Regional Development Fund (ERDF), the European Social Fund (ESF), the Cohesion Fund (CF), the European Agricultural Fund for Rural Development (EAFRD) and the European Maritime and Fisheries Fund (EMFF). Only three of these funds (ERDF, ESF and Cohesion Fund) are formally part of EU cohesion policy.

5 For instance, the Commission Implementing Regulation (EU) No 964/2014 of 11 September 2014, laying down rules for the application of Regulation (EU) No 1303/2013 of the European Parliament and of the Council as regards standard terms and conditions for financial instruments.

6 This summary of changes introduced in 2014-2020 refers only to the ERDF and ESF. For information on other ESI Funds (e.g. EARDF and EMFF) see 'Financial instruments in ESIF programmes 2014-2020. A short reference guide for Managing Authorities', 2014.

7 Proposal for a regulation of the European Parliament and of the Council laying down common provisions on the European Regional Development Fund, the European Social Fund Plus, the Cohesion Fund, and the European Maritime and Fisheries Fund and financial rules for those and for the Asylum and Migration Fund, the Internal Security Fund and the Border Management and Visa Instrument, COM(2018) 375 final.

8 In the previous programming period (2007-2013), the use of financial instruments was promoted under JEREMIE (Joint European Resources for Micro to Medium Enterprises) and JESSICA (Joint European Support for Sustainable Investment in City Areas), joint initiatives of the European Commission and the EIB Group. Some agreements under these instruments have been extended to the new period.

9 The ex-ante assessment on the use of financial instruments, required under Article 37(2) of the CPR is not to be confused with the ex-ante evaluation under Article 55 of the CPR, which is part of the programming process.

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