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Financial instruments in cohesion policy

SUMMARY

The use of financial instruments in cohesion policy is increasing, as they are considered a resource-efficient way of using public funding. They 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, combined with grants; and 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. These considerations are likely to feed into the debate on the post-2020 cohesion policy framework.

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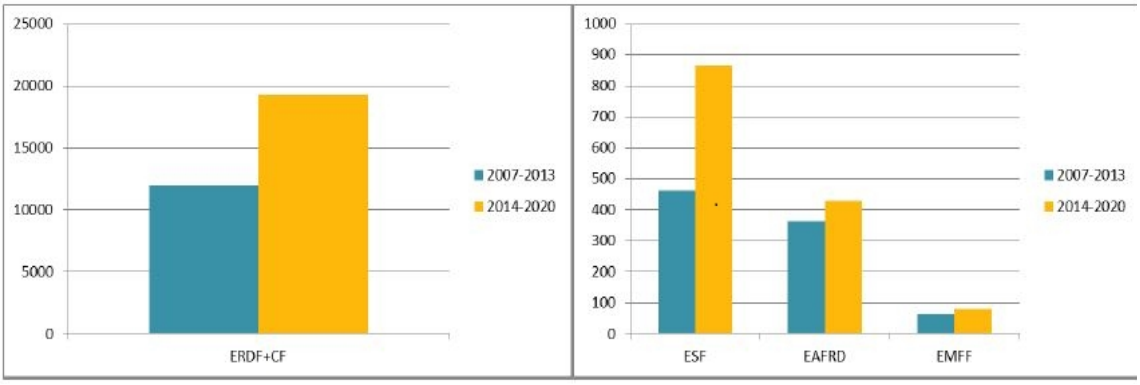
Background

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 the 2014-2020 period, cohesion policy investments are targeted at 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 the 2007-2013 programming period.[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 €12.5 billion in 2007-2013. The types of instruments, scope and amounts allocated to FIs have grown quickly, and in the 2014-2020 period they are applied on an even wider scale for all thematic objectives of cohesion policy, with 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.

While the implementation of FIs in the 2014-2020 period is still at a very early stage, the results presented by the European Commission in its latest summary report for the 2007-2013 period show that FIs represented about 5 % of all resources from the European Regional Development Fund (ERDF) and 0.7 % from the European Social Fund (ESF). By the end of 2015, there were a total of 1 052 financial instruments set up in 25 Member States (all Member States except Ireland, Luxembourg and Croatia), receiving support from 188 operational programmes, with payments to final recipients reaching over €12.5 billion. 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 in eight Member States through 19 operational programmes and targeted specific populations such as the self-employed, long-term unemployed and women, mainly offering microcredits and guarantee funds for microcredits. The closing date for Member States final reporting on FI investments under the 2007-2013 period is 31 March 2017.

The European Commission published its first summary report with preliminary data for 2014-2020 in November 2016. It showed that by the end of 2015, 21 Member States have started the implementation of 125 FIs through 64 operational programmes. The main areas included SME support, energy efficiency, and research and development. FIs represented about 7.9 % of ERDF and Cohesion Fund allocations. More detailed results are expected as the implementation process becomes more advanced.

Legal framework

Financial instruments are defined in Article 2 of the Financial Regulation (No 966/2012) 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 context of cohesion policy.

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 European Structural and Investment Funds (ESIF).[2] These provisions establish rules related to implementation, management, control and reporting. More detailed provisions on the use of FIs in case of every 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[3] 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 the 2014-2020 period 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 it was from 2011 onwards only), with the use of a range of indicators.[4]

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, **tailor-made instruments** tend to be preferred by Member States, as they allow to address specific market needs better 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 the local market needs and economic situation. Combined solutions are also possible, such as contributions from various programme 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 keeping 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).[5] EU-level FIs have several advantages, namely 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 these advantages, Member States still prefer the use of national and regional FIs. Some of the reported reasons for this are the relatively high fees and rigid implementation conditions of the EIB/EIF.

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.

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 financial instruments directly, it is more common to entrust this task to a holding fund, i.e. a fund contributing support to several financial instruments. 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).

fi-compass

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

Life-cycle of a financial instrument

The life-cycle of financial instruments consists of several phases including the design and set up stage, implementation and winding up (see Figure 3). At the strategic planning stage, the use of financial instruments 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**.[6] 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 fit of FIs with cohesion policy objectives. The managing authorities must also assess whether a grant is not 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.

Figure 3 – Life-cycle of financial instruments

Data source: fI-Compass, EIB, 2015.

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 financial instruments as an annex to the annual implementation report. On this basis, from 2016 onwards the Commission prepares 'summaries of the data on the progress made in financing and implementing the financial instruments'. These summaries are transmitted to the European Parliament and the Council, and made public. Programme audits are carried out primarily at the level of managing authorities and entities implementing financial instruments 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 it can continue to operate.

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 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 investments, 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 the drawing on their financial expertise, know-how and skills in the areas of investment and financial management. The possibility to deliver cohesion support through grants or financial instruments 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 financial instruments 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 still remain. While the implementation of FIs under ESIF in the 2014-2020 programming period is at an early stage, the first feedback from Member States 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 more 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 FIs implemented by the EIB Group and national ones. The EIB/EIF are exempt from applying EU procurement rules, which enables a higher speed of set-up and flexibility if they manage an FI. In case of financial instruments set up at national level (currently preferred), the public procurement requirements for selection of financial intermediaries makes the process lengthy and complicated, 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 FIs' 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 tailor-made instruments seem to be the choice currently preferred by Member States, 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 could 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 report of the European Court of Auditors 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 financial instruments, and their extension to appropriate areas eligible for funding. Together with the Council of the EU, it also pushed to ensure more 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 Commission summaries of progress in implementing FIs are transmitted to the co-legislators on an annual basis and made public.

In its 2012 resolution on innovative financial instruments in the context of the next multiannual financial framework the Parliament welcomed the strengthening of the legislative framework on FIs in cohesion policy in the Commission’s proposal, and its extension to all thematic objectives. It highlighted the need to achieve critical mass and a substantial multiplier effect, ensure proper coordination and avoid overlap of the different schemes.

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 for financial instruments. It expressed concern about the low rates of disbursement of financial instruments to beneficiaries and encouraged the use of technical assistance tools, such as fi-compass. It also supported extending the use of FIs in ESIF. The Parliament is currently preparing an own-initiative report on 'The right funding mix for Europe's regions: balancing financial instruments and grants in EU cohesion policy' (rapporteur: Andrey Novakov, EPP, Bulgaria), with a draft report expected in January 2017 and scheduled to be voted on in plenary in spring 2017.

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 financial instruments and subsidies in addressing various territorial situations, and warned against crowding out the subsidies from FIs and excessive reduction of the subsidies system.

Outlook

The increasing use of financial instruments is supported in the multiannual financial framework (the multiannual EU budget), the ESI funds policy framework and the European Fund for Strategic Investments (sometimes known as the Juncker Plan). This is due to the fact that this type of revolving support is perceived as a resource-efficient way to use public spending. The European Commission is pushing for extending the use of financial instruments 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. Better coordination of the deployment of financial instruments under ESI funds with the European Fund for Strategic Investments (EFSI) is also expected.

However, for financial instruments 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 still at an early stage, but first 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. Early experiences 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. In case of the tailor-made instruments, which are currently the choice preferred by Member States, there is a need for better harmonisation of the applicable rules. 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 strengthening 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 financial instruments established under the previous period are becoming 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 financial instruments in the future.

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Endnotes

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

2 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.

[3] 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.

[4] This summary of changes introduced in the 2014-2020 period 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.

[5] 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.

[6] 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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