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Financial instruments in support of territorial development

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Executive summary

The use of financial instruments (FIs) has been increasing over the last two decades. Already in 1994 FIs were created, backed by the EU budget to support SMEs. For infrastructures, the EU was only co-financing with grants. However, on the backdrop of a decreasing EU budget as percentage of GNI, the EU and the EIB sought to involve further the private sector, first by promoting public-private partnerships (PPPs) and the loan instruments of the EIB. Eventually, due to the gap between financial requirements and the effective budget, the EU budget started offering guarantees in the Trans European Networks for Transport (TEN-T).

In the last decade the combination of a financial crisis and the Europe 2020 objectives for energy and growth, the need to leverage the private sector in times of economic stagnation, and higher risk have led to a multiplication of FIs in many areas. With the public budgets unable to invest in infrastructures and the banking sector in a crisis, there was a need to attract private sector funding from institutional investors as well as further encouraging banks to extend credits to SMEs.

FIs are tools that can enhance the efficiency of the EU budget programmes in *specific areas of intervention* where they are better suited than grants. The revolving nature of FIs is a benefit for the public authorities that manage to implement them successfully. The EU-supported risk capital and the interest rates should allow the funds to keep their value and be reinvested repeatedly, generating a larger number of investments than a grant allocation.

However, the proper use of FIs requires a considerable rethinking of the role of public budgets, the right legal framework and expertise and proper assessments. There is a risk that opportunities are lost due to poor FI design, leading to little use and/or impact, or even disruptive impact in a normal functioning debt and equity market.

While FIs have room to increase their potential applications, in many areas of public interventions the use of grants will always be necessary, and FIs can thus only be considered *complementary* tools.

Local and Regional Authorities (LRAs) should consider carefully the ultimate objective of the funds. Despite the importance attached to the leverage effect, seeking a high leverage should not be the sole objective of the public sector, but rather the final impact on the economy, living standards and the public goods that any given project it delivers. Focusing on the leverage objective can weaken

the actual function of the FIs, as a higher leverage does not indicate that a project is socially better, but only that its private returns are attractive enough. A focus on leverage may lead to the excessive use of FIs and weaken the additionality of EU interventions, i.e. that they should not be used were the private sector would intervene by itself.

In the first place it is important to note that the choice regarding whether to implement an Operational Program through an FI rather than using traditional grants lies with the Managing Authority designated for the specific Operational Program. In principle every LRA can be chosen as Managing Authorities (MAs); according to Art 123 (1) of the Common Provisions Regulation (CPR), "each Member State shall designate, for each operational programme, a national, regional or local public authority or body or a private body as managing authority. The same managing authority may be designated for more than one operational programme".

Despite the absence of formal legal impediments to the choice of small LRAs as MA, the big administrative and technical capacity required to implement an OP seems to have led to an established trend among Member States in choosing authorities at national and regional level[1] (not local) as MAs.

The report presents some of the regulatory challenges that MAs need to face in order to set up FIs within the Cohesion Policy framework. Setting-up FIs is a complex labour intensive task. Moreover, given the complex nature of the tasks to be performed in the ex-ante assessment a problem of cost-effectiveness might also arise making less attractive for MAs the use of FIs for small-sized projects.

In this view, in order to safeguard the access to FIs by small (or less wealthy) MAs and removing the barriers to the development of FIs for small projects we recommend the strengthening of *specific technical assistance program* focused on assisting MAs in the development of the ex-ante assessment. The methodological guidance documents published by the European Commission are a step in the right direction, but without further assistance these are likely not sufficient to enable smaller MAs to access FIs.

We encountered a clash between Art 38 of the CPR and the State-aid guidelines preventing MAs from the direct implementation of an FI. The General Block Exemption seems to be compatible only in the case of small enough investments falling within the *de minimis regulation*. On the one hand, this could represent

[1] On the Regional Policy website of the European Commission is available a comprehensive list of all the Managing Authorities for the 2014-2020 programming period.
http://ec.europa.eu/regional_policy/en/atlas/managing-authorities//?search=1&keywords=&periodId=3&countryCode=ALL&typeId=ALL

an incentive for MAs to directly implement FIs targeting projects of smaller size; on the other hand it could eventually bring to *de facto* non adoption of the implementing option foreseen by Art 38 (iv). It is recommended that such regulatory barrier to the dis-intermediated implementation of FIs by MAs should be removed.

For what concerns the access to FIs by LRAs, it is important to note that this requires that the LRA is able to raise the funds necessary to service the loans. LRAs with a bad credit rating or suffering of strict national borrowing rules, may not be able to benefit directly from FI funds. LRAs are important however to help develop the right instruments and projects in the region, so as to take maximum advantage of the flexibility that the funds offer.

The *budget stability rules* create further complications in some member states. These are very strict in some countries and de facto block the ability to benefit from FIs for some regions, regardless of whether the finance is provided by the private sector.

1 Introduction

The European Union operates today two groups of financial instruments (FIs). The first are instruments focusing on SMEs. The EU budget supports the EIF and the regional authorities in setting up financial instruments that provide loans to SMEs that are channelled either through financial institutions or directly through MAs. The second group of instruments focuses on infrastructures. The operation and origin of these instruments is very different.

The financial instruments for SMEs have been operating since 1994. There is evidence that the private banking sector neglects small businesses due to transaction costs and low profitability of individual small loans (see Skidelski et al. 2011), even if in aggregate terms investing in SMEs is profitable and very important for the economy.

The history of financial instruments for infrastructure is more recent and is closely linked to the expansion of PPPs. The pioneer in Europe was the UK, which introduced a rationalisation of the public sector based on theories of allocative efficiency stemming from principal-agent theories by economists such as Stiglitz (1987). According to these theories, PPPs allowed for a better distribution of responsibilities and risks and overall savings. The positive examples of such arrangements in the UK in a number of sectors, from infrastructures to hospitals and even education centres, led to their increasing use in other member states, such as the Netherlands, Denmark and Sweden. In addition to allocative efficiencies, PPPs have the benefit of increasing the number of projects that public authorities can launch with a given annual budget. This has been of interest to the EU, given the need to find methods to raise the co-financing for EU budget support infrastructures.

In fact, over the last two decades, the European Union's objectives and aspirations have increased on the backdrop of a decreasing EU budget as percentage of GNI. In addition, the enlargement of the EU to poorer member states raised questions on the ability of those countries to co-finance projects. The EU started promoting PPPs, particularly in the area of Trans-European infrastructure and for large infrastructures in the Cohesion Countries.

Co-financed infrastructures would be raising funding from financial institutions and let a private operator build and operate infrastructures under a form of concession. The Commission promoted such arrangements and published one of the first guidance documents on PPPs and EU funds (European Commission, 2003).

The EU enlargement made such considerations more pressing as the new member states lacked the necessary public resources to co-finance such infrastructures, while their transport networks and environmental infrastructures (e.g. water network and purification infrastructures) needed large upgrades. The infrastructure PPPs were not as successful as wished for, due to the lack of knowledge about PPPs in many EU countries, as well as the rules governing them (as documented by the European Parliament (2006a, 2006b) and PWC (2005)). In the EU, only few countries had the expertise and the necessary legislation to implement PPPs. Attracting private finance was not easy even with the participation of EIB loans.

Due to the growing gap between the EU budget funds and the estimated needs for the Trans-European Networks (TEN) strategy, the European Commission and the EIB launched the Loan Guarantee Instrument for Trans-European Transport (LGTT) in 2004. This is the first EIB infrastructure lending with a guarantee by the EU budget.

FIs have since expanded in scope, driven by the combined need of achieving the goals of the Lisbon strategy and subsequently for Europe 2020 in an expanding EU within a constrained EU budget. The Multiannual Financial Framework (2007-2013) saw these instruments expand to 26: 11 instruments centrally managed by the European Commission or jointly with a financial institution, 3 instruments under shared management, thus mainly under the control of national authorities, and 13 external instruments. To a large extent, FIs are just financial tools to encourage different forms of PPPs.

The financial crisis starting in 2007 deeply affected the rationale, size and shape of the financial instruments over the period. With the public budgets unable to invest in infrastructure and the banking sector in a crisis, there was a need to attract funding from risk-averse and crisis-wary institutional investors for infrastructures of public interest, from banks to extend credits to SMEs and from investors to foster research and innovation.

While the funding for SMEs and innovation encountered some success, new FIs created for infrastructures and for urban projects were less successful. One of the reasons lay in the design of the instruments and EU financial regulations. Both design and rules were originally conceived when the private banking system was working well and sources of funding for good projects were abundant. Under the new economic conditions, the tools were unable to attract private funding and EU rules forbid the combination of different EU subsidies or subsidised instruments.

Not surprisingly, it is only after the reform of the Financial Regulations in 2012[2] that the statistics on the implementation of financial instruments (European Commission, 2014) have started improving across the board.

This report will review the implications of the expansion of FIs for the LRAs in the new MFF. It will first describe the rationale for the use of financial instruments for territorial development and their role during the 2007-2013 MFF. It will then analyse the implications for LRAs, first on the rationale and logic for LRAs to set up and promote such instruments, followed on a discussion on the ability of the LRAs to access the financial instruments as beneficiaries.

[2] 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 (OJ L 298, 26.10.2012, p.1).

2 The rationale for the use of financial instruments

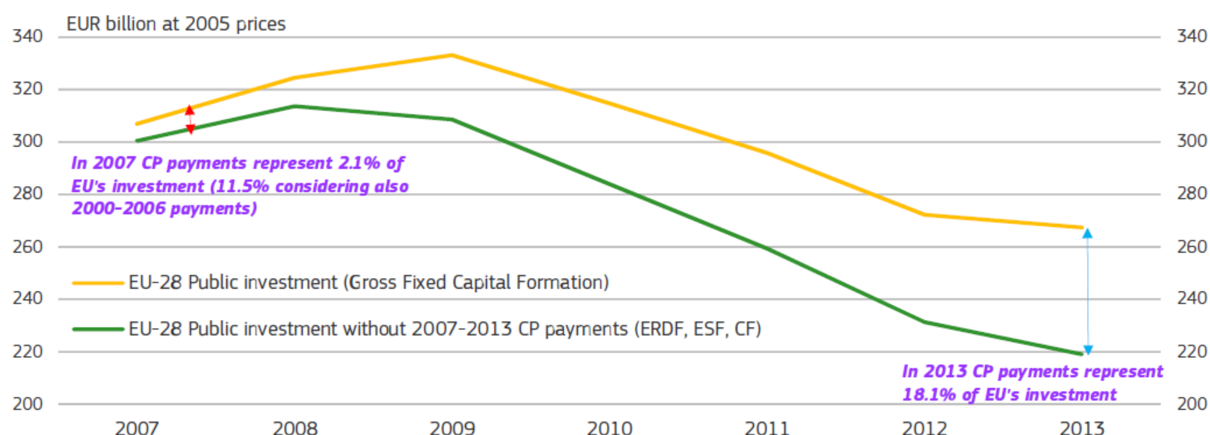
The EU budget does not have the financial capacity to support all objectives of European importance nor does it have the ability to cover the investment decrease in the public and private sector. The EU budget is relatively small in proportion to these challenges, but its contribution is much more than symbolic. It is in fact very substantial for some of the policy areas it supports, and in particular for some countries of the EU. To put it into perspective, approximately half of the EU budget is 'direct investment' (i.e. mainly infrastructures). This sum – EUR 53.9 billion, according to Eurostat for 2011 – represents 15% of the total EU direct public investment (Sauter, Illes and Núñez Ferrer, 2014). With the concentration on poorer member states, the share for some regions is thus quite significant. Similarly, while the EU R&D share of expenditure as a percentage of the total is only 5%, the fact that this funding excludes many capital expenditures that member states cover (e.g. buildings, existing machinery, non R&D linked staff, etc.) means that EU funding is a substantial share of the actual research budgets in member state institutions (Núñez Ferrer and Katarivas, 2014).

The role of EU investment becomes particularly important during this long-lasting financial crisis, if the EU intends to narrow the supposed "investment gap" that is affecting many European economies. This is clear from the statistics: As a result of the cutbacks in national investments, the reliance on EU investment (mostly Cohesion Policy) to finance growth-friendly investments has increased considerably. In 2007, Cohesion Policy funding was equivalent to 2,1% of public investment in the EU as a whole, and by 2013 it reached 18,1% (Figure 1).

Given the limited size of the EU funds, the introduction of FIs in the Cohesion Policy (now part of the so-called European Structural & Investment Fund, ESIF) to expand their reach and to better allocate risks between the public and private sector, is a welcome development. In this view, the recent launch of the so-called Juncker Plan[3] (The European Fund for Strategic Investments, EFSI), a dedicated non pre-allocated Financial Instrument mechanism to leverage investment, is another recognition of the potential role of EU financial instruments in delivering growth-friendly expenditures. The Juncker Plan is not part of the ESIF of the EU, but due to its non pre-allocated nature can be used by all member states and regions, for infrastructures, research or SME support.

[3] Details for the Juncker Plan can be retrieved from http://ec.europa.eu/priorities/jobs-growth-investment/plan/index_en.htm.

Figure 1: Contribution of Cohesion Policy (CP) to public investment, EU-28, 2007-2013



Source: 6th Cohesion Report European Commission 2014 (a).

2.1 Grants versus FIs in Cohesion Policy

The majority of the EU Cohesion Policy funds are delivered to the final recipients in the form of grants. Nevertheless, FIs started to be introduced in the Cohesion Policy since the MFF 2000-2006. Previously these were only used in the Commission's centrally managed policies. FIs are defined in the EU Financial Regulation (p.39) as measures of "financial support provided from *the budget in order to address one or more specific policy objectives by way of loans, guarantees, equity or quasi-equity investments or participations, or other risk-bearing instruments, possibly combined with grants*". Of course, member states could create PPPs to build and co-finance projects, but the private participation itself was not directly supported by the EU budget.

There are three broad categories of FIs:

- **Loans:** The EU budget can finance loans by financial institutions.
- **Guarantees:** Offer support to loans by financial institutions to reduce investors' risks by covering the first losses of projects.
- **Equity:** Aims to provide finance for early growth-stage investments in businesses and to boost the EU venture capital market.

Since their introduction, FIs increased their role in financing EU policies; The Commission reports (2012) that during the first half of the 2007-2013 MFF, about 5% of the ERDF, 0.7% of the ESF and up to 1% of EU Budget resources were deployed through FIs (European Commission, 2012). The recent economic crisis, together with the constraints to public budgets and the intrinsic ability of FIs to leverage financial resources, is pushing these instruments towards a more

central role during the present MFF both in terms of policy areas covered and in terms of resources allocated through these tools. The expansion of the outreach of FIs is evident also in the design of the present MFF where Member States and managing authorities are entitled to choose between grants and FIs and among FIs with greater flexibility, and to select the one that they retain the most suitable for each investment portfolios. Moreover, more clarity and certainty in the legal framework for FIs has been ensured in the regulations governing the Cohesion Policy, rural development measures and the Connecting Europe Facility, as well as the groundwork laid down by the reform of the financial regulations.

An argument that is often raised in favour of the use of financial instruments is that they have a high leverage effect, i.e. they attract a much higher level of private or public funding than the EU contribution. While this is true, financial instruments are not a panacea and cannot replace grants nor increase investment single-handedly. Financial instruments are debt or equity instruments and as such have a specific role. If they can substitute traditional grants in certain areas, it may mean that the EU was subsidising such projects in excess to start with. There are most likely quite a large number of cases. This is of course valid for any public expenditure, national or EU. Motorways are a good example, where many member states have refused to introduce tolls or vignettes that could have raised the funding to cover the capital costs over time. Another case is the cost recovery of water infrastructure investments. In a number of countries those are highly subsidised by the state, leading often to sub-optimal levels of investment and network inefficiencies (Egenhofer et al., 2012).

2.1.1 Nature of the Financial Instruments

Despite the experience of financial instruments that has already accumulated, many public authorities including many LRAs still have difficulties understanding how to set them up or how to use them. Without understanding the nature of financial instruments there is no way to respond to the questions that many LRAs are asking. e.g. what kind of financial instruments should be set up for which priorities? What is the role of LRAs in designing the financial instruments? Who are the beneficiaries and how to be a beneficiary as an LRA?

While FIs can play a significant role in allowing projects to be undertaken that would not have been possible without a FI, the nature of the FIs is radically different from a grant, because it is a debt instrument. This limits considerably the scope of FIs. They can only be used to better discriminate between interventions that are 'bankable', i.e. where the capital can be recovered after the implementation of the project, either through revenues generated by the project's activities or indirectly by savings generated. It is possible for some

types of infrastructures to use shadow pricing through indirect payments from the public sector to monetise the benefits of a project. This, as will be explained later, is however complex and only possible in rare and very strict conditions. Depending on the national legislation in place, this may also not be possible.

FIs are primarily a *risk mitigation tool* for financial institutions and investors because they affect the cost-benefit balance of projects for the investors. FIs, take over part of the risks associated with projects, encouraging investors to participate. They are also useful when returns are too low to attract investors, or to counterbalance market failures that reduce private investment. Projects supported by FIs should thus ideally generate high social returns due to a large public good component, as well as generate enough financial returns to repay the debt component of the project, but not be profitable enough to compete with existing sources of finance.

This is more complex than it seems, as it is not always easy to identify a market failure, the lack of sufficient private returns, or the perceived risk by the private sector for a project. Avoiding using financial instruments for projects that would have been financed by the private sector in any case is difficult. Due to asymmetric information, the funds provider may not be able to assess whether there exist external funding opportunities. The private sector developers will thus have an incentive to apply for supported products, as these will benefit from lower repayment rates than those offered by private financiers and investors.

It is important to take into account that due to the very low interest rates for obligations such as bonds, even projects with low returns may be attractive to investors as long as the returns are safe enough, thereby reducing the need for FIs even for areas of low returns.

2.1.2 Suitability of FIs compared to grants

According to the European Commission (2014b), the FIs for the implementation of EU policies should have the following characteristics:

- Leverage resources and increase the impact of EU programmes;
- Obtain efficiency and effectiveness gains due to the revolving nature of funds, which stay in the programme area for future use for similar objectives;
- Increase the quality of projects as investment must be repaid;
- Improve the access to a wider spectrum of financial tools for policy delivery and private sector involvement and expertise;
- Move away from “grant dependency” culture; and

- Attract private sector support (and financing) to public policy objectives.

The leverage of each FI depends on the type of instrument, its sector and contextual conditions. Based on information to date, the following leverage effects have been estimated by the Commission for the Cohesion supported FIs (European Commission, 2012):

- For equity-based instruments, it is estimated that EUR 1 of public support led to equity investment into enterprises between EUR 1 and EUR 3.4.
- For guarantee-based instruments, the estimated leverage amounts to between EUR 1 and EUR 7.5.
- For loan-based instruments, the estimated leverage effect amounts to between EUR 1 and EUR 2.

FIs are tools that have the potential to enhance the efficiency of the EU budget programmes. In *specific areas of intervention* they are better suited than grants. Where FIs are possible but grants are used, it is an indication that the sector may be over-subsidised. This is nevertheless a very controversial topic, as the method of financing services and infrastructures with a high public good nature can have highly political connotations. In the case of some infrastructures, for example public transport, charging users the actual costs of network investments and maintenance goes counter to the political position of many parties, public perception and even some policy objectives. The use of financial instruments rather than grants, if then repaid directly by the users, may reduce the use of public transport, may increase emissions from private transport, affect the citizens with lower income and so forth. This means that the cost recovery mechanism will need to be designed taking into account these factors. A possibility is to use forms of indirect pricing, such as shadow pricing covered by a public budget, which in turn is raised in relation to the investment, e.g. congestion charges, vignettes, etc.. Similar considerations can be applied for other areas such as health, water, energy or cultural or environmental sectors with high public good value.

Nevertheless, there is evidence that exclusively publicly funded infrastructures often suffer from higher investment costs and inefficiencies. Lack of direct charges on users have demonstratively led to network inefficiencies and abuses in a number of public infrastructures, such as water infrastructures. A PPP system assisted by FIs can improve the efficiency of the system and encourage better management of the resource (Egenhofer et al., 2012).

The revolving nature of FIs benefits the public authorities that manage to implement them successfully. Ultimately, the EU supported risk capital and the

interest rates should allow for the funds to be reinvested repeatedly, generating a larger number of investments than a grant allocation.

While FIs have indeed room to increase their potential applications, in many areas of public interventions the use of grants will always be necessary, and FIs can thus only be considered *complementary* tools. The proper use of FIs requires a considerable rethinking of the role of public budgets and proper assessments. There is a risk that the opportunities are lost by badly designing the FIs, leading to little use and impact.

Despite the importance attached to the leverage effect, seeking a high leverage should not be the sole objective of the public sector, but rather the final economic impact and the public goods that the projects deliver. The leverage objective is partially weakening the actual function of the FIs, as a higher leverage does not indicate that a project is socially better, but only that it is attractive enough for its private returns. A focus on leverage may lead to the excessive use of FIs, weakening the additionality principle of EU interventions, i.e. they should not be used were the private sector would intervene by itself.

3 Performance of FIs in the 2007-2013 MFF

For the 2007-2013 Financial Framework there were 26 FIs (Table 1): 11 internal instruments managed by the European Commission centrally or jointly with a financial institution, 3 instruments under shared management as part of the Cohesion Policy (thus mainly under the control of national authorities), and 13 external instruments. We will here mainly review the case of the funds under shared management, i.e. those for the cohesion policy.

Table 1: Innovative Financial Instruments in the 2007-2013 programming period

Internal Central and Joint management	Internal Shared management	External
CIP GIF High growth and innovative SME facility	JEREMIE Joint European Resources for Micro to Medium Enterprises	WBIF Western Balkans Investment Framework
CIP SMEG07 SME guarantee facility	JESSICA Joint European Support for Sustainable Investment in City Areas	NIF Neighbourhood Investment Facility
RSFF Risk Sharing Finance Facility	JASPERS Joint Assistance to Support Projects in European Regions	EU-A ITF EU-Africa Infrastructure Trust Fund
LGTT Loan Guarantee Instrument for Trans-European Transport Network Projects		ACP Investment Facility
Marguerite Fund The 2020 European Fund for Energy, Climate Change and Infrastructure		GEEREF Global Energy Efficiency and Renewable Energy Fund
EPMF European Progress Microfinance Facility		EFSE European Fund for Southeast Europe

TTP Technology Transfer Pilot Project		GGF Green for Growth Fund
JASMINE Joint action to support microfinance institutions in Europe		LAIF Latin America Investment Facility
ELENA European Local ENergy Assistance		IFCA Investment Facility for Central Asia
EEEF European Energy Efficiency Fund		AIF Asia Investment Facility (NEW, end 2011)
PBI Project Bonds Initiative		CIF Caribbean Investment Facility (NEW 2012)
		IFP Investment Facility for the Pacific (NEW 2012)

Updated table from Núñez Ferrer et al. (2012).

With the exception of support to SMEs, the performance of Financial Instruments has been weak until 2012. A number of holding funds created for urban investments for example had difficulties disbursing them for projects. In a number of areas, projects had difficulties to access funding, as loans supported by EU instruments could not co-finance projects benefitting from grants, excluding the private entrepreneurs that won a grant, but lacked sufficient own funding. In some countries this led to a deadlock where banks were not lending without EU guarantees or other support. A report by the European Court of Auditors (ECA, 2012) highlights the problems created by a lack of regulatory clarity and the existence of counterproductive rules, which set requirements which were at times not attractive to the private sector and required successive changes and reinterpretations. Many hurdles have now been removed with the reform of the financial regulation[4] in 2012, including the possibility to combine support instruments into a single project, and was reflected by an increase in the absorption rates of the funds These changes will have important implications for the 2014-2020 programmes.

[44] 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 (OJ L 298, 26.10.2012, p.1).

The previous programming period was the first one making a relevant use of FIs within the scope of the Cohesion Policy. During the MFF 2007-2013, the deployment through FIs of resources of the European Regional Development Fund and the European Social Fund of FIs was limited to specific objective such as *enterprises' support*, *urban development*, *energy efficiency* and *renewable energy* in the building sector (ibid).

To support and promote the use of FIs, 2 initiatives were set up by the EIB to promote the use of financial instruments:

- JEREMIE (Joint European Resources for Micro to Medium Enterprises), an initiative aimed at promoting the use of financial instruments to improve access to finance for SMEs. JEREMIE supported the creation of new business or the expansion of existing ones, and the access to investment capital.

- JESSICA (Joint European Support for Sustainable Investment in City Areas), an initiative promoting the use of FIs in support of sustainable urban development and regeneration.

Moreover, two technical assistance facilities were launched:

- JASPERS (Joint Assistance to Support Projects in European Regions), a facility for the twelve EU countries who joined the EU in 2004 and 2007. It provided the Member States concerned with the support they need to prepare high quality major projects, which will be co-financed by EU funds.

- JASMINE (Joint Action to Support Microfinance Institutions) providing both technical assistance and financial support to non-bank micro-credit providers/micro-finance institutions and helping them to improve the quality of their operations.

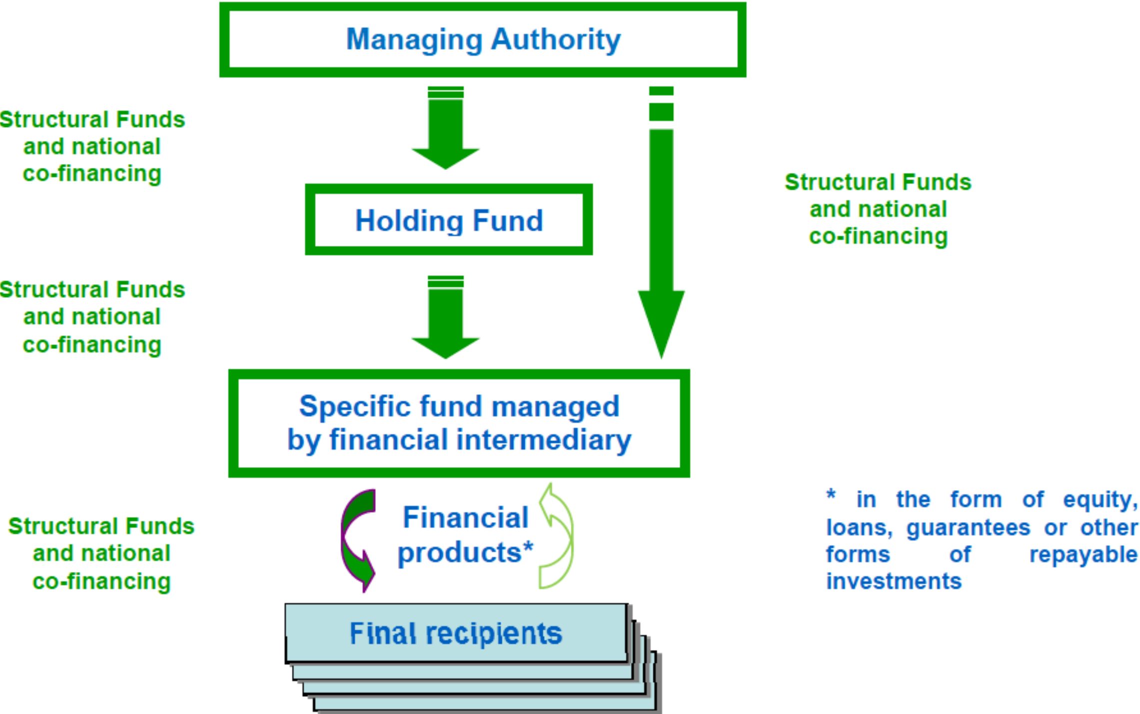
It is important to note that the FIs implemented in the context of the Cohesion Policy were not the only FIs deployed through the EU budget. There have been a number of other instruments managed by the Commission and the EIB that can positively contribute to growth and cohesion. These were for example the Risk Sharing Finance Facility targeting later stages of research and deployment, the High growth and innovative SME facility, targeting innovative SMEs and the SME guarantee facility offering support to SMEs in general. Other smaller instruments have been deployed specially in the area of energy.

Based on the progress report by DG REGIO on financial instruments by the EU structural and cohesion funds (European Commission, 2014c), on 31.12.2013 a

total of 941 financial instruments co-financed from the ERDF and ESF were reported as established in 25 Member States, while only three Member States had not established financial instruments as a form of support. Financial instruments of the Cohesion Policy are implemented through specific funds managed by Financial Intermediaries, with different approaches adopted in Member States in relation to the establishment of Holding Funds.

Holding Funds, which are funds set-up to invest in other funds, have been used mainly for Jeremie and Jessica initiatives, but other local holding funds have also been set-up in countries like Hungary, Poland, and Lithuania. When a Holding Fund is not created, financial resources are transferred directly from the Managing Authority to a Specific Fund – Financial Intermediary which in many cases is commercial bank, state owned bank or agency, state institution or investment fund.

Figure 2: Implementation of Financial Instruments



Source: European Commission (2014c), p.17.

The DG REGIO progress report (ibid) of the performance of financial instruments in member states revealed the following:

- The number of the financial instruments has increased during the second half of the programming period between 2011 (592) and 2013 (940) mainly due to the increase in absolute numbers in Hungary, Poland, Portugal and then remained stable in 2013 (941).

- There are substantial variations in the number of the financial instruments used by member state. The number of financial instruments ranges between 1 (Finland) and 2 (Austria, Malta) to 165 (Hungary) and 231 (Poland). According to reports of Member States, financial instruments are reported taking into account either the type of financial instrument or the number of Financial Intermediaries involved (Poland) which can therefore present a very different picture.

- The majority of funds are allocated to enterprise development. 91% of funds target enterprises, 6 % are dedicated to urban development and 3% to energy efficiency.

- The allocation of funds in Holding Funds and directly to Specific Funds – Financial Intermediaries has been similar. Investment in Holding Funds amount to 6.251 BEUR or 45.7% of OP contribution while direct investments in Specific Funds amount to 8.026 BEUR or 54.3%.

- Insufficient allocation of Holding Funds resources into Specific Funds - financial intermediaries. Only 4.120 BEUR out of 6.251 BEUR or 66% of Holding Funds were allocated to financial intermediaries. As final recipients receive loans, guarantees and other financial instruments only once financial resources are allocated from Holding Funds to such bodies, it means that no resources could be received by final recipients, thus contributing to a low level of absorption.

- A low absorption rate at the level of final recipients (enterprises). Only 6.7 BEUR, equal to 47% of the Operational Programmes' (OP) contribution of 14.278 BEUR have been paid to final recipients, one of the possible reasons being the late launch of the Funds.

4 Potential forms of financial instruments for territorial cohesion in the 2014-2020 MFF

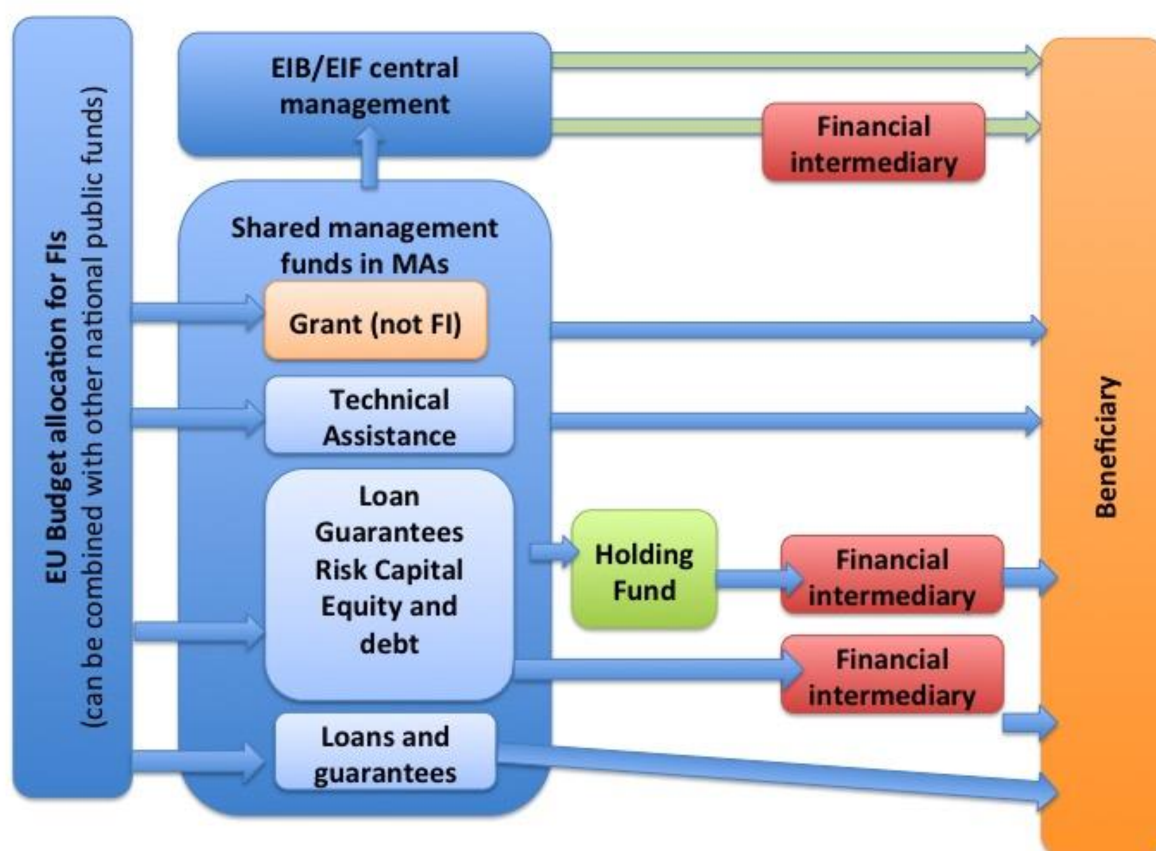
Contrary to the more prescriptive form of FIs in the 2007-2013 period, the objectives and structures of the FIs for 2014-2020 allow for a wider range of interventions. While in the past the EU had limited their scope, it is now the member states and regions that will decide on priorities within the 11 thematic areas. In exchange, these need to provide the EU with a rigorous ex-ante assessment and a solid rationale for the FIs that are being proposed. Member States and managing authorities can now use FIs in relation to all thematic objectives covered by Operational Programmes (OPs), as long as they are able to justify them to the Commission in the ex-ante assessment as stipulated in the regulations. This allows for better targeted and tailored instruments, but also may be bewildering for the MAs and LRAs. Given the difficulties of MAs in the past in setting FIs, the European Commission and EIB have set up an advisory service "fi-compass"[5] specifically to help MAs on financial instruments under the European Structural and Investment funds (ESIF) and microfinance under the Programme for Employment and Social Innovation (EaSI). FI-compass is also developing off-the-shelf instruments, which are ready-made forms of financial instruments that can directly be used to set up for specific objectives.

FIs also can be combined with other forms of support and other financial instruments. This facilitates the development of integrated plans composed of parts that may be financed differently. A theoretical example of a project combining grants, and EFSI and ESIF funds is presented in section 6.3.

FIs can take many forms, such as loan guarantees, venture or risk capital (seed money, equity, quasi-equity or mezzanine loans). Figure depicts the flow from the EU budget support to the final beneficiary. Some of the support can be paid directly to beneficiaries, such as technical assistance programmes, considered also financial instruments, due to their direct link to raise funding and reduce project risks. For completeness, grants are also included in the figure, as they can be combined with FIs, and contribute in reducing the costs of a project, as well as the financial risks for the investor.

[5] http://www.fi-compass.eu/.

Figure 3: Understanding different forms of financial instruments



Source: Authors' own graph.

EU funds (maybe complemented by other public funds) are then used as equity and debt instruments either through financial institutions, or through holding funds that may be set up by national managing authorities (MAs). The rules also allow for the MAs to contribute to centrally managed FIs (such as COSME). The contribution will be ring-fenced for actions in the region where the funding originates. This is very useful for MAs that would like to increase funding in areas covered by the central instruments, such as SME support, but have difficulties setting one up. In addition, MAs themselves can directly provide FIs, but the rules are restrictive - as explained in the next chapter.

Examples for the present financing period are too few and early to assess, but examples of instruments that have worked successfully and can be set up under the present financial frameworks are described below.

4.1 Holding Funds for infrastructure

A considerable number of Holding Funds have been set up in member states, although many had difficulties to operate due to the lack of an appropriate local legal framework, human capital limitations and EU rules on co-financing. These barriers are being removed due to the reforms in the regulations and the improving capacity of local institutions.

In the case of urban development Funds (UDFs), funds can be invested in public-private partnerships or other projects that are part of an integrated urban development plan. Holding funds can also be created, which can then in turn invest in various UDFs. Investments can take the form of loans, guarantees and/or equity depending on the type and development phase of the project to be financed. A loan, for example, will require regular payments of interest and capital. This would be most suitable for low-risk projects generating periodic cash inflows such as energy efficiency investments in buildings, which are repaid in a regular manner, which is the most common operation of ESCO (Energy Service Company) style UDFs.

Due to the potentially high collateral value of existing buildings, it is possible to provide a loan for up to 80-90 % of the total investment. Regular income from energy savings embedded in the energy bills would then ensure the profitability of the instrument.

Case Study 1: Holding Fund FIs for Urban Development in London

Name: London Green Fund (UK London)
Funding source: ERDF
Type of FI: Loans and equity
Financial size: EUR 479.7 million (GBP 406.5 million) = EUR 70.8 million (GBP 60 million) ERDF + EUR 59 million (GBP 50 million) regional public funding + EUR 112.1 million (GBP 95 million) private funding + EUR 236+ million (GBP 200+ million) EIB loan)
Thematic focus and objectives: Urban development

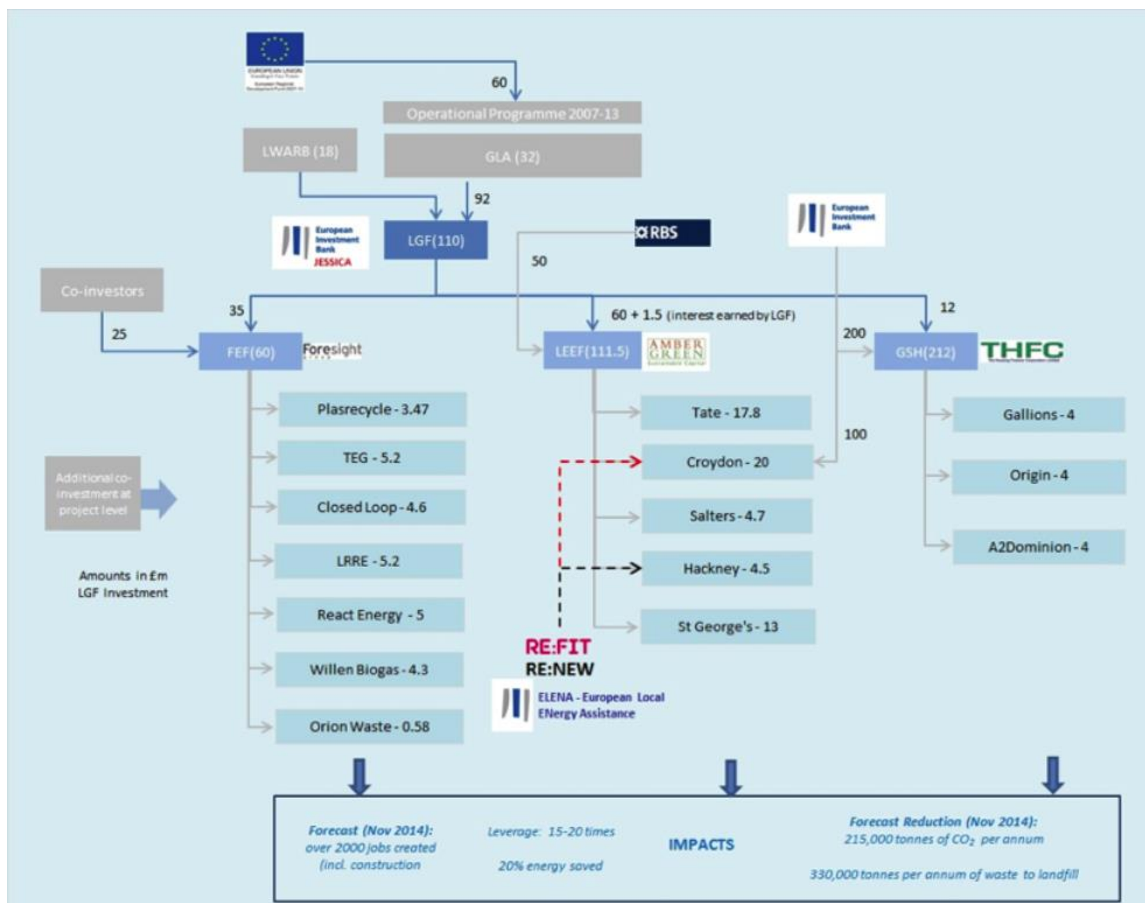
Key Features:

London Green Fund set under JESSICA was launched in 2009 objective of supporting the city reach the ambitious climate change objective of achieving a 60% reduction in carbon emissions by 2025. It is managed by the EIB and it started with a capital of GBP 100 m, half provided by the ERDF, the rest by the Grater London authority and the London Waste recycling board. In 2014, the fund has increased by GBP 10 m by the ERDF funding, plus another GBO 1.8 m

in interest earnings. The holding fund supports three separate urban funds on: energy efficiency (London Energy Efficiency Fund), waste management (Foresight Environmental Fund) and Greener Social Housing Fund. Each fund is obliged to attract private funding, the funding attracted brings the total value of the London Green Fund close to GBP 500 m.

Waste infrastructure such as waste-to-energy and recycling facilities is financed through equity investments, while the funds to improve the sustainability of public, private and voluntary sector buildings are financed mainly via debt.

Overview of the governance structure of the FI



The figure above shows the three funds, and the projects that they support. It is interesting to note the participation of the EIB in co-financing them further, or complementing the fund with the centrally managed technical assistance instrument ELENA.

The London Green Fund is a successful example of separate Funds with in a Holding Fund.

Source: FI Compass Case Studies.

Case Study 2: Holding Fund FI for Urban Development in Poland

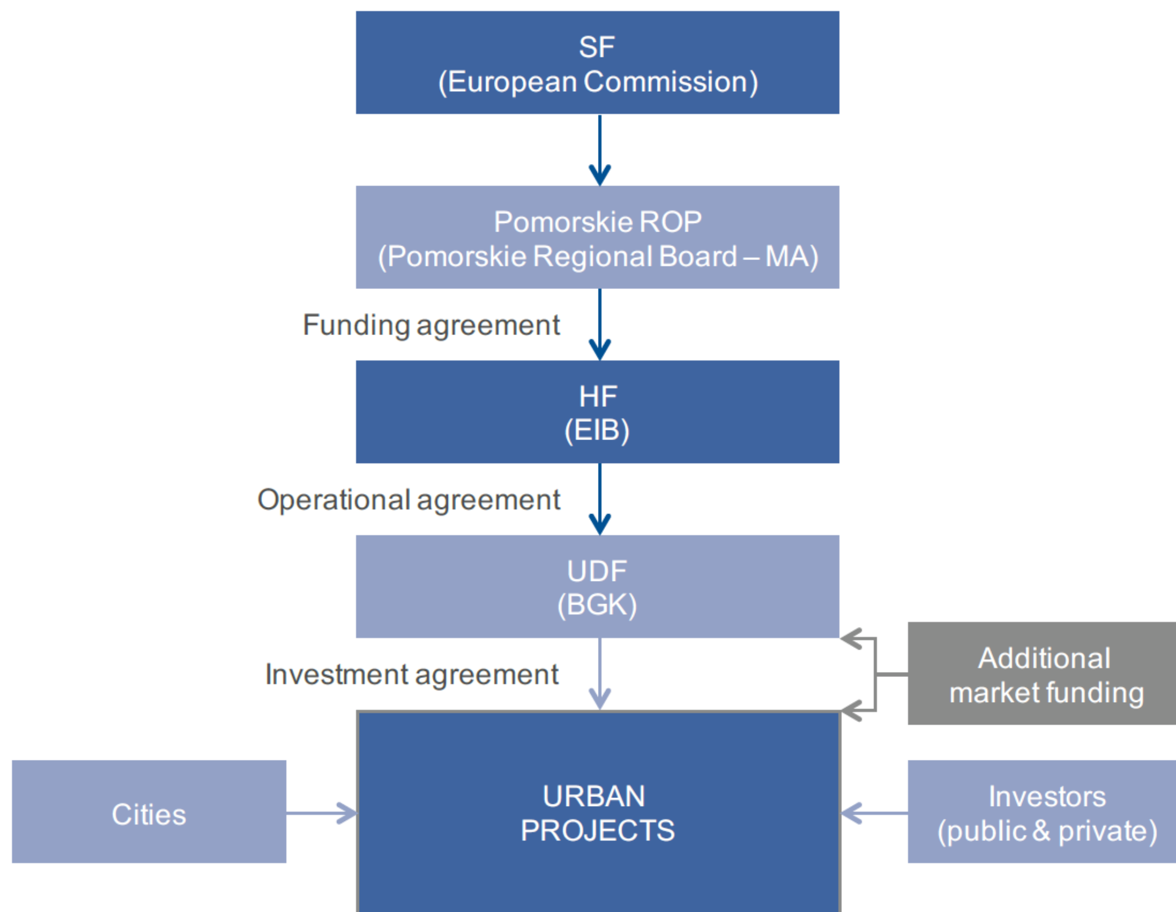
Name: BGK-managed UDF in Pomorskie (Poland)
Funding source: ERDF (as the source of EU funding within Pomorskie ROP) – Jessica Program
Type of FI: Loans
Financial size: EUR 59.96 million (EUR 33.87 ERDF + EUR 5.98 million regional co-financing + EUR 20.11 million of private funding from the UDF Manager, BGK)
Thematic focus and objectives: Urban development

Key Features:

Under SF regulations in the 2007-2013 programming period, financial instruments supporting urban development were deployed under the JESSICA initiative, through which member states can use a part of their OP allocation to make repayable investments in integrated, sustainable urban-renewal projects. In the case of Pomorskie, the Managing Authority used a Holding Fund managed by the EIB that was responsible for selecting, funding and monitoring the performance of urban development funds (UDFs).

The Holding Fund manager's selection of UDFs took place via a competitive procedure, with an invitation for expressions of interest, and was based on evaluation of UDF business plan proposals. The Polish National Development Bank (BGK) was appointed as UDF in the four major cities of Pomorskie, offering low-interest loans to urban projects, as well as additional loan funding of EUR 20.11 million through its own products, available to the final recipients. The UDF has a decision-making body in the form of an Investment Committee, whose tasks include granting final acceptance on signature of investment agreements. An important governance arrangement is UDF's monthly and quarterly performance reporting to the EIB as the Holding Fund manager.

Overview of the governance structure of the FI



The UDF introduced a low-interest rate long-term loan. Investment terms depend on the type of project and the investor. As a general rule, the interest rate is the National Bank of Poland's reference rate, which can be reduced by up to 80% based on the so-called social indicator. This indicator assesses the project's impact in four spheres: social, economic, environmental and spatial planning using a cost-benefit analysis. Projects with the highest contributions are offered more favourable interest rates. However, the loan's final interest rate must not be lower than 0.25% p.a. Loan repayment can be up to 20 years and the grace period can be up to 12 months following the project's completion.

According to the Managing Authority, as at October 2014 the UDF had signed 19 investment agreements under JESSICA for loans of EUR 41.7 million, which is about 105% of the ROP allocation for the UDF. Committed allocation exceeds the contributed capital due to interest earned on this capital. Loans paid to final recipients are EUR 25.6 million, which is about 61% of the allocation. Supported investments total approximately EUR 91 million.

Source: FI Compass Case Studies.

4.2 Financial Instruments in support to SMEs

A number of MAs have set instruments to support SMEs under the Cohesion Policy's JEREMIE instrument. Below are some examples of such structures.

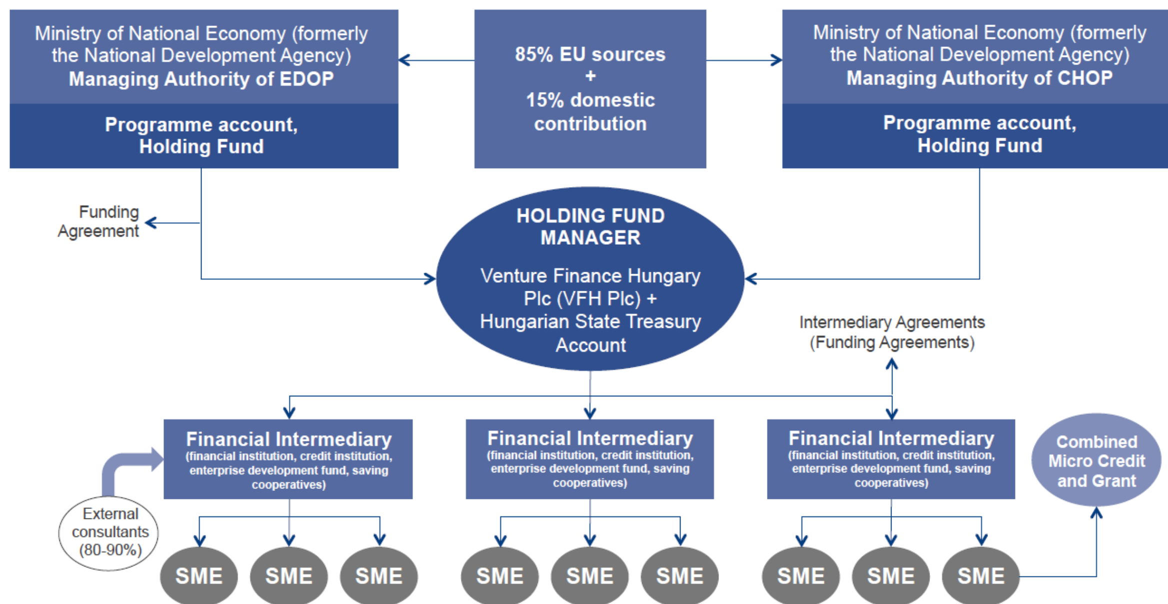
Case Study 3: Combined Micro Credit and Grant scheme in Hungary

Name: "New Széchenyi" Combined Micro Credit and Grant scheme (CMCG), Hungary
Funding source: Operational programmes "Economic Development Operational Programme" and "Central Hungary Region Operational Programme", co-financed under ERDF
Type of FI: Combination of loans (micro credit) and grants
Financial size: EUR 222.9 million Total, of which EUR 172 million ERDF, EUR 30 million national contribution and EUR 20.9 million in private resources.
Thematic focus and objectives: SME support. It provided micro financing opportunities to those micro enterprises that did not make use of credit or had limited access to financial resources.

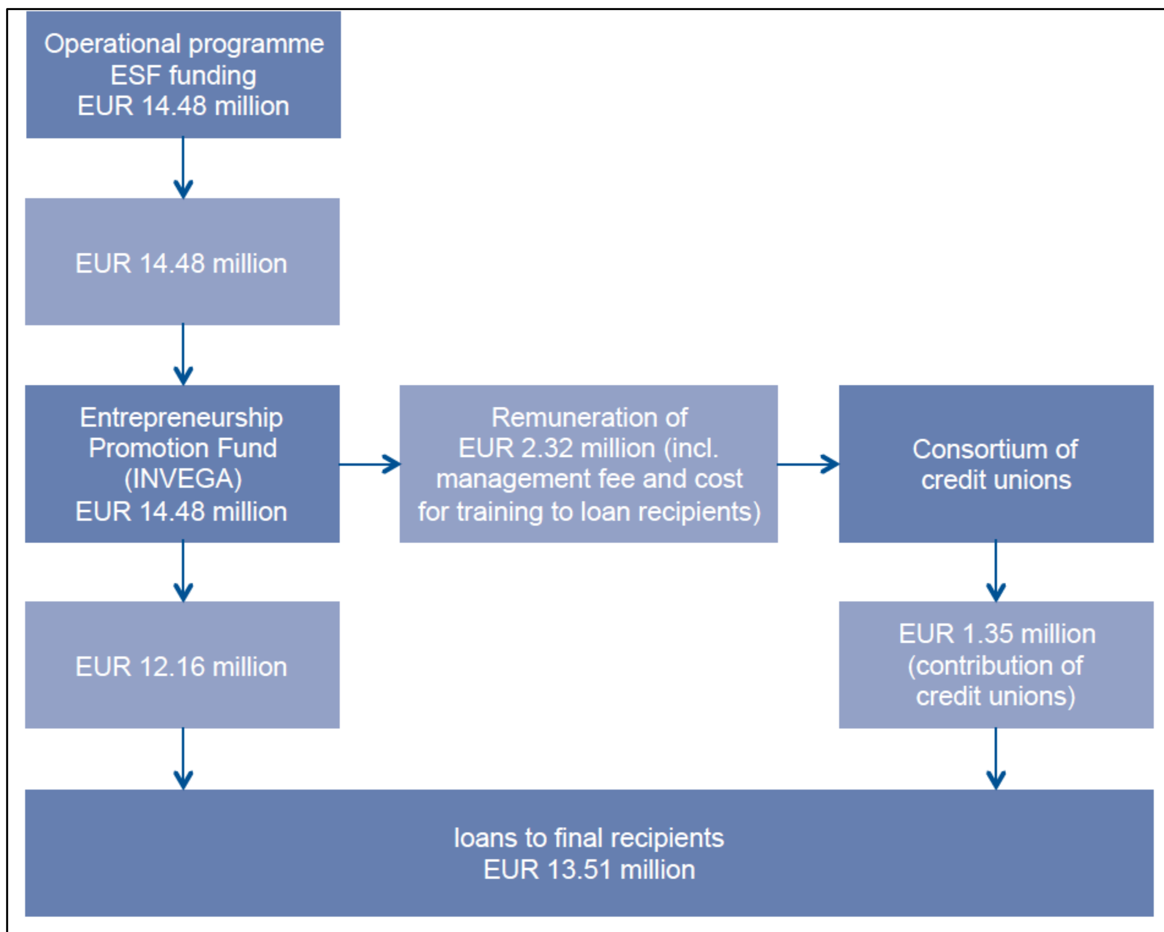
Key features:

In this financial instrument there were three main types of partners: the managing authority (the National Development Agency and, since the end of 2013, the Ministry of the Economy); the holding fund manager Venture Finance Hungary; financial intermediaries such as financial institutions, local business development centres, and savings cooperatives. There were more than 140 financial intermediaries involved, while commercial banks were not involved in the distribution of the CMCG.

Overview on financing structure at CMCG



This example describes how ESI Funds can contribute to the financing of microenterprises, which often have limited funding for covering their own contribution, which prevents them from applying for loans. The managing authority allocated EUR 202 million of ERDF (85%) and national (15%) funds into this instrument, which finances up to 45% of a project's costs through a grant, up to 45% through a loan, while SMEs finance at least 10% through their own contribution. The funds were available between January 2011 and February 2013, when the scheme ended since its funds were fully used. Over 140 micro financing institutions, local enterprise development foundations, and saving cooperatives joined the scheme and spread the benefits of the financial instrument all over Hungary to encourage competitiveness, and long-term growth of the national economy. As long as the instrument was available, it helped 9,389 final recipients' projects bridge the gap in market finance revealed by the managing authority: SMEs did not make use of credit, and/or had limited access to financial resources.



Source: FI Compass Case Studies.

Case Study 4: SMEs support in Lithuania

Name: Entrepreneurship Promotion Fund (Lithuania)
Funding source: ESF (OP for the Development of Human Resources 2007-2013)
Type of FI: Loan combined with training and consultations
Financial size: EUR 14.48 million (entirely ESF contribution)
Thematic focus and objectives: SMEs

Key Features:

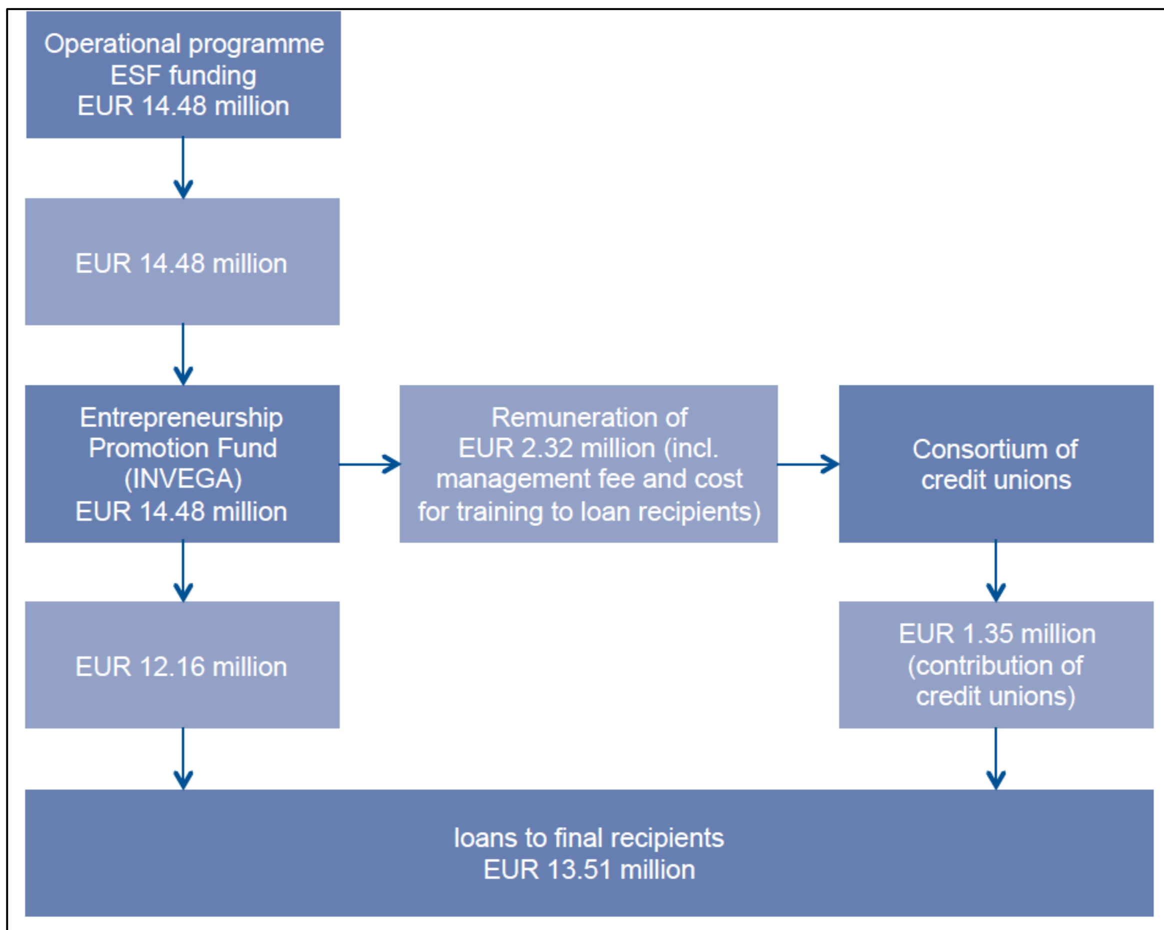
The Entrepreneurship Promotion Fund (EPF) offers loans at better-than-market conditions, in combination with free training to micro and small enterprises that have been operating for less than one year, as well as individual entrepreneurs and business-oriented social enterprises.

The combination of loans and training was a very important aspect of the strategy. Although training was not obligatory, it was very popular among final recipients. It has been shown that providing training on different aspects of business development improves final recipients' entrepreneurial and management capacities. From the EPF perspective, providing training increased the scope for creating jobs and reduced the probability of loan defaults by the final recipients.

A steering group, which consisted of delegates from the managing authority, the intermediate body and the fund manager, monitors the implementation of the investment strategy, as well as results and actions taken to reach the OP goals. The managing authority was responsible for all financial issues. It supervised the holding fund manager and approved the manager's expenditure reports. The Ministry of Social Security and Labour act as the Intermediate Body. INVEGA, an institution owned by the state, managed the holding fund. A consortium of credit unions provided financial intermediation and training to final recipients.

Overview of the governance structure of the FI

By the end of September 2014, 1,017 loans had been issued, of which 479 loans to persons from the priority group. By the end of March 2014 these loans had helped create 1,758 new jobs, of which 610 among young entrepreneurs.



Source: FI Compass Case Studies.

5 Rules impacting lras wishing to set up a FI

The following sections describe the legal obligations that an LRA, acting as a Managing Authority (MA), need to comply with in setting up a financial instrument within the cohesion policy legal framework.

5.1 Rule governing FIs

The legal base for the use of FIs in cohesion policy is Art 37 of the Common Provisions Regulation[6] (CPR) ruling the European Structural and Investment Funds (ESI Funds).

Art 37 (2) of the CPR states that "support of financial instruments shall be 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 types of financial instruments to be supported".

Art 37 (2) specifies a detailed list of items that should be included in the ex ante assessment[7] of the FIs. These 7 items are presented in Table 2 below.

Table 2: Ex ante assessments requirements as per Art 37 (2) of the CPR

a	An analysis of market failures, suboptimal investment situations, and investment needs
b	An assessment of the added value of the financial instruments
c	An estimate of additional public and private resources to be potentially raised by the financial instrument down to the level of the final recipient (expected leverage effect)
d	An assessment of lessons learnt from similar instruments and ex ante assessments carried out by the Member State in the past, and how such lessons will be applied in the future
e	The proposed investment strategy, financial products to be offered, final recipients targeted and envisaged combination with grant support as appropriate
f	A specification of the expected results and how the financial instrument concerned is expected to contribute to the achievement of the specific objectives
g	Provisions allowing for the ex-ante assessment to be reviewed and updated as required during the implementation

[6] Regulation (EU) No 1303/2013.
[7] The ex-ante assessment should not be confused with the ex-ante *evaluation*, which is part of programming (see Art 55 of the CPR).

The ex-ante assessment represents the key document that managing authorities need to produce in order to implement a program through FIs. The production of the required economic and financial analysis is the first entry hurdle that MAs need to overcome in order to access FIs.

To assist MAs in developing the ex-ante assessment the European Commission and the EIB published 450 pages of methodological guidelines divided in 5 volumes: volume 0[8] and volume 1[9] dedicated to general methodology, volume 2 dedicated to FIs for thematic objective 1[10] (research, technological development and innovation), volume 3[11] dedicated to FIs for thematic objective 3 (competitiveness of SME, including agriculture, microcredit and fisheries), volume 4[12] dedicated to FIs for thematic objective 4 (low-carbon economy) and volume 5[13] dedicated to FIs for urban and territorial development.

The methodology illustrated in these five volumes was produced as a structured answer to the frequently asked questions of MAs regarding the ex-ante assessment; MAs are not forced to follow the proposed methodology and are free to develop their own approach; nevertheless an analysis of the official guidelines is useful to understand the effort required to MAs in order to successfully apply for FIs.

5.2 The two building blocks of the ex-ante assessment

According to the ex-ante assessment methodology, the requirements of Art 37 (2) can be split into two building blocks:

1. Market assessment
2. Implementation and delivery

5.2.1 Market Assessment

The first building block is composed by a number of economic and financial analysis where MAs are expected to describe the detailed characteristics of the market in which the FI will be implemented, the dynamics which characterises it and the qualitative and quantitative rationale that justifies the delivery of the program through an FI rather than through other forms of support (e.g. grants).

[8] http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/ex_ante_vol0.pdf
[9] http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/ex_ante_vol1.pdf
[10] http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/ex_ante_vol2.pdf
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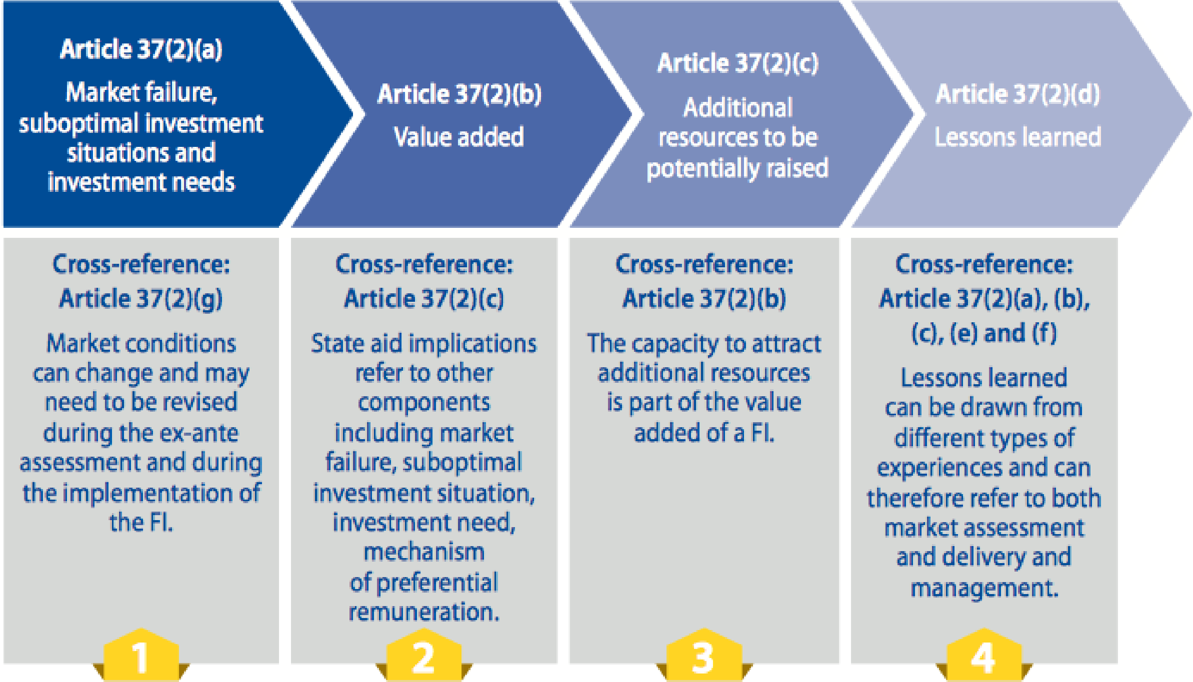
[12] http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/ex_ante_vol4.pdf
[13] http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/ex_ante_vol5.pdf

The development of the market assessment analysis is a highly technical task where a thorough understanding of the local and regional markets' dynamic need to be complemented with advanced tools of financial analysis.

Figure 4: Methodology for FIs market assessment



Source: European Commission ex-ante assessment methodology (2014).

More specifically, the comprehensive market assessment needs to cover a wide range of aspects such as:

The **identification of market problems** is at the core of the first building block; MAs are required to present the market problems of the area where the FI will be implemented. The aim of this part should be to highlight the presence of the market failures and/or of the suboptimal investment situations that are meant to be supported through the public intervention.

A detailed **demand and supply analysis** is necessary. The demand and supply analysis is crucial to assess the *investment gap* that need to be filled and, consequently, the amount of public resources that need to be mobilized. This is also a highly technical task as it entails precise estimation of the size of financial resources required by final users of the program (i.e. estimation of number of applicants and the amount of the requested benefit); the analysis need to capture or estimate the size of the *unmet demand* which, by its very nature, is not observable. The demand analysis needs to be complemented by a supply analysis; this includes the mapping of all the existent sources of financing available for the target market. The analysis should cover public and private

available funding as well as a break down by type of funding (i.e. debt, equity, quasi equity etc.).

Art 37(2) (b) of the CPR requires the ex-ante assessment to include an **assessment of the value added** of the financial instrument. The value added[14] need to be analysed with respect to the consistency with other forms of public intervention in the same market, possible State aid implications, the degree of proportionality of the intervention and the extent to which the proposed FI is able to minimize market distortions. The analysis of the value added needs to compare the proposed FI to any other type of support (other FIs but also grants) and prove to be the option bringing the higher added value.

Following Art 37(2) (c) of the CPR the ex-ante assessment shall include an estimation of the **expected leverage effect** in terms of additional public and private resources that will be raised through the risk-sharing provision introduced by the FI. Moreover, whenever MAs would opt for the introduction of preferential remuneration systems (e.g. asymmetric profit/loss-sharing) to attract counterpart resources (as opposed to equal risk-sharing) they would need to provide a thorough assessment of the need for these systems and of the extent of their use.

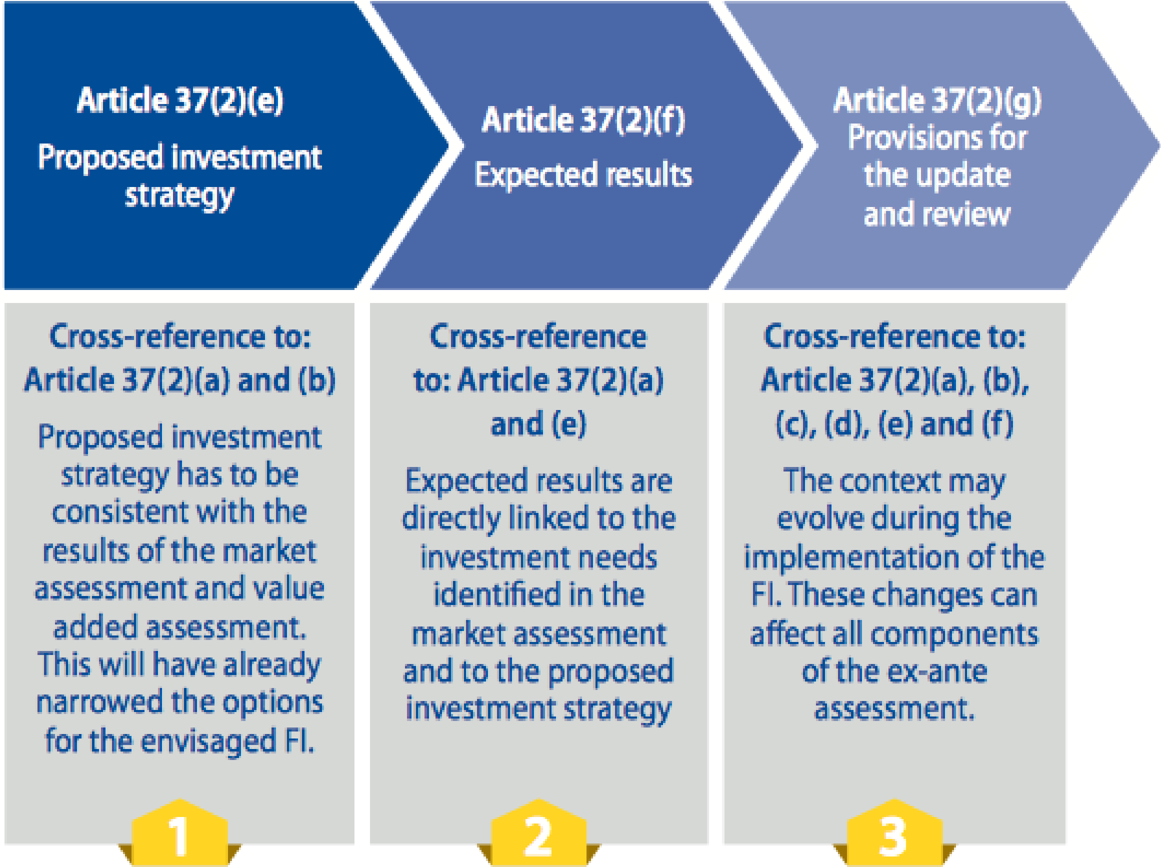
The last methodological step to the first building block regards, as requested by Art. 37 (2) (d), is the **assessment of the lessons learnt** from similar instruments and how the hints provided by previous experiences will be applied in the current context.

5.2.2 Delivery and Management

In the second building block of the ex-ante assessment MAs need to present the implementation and delivery features of the proposed FI (proposed investment strategy, specification of expected results and provisions for "on going" adjustments).

[14] The *Quick Guide* to the ex-ante assessment methodology for financial instruments for 2014-2020, differentiates between a qualitative and a quantitative dimension of the value added, both to be addressed.

Figure 5: Methodology for FIs delivery and management



Source: European Commission ex-ante assessment methodology (2014).

Art 37(2) (e) foresees the performance of an ex-ante assessment of the investment strategy. The selection and the features of the financial product to be set up need to be presented in details in this section. This includes the forecasted range of interest rate, guarantee fees, collateral, tenor/duration, grace period, premiums for voluntary repayment, waiver of availability fees. The choice of the financial product and its design need to be consistent with the conclusions developed in the markets assessment and the value added assessment. If necessary to address different market segments, the investment strategy should adjust to the characteristics of the final recipients. In this view, final recipients and eligibility criteria need to be presented and justified.

On top of the product-specific features, the investment strategy should define the governance structure and the implementation options of the FI following the rules laid down by Art 38 of the CPR. MAs need to choose between providing contributions to an FI set up at Union/national/transnational/cross-border/regional level; moreover if the FI not set up at Union level, MAs need to decide whether they will contribute to an *off-the-shelf financial*

instruments[15] (in compliance with the standard set by the Commission) or to a tailor-made instrument (newly created or already existing). Likewise, MAs need to decide to who entrust the implementation of the FI according to the options laid down in in Art 38 (4).

The development of the market assessment and of the investment strategy should bring MAs to draw a clear picture of what the FI will have to deliver in terms of expected results. In order to comply with Art 46 of the CPR, calling MAs for presenting an annual implementation report to the Commission, MAs need to develop a set of exhaustive *quantitative indicators* suitable for the measurement of the FI's performance in delivering on the expected results. Compiling quantitative indicators requires the establishment of efficient *monitoring and reporting systems* able to ensure a timely information flow between the institution implementing the FI (which in many cases is not the MA) and the MA.

The last step of the ex-ante assessment methodology answers to the provision of Art 37 (2) (g) requiring MAs to set up mechanisms to revise and update the assessment itself in case unexpected events would make a revision necessary. A possible such case is a lower or higher anticipated demand for one instrument which would require a reallocation of the guarantee resources.

5.3 FIs and compliance with State aid rules

Art 37 of the CPR states very clearly that when using ESI funds in support of FIs, "managing authorities, the bodies implementing funds of funds, and the bodies implementing financial instruments shall comply with applicable law, *in particular on State aid* and public procurement".

The provisions governing structural funds contributions to FI are mostly in line with the new State aid rules (Nicolaides, 2014). According to both sets of rules, public intervention is permitted only in *bankable investments* that are not able to attract enough private capitals because of low profitability or of the high-risk profile.

[15] As of now 3 off-the-shelf instruments have been activated: one for energy efficiency/renewable energies Renovation Loan based on a Risk sharing loan model (RS Loan) (Annex IV of 2014/964/EU); and two for SMEs: the Loan for SME's based on a portfolio risk sharing loan model (Risk Sharing Loan) (Annex II of 2014/964/EU) and the Guarantee for SMEs (partial first loss portfolio, capped guarantee) (Annex III of 2014/964/EU).

There is, however, one provision in the Guidelines on State aid to promote risk finance investments[16] that can potentially affect FI implementation, especially where smaller investments are concerned. Paragraph 20 of the guidelines provides that "it is important to recall that risk finance aid measures *have to be deployed* through *financial intermediaries or alternative trade platforms* […]. Therefore, a measure whereby the Member State or a public entity makes direct investments in companies without the involvement of such intermediary vehicles *does not fall* under the scope of the risk finance State aid rules of the General Block Exemption Regulation and these Guidelines". As the programming period just started there is no available information on direct investments.

As noted in paragraph 1.1.2, MAs are entitled to several options when deciding how to structure the governance of the FI. More specifically, Art 38 (4) of the CPR provides that MAs can entrust implementation 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;
(iv) or *undertake implementation tasks directly*, in the case of financial instruments consisting solely of loans or guarantees.

While (i), (ii), (iii) clearly fall under the exemptions foreseen by the State aid regulation, the case in which an MA would undertake implementation tasks directly (iv) is more controversial. The absence of a financial intermediary in delivering the financial support to the final recipients (e.g. an SME) as mandated by the State aid guidelines, seems to point towards a possible incompatibility with the single market.

The implications of this issue are interesting. On the one hand, it can lead to the exclusion of MAs from the implementation of FIs leaving this role to the EIB and financial intermediaries.

Despite MAs, especially those corresponding to smaller LRAs, often opting for the devolution of the implementation tasks due to lack of internal capacity, this doesn't seem a positive outcome as it would be important to grant the possibility of not using financial intermediaries charging fees for their services.

[16] Communication from the Commission "Guidelines on State aid to promote risk finance investments", (2014/C 19/04).

On the other hand, this could eventually turn out to be a push for MAs to implement FIs *targeting small investments***.** As noted by Nicolaides (2014), MAs face two options to avoid breaching the State aid rules; "the first is to ensure that loans and guarantees conform to the market economy investor principle[17]. Although this is of course feasible, it would rather defeat the purpose of mobilising FI to achieve results which are not achieved by the market. The second way is to ensure that any aid remains below the thresholds defined in the new de *minimis regulation* [Regulation 1407/2013]. The conclusion must therefore be that, in the case of funding provided directly to enterprises by MAs, the only realistic possibility of compliance with State aid rules is to limit any support to small amounts that do not exceed the threshold of *de minimis* aid".

5.4 Optimal size and scope of financial instruments

There is a tendency for LRAs to consider that to ensure that local priorities are covered by FIs, there is a need to have many specialised funds in specific investments. From an efficiency point of view, however, the opposite is generally the rule. The larger the fund of a financial instrument, the lower the costs of operating the fund and the lower the risk premium. The European Commission (2014b) reference guide de facto encourages the creation of larger FIs based on the findings of the European Court of Auditors (2012) and European Parliament (Núñez Ferrer et al., 2012) in this respect. The European Court of Auditors (2012) in their analysis of the SME Financial instruments criticises the fragmentation of FIs and claims that some of the funds do not reach the necessary critical mass. The report for the European Parliament explains the importance of risk spread for financial instruments: the larger the portfolio and the fund, the lower the risk from individual investments and thus the lower the risk premium, i.e. interest charged.

In fact, this is in line with experience and theory. A fund covering several priorities may allocate funding based on actual demand for each target area, thus avoiding an excess demand that cannot be covered in one FI while keeping unused funds in another FI. This has been observed in a few member states. A larger fund can also benefit from lower costs of administration compared with many specific funds.

However, specialised local funds may be better suited to understand the local and sector specific needs. Larger financial instruments funds with a larger

[17] The essence of the MEIP is that when a public authority invests in an enterprise on terms and in conditions which would be acceptable to a private investor operating under normal market economy conditions, the investment is not a state aid.

territorial coverage and objectives may lead to a shift funding towards projects in sectors that are less risky, larger, more profitable or benefit of a higher profile, even if those have a weaker public good component and the socio-economic impacts are lower. This may be detrimental for projects that are either riskier, less visible or offer lower returns. An example would be to have a fund covering investments in innovation, industry and rural development, it is not difficult to imagine that rural investments may be disfavoured in such a fund. This can, however, be also counterbalanced by evaluating projects based on different criteria, ensuring that the rating takes into account such issues as level of public or social goods provided, or prioritising specific areas of intervention.

While in some countries there is a problem with the dispersion of FIs, in other countries FIs are centralised. This is the case of Bulgaria, which has decided not to have regional FI structures. According to results from interviews, such a development is linked to the fact that there is no expertise and capacity to run FIs at regional level.

5.4.1 Policy areas more suitable for financial instruments

Given the nature of the FIs as debt instruments, the most suitable policy areas are those were the impact of the funds will create important public returns, while raising a financial return for the beneficiaries, which in turn can be used to repay the intervention. FIs should also only be used where the interest of the private sector is not high enough to raise the funding necessary to exploit the opportunities.

The 2007-2013 MFF already focused on important intervention areas, even if slightly restrictive. The weaknesses of the instruments were mainly due to rigidities in the regulations, not in the objectives of the funds. Under the present economic environment, the main areas are still SMEs, innovation, investments in energy efficiency and in urban infrastructures. Investments in renewables start to be less important as the market matures. Some other areas may of course also be considered, depending on the specific needs in different regions.

A natural area for the use of financial instruments is support to businesses, such as SMEs. The support should, however, be developed in response to a lack of private finance due to a market failure. For example, where risks are higher, but benefits for society are important, for example for innovative businesses creating a new product of high social value. For those businesses the private sector may consider the investment too risky. The high public goods value of an investment is also not interesting to private investors, if the private net present value adjusted to risk is too low. There are areas where the returns to investment

in SMEs are positive, but the private sector considers them too low to be interesting. In such cases FIs are appropriate.

The potential for successful implementation of FIs in urban areas is high. Urban infrastructures and energy efficiency in housing are promising due to population density and higher incomes, i.e. the higher citizens' capacity to pay, and the potential of economies of scale in projects, can keep costs down.

Examples on successful methods to set up the instruments are being published in the fi-compass website. LRAs should be following the fi-compass information closely and take full advantage of its services. Successful FIs are important not only for the LRAs but also for the European Commission and EIB.

6 Conditions affecting access by LRAs to FI funding

There is no rule at EU level that directly hinders LRAs to access FIs, but the nature of Financial Instruments and rules at national level may render it difficult for a number of LRAs to access FI for their own spending priorities. By own spending priorities we are referring to investments in public infrastructures, such as roads, schools, municipal buildings, etc.

This section will explain the following:

a. How the nature of FIs restricts the kind of investments that can be undertaken for an LRA.
b. The problem of determining and managing the revenue stream that will reimburse the debt raised for the investment.
c. Debt limitations for LRAs due to national rules.

While these barriers are important there are a number of solutions, but those may often require the LRAs to change their ways of managing and financing public services. It requires a cultural shift and the European Commission and EIB evaluation (2013) of FIs describes the difficulties and time that such a shift creates. Changes in the way procurement has to be designed to take into account repayment periods and the overall returns to investment (no longer are initial capital costs the only factor), require a different evaluation method. For some FIs to operate, it may entail a change in the cost recovery systems, which may require introducing charges to users. This can cause controversy in some countries and LRAs.

6.1 Accessing the FIs for LRAs own spending priorities

While LRAs may benefit from FIs, it is clear that these are repayable instruments. This requires for projects to be bankable, i.e. be backed by a revenue stream, which will cover the costs of the project. The revenue stream may not necessary be generated by the final beneficiaries of the project themselves (such as road-users paying a toll), but the cost recovery methods to pay back the investment needs to be robust and justifiable.

FIs should not be used for pure public goods. In these cases, FIs are therefore poor substitutes for grants. There are many investments, however, that generate indirect economic returns which the public sector can estimate and indirectly

recover some of the benefits through taxation. This is a form of shadow pricing. If for example a town decides to upgrade cycle lanes and reduce car traffic, it may use a FI that is then repaid through a congestion charge, for example. The tax return to repay the loan makes the FI viable.

Municipalities have been using FIs for energy efficiency investments in municipal buildings, which then are repaid based on an estimation of the fall in energy costs. For other investments, FIs have been recovered through user fees or tax revenues.

FIs may be set up specifically to assist municipalities and other local authorities. This is the case in Bulgaria where a Revolving Fund for Local Authorities and Governments (FLAG) has been created. The role is to provide loans for the local authorities to co-finance grants by the EU structural funds and technical assistance for the preparation of projects. As a new instrument it is too early to evaluate its performance at this stage, but the capacity of municipalities to access these funding is questionable.

In 2014 a new Public Finances Act in Bulgaria came into force on 1 January 2014 restricting the municipalities' borrowing capacity. This act is the tool for the implementation of the EU's Stability and Growth Pact and imposes a balanced budget on municipalities. Annual municipal debt payments are limited to 15% of the average revenue (own and from state subsidies) over the last three years. With reduced revenues from the state, municipalities have recently seen their debt levels grow and this will restrict the access to any financial instrument. Other LRAs will face the same problems in other countries as explained below.

6.2 Level of fiscal decentralisation, credit rating and national rules on local debt

Many LRAs have limited capacity to implement FIs. This may be due to limited competences and a limited level of fiscal decentralisation, a bad credit rating of the municipality and debt rules.

6.2.1 Level of competences and level of fiscal decentralisation

LRAs will not be able to attract funding for areas were they do not have direct competences, for example to modernise schools in the area, if the responsible higher authorities are not involved.

The level of fiscal decentralisation determines the freedom of the LRAs to determine their spending levels and priorities, as well as the level of power in raising revenues through local taxation. The level of fiscal decentralisation in member states will strongly determine the ability of LRAs to make use of FIs for their own spending priorities.

An LRA will find it difficult of nearly impossible to access an FI to finance an infrastructure for which the region does not have the legal right to raise the finance to repay the investment, for example a legal restriction on creating local taxes. If the FI requested was, for example, for upgrading an educational establishment, and the LRA is not able to charge the students, recover the investments from new local taxes or having a guaranteed allocation from the central government, the FI will not be accessible.

6.2.2 Credit rating and debt rules

The financial crisis has left many LRAs in a state of high indebtedness and thus low credit rating. In such cases, the LRAs will suffer from a low credit rating and financial intermediaries will unlikely extend a loan to those LRAs.

In some member states, strict deficit rules curtail the ability of local authorities to raise debt, making sure that the use of FIs close to impossible for many LRAs which do not enjoy revenue raising powers and/or budget surpluses.

6.2.3 Budget stability rules and impacts on FI use by LRAs

The authors have performed interviews to authorities worried on the impact of the fiscal stability rules in the country. Those rules can be a barrier for the LRAs to access financial instruments.

As debt or equity instruments, using financial instruments increases the deficit of the regional authorities and strict limitations of the debt raising capacity of the region means that this may be not possible. Finding off-balance sheet solutions, while in principle doable, may often be very difficult. The COR 'division of powers' web information source[18] presents the fiscal decentralisation levels of LRAs and the legal situation. In some countries, such as Spain and Italy, or Bulgaria as mentioned above, LRAs have to follow strict deficit rules, which makes using FI difficult or not possible in many indebted regions.

[18] http://extranet.cor.europa.eu/divisionpowers/Pages/default.aspx

In Spain, despite the large powers at regional level, the recent constitutional reform has placed strict limits to the debt raising capacity of regions. Despite high revenue autonomy in regions, highly indebted regions are not allowed to raise debt, unless sanctioned by the central state, and regions are required by law to prioritise debt servicing to investments when in excessive deficit.

The Organic Law on Budgetary Stability and Financial Sustainability of 2012 imposes on the Spanish regions to a financial sustainability principle, which requires regions to keep their indebtedness under a deficit ceiling. This deficit is based on a distributed share of the Spanish deficit limit established by the EU stability and growth pact. In addition, the debt of the regional authorities cannot exceed 13% of the region's GDP.

Any region wishing to exceed this ceiling will need to request it to the state. A particular concern for LRAs is the obligation for the authorities to record any projects with public good nature financed by the private sector also as public debt, following the rationale that the public sector operates implicitly as guarantor.

Those rules create a situation where, given the level of indebtedness of Spanish LRAs, many will not be able to use FIs. This is an unfortunate situation, as the design of FIs is supposed to reduce the costs of public infrastructures and make projects financially viable.

6.3 Taking advantage of the new flexibility in the funds

While complex to set up, under the new rules it is possible to use a combination of funding instruments to complete projects.

As an example we can take the development of a grid infrastructure in a small town and rural area linked to the national grid. In such a case, grants could co-finance with EARDF FIs biogas in the rural area, and with ERDF grants and FIs the operations of an ESCO for a local grid investment and energy efficiency. The local grid can also be then part of a new national transmission grid financed by EFSI. The individual, but separate projects supported by ESIF and EFSI make together one integrated project.

It is essential that LRAs collaborate with MAs to ensure that the right priorities are included in the FIs and in their investment strategies. All LRAs should be following the work of the advisory services 'fi-compass' set up by the European Commission and the EIB. It is essential that LRAs collaborate with MAs to

ensure that the FIs are set in a way that the local priorities and business opportunities are eligible.

7 Conclusions and recommendations

The sections above presented some of the regulatory challenges that MAs need to face in order to use FIs within the Cohesion policy framework. The analysis presented in the previous paragraphs described the major regulatory challenges that an MA willing to implement a program though an FI need to face.

The implications of this analysis should be of concern for LRAs to the extent that they are MAs implementing an operational program. In this regard, it is important to stress that in most of the cases *MAs are entities at national or regional level* so the implications for local authorities are relatively few. The reasons for this are not directly linked to the FIs regulation but rather to the general EU structural funds governance and the criteria through which MAs are selected in each Member State.

Nevertheless regional authorities are often designated as MAs and in setting up an FI have to comply with CPR provisions on this matter.

The introduction as mandatory prerequisite of the ex-ante assessment, while being an effective exercise that helps MAs to understand when and which type of FIs should be used, is a highly technical and labour-intensive task. MAs, especially if they are small LRAs, might find it difficult to have the necessary in-house capacity to perform properly such an exercise. Moreover, given the complex nature of the tasks to be performed in the ex-ante assessment a problem of cost-effectiveness might also arise making less attractive for MAs the use of FIs for small-size projects.

In this view, in order to safeguard the access to FIs by small (or less wealthy) MAs and removing the barriers to the development of FIs for small projects we recommend the strengthening of *specific technical assistance programs* focused on assisting MAs in the development of the ex-ante assessment. The methodological guidance volumes published by the Commission are a step in the right direction, but without further assistance these are likely not sufficient to enable smaller MAs to set up or access FIs.

For what concerns the compatibility of State aid rules with the FIs regulation, there seems to a clash between the Art 38 of the CPR and the State-aid guidelines preventing MAs from the direct implementation of an FI. The general block of exemption seems to be compatible only in the case in which the investment would be small enough in order to fall within *de minimis regulation*. On one hand, this could represent an incentive for MAs to directly implement FIs targeting projects of smaller size; on the other hand it could eventually bring

to non adoption of the implementing option foreseen by Art 38 (iv). We believe that any regulatory barrier to the dis-intermediated implementation of FIs by MAs should be removed.

For what concerns the ability of LRAs to access to funds of an already existent FI, it is important to note that this requires that the LRA is able to raise the funds necessary to service the loans. LRAs with a bad credit rating or suffering of strict national borrowing rules, may not be able to benefit directly of FI funds. LRAs are important however to help develop the right instruments and projects in the region, so as to take advantage to a maximum of the flexibility the funds offer.

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