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Financial Instruments now and after 2020

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Abstract

The use of EU financial instruments (FIs) has become increasingly popular in the 2014-2020 programming period. FIs are viewed as more effective than grants for financially viable projects due to their revolving nature and obligation to repay by final recipients. At the national level research has been carried out on the lessons learned from the ESIF FIs implemented in Hungary. Further, the experiences with EFSI have been investigated and its actual and potential effectiveness has been analysed.

The results show that while several FIs have been successfully launched, several difficulties have arisen during their practical implementation. These concerned both centrally implemented instruments and those under shared management. In particular it has been questioned whether instruments such as EFSI really targeted areas where there is an investment gap and blending different sources also proved difficult due to the divergence in regulation. At the national level, compliance with the rigid ESIF rules and regulation in the areas of state aid and public procurement was also challenging.

It is important to address these issues adequately in the post-2020 programming period to ensure smooth implementation. Plans to establish a Single Rule Book for FIs is welcome, although it is important that the common rules are oriented towards the more flexible approach relevant to centralised FIs rather than the more rigid cohesion policy rules. The flexible approach should be extended to the FIs managed by EU Member States.

Keywords:* *Cohesion policy, financial instruments, development fund's effects, institution system, simplification

1. Introduction

The European Commission is currently working on the new legislative proposals for cohesion policy after 2020. The main question is how to change the structure and the rules to achieve more results and contribute to the objectives of the EU.

It seems that there is no consensus in the literature whether cohesion policy has a true impact on EU Member States' economic performance, although we saw that the specialized studies that have carried out an in-depth analysis of the question seem to find quite a significant impact. Therefore, it is still proposed that cohesion policy is a very useful tool to help convergence even though their usefulness might not be immediately obvious from basic economic data. EU funds helped to alleviate the negative effects of the crisis in CEE countries. Counterfactual impact evaluations and macro-level approaches shows that without EU funds the Hungarian GDP growth rate would be even lower (Nyikos2 2013, Balás 2015).

Administrative capacities and efficient procedures may have generally a bearing on whether the impacts of funds are maximised. This is especially important, since the Member States are responsible for management of the programmes, including project selection, control and monitoring – to prevent, realize and correct any irregularities – and also project evaluation (Nyikos and Talaga 2015, p.116). The literature has also highlighted that the contribution of Cohesion Policy to economic development is conditional upon the capacity of national and regional institutions to design robust strategies, allocate resources effectively and administer EU funds efficiently (Bachtler et al. 2014, p.735). It has also been suggested that for the efficient functioning of all implementation systems it is essential to clearly define powers and responsibilities and set up well-functioning coordination mechanisms which are well documented and properly implemented (Nyikos1 2013, p.52).

The role of financial instruments[1] (FI) in the cohesion policy has increased over several programming periods. They have several advantages, including their leverage effect on public investment resources, their capacity to combine different forms of public and private resources, and their longer-term financial sustainability. FIs are considered to be more sustainable than grants, generate better quality projects, and they may be more cost-effective in some circumstances. However, the success of the financial instruments also depends significantly on the existence of a properly functioning, cost-effective institutional system. This requires a special combination of skills and expertise covering both financial and banking knowledge as well as understanding of and familiarity with cohesion policy implementation (Nyikos 2016).

In the light of past experiences summarized above and in the anticipation of the new cohesion policy legislative proposals, we try to answer the following questions: what are the limits to the use of financial instruments and how can greater use of financial instruments be encouraged?

In our analysis we refer to the relevant European and national regulation, literatures, evaluations and the experiences of the authors to seek an explanation of the results and as an attempt to collect the relevant factors that could influence the findings.

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1 Regulation (EE, 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; “financial instruments" means 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”.

2. Discussion

2.1. Investment gap, funding gap and revenue-generating projects

The challenge of fostering investments and addressing market failures in Europe, the **investment gap** exists, so there is a need for cohesion policy to provide funding. However, the investment needs and the conditions for financing differ across the Member States (MSs) and the availability of different types of financing from ESI-funds (e.g. grants), led subsequently to different solutions in terms of ESIF[2] and/or EFSI[3] implementations. There are huge differences between Western and Eastern Europe and a one size fits all is not the best approach.

In Eastern Europe the lack of finance is more obvious, but at the same time this has to be correlated with the market demand (e.g. a lack of good projects). Furthermore, the lack of good, well financeable projects is not always related to the lack of finance, but to more structural problems like the lack of proper administrative capacity to develop and implement projects. It is an important factor if we try to answer the question what is the proper and efficient solution to develop, finance and implement public and private projects.

Financial instruments[4] are struggling to find their place among the ESIF grants. FIs have attracted interest because of their revolving character, meaning that FIs invest on a repayable basis. Their use has been promoted[5] because of the added value the revolving instruments have over grants in terms of the efficiency of the use of public resources with possible use of private sector skills and expertise in areas such as identifying investments, decision-making, managing commercial operations and the ability to achieve returns. **Repayable forms of support** - *loans, guarantees, equity and other risk-bearing mechanisms, possibly combining with technical support, interest rate subsidies or guarantee fee subsidies* - can act as an incentive for better quality investments in a sense that investments need to be economically viable and **revenue generating** so that the final recipient is able to repay the support provided.

However, it should be also noted that a shift from grants to financial instruments is **not advisable or possible in all policy or geographic areas**. Especially in less developed regions in several cases very useful and necessary public projects could not be financed by using FIs:

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[2] European Structural and Investments Funds. The details of the EFSI support are regulated by Regulation (EU) 2015/1017 of the European Parliament and of the Council of 25 June 2015 on the European Fund for Strategic Investments, the European Investment Advisory Hub and the European Investment Project Portal and amending Regulations (EU) No 1291/2013 and (EU) No 1316/2013 — the European Fund for Strategic Investments.

[3] European Fund for Strategic Investment

[4] FIs are defined in the Financial Regulation (Article 2(p) of Regulation (EU, EURATOM) No 966/2012 of 25 October 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 equity or quasi-equity investments, of loans or guarantees, or other risk-sharing instruments, and may, where appropriate, be combined with grants". The CPR uses this definition (see Article 2(11)).

[5] ESI Fund programmes should contribute to delivering the objectives of the Investment Plan for Europe by more effectively using funding and by doubling use of financial instruments (FIs) during the 2014-2020 period compared to the previous programming period. The Investment Plan for Europe focuses on removing obstacles to investment, providing visibility and technical assistance to investment projects and making smarter use of new and existing financial resources.

even though the revenues could cover the maintenance and operation costs but not the investments costs. In this case, public money could provide the missing revenue (e.g. shadow tolls). In economically distressed areas grants have a potential to spur additional investment activities. At the same time, generous non-repayable grants may face also greater challenges in distressed areas – for example in terms of the relative difficulty of attracting and sustaining economic activity there. The economic context and geographic characteristics imply different challenges for the use of financial instruments.

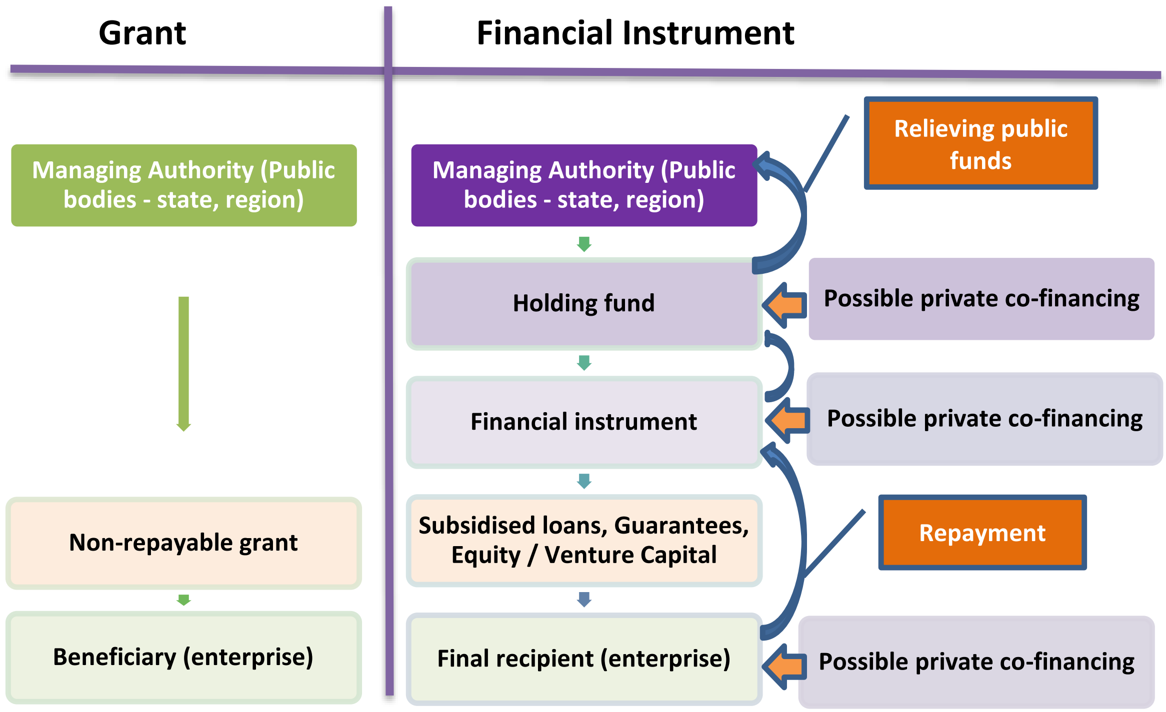
For the **decision about support schemes** policy-makers/experts have to estimate separate effects: (i) different levels of the economic value of the incentives; (ii) different types of incentives (distinguishing between below market rate loans ("soft-loans"), grants to repay interest-rate costs and non-refundable capital grants); (iii) different sizes and (iv) industrial sectors of the assisted firms; (v) different geographic areas where the programme is implemented[6]. The choices between the impacts of different types of programme incentives often involve trade-offs.

At the level of projects, another additional obstacle arises for finding a proper public financial solution for revenue generating projects: there is a contradiction in the cohesion policy rules for calculating the financing gap. In the application for traditional EU funding it has the implicit effect that applicants that use a lower affordability threshold will obtain a larger EU grant. This gives an incentive to demit tariffs and revenues or keep them low and so not to charge sufficient amounts for the service, otherwise the grants that the beneficiary has to pay back as income is higher than originally expected.

Other reasons for a low use of financial instruments, especially among SMEs, can include reluctance among SME owners to accept them. On the one hand, this might be due to the design of the financial instruments (for example too short repayment period) and regulatory uncertainty can also limit their attractiveness. Clearly if a grant is available than the first choice is grant, if not, only then the FI is considered.

[6] Final Report to DG Regional Policy "Counterfactual Impact Evaluation of Cohesion Policy. Work Package 1: Examples from Enterprise Support" (2012).

Figure 1: A model of grant vs FI support

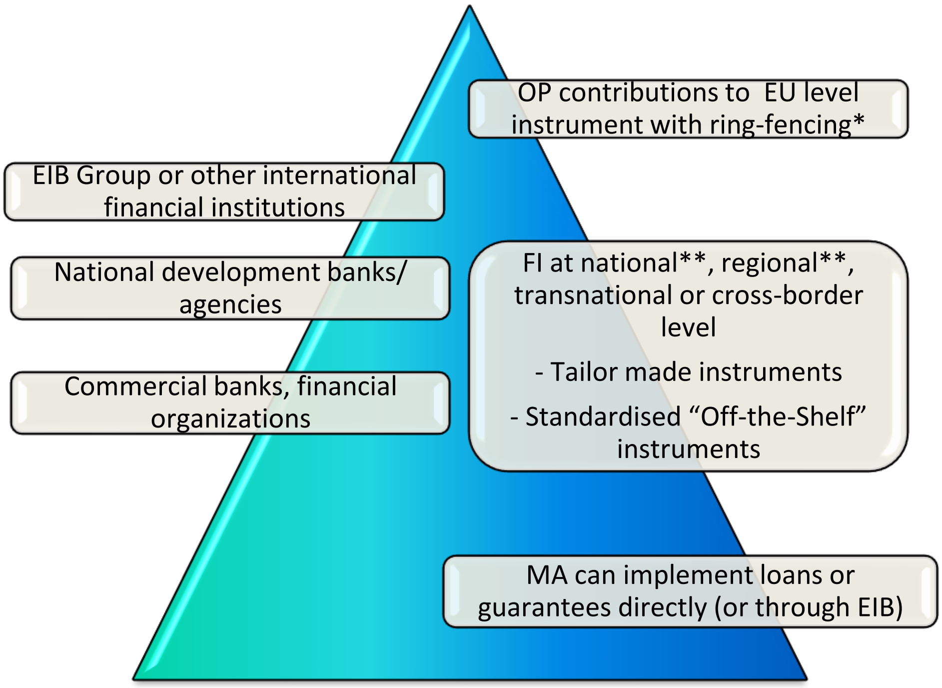


Source: Nyikos compilation

The crucial criterion for the evaluation of a **financial instruments' added value** is their ability to ***fill the funding gaps and compensate for the market failures*** that were identified in the market analysis. *"The size of the market of a public sector led FI is the amount of finance that could be extended by the fund given any level of return sought, but only in those parts of the market in which the private sector will not invest for reasons of market failure. It is therefore highly dependent on the rate of return sought and the specific investment and pricing strategy which a fund may adopt (...) [Correspondingly] the size of the market for a new fund is subject to a large degree of uncertainty (...) Evidence of the finance gap and the optimum size of FIs should be drawn from a variety of sources, including, very importantly, the insight gained from operating these funds in the same or similar markets"*[7].

Figure 2: Different types of FIs at different levels and the possible intermediaries in 2014-2020

[7] EIB (2015), Using Financial Instruments for SMEs in England in the 2014-2020 Programming Period - A study in support of the ex-ante assessment for the deployment of EU resources,



Source: Nyikos compilation

* Up to 100% of the paid support may come from ERDF, ESF and CF; separate priority axis to be foreseen

** ERDF, ESF, CF co-financing rate is to increase by 10 percentage points if an entire priority axis is implemented through financial instruments

Despite the fact that at MS level **ex-ante assessment and justification of FIs** is obligatory, the political decision on EFSI was to launch the programme without an ex-ante assessment. The overarching question is how is it acceptable that EU-policy decision making is made in such a way that the relevance is unjustified and that the effectiveness and efficiency are unproven? Ex-ante analysis is a **complex and time-consuming process**, but a thorough understanding of the market situation is a precondition for a successful public intervention using financial instruments and to define the market failure and the expected result of the FI which is necessary.

Added value can only be created when coherence with the other existing possibilities of financial support can be guaranteed. Coherence is achieved when the planned financial instrument can be justifiably and consistently integrated into the range of existing European and national funding mechanisms. This is the case when the financial instruments make currently existing support instruments redundant or when the existing support mechanisms alone are incapable of closing the gap in demand. Furthermore, added value can be created through complementarity with other instruments, large leverage effect, positive effects on public budgets through back flow, avoidance and reduction of dead-weight-effects and the attainment of (more) challenging political goals[8].

[8] TAURUS ECO Consulting GmbH (2014), Ex-ante Evaluation of the Financial Instruments from the Operational Programme for the Federal State of Berlin within the European Regional Development Fund (ERDF) during the funding period of 2014-2020.

At national level **state aid** rules are also an important factor to **determining the scope of FIs**, as they can impose a range of restrictions in terms of the proposed investment strategies; state aid compliance needs to be checked for each level of the FI *(at private co-investor, at holding fund manager, at financial intermediary and also at final recipient)*.

An area where difficulties arise concerning the use of financial instruments under the ESI Funds is the assessment of the funding gap/investment needs, because there are incoherencies between the two legal approaches, the other that financial support from FIs is repayable, which entails also risks of loss arising from the non-repayment, so the state aid elements are difficult to determine at the time of the financing decision.

Figure 3: State aid implications of FIs

Common assessment principles for state aid	Ex-ante assessment of FIs (CPR Art.37)
Contribution to a well-defined objective of common interest;	Contribution to the achievement of specific objectives set out under a priority;
Need for state aid intervention;	Analysis of market failure or suboptimal investment situations and investment needs;
Appropriateness of the aid measure; Avoidance of undue negative effects;	Added value of the FI and measures to minimise market distortion;
Incentive effect;	Leverage of additional resources and assessment of the need for and the level of, preferential remuneration to attract counterpart resources from private investors;
Proportionality of the aid;	Proportionality of the envisaged intervention;
Transparency of aid.	Depending on the support scheme the quantified value added may contribute to the assessment of the transparency.

Source: Nyikos compilation

Regarding State aid rules, the envisaged FI should be either:

- **Market-conform** (pari passu)[9]; or

[9] When:
- The amounts are similar and on similar terms.
- The private investment is not nominal/marginal.
- The investments take place at the same time.
- The private investors derive no extra advantage [an advantage outside the framework of the investment].
- The private investors do not have other exposure/liability in the company in which they invest.

- covered by the **de minimis regulation**[10] (specific de minimis rules for primary production in agriculture and for fishery apply), which means that the support is presumed not to affect competition and trade between MS; or
- covered by the **block exemption regulation** (GBER[11], ABER[12]) which defines categories of state aid that are presumed to be compatible and hence are exempt from the notification requirement; or
- if the envisaged FI is set up as an **off-the-shelf instrument;** it is exempt from notification procedures, since the design of such instruments ensures that they do not need to be notified to the Commission; or
- if not covered by a block exemption regulation and hence **requires a state aid notification** under the appropriate state aid rules as well as approval by the Commission before implementation so as to confirm the compatibility of the aid with the internal market.

The logic behind using public sources in FIs is that economically viable but commercially not bankable projects can receive finance due to having a development purpose. Basically if the project could receive funding from the market, there is no need for development support (market distortion and crowding out effect). However, if the conditions of the market finance differ too much from the FIs' financing conditions, that means that state aid is granted, so the measure needs to be in line with some state aid legal basis.

The whole logic from another point of view: defaults and other failures to payback financial instruments are unavoidable. However, based on cohesion policy rules the institutional system tries to avoid irregularities and failures, and the more risk-averse public authorities and financial intermediaries are, the more closely they tend to behave like private investors who care predominantly about their financial returns[13]. As a result, they provide finance to businesses and public organisations that could also obtain funding from the markets, so the result is again market distortion and a crowding out effect. In addition, the conditions when default is not due to some irregularity have to be clarified.

Public investment is free of state aid when it is made at the same time and on equal terms with investments by private investors. The first question is whether the public investment is really needed or not (again market distortion and crowding out effect or not). The second remark is that the share of the private investor(s) should be substantial (min. 30%) for the pari passu status.

When considering these conditions one of the basic question is how the establishment of the financial instruments took place, which already determines most of the conditions of the FI

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[10] Commission Regulation (EU) No 1407/2013.
[11] Commission Regulation (EU) No 651/2014
[12] Commission Regulation (EU) No 702/2014 of 25 June 2014 declaring certain categories of aid in the agricultural and forestry sectors and in rural areas compatible with the internal market in application of Articles 107 and 108 of the Treaty on the Functioning of the European Union.
[13] Funding only bankable projects that have sufficient collateral, future cash flows or adequate risk profiles

products, just through looking at the market conditions and the relevant cohesion policy and state aid regulations. Decisive issues are:

- co-finance versus distribution FI model
- co-finance at the holding fund and/or FI and/or project level
- private co-finance substantial (30% or more) or not and at which level
- equal investment conditions at the project level for the financiers or not.

This means that for the definition of FI's scope and conditions and establishment of the tool at national level financed by ESIF has to be in line with:

- **the financial market regulation,**
- **the ESIF regulation and**
- **the state aid rules.**

In addition, for selecting the financial intermediary public procurement process is obligatory and of course the needs to correct the market failure is the objective of the whole effort. It is easily possible to develop a scheme in line with every relevant rule which is not asked and used by the entrepreneurs.

EU level FIs have several advantages, namely that no national co-financing is needed or contracts can be concluded with the EIB/EIF directly by managing authorities without the need for public procurement, and the EIB/EIF can select financial intermediaries to manage FIs on the basis of its internal procedures (NO public procurement again). This puts Member State institutions and the EU institutions on an unequal footing (Nyikos and Soós 2018, p.125). EIB/EIF is exempted from the state aid rules and cohesion policy rules (determined thematic objectives, monitoring prescriptions, co-financing…etc.) as well.

Interestingly despite the advantages mentioned, most of the Member States still prefer the use of national/regional FIs, mainly because the tailor made solutions could cater better for local needs for finance.

2.2. Main features of cohesion policy regulation 2014-2020 on FI

The regulatory framework in which FIs are developed can determine their use and effectiveness.

For the programming period 2014-2020, FIs in cohesion policy are designed to address specific market needs in accordance with the objectives of the ESI Funds programmes. The Common Provisions Regulation (CPR)[14] applies to all five ESI Funds and FIs can support all thematic

14 Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the

objectives[15]. The relevant legislative framework on FI implementation is more complex, with the EU level co-legislators aiming at better tailoring rules to the specificities of these instruments. The regulation is complemented by delegated and implementing acts and guidance documents issued by the European Commission (EC).

The main difference between the 2007-2013 and 2014-2020 regulations is that in the 2007-2013 programming period there were short and limited rules and later few guidance documents on Financial Engineering Instruments (FEIs)[16] which gave a lot of room for manoeuvre for the Member States without legal certainty. In the 2014-2020 programming period a more detailed regulation has been introduced and several guidance documents have been issued on FIs which are not necessarily in line with the Member State practices that have been in place since 2007-2013. Despite the provisions in the CPR, in several cases the interpretation is not explicit and there is an apparent need to amend the text of the CPR. (Nyikos 2016).

Figure 4: Regulatory changes relating to FIs supported by the ERDF and ES

	2007-2013	2014-2020
Scope	Support for enterprises, urban development, energy efficiency and renewable energies in building sector;	Support for all thematic objectives covered under a programme;
Set-up	Voluntary gap analysis for enterprises and at the level of holding fund;	Compulsory ex-ante assessment;
Implementation options	Financial instruments at national or regional level – tailor made only;	Financial instruments at national or regional level, transnational or cross-border level: tailor made OR off the self OR MA loans/guarantees Contribution to EU level instruments;
Payments	Possible to declare to the Commission 100% of the amount paid to the fund – not linked to disbursements to final recipients;	Phased payments linked to disbursements to final recipients National co-financing which is expected to be paid can be included in the request for the interim payment;
Management cost and fees, interest, resources returned, legacy	Legal basis set out in successive amendments of the regulation and recommendations/interpretations laid down in COCOF notes;	Detailed provisions set forth in basic, delegated and implementing acts;
Reporting	Compulsory reporting only from 2011 onwards.	Compulsory reporting from the outset, on a range of indicators linked to the financial regulation.

Source: EC "Financial instruments in ESIF programmes 2014-2020 - A short reference guide for Managing Authorities", July 2014

FIs financed by the ESIF must also comply with the relevant programme, eligibility rules, expenditure related provisions, co-financing elements, monitoring and reporting requirements[17]. Additionally, the Commission released and intends to issue further guidance on different aspects of FIs. In several cases, these documents seem to be more restrictive than

Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006.

[15] laid down in Article 9 of the CPR

[16] Four COCOF notes on financial engineering instruments from 2007 (COCOF/07/0018/01), 2008 (COCOF 08/002/03) 2011 (COCOF 10/0014/004) and 2012 (COCOF 10/0014/05).

[17] EC, Financial instruments in ESIF programmes 2014-2020 - A short reference guide for Managing Authorities, July 2014.

the regulation[18]. Risk of "audit freak" of practitioners and final beneficiaries may also lead to inflexible and inefficient use of funds.

The overwhelming evidence from the information and data collected through audits, reviews and evaluations of financial instruments shows that FIs can achieve the underlying goals. However, to evaluate FIs efficiency and effectiveness we need more information than what we have now in the EC monitoring system, because of the differences between

- the payment- and monitoring system of cohesion policy and
- reactions of MSs (overbooking to avoid absorption-failures) and nature of FIs (revolving and reinvesting more than once during the programming period).

The success of financial instruments significantly depends on the existence of a properly functioning and cost-effective institutional system. This requires a special combination of skills and expertise covering both financial and banking knowledge and familiarity with the process of cohesion policy implementation. FIs are amongst the most complex funding instruments, with significant risks if they lack adequate planning and delivery mechanisms.

Figure 5: Risks affecting the performance of FIs

Risk category	Examples of types of risks
Executive and governance risk	Lack of commitment, support or sponsorship; insufficient alignment with other initiatives;
Management risk	Insufficient project/programme management; unsatisfactory planning, monitoring or controls; inadequate scope; or inappropriate decision-making process;
Financial risk	Credit risk (defaulting loans or mezzanine loans, defaulting underlying loans covered by guarantees), counterpart risk (final recipient or financial intermediary), treasury risk, or operational risk, costs of the FI;
Organisational risk	Inadequate organisational alignment; change management; insufficient communication; lack of competences; insufficient staffing; lack of training; ineffective business continuity plan; or IT risks (related to hardware, software, security, availability, disaster recovery, etc.).

Source: Nyikos compilation

In the 2014-2020 programming period the cohesion policy regulation from the lack of adequate regulations (2007-2013) moved to overregulation and the logic of grants management is felt to have prevailed in many areas of FI rules (e.g. transaction based audit, monitoring and reporting system; unmanageable amount of indicators coupled with interpretation problems). The level of details makes it difficult to apply the rules in practice.

2.3. Recommendations for after 2020

It is expected that after 2020 there will be less funds available, but the demands of European businesses for financing with attractive conditions will remain. The concept of "doing more

[18] See detailed explanation in Nyikos: The Role of Financial Instruments in Improving Access to Finance, Combined Microcredit in Hungary EStIF 2|2015.

with less” provides new challenges for both EU and Member State policy makers. In is rightly expected that the importance of FIs will grow, as their revolving nature will make them more sustainable in the long term.

Compared to grants, financial instruments have a particular advantage – they tend to attract investors with better projects. The requirement to pay back support makes them less attractive for businesses that do not expect returns on them invest investment. In contrast, if investments are paid for by grants, businesses might be willing to implement their projects, even if they do not expect them to create significant future revenues. The relevant and recurrent question is whether businesses really need grants to finance projects (with the exception of risky RDI projects).

The demand for uniform standards and management methods of the new FIs is[19], in several cases, pushing the implementation structure towards different solutions than what was done before. This new direction using centrally defined unified solutions (single rule book) could be a good way forward; nevertheless, clear rules and strong methodological guidance – *or clear decision on more flexibility* – are needed. FIs as market tools have to comply with the complex ESIF, state aid, public procurement and financial rules and regulations. The flexibility by the EU level regulations, namely more favourable implementing conditions of EU level instruments vis a vis tailored instruments implemented nationally is far from being justified. In the new legislative package for 2021-2027 the more flexible rules should be made available to Member States or national promotional banks or other public institutions when managing ESI Funds as well.

Less regulation laying down the fundamental criteria would be more useful. “New requirements should not be imposed without taking into account the differentiation of particular forms of financial products and the fact, that certain provisions applicable to one product may not be applicable to other ones. For the final recipient, the process for accessing the financial instrument should be simpler than receiving a grant (if grants will still be offered), especially for SMEs, and similar to the requirements for other types of financial products from public and private sources, otherwise there will not be an incentive for final recipients to apply for and use financial instruments”.[20]

However, even with the change of the FI architecture, the incorporation of past experiences is very important and the **need for expertise and administrative capacity** is crucial. Administrative capacity at all levels could be increased by coordination among the Member States and **dissemination of information** on good practice, problems and solutions, etc. would be useful. More emphasis should be placed on producing and making available for the Member States summary documents, and other comprehensive information.

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[19] 2014-2020 FI rules on remuneration, selection of intermediaries …etc.

[20] Interim Report on Access to Financial Instruments from the High Level Expert Group on Monitoring Simplification for Beneficiaries of ESI Funds HLG_16_0004_00 22/08/16.

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