- FI are not new, they are widely used across EU as more and more are established.
- There is little knowledge about FI in ETC yet - true - but such knowledge exists in your MS/region, maybe not far from your office.
- Therefore, do not be scared to learn about FI and try it out in your ETC programme.

Credit: iStock/Pakhnyushchyy

can financial instruments be successfully implemented in european territorial cooperation programmes?

Financial instruments (or revolving funds) are still quite new in European Territorial Cooperation (ETC) even though they have been used in cohesion policy for many years. The basic mechanism is that programmes can use EU funds in a revolving way (i.e. EU funds are invested - repaid - reinvested - repaid - etc.) alongside grant mechanisms. The European Commission and The European Investment Fund are open to try it out and support ETC programmes with a pilot.

And you? Are you ready to explore this new way of financing in your programme?

*By **Katarzyna Pelc,** INTERACT Point Viborg*

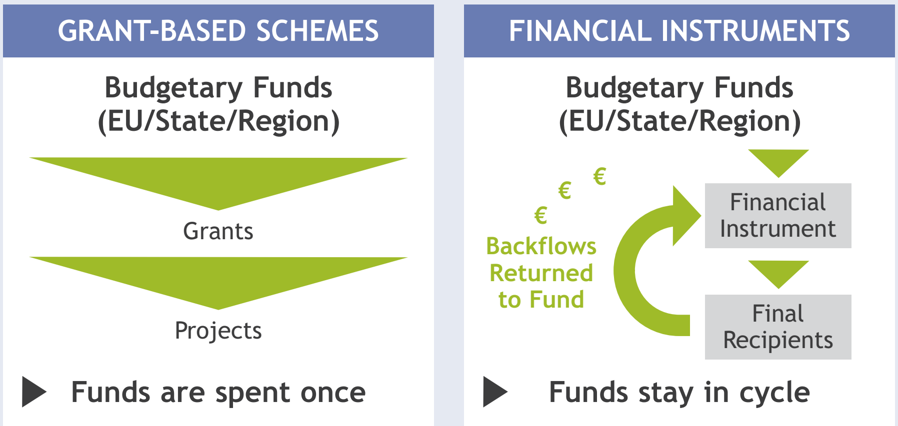
In the current programming period, 70 European Territorial Cooperation (ETC) programmes are managing in total EUR 8.7[1] billion European Regional Development Funds (ERDF). This includes 53 Cross-border Cooperation programmes (CBC), 13 transnational, one interregional and 3 networking pro-gram-mes. Some of the largest programmes have a budget of over EUR 300 million ERDF, while the smallest have a budget of less than EUR 30 million ERDF. Different rates for national co-financing are used, varying between 50% and 15%. The total amount of funds managed by ETC program-mes (ERDF + national co-financing) could therefore amount to approximately EUR 12 billion.

Approximately EUR 12 billion is being spent by 2007-2013 ETC programmes in the form of grants for beneficiaries from all over the EU.

1 *http://ec.europa.eu/regional_policy/cooperate/cooperation/index_en.cfm*

INTERREG V: What the future could be?
Grant-Based Schemes and Financial Instruments

The main characteristic of a grant is that they do not need to be paid back and can be spent only once. Financial instruments (FI) are different in that they are repayable in nature and can therefore be reused in the programme area. Consequently, their impact can be many times greater than grant assistance.



Source: INTERACT Programme

Characteristics of grants and financial instruments

Grant	Financial instruments
Gifts: do not need to be repaid	Loans, guarantees, equity, mezzanine: need to be repayable in nature
Can only be spent once	Have revolving character: funds stay in cycle and can be reinvested in the programme area after they have been repaid; Leverage public funds with private sector capital invested in the programme area at much higher rate than grants e.g. 1:4.5, 1:7.5 or more[2]; Can have a greater multiplier effect than grants.
Reimbursements of expenses	Advanced payments to final recipients
In many cases, driven by market failure	Market driven instruments promoting entrepreneurship, efficiency and effectiveness. However, FI with Structural Funds can be used only in the situation of market failure or suboptimal investment situations
Often complex and lengthy procedures: grants can be granted several months after the application/payment request has been submitted	The process of setting up FI can be lengthy. However, once set up, FI have simple, short procedures: a loan can be granted to recipients within one week using the standard procedures operated by the financial intermediary

Source: INTERACT Programme

Out of almost 5.000 ETC projects from 2007-2013, EUREFI (Europe Regions Funding) is the only one which operates as a revolving fund. It is a project within CBC INTERREG IV Greater Region Programme covering Luxembourg and parts of Belgium, France and Germany. It is the first ETC funded cross-border venture capital fund created jointly by EU and a group of private partners in Wallonia (Belgium), Luxembourg and Lorraine (France). According to the information provided under annual implementation report for 2011, the size of the instrument is EUR 4.12 million, with EUR 1.12 from ERDF. From the latter amount, EUR 0.39 million was paid to final recipients by the end of 2011. EUREFI assists SMEs and industries during their expansion into neighbouring markets, helps consolidate their financial structures by boosting their own resources, providing expertise with developing business plans and ultimately improving integration of investment policies in partner countries/regions.

Key messages from the European Commission

- **The share of FI in cohesion policy has reached 5% so far in the 2007-2013 period, and in 2014-2020 the Commission will encourage Member States to increase this share significantly.**
- **FI need to play a more important role in delivering the objectives of cohesion policy in 2014-2020.**
- **We need a wider range of partners to be involved in the implementation of 2014-2020 cohesion policy to make it a success.**

2 *"Financial Engineering Instruments implemented by Member States with ERDF Contributions, European Commission Synthesis Report"*, 24.01.2012, P. 12

Financial Instruments in 2014-2020: What does the European Commission say?

Investment orientation, innovation and maximising the impact of EU funds are the keys to reaching the objectives of the Europe 2020 Strategy for smart, sustainable and inclusive growth in Member States and regions. Cohesion policy and all its instruments will need to be deployed in order to achieve these objectives, among them FI. Draft regulations and strategic documents[3] which shape EU funding in 2014-2020 call for a greater use of FI by Member States and programmes, as they can provide an important, new financing stream for innovative and strategic projects, and also support long-term, sustainable investment at a time of fiscal constraint.

"We need to optimize cohesion policy and do more through revolving funds in 2014-2020. Even though, at the moment, most funds are distributed as grants, the added value of FI is widely recognized, especially their revolving character and leverage effects, particularly in a context of shrinking public resources and fiscal consolidation affecting Member State economies"

***Rudolf Niessler**, Director, Unit B Policy, European Commission, Directorate General for Regional Policy*

- By end 2011, a total of 592 Financial Instruments (FI) (68 holding funds and 524 specific funds) had been set up through 178 Operational Programmes (OP) in almost all MS (except Ireland and Luxembourg) and in one region covered by ETC CBC programme.
- The total value of OP contributions to all funds is EUR 10 781, including EUR 7 078 m of SF (ERDF+SF) assistance.
- Of this, just over a half (EUR 5 629 m) was allocated to holding funds, with the remainder half (EUR 5 151 m) directly to specific funds set up without holding funds.
- The highest share, namely EUR 8 903 m including more than 96% from ERDF, was invested in FI for enterprises (micro/SMEs). Out of the total amount of EUR 5 753 m of SF assistance paid to the FI for enterprises, 20% (EUR 3 583 m) was effectively paid to final recipients by end of 2011.
- FI for urban development supported through cohesion policy constitute EUR 1 075 m of SF assistance in ten MS. At the end of 2011 EUR 576.70 m was paid by MA and holding funds to specific funds operating in urban development area. The scope of the projects supported by specific funds included e.g. brown field regeneration and development of sustainable urban infrastructure.
- Cohesion policy also supported FI in energy efficiency and renewable energies with EUR 250 m of SF assistance in five MS - altogether support paid to specific funds for energy efficiency and renewable energies amounted to EUR 51.50 m of SF at the end of 2011.

Source: *"Summary report on the progress made in financing and implementing financial engineering instruments co-financed by the Structural Funds Programming period 2007-2013".* Situation as at 31 December 2011, December 2012

Turning challenges into opportunities

"In 2007-2013 an important lesson was learnt when it comes to FI. In particular, the regulatory framework was not adapted to a significant growth of FI in cohesion policy, and had to be adapted during the programming period, there have been cases with unjustified overallocation of funds which remained unused for a long time. Some managing authorities and financial institutions involved in the process did not have the capacity and know-how to effectively utilize FI. Unfortunately, this caused delays in setting up FI and reduced their effectiveness.

However, these challenges cannot discourage us from using more FI in 2014-2020. We are learning from previous mistakes and will turn current challenges into future opportunities. In particular, the Commission is preparing a regulatory framework that is more adapted for FI in the future; their thematic scope will be widened and Member States and managing authorities will be able to deploy them for all thematic objectives of Operational Programmes. FI will need to be better designed and better targeted following ex-ante assessments, analysis of market failures and investment needs in the region. All these will help tailor them better to each programme's specific circumstances.

When we engage in getting the best out of 2014-2020 cohesion policy, we need to think in terms of partnership. It is now evident that cohesion policy cannot be delivered by public sector only, and we need to involve private partners as co-investors and fund managers, including financial institutions, drawing upon their technical and financial capacity and expertise. The Commission would like to see this reflected in 2014-2020 Operational Programmes and the new regulations will provide the basis for it."

***Rudolf Niessler**, Director, Unit B Policy, European Commission, Directorate General for Regional Policy*

3 *"Europe 2020 Strategy for smart, sustainable and inclusive growth"; "A Common Strategic Framework 2014-2020"; "Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions: A Budget for Europe 2020."*

Financial Instruments in 2014-2020: What do ETC programmes say?

The work on 2014-2020 programming has started, and ETC stakeholders are exploring new ideas and tools, which can help deliver the objectives of Europe 2020. Questions are being raised as to whether the utilisation of revolving funds would also be possible in territorial cooperation. Even though FI and investment principles are new concepts in ETC, some programmes see them as positive tools:

1) which could help address current challenges; i.e. involvement of private sector, revenue generation, sustainability of results, more innovation, state aid;
2) which could open new avenues and possibilities for programmes; e.g. reinvesting funds into the programme area, leveraging private sector capital invested in the programme area alongside EU funds, pooling expertise and know-how between national and regional authorities, financial institutions and final beneficiaries; building institutional capacity through partnerships between public and private sectors, and strengthening entrepreneurship.

On the one hand, there is the need for a change in ETC in order to address current challenges. There is also willingness to try new things. On the other hand, based on bitter lessons learnt from recent controls and audits by national and EU audit services, many ETC programmes choose prudency, staying on the safe side and avoiding any new (i.e. risky) endeavours. They know that the cost of errors can be very high, sometimes as high as a suspension or interruption of payment to a programme or its Member States for several months. In consequence, they are afraid of trying something which is new for them; e.g. FI. The thinking is often as in the equation below, even though there is no evidence that FI are more risky instruments than grants.

INNOVATIVE = RISKY = EXPECT AN AUDIT VISIT = POTENTIALLY HIGH ERROR RATE = PROBLEMS

Still, some ETC programmes are tempted and would like to pilot FI in 2014-2020; however, only if the Commission is supporting the process.

ETC Programme North West Europe presented twice to the Monitoring Committee the idea of using part of ERDF in a revolving way. Two feasibility studies were carried out in 2004 (under the IIIB Programme) and in 2008 (under the IVB Programme), which analysed the possibility of allocating part of ERDF into FI investing in growth enterprises from the North West Europe programme cooperation area.
They both concluded that "*North West Europe Small and Medium Enterprise Fund*":

- was needed to address the gaps in the region in assisting SMEs wanting to grow and expand across the borders;
- would help leverage private early-stage financing for young, innovative, knowledge-based businesses who wish to set up a partnership outside their national market to become competitive;
- would be feasible from the point of view of the supply side; i.e. investors who would co-invest alongside the North West Europe programme;
- would be fully integrated with the core objectives of the programme and EU policies.

Despite positive conclusions, the Monitoring Committee decided not to launch a financial engineering operation.

Trying FI in a transnational context

"In the North West Europe Programme, we try to look at new concepts and pioneer new ideas which can help address the needs in the programme area, while also fulfilling the policy objectives. The idea of using part of ERDF funds in a revolving way and involving more beneficiaries from the private sector has always been attractive. We looked at FI twice, but perhaps the timing was not the best. On both occasions, when it was presented to the Monitoring Committee, the programme's implementation was well advanced, programme documents were completed, and a significant part of the funding was already allocated. Looking at it now, it could have been difficult at that time to try something completely different from our daily business, something so new and unexplored. We also felt we lacked the know-how, resources and capacity to properly manage the process, as well as that we were on our own with this new idea. Investment processes like these are new for ETC, but we would like to explore it and see how to make it work in the transnational context. That is why we are trying it once again, and believe it can be different this time. We plan to present FI to the Programme Preparation Group (February 2013) at an early stage of the 2014-2020 programming process. In this way, there is a good chance of anchoring it well into the programme's strategy and documents and, most importantly, we feel we are not on our own during this challenging process. The European Investment Fund has strong experience in this area and has been supportive to us and so we may join forces to try and make it work in the transnational context of the North West Europe Programme."

Christophe Wacquez*, Process Unit Coordinator (Finance, IT, Administration), ETC North West Europe Programme*

Are Financial Instruments feasible and suitable for ETC? What does the European Investment Fund say about it?

Following ETC programmes' interest and requests, since 2011, INTERACT has been carrying out research on FI, organizing six meetings for ETC finance staff to brainstorm ideas on how to implement revolving fund operations, and initiating a dialogue with the European Investment Fund (EIF).

EIF is an EU investment institution based in Luxembourg, responsible for the provision of finance to SMEs and promotion of the implementation of EU policies in the field of entrepreneurship, technology, innovation, growth, employment and regional development.

EIF works closely with many different financial intermediaries – a network of private fund managers and lending institutions (e.g. banks). EIF and financial intermediaries manage and mobilise structural funds within the regulations to attract additional private capital. Through its investment activities all over Europe using Structural Funds, EIF had attracted private finance at the level of EUR 2 billion by the end of 2012. As an example, in 2010 Financial Instrument was created in Lithuania, and over a period of three years (2010, 2011 and 2012), through this instrument, approximately EUR 100 million was distributed through three major banks to over 600 final recipients (SMEs). Currently, recipients are repaying approximately EUR 1 million each month, which is then being used again for re-investment. From our point of view, Lithuania is a good example of how FI managed by EIF can work successfully, also now, in times of economic and financial crisis.

EIF is involved in managing various FI, operating on regional, national and transnational levels. For example, the Baltic Innovation Fund (BIF), established in 2012, shows that FI operating across borders can be successful. The capital of BIF originates from three Baltic States (Latvia, Lithuania and Estonia) and EIF, which is then used to attract further private investors. Importantly, the Baltic States are using already repaid FI to fund their investment in this process, thus proving the concept of revolving investments working successfully.

Key aspects of Financial Instruments

Critical mass

"EIF is interested in working closely with an ETC programme on a pilot for implementing FI in 2014-2020, and we can use our expertise to assist the process. If such a pilot materialises, it will most likely be a smaller operation compared to many of our activities. The critical mass (or size) of FI is key for the process to succeed. However, the amounts can vary depending on instruments and location. For example, a capital volume of a holding fund of circa EUR 100 million generally makes it possible to set a balanced portfolio, gives flexibility to manoeuvre between transactions, attracts between 30%-100% of private investors' capital at the level of underlying funds, and helps maximize profits at acceptable levels of risk. Alternatively, much smaller activities are implementable and the minimum acceptable capital volume that would need to be invested by an ETC programme would be approximately EUR 10 million. I do believe that the multi-country scope of ETC provides a suitable structure for setting up and implementing FI, which can be a success."

***Graham Cope**, Senior Head of Region,*
European Investment Fund

Are ETC programmes suitable for Financial Instruments?

"INTERACT's work with experts has led us to the conclusion that ETC programmes are suitable for FI because:
1) they have well-established, stable and mature governance structures, and FI set up in ETC would probably operate in a much more stable environment compared to those operating at national or regional levels. In most cases, ETC programme governance structures remain unchanged for the entire programming period, while national governments may change often (in some countries more often than in others), which can slow down or even block the process.
2) ETC programmes have a multi-country scope and operate across borders. This is how investors wish to operate; i.e. with no national borders (which can create artificial barriers for investments), thus with best chance to maximize profits. Investors investing in growth enterprises across the EU know no national borders and wish to operate on pan-European and global scales to maximize profits. This is why multi-country revolving fund operations implemented through ETC programmes seem natural and could potentially address the weaknesses of current FI operating at national and regional levels.
3) ETC programmes have a well-established network of stakeholders at different governance levels and sectors. This could be an asset when mobilizing involvement of private investors to co-invest in FI alongside the contributions from ERDF.
4) the goal of internationalisation and "transnationalisation" of enterprises might be the driving force for FI established by ETC programmes."

***Graham Cope**, Senior Head of Region,*
European Investment Fund

Leverage/multiplier effect

FI supported through EU funds create a multiplier effect for the EU budget by facilitating and attracting other public and private financing throughout the various levels of the implementation chain (i.e. financial institutions, banks, development agencies, private sector investors and beneficiaries). Through risk coverage or risk participations, the EU funds invested in FI may attract investors to invest, or invest more, in cases where they would not have invested at all or invested less without support from the EU budget. This multiplier effect (sometimes also called the impact or leverage) of FI can be many times greater than grant assistance. However, it differs according to the type of FI, the economic sector it addresses, and the socio-economic conditions in its location/region.

Some evaluations have discovered that each EUR 1 of Structural Funds committed to a small loan fund in 2007-2013 in some cases can mobilise (leverage) some 4.5 Euro of private investment[4]. This multiplier effect is even greater in the case of guarantee funds, as EUR 1 of public resources put into guarantee funds supports the disbursement of SME loans ranging from 1 Euro to 7.5 Euro[5].

By sharing risks with other investors, FI unblock private financing and other public sector funding which, when pulled together, can result in a greater envelope for investments in the programme area. This multiplier effect is further strengthened by the accumulation of interests generated and dividends paid back to FI.

Financial Instruments in 2014-2020 ETC: What the future could be?

"2014-2020 ETC programmes could use ERDF partly to finance grants and partly to invest in FI. FI are flexible mechanisms and can be combined with grants to provide tailored assistance reflecting specific needs in the programme area. In practice, an ETC programme piloting FI will carry on with its traditional type of activities; i.e. offering grants to finance cooperation projects, and in parallel, it will use part of its ERDF in a revolving way to finance other types of activities which generate revenue, involving private sector beneficiaries and private capital."

***Graham Cope**, Senior Head of Region,*
European Investment Fund

Some considerations for Financial Instruments in ETC

Due to their specific and multi-country context, it is advisable that ETC programmes implementing FI:

- consider private sector capital contributing to the implementation of FI;
- delegate management tasks for the implementation of FI to a professional financial institution (as stated in Article 32 of the draft Common Provisions Regulation);
- note that the concept of "*final recipient*" rather than "*project*" will apply to the part of ERDF invested in FI (with repayable instruments it is necessary to state who is liable for repayment of funds).

The Implementation Process of Financial Instruments: Who decides what and the delegation of tasks to a fund manager

Source: European Investment Fund

- Managing Authority and Monitoring Committee decide amount of Structural Funds to be involved, the main elements of financial instrument and the work of the Manager.
- Monitoring Committee oversees implementation of the fund in accordance with approved strategy and the work of the Manager.
- Manager selects best financial intermediaries and manages the contracts with them.
- Financial Intermediary selects final recipients and decides which to progress with, then signs contracts with them.
- Final recipients sign the contract, use the financing, then repay according to agreed timetable.
- Upward reporting and downward monitoring undertaken at all levels. Managing Authority and Monitoring Committee monitor implementation and make adjustments if needed.

4 Commission staff working document *"Financial Instruments in Cohesion Policy"*, Brussels, 27.2.2012, p. 2
5 *"Financial Engineering Instruments implemented by Member States with ERDF Contributions, European Commission Synthesis Report"*, 24.01.2012, p.12

"The revolving character of FI is a clear advantage and the Commission would like to see more EU funds invested in such instruments in the future. Even though FI have been used across the EU in the current programming period, it is still a new concept for ETC. Implementing it will therefore be a new experience for all of us, but we are open to this idea and will support any ETC programme piloting it"

Vicente Rodriguez-Saez*, Deputy Head of Unit, Unit D.1 Competence Centre Macro-regions and ETC, European Commission, DG Regio*

Next steps

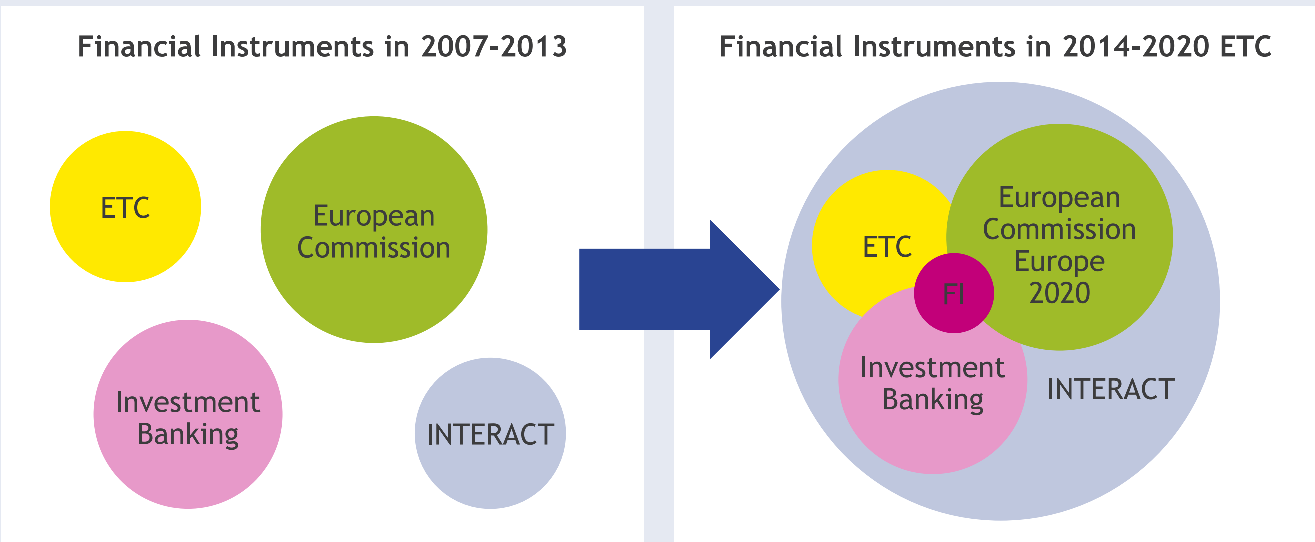
Some ETC programmes will discuss FI within 2014-2020 Programme Preparation Groups early in 2013, with technical support from European Investment Fund presenting key mechanisms. Setting up FI can take approximately one year, and it will follow the outcomes of ex-ante assessment of market imperfections and suboptimal investment situations in the programme area. It is important to start this process now in order to set up FI as early as possible in the 2014-2020 programming period to fully utilise the benefits of its revolving nature.

INTERACT has been monitoring how the concept of FI in 2014-2020 cohesion policy has been evolving, and has documented in a practical paper the key aspects, challenges, proposed solutions and ideas for FI in ETC. This practical paper is being drafted, with support from the European Investment Fund and the European Commission, and will be available on INTERACT's website in February 2013.

The paper covers FI draft regulations and EU strategic documents for 2014-2020, as well as characteristics and mechanisms, steps to establish and implement FI, examples of FI in action, FAQ by ETC (e.g. added value, transnationality, control and audit, do programmes have the capacity to do it, can programmes afford it), etc.

INTERACT is committed to managing the process of bringing three worlds together - ETC, Europe 2020 and investment banking - and to ensure the information flow and correct understanding of nuances of each of them. We hope the result (small, red shape in the middle of the graph below) will be the pilot FI in 2014-2020 ETC, established based on commitment, openness, cooperation and a strong feeling of ownership by all.

Pilot Financial Instrument in 2014-2020 ETC: Process management by INTERACT



Source: INTERACT Programme

European Investment Fund
www.eif.org