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This analysis aims to identify and showcase the main features of the Financial Engineering Instruments (FEIs) to present the lessons learned from the implementation of the JEREMIE initiative in Romania. Its purpose is to promote such innovative instruments, their related benefits and the requirements for implementation.

The document is mainly intended for decision and policy makers concerned about the implementation of financial instruments over the 2014-20 programming period, but also to potential investment fund managers and stakeholders involved in the implementation process (e.g. financial intermediaries, beneficiaries).

Consequently, the analysis describes the key aspects to be considered, in view of the next programming period, which can facilitate the effective integration of Financial Engineering Instruments (FEIs) within the Operational Programmes co-financed through European Structural Funds.

The results of the analysis should serve as starting point for further research papers and analyses, as well as debates between the main stakeholders, on the use of JEREMIE (and possibly other FEIs) in the future programming period in Romania.

The analysis considers documentary sources, various research papers and studies issued in Romania or other Member States, the EC Guidelines on financial instruments, as well as findings, conclusions and recommendations contained in evaluation reports.

The paper has been prepared by EY and commissioned by the Ministry of European Funds.

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Building a better working world

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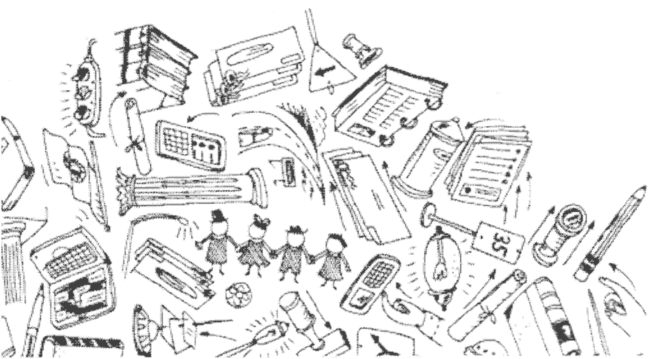
"**FINANCIAL INSTRUMENTS** have all advantages we will now need. They provide sustainability by allowing for the recycling of funds in the long-term; they have a leverage effect, attracting other sources of finance including private funds and not crowding them out, making possible combination of public/private sector financial resources; they provide incentives towards better performance and efficiency; **they promote** new sources of expertise and know-how; they allow **for the modernisation and development of financial markets; they work as catalyst for partnership and cooperation;** and they can be tailored to specific needs of partners, of territory of a sector."

(Prof. Danuta Hübner, Chair of European Parliament Committee on Regional Development)



Introduction to FEIs

Until recently, the Cohesion Policy of the European Union has materialized itself almost exclusively through grants or subsidies. These forms of financial assistance have effectively contributed to the accomplishment of the Cohesion Policy objectives, by making regions more competitive, fostering economic growth and generating the premises for creation of new jobs. However, as regards the efficiency dimension, it is now widely considered that other (innovative) forms of financial assistance have the potential to enhance the impact of certain interventions or public policies: Financial Engineering Instruments (FEIs).

During the current programming period, the European Commission (EC) set up two financial engineering instruments (JEREMIE and JESSICA), which can be used to finance projects for supporting SMEs and projects for sustainable urban renewal and development under Structural Funds. As expected, these instruments have a diversified array of features, customized for each type of financial assistance (equity, debt or other risk sharing instruments) but also to the intervention objectives and final recipients. Consequently, the investment return perios is variable, depending on the type of financial instrument used.

Financial Engineering Instruments are integral part of the implementation strategy of the Operational Programmes[1] agreed between the Member States and the Commission, for: using forms of reimbursable financial assistance ensuring the sustainable long-term financing of investment; development of new public-private partnership, bringing in the expertise of international financial institutions; promoting sustainability of Structural Funds' resources; pooling expertise of national and local authorities, financial intermediaries and final recipients; building institutional capacity through partnerships between the public and private sector, and a broader involvement of financial institutions and/or financial intermediaries in the implementation of the EU regional policy.

Article 44 of Council Regulation (EC) No 1083/2006 states that "as part of an operational programme, the Structural Funds may finance expenditure in respect of an operation comprising contributions to support any of the following:

- financial engineering instruments for enterprises, primarily small and medium-sized ones, such as venture capital funds, guarantee funds and loan funds;
- urban development funds, that is, funds investing in public-private partnerships and other projects included in an integrated plan for sustainable urban development;
- funds or other incentive schemes providing loans, guarantees for repayable investments, or equivalent instruments, for energy efficiency and use of renewable energy in buildings, including in existing housing.

JEREMIE (Joint European Resources for Micro and Medium Enterprises) was developed by the EC and the European Investment Bank Group (EIB and EIF) with the purpose of improving the access of SMEs to finance in the regions supported by the ERDF. JEREMIE offers the EU Member States, through their national or regional Managing Authorities, the opportunity to use part of the resources made available from the EU Structural Funds and also national resources into Holding Funds. The JEREMIE Holding Funds make available finance to SMEs in a flexible, sustainable and innovative way, by providing equity, loans or guarantees through selected local financial institutions acting as European Investment Fund (EIF) intermediaries.[2]

JESSICA (Joint European Support for Sustainable Investment in City Areas), is an initiative of the EC, developed in co-operation with the European Investment Bank and the Council of Europe Development Bank. It is aimed at supporting sustainable urban development and regeneration through FEIs. JESSICA funds are specifically targeted at financing, inter alia, the development of urban infrastructure, heritage or cultural sites, for tourism and improvements in energy efficiency.

1 (European Commission, Directorate-General Regional Policy 2013), p. 5

2 (European Investment Bank 2011), p.1

Implementation Framework

As expected, **financial instruments require a rather different implementation mechanism than grants**. This is reflected in the institutional and organizational set up of FEIs for the 2007-13 programming period which is characterized by the **widespread use of holding funds as first stage intermediaries between the Managing Authority and final beneficiaries.**[3]

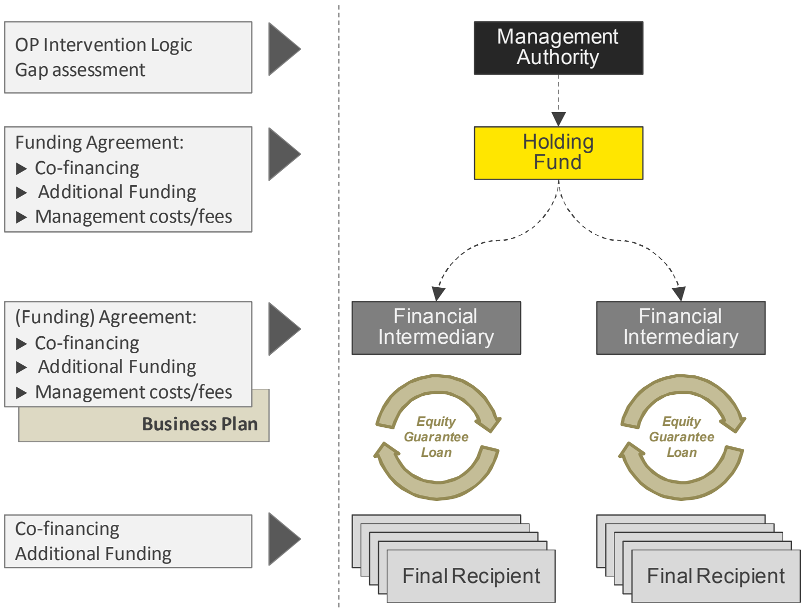
The specific implementation mechanism has been developed by the European Commission together with the European Investment Bank (EIB) and the European Investment Fund (EIF). A graphical representation[4] of the typical structure for implementation is presented below.

The implementation mechanisms for schemes financed through FEIs involve the existence of several stakeholders, with well-defined roles, placed between the Managing Authorities and final beneficiaries: the holding funds and the financial intermediaries, such as banks or venture capital funds. In many cases, the holding fund is organized within the framework of either JEREMIE (for SME support) or JESSICA (for urban development).

A snapshot of the state of play regarding FEIs, taken at 31.12.2011[5], revealed the fact that a total of 592 FEIs (68 holding funds and 524 specific funds) had been set up through 178 Operational Programmes in almost all Member States (except Ireland and Luxembourg) and for a Cross-Border Co-operation Programme.

Therefore, Financial Engineering Instruments can be directly administered by managing authorities / intermediate bodies, or indirectly through holding funds, facilitating the beneficiaries' access to equity, loan or guarantee instruments[6]. This implementation structure has been defined as such for various reasons: firstly, the involvement of financial intermediaries from the private sector or of other financial institutions means **that loans, guarantees, and equity capital are subject to a thorough financial review conducted by professionals in a way that does not happen with grants**[7] and secondly, the two-way flow between financial intermediaries and final recipients (the 'revolving' characteristic of FEIs), may generate mutual future benefits for the stakeholders directly involved.

The majority of activities in FEIs available under the Cohesion Policy is aimed at supporting enterprises. The contribution of Operational Programmes to FEIs supporting SMEs amounts to MEUR 8,903, of which MEUR 5,753 of Structural Funds, accounting for around 90% of the total allocations for FEIs.[8]



[3] (Kalvet, Vanags and Maniokas 2012), p.7

[4] (European Comission, 2012), p.15

[5] European Commission, Directorate-General Regional Policy 2013), p. 2

[6] *as in the case of Romania*

[7] (Kalvet, Vanags and Maniokas 2012), p.7

[8] (European Commission, Directorate-General Regional Policy 2013), p. 2

When analyzing the **financing mechanisms proper to FEIs, which takes place between the EU and the Member States**, one should mention that, upon closure of an Operational Programme, eligible expenditure is considered to be the amount paid out by 31st December 2015 by the holding fund / financial engineering instrument: (a) for financing investments of the final recipients (e.g. SMEs, urban development projects, energy efficiency and use of renewable energy sources for buildings) or (b) accounting for the amount of guarantees provided, including the amounts committed as guarantees (corresponding to underlying loans issued and disbursed).

However, the implementation of the investment activities by the final recipient may continue beyond 31st December 2015.

As regards **legacy resources (residual funds)**, Section 9.2. of the *"Revised Guidance Note on Financial Engineering Instruments, under Article 44 of Council Regulation (EC) No 1083/2006"* sets out requirements regarding the inclusion of an exit policy and winding-up provisions in the funding agreement.

Such exit policy and winding-up provisions must set the conditions for returning to the managing authority, or to another designated competent pubic authority, any resources attributable to the Structural Funds contribution related to the interventions achieved by using FEIs.

These resources stem from the contribution of the operational programme related to financial engineering instruments, as well as any return earned by it, after one or more full cycles of investment in enterprises, urban projects or energy efficiency / renewable energy schemes have been completed.

The current General Regulation and the Implementing Regulation do not set out a specific duration of the obligation of re-use for the resources returned to the authority. Though it is recommended that resources returned should be used until full exhaustion of the funds, to finance the same type of actions, after the closure of the programming period, there is no specific legal obligation to further use the residual funds in the context of interventions financed from the Structural Funds.

However, for the next programming period, the **Member States shall ensure that the resources and gains deriving from the support from the FEIs are used in accordance with the aims of the programme for a period of at least 10 years after the closure of the programme** [as specified by Art. 39, of COM(2011) 615].

Investments in the following areas:

FEDR

JESSICA

- **urban infrastructure** – including transport, water/waste water, energy
- **heritage or cultural sites** – for tourism or other sustainable uses
- redevelopment of **brownfield sites** – including site clearance and decontamination
- creation of **new commercial floor space** for SMEs, IT and/or R&D sectors
- **university buildings** – medical, biotech and other specialized facilities
- **energy efficiency** improvements

FSE

JEREMIE

- creation of **new business or expansion** of existing ones
- access to investment capital by SMEs to **modernize and diversify** their activities, develop new products, secure and expand market access
- business oriented **research and development**, technology transfer, innovation and entrepreneurship
- technological **modernization** of productive structures to help reach **low carbon economy targets**
- productive investments which create and safeguard **sustainable jobs**

Advantages yielded by using FEIs

- FEIs provide the Member States with the possibility of using repayable (revolving) forms of assistance instead of one-off grants, in granting support to companies and financing other types of projects. These instruments offer certain advantages, when compared to traditional financial aid:

- **Sustainability** – through "recycling" financial assistance
- **Potential to attract additional financing sources** (e.g. private funds)
- **Potential to lead to the development of expertise and know-how**, and
- **Contribution to the development and/or modernization of financial markets** (through new products or market players).

Multiplier Effect

The European Commission[9] emphasizes the advantages derived from the widespread use of financial instruments: "The possibility of using the same funds several times through various revolving assistance contributes to the impact and sustainability of the instruments. **Consequently, the impact of revolving funds can be many times greater than grant assistance, giving them a particular added value and increased relevance in times of budgetary constraints."**

When considering issues regarding such innovative financial instruments, alongside the widely used term of "revolving funds", one of the most recurrent attributes associated with these tools is the **"multiplier effect"** or **"leverage effect"**.[10]

In general terms, the **multiplier effect** is an effect whereby under certain conditions, a relatively small change in input of some kind (e.g. levels of investment or expenditure) may produce a relatively large change in output.

> In the context of the Cohesion Policy of the European Union, and FEIs, the "multiplier effect" is an often used term to describe the extra funding generated by the initial input from the EU budget and the EIB Group.[11] .

Financial Instruments are primarily designed to create such an effect for the EU budget by attracting additional public and private financing sources for projects of EU interest. **Through risk hedging or risk participation, the EU intervention may encourage investors to invest in cases where they would otherwise not have invested at all, or would have invested less without EU budget support.**[12]

For instance, in the case of SMEs, a first loss guarantee product aids to the creation of new SME loan portfolio several times larger than the guarantee cap amount. In the case of equity instruments, the leverage effect is achieved by mobilizing the participation of private investors alongside JEREMIE Holding Fund (JHF).

An EC Working Document on FEIs, published in 2012, underlines the following aspects: "the impact/ multiplier effect is further strengthened by the accumulation of interest generated and dividends paid to the funds. The revolving character of such instruments creates enhanced incentives for better performance on the part of the final recipients – such as better quality of projects and greater financial discipline. Also, the participation of private sector funding guarantees the input of expertise and know-how. Specific expertise in supporting, for example start-up SMEs, can be invaluable. Drawing upon this expertise helps to improve the overall quality of projects".

Cost-effectiveness

An interesting study (for impact assessment) performed in 2012[13] on the effectiveness of financial assistance granted to SMEs in Northern Italy, has revealed the existence of a **"greater cost-**

[9] (European Commission 2012a), p. 2

[10] *Terms which are most of the time misunderstood, or misused, if taken out from the context of the Cohesion Policy*

[11] (European Parliament, Directorate-General for Internal Policies, Policy Department for Budgetary Affairs 2012), p. 33

[12] *ibid.*

[13] (Associazione per lo Sviluppo della Valutazione e l'Analisi delle Politiche Pubbliche (ASVAPP) 2012), p. 25

[14] Provided under Italian Law 488/92, a large-scale very generous programme targeting industrial firms: it supported investments in physical capital through generous non-repayable grants assigned through open competitions implemented on a regional basis.

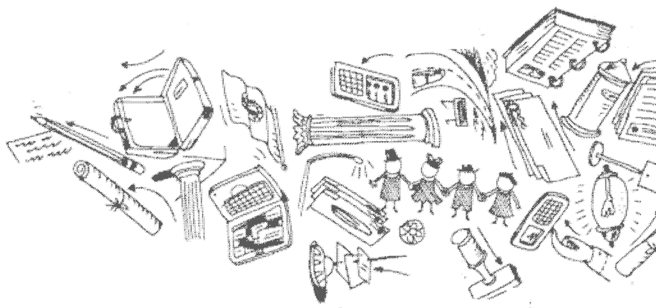
[15] *A secondary, but somewhat controversial aspect refers to a decreased risk posed to the EU Budget, through the use of FEIs, when compared to grants. This issue can be further documented by consulting Section "2.4.3 Is risk a problem?" from the "Overview of financial instruments used in the EU multiannual financial framework period 2007-2013 and the Commission's proposals for 2014-2020".*

[16] (European Commission 2012c), p.7

effectiveness of soft loans and interest rate subsidies than capital grants for the employment and sales outcomes”. The study has revealed “an average cost of about EUR 63,000 per job *[created]* by projects financed under grant schemes versus a cost of EUR 21,000-29,500 per job by using subsidized loans and an average cost of EUR 1.15 per extra Euro of sales, by using grant schemes for investment, versus EUR 0.12-0.50 per extra Euro of sales for soft-loans and attractive interest rate.“

In other words, the study points out the fact that in the case of the assistance granted through financial instruments (in the above case: soft -loans and subsidized loans), the effects have been on an average 5 times higher, for enterprises making use of FEIs, as compared to a control sample made up of similar enterprises, which had benefited from assistance through non-repayable grants.[14] This is possibly the greatest advantage[15] derived from using financial instruments by comparison with non-repayable grants.

However, regardless of the example above, care should be taken when making eventual comparisons in terms of cost-effectiveness between the two mechanisms differences (FEIs and grants), for this should be offset against the costs involved in setting up and running such innovative financing schemes.[16]



Current state of play

At EU level

At European level there is a growing popularity in the use of FEIs in the implementation of the Cohesion Policy. However, significant differences are being noticed between different Member States: Lithuania, Bulgaria, UK and Belgium are in top positions, in terms of FEIs use level, allocating amounts nearly 10 times as much as the late-followers, Malta, Romania and Slovakia.[17]

With regard to the EU-wide utilization of Financial Engineering Instruments, an overview of the current achievements[18] is presented below:

- Around 5% of the European Regional Development Fund allocations have been committed to different types of financial instruments, in comparison with 0.7% of the European Social Fund .
- More than 500 specific funds have been set up, out of which: 484 (92.37%) for enterprises, 28 (5.34%) for urban development and 12 (2,29%) for energy efficiency/renewable energies.
- Out of all specific funds, 353 have been directly implemented (without using a holding fund), while 171 have been implemented through 68 holding funds. Holding funds have received contributions from 1 to 10 operational programmes and have made their contributions to between 1 and 13 specific funds.
- At the end of 2011, the total value of OP contributions paid by managing authorities for financial engineering instruments (either to holding funds or directly to specific funds) amounted to 10,780.67 million EURO, out of which 7,078.15 million EUR from Structural Funds.

In Romania

Although Financial Engineering Instruments are part of the Cohesion Policy, being actively promoted and supported by the European Commission, the use of such financing schemes in Romania is somewhat limited and below the European average[19].

JEREMIE initiative is financed under the Sectoral Operational Programme Increase of Economic Competitiveness (SOP IEC), Priority Axis 1 "An innovative and eco-efficient production system", Key Area of Intervention 1.2 "SMEs access to finance". The total allocation for 2007-2013 amounts to 100 Million EUR, representing 1% of the total ERDF allocation for Romania, 3.9% of ERDF allocation for SOP IEC, and 10.8% of the total ERDF allocation for programme Priority Axis 1 – "*An innovative and eco-efficient productive system*".[20]

The initial indicative allocation for the two types of interventions financed under the JEREMIE initiative has been the following:

- Guarantee facilities for SMEs – c. 60-70%;
- Venture/growth capital fund(s) – c. 30-40% of fund.[21]

In accordance with the legislation in force at EU level and national legislation provisioned in Government Decision no. 776/2007, the Government of Romania and the European Investment Fund have signed a Funding Agreement under which EIF is vested with the responsibility of administering the JEREMIE Holding Fund (JHF) in Romania.

The Funding Agreement was signed on 18.02.2008 and was subsequently approved through Government Decision no. 514 as of 14.05.2008. Subsequently, one completed the institutional arrangements such as: opening up an EIF office in Bucharest; selection, according to own procurement procedures, of a commercial bank for current financial operations; the set-up of a bank account to ensure treasury services on behalf of JEREMIE and creation of the Investment Board.

In July 2008, the Ministry of Economy and Finance transferred 100 Million EUR, according to the implementation schedule, to the EIF account opened with a Romanian commercial bank. The reimbursement from the European Commission of subsequent ERDF contribution amounting to 86 Million EUR was transferred on the 26.02.2009.[22]

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[17] *The comparison is made considering the percentual allocation of funding from Operational Programmes to FEIs, and based on* (Kalvet, Vanags and Maniokas 2012), p.6

[18] *Most recent data was consolidated at the end of 2011 through the "Summary report on the progress made in financing and implementing financial engineering instruments co-financed by Structural Funds" and at 31.12.2010, according to the Synthesis Report "Financial Engineering Instruments Implemented by Member States with ERDF Contributions" and aforementioned "Commission Staff Working Document", 2012*

[19] *Based on the illustration in (Kalvet, Vangas and Maniokas 2012), p. 7.*

[20] (Lucaciu 2012), p.4

[21] *Presentation prepared by EIF on the 30.03.2009 based on figures available for December 2008*

The EIF has published up to date three calls for Expressions of Interest (EoIs).

According to the 2009 Annual Implementation Report of SOP IEC, the first Call for EoI (aimed at Structured Loan Portfolio Guarantees for SMEs), with an indicative allocation of 65 Million EUR, has resulted in the submission of two expressions of interest. They were sent by two important commercial banks operating in Romania. the first one was sent by a financial institution that finally could not present a guarantee portfolio that met the eligibility requirements specified in the call; and the other one was dropped out by the applicant due to economic conditions.[23]

During 2010, two calls were published, one for Risk Capital Funds, disposing of an indicative allocation of 35 Million EUR, and the second aimed at First Loss Portfolio Guarantees, for the loan portfolio[24] valued at EUR 63 Million). They were highly attractive, resulting in 16 submissions of expressions of interest for the venture capital instrument and 9 submissions for the guarantees instrument. 15 out of the 16 and 8 out of the 9 offers were declared eligible and entered the selection process. The EIF selected 2 applicants for the venture capital instrument and other 2 for the guarantees instrument. The two financial intermediaries selected for the guarantees funds were BCR-Erste Bank and Raiffeisen Bank.

The result of the selection process was approved by EIF on 13.12.2010, the contracts with the selected banks being signed on 30.12.2010.[25]

The venture capital financial intermediaries selected, *Ascenta* and *Catalyst*, were each allocated a capital amount of 17.5 Million EUR. As a result of the failure in negotiations between Ascenta and a potential private investor in the venture capital fund, the financial intermediary decided to withdraw its offer. Subsequently, the Monitoring Committee of SOP IEC decided to reallocate the funds, by significantly increasing the guarantee operation from 65% to 80.5%, while maintaining the allocation of 17.5% to the venture capital operation addressed to *Catalyst*. the difference of 2% was retained as the fund reserve.[26]

The second financial intermediary, *Catalyst*, signed the Operational Agreement with the EIF in December 2011, under the reserve of some private investors' potential contributions.[27]

The European Investment Fund announced on December 5, 2012 the allocation of 10 mil, Euro to the investment fund *Catalyst* Romania. The venture capital fund is administered by a local team of *3TS Capital Partners* and it has a target capital amounting to 30 mil. EURO.

Beside EIF, which by JEREMIE is the top contributor to the capital of Catalist, investments have also been made to the fund by *BT Asset Management (BTAM)*, a member firm of Banca Transilvania Financial Group.

The reallocation of funds from the venture capital funds to the guarantees operation led to the signature of a new guarantee agreement in December 2011 with a third financial intermediary, *UniCredit Ţiriac Bank*, selected in the 2010 call for expressions of interest on the reserve list. It has a guarantee portfolio of 87.5 Million EUR and which began implementation in March 2012.[28]

The responsibility for the achievement of the indicators falls with the Managing Authirity of SOP IEC, although the European Investment Fund is formally entrusted by the Government with the task to manage the JEREMIE Holding Fund, under the supervision of the MA SOP IEC and the JHF Romania Investment Board. Given that the target values of the abovementioned indicators have been set in a prudential manner, there are real chances of being achieved during the current implementation period.

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[22] (Ministry of Economy and Finance of Romania, Managing Authority for SOP IEC 2009), p. 17

[23] (Ministry of Economy and Finance of Romania, Managing Authority for SOP IEC 2010a), p. 54-55.

[24] The First Loss Portfolio Guarantee is a form of taking over the credit risk covering the expected and unexpected losses occurred within a portfolio of loans eligible for SMEs, at a fixed guarantee rate of 80% and a default cap of accrued losses. Such losses have been estimated, beforehand, by the EIF experts in the due diligence process", according to Piotr Stolowski, Mandate Manager – Regional Business Development, with the European Investment Fund.

[25] (Ministry of Economy and Finance of Romania, Managing Authority for SOP IEC 2011), p. 63-64.

[26] (Ministry of Economy and Finance of Romania, Managing Authority for SOP IEC 2012b), EIF representative, Camelia Drăgoi, p. 7-9.

[27] (Ministry of Economy and Finance of Romania, Managing Authority for SOP IEC 2012b).

[28] (Ministry of Economy and Finance of Romania, Managing Authority for SOP IEC 2012a), p. 55-56

In order to objectively measure the performance in implementing JEREMIE, one should monitor the system of indicators in place related to the Key Area of Intervention 1.2 "SMEs access to finance" of SOP IEC:

- SMEs supported through loan guarantee operations; target value: 200 SMEs by 2015 (according to the "de minimis" state aid scheme for loan guarantee instrument)[30]
- SMEs supported through venture capital funds; target value: 20 SMEs, by 2015 (according to the state aid scheme for the venture capital instrument)[31]
- Guarantee funds and venture capital funds developed; target value: approx. 10

According to the latest information available, the achievements regarding the JEREMIE initiative in Romania are the following:[29]

- JEREMIE HF amount contracted for guarantee instruments amounts to 80.5 Million EUR
- JEREMIE Holding Fund amount committed for venture capital instrument amounts to 17.5 Million EUR
- 4 specific funds have been supported: 3 loan guarantee funds and 1 venture capital fund
- 1,500 SMEs have been supported through guarantee instruments
- The ratio of loans generated by guarantee instruments amounts to 115 Million EURTotal portfolio ratio of guarantee instruments amounts to 402.5 Million EUR[29]:

The reasons behind the limited use of FEIs in Romania can be intuitively traced back to two very different root causes:

- Lack of previous experience in managing "niche" financial instruments, which, represents a major forward leap in complexity, when compared with mainstream one-off grants regarding which Romania has therefore enough expertise gained by implementing PHARE and SAPARD funds during the pre-accession period.
- Another issue, applicable to all Member States, refers to the availability and capacity of private financial institutions to implement FEIs, which is an essential premise for an efficient process. In light of the 2008 financial crisis, the Romanian business environment has started being perceived by investors as less favorable than in other European countries. Since the demand for loans intended for SMEs quickly recorded a dramatic drop, even the large players on the Romanian market were less willing to invest in what is generally considered "unchartered territory".[32]

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[29] *ibid.*

[30] (Lucaciu 2012), p.11

[31] *ibid.*

[32] *Our interpretation, based on information collected from (Lucaciu, 2012), p. 12,* (Kalvet, Vanags and Maniokas 2012), p.6 and (European Commission, 2011), Chapter 4: Challenges faced in implementing Financial instruments

[33] (European Commission 2012a), p.4

[34] *Although a quick set-up of the FEI management system is not a guarantee for its subsequent successful implementation*

[35] (Kalvet, Vanags and Maniokas 2012), p.16

[36] (European Commission 2012a), p.5

[37] *ibid.*

[38] *It can be observed in "Overview of financial instruments used in the EU multiannual financial framework period 2007-2013 and the Commission's proposals for 2014-2020" (p.75), "Commission Staff Working Document - Financial Instruments in Cohesion Policy" (p.6) , "Financial Engineering Instruments Implemented by Member States with ERDF Contributions " (p.2)*

[39] *In which they generally dispose of sufficient knowledge and know-how*

[40] (European Parliament, Directorate-General for Internal Policies, Policy Department for Budgetary Affairs 2012), p. 34

[41] *ibid.*

Challenges in implementing FEIs

Overview

The European Commission's audit reports, opinions of the Court of Auditors, together with various studies, observations of the European Parliament and of the institutions involved in the Cohesion Policy implementation have pointed to a series of challenges that need to be addressed, in order to ensure a significant impact related to the use of financial engineering instruments.[33]

The **higher complexity and relative lack of expertise in setting-up and managing FEIs, as well as institutional capacity issues at the level of most of the Member States, delays in setting up and launching of the funds are present at the level of the Member States**[34] (e.g. Lithuania is recognized as one of the most intensive users and promoters of FEIs, allocating around 13% of the total ERDF available funding to such operations. However, the first contracts with financial intermediaries for the implementation of FEIs could not be signed earlier than late 2009 and 2010).[35]

Moreover, an additional setback limiting the use of Financial Engineering Instruments is linked to the **requirement of thorough knowledge of investment markets, from the part of the policy implementers,** Besides, it is necessary to become aware of the legislative framework on structural instruments and state aid, which is most cases is not applicable**.** Additionally, **management costs and fees have not always been set up in a transparent manner or linked to the performance** of the funds.[36]

A common practice in the Member States is the resource over-allocation to financial instruments which "remain blocked in the funds instead of being disbursed to the final recipients, thus circumvent the automatic de-commitment of funds".[37]

All of the above mentioned challenges are complemented by a common conclusion deriving from multiple analyses of FEIs[38], namely: the somewhat "over-optimistic" member state fund administration authorities, that do not always consider the peculiarities of the "real economy", therefore misjudging the size of the multiplier effect factor, which, as stressed above, should be regarded as one of the main benefits of the use of Financial Engineering Instruments.

Most of the time, in the implementation of financial instruments, the focus is on achieving regional development objectives[39], and less on the specific objectives and expectations of private investors. **This approach is likely to lead to limitations in the multiplier effect, even below levels which can be achieved outside the Cohesion Policy**. As portrayed in the Commission Working Document, there is a concern as to whether the nature of the Cohesion Policy, by its nature, would work against the necessary critical mass for financial instruments and result in a scattering of resources and too high overhead costs.

Furthermore, the Member States with over-conservative policies have expressed their concerns that an extensive use of FEIs can expose the EU budget to greater risk than it may bear.[40] However, a more thorough risk analysis underlines the fact that **the use of financial instruments does not imply more financial risk than one-off grants**. It must be acknowledged that the use of grant schemes is not risk-free: the results of projects benefiting from non-repayable grants may not be as expected; the work might be inadequate or exceed the implementation schedule; public procurement rules may not be observed and the grant-receiver may undergo bankruptcy. Under such circumstances, the recovery in part or in full of the financial assistance is desirable, but not always possible.[41]

Challenges for Romania

The transfer within 6 months of the capital amount of the JEREMIE Holding Fund into the EIF account has created the premises for progress with regard to expenditure, giving it also a head start regarding the absorption rate of funds.

However, according to the European Commission audit carried out in 2009 on the JEREMIE initiative in Romania (both at MA level and at the level of Luxemburg office of the EIF), the implementation was regarded as too slow.

For the first 2 years since the beginning of implementation, the EUR 100 Million initially allocated have remained practically unused. It was thus considered necessary for the Managing Authority to monitor more closely the financial progress of the JHF.

Furthermore, the Commission audit has revealed the importance of harmonizing the selection procedures for the financial intermediaries with the provisions of the funding agreement and the European Commission's transparency and equality principles.

The Commission's analysis has also revealed the fact that the **Funding Agreement between the Government of Romania and the EIF lacked provisions regarding the winding-up of the Fund and the exit options**.

Some of these issues have also been mentioned in the Interim Evaluation Report of SOP IEC.[42] For the first call launched in 2009 only two banks submitted expressions of interest and the high complexity degree of JEREMIE led to delays in launching the instrument, reducing their potential positive effects during the peak period of crisis. Furthermore, the institutional arrangements and the limited available human resources seem to account for the reasons of the MA involvement in the management of JEREMIE.

Another issue of the JEREMIE implementation in Romania has been the applicability of Art. 7 of European Parliament and Council Regulation (EC) no. 1080/2006, regarding the eligibility of expenses, a topic tackled by the team members of EIF and MA SOPIEC, on the one hand, and EC.

In line with the provisions of the EC Regulation 1083/2006 and 800/2008, the Government of Romania had to prepare and adopt in 2010 two state aid schemes, one for the venture capital operation (by Order no. 625/ 07.04.2010 of the Ministry of Economy, Commerce and Business Environment) and one de minimis state aid scheme for the guarantee operation (by Order no. 1338 / 15.07.2010 of the Ministry of Economy, Commerce and Business Environment) that also significantly slowed down the implementation process.

The European Commission's response

Faced with challenges at the level of every Member State, the Commission has taken the necessary measures to make available more detailed guidance and rules on financial instruments. **The Commission's initiatives have been materialized by publication of studies and explanatory notes, as well as by setting up of collaborative platforms for sharing of experiences, making available technical assistance and introducing several amendments to the regulations.**[43]

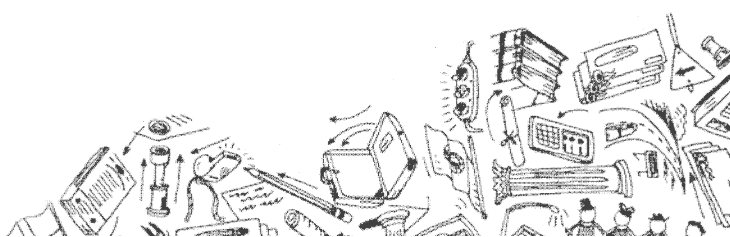
In 2011, the Commission proposed to introduce into the current Regulation a **legal obligation to ensure that the financial resources paid into the funds are linked to actual investment needs**. This would have ensured that resources do not remain unspent in such funds for long periods. Yet, the proposal has **not** been accepted by the legislative authorities and the Commission will therefore need to apply other measures - mainly audit, to draw the attention on this particular risk.

One of the most interesting amendments to the General Regulation refers to the mandatory yearly reporting on financial engineering instruments, by each Member State, as well as by the Commission. [44]

As far as technical assistance measures are concerned[45], the Commission has granted support to concerned managing authorities, resulting in the deployment of more than 110 evaluation studies and analyses. These studies have aimed at identifying opportunities and sectors with high potential for the implementation of financial instruments in order to ensure the access to finance for SMEs and investments in sustainable urban development.

Moreover, the Commission decided to set-up *Specific Networking Platforms* (2009), with the aim of supporting the exchange of know-how and good practice between the Commission, the managing authorities and other stakeholders.

Acknowledging that the legal framework on FEIs is not properly detailed, the Commission has implemented multiple legislative amendments as to enhance the understanding and extend the use of FEIs. Thus, in 2009 and 20011 modifications to General Regulations, ERDF Regulation and Implementing Regulation took place.



FEIs during the 2014-20 Programming Period

The European Commission Working Document on Financial Instruments reinforces the **Commission's commitment to promote and make further use of FEIs also during the next programming period, when "financial instruments can be used in all policy areas where their use is appropriate"**.

In the legislative proposals for the 2014-20 Cohesion Policy, adopted by the European Commission, particular attention is paid to financial engineering instruments. They are deemed as effective and efficient for the achievement of Europe 2020 Strategy targets, still the following can be further strengthened: the proposal of General Regulation stipulates that financial instruments are "increasingly important, due to their leverage effect on CSF Funds, their capacity to combine different forms of public and private resources to support public policy objectives and because revolving forms of financing make such support more sustainable on the long run".[46] Thus, it should be expected that **during the next programming period, the contribution of EU funding implemented through FEIs will grow**. Consequently, the public authorities involved in the implementation of the Operational Programmes need to be ready to this evolving approach.

Even though the legislative framework of the next programming period is not final, the draft regulations already provide for some proposals that can facilitate the actual implementation of the FEIs.

First of all, **the scope of financial engineering instruments will be widened**. The new regulations do not set out any constraints in regards to sectors, beneficiaries, types of projects and activities to be supported.[47] Consequently, the funds managing structures, at the level of each Member State, will gain **more freedom of choice in the implementation of the FEIs**, according to their own needs, in order to match the use of FEIs with the objectives of each Operational Programme under which one will decise to use them.

Moreover, the **Regulations encourage the combination of the use of FEIs with other forms of support, in particular grants**. Thus, the implementation of FEIs can be mixed with other types of services intended for SMEs, aimed at improving the beneficiaries' access to financing - for example supporting them in the effective use of loans and better in achieving the goals of development and competitiveness.

Moreover, considering the low level of usage of the FEIs during the current programming period in Romania, it is necessary perform more extensive studies on the local needs and market gaps, to include the possible private participation and the estimated added value obtained from the implementation of FEIs, as well as to avoid overlaps and inconsistencies between instruments implemented by different stakeholders at different levels (especially at national vs. regional level).

An ex-ante evaluation for the use of FEIs in Romania has been initiated by the MA of SOP IEC, which is currently under completion. Such initiative is in accordance with the proposal of the General Regulation for the 2014-2020 period, which provides for the performance of an ex-ante evaluation in order to identify cases of market failures for suboptimal investment and investment needs.

Both the ex-ante evaluation and the lessons learned from the JEREMIE implementation during the current programming period will provide useful information in order to decide the optimal scope and features of the the FEIs implementation system.

[42] (Ministry of Economy and Finance of Romania, Managing Authority for SOP IEC 2010b), p. 25-26

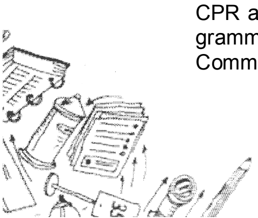
[43] It involves *sacrificing flexibility to a certain degree, as to obtain a higher level of assurance, (European Commission 2012a), p.6*

[44] *(Regulation (EU) no 1310/2011 of the European Parliament and of the Council of 13 Dec. 2011 amending Council Regulation (EC) no 1083/2006 as regards repayable assistance, financial engineering and certain provisions related to the statement of expenditure) – Each member state is obliged to annually report on the following topics: (1) Description of financial instruments and their implementation arrangements; (2) Identification of bodies involved in the implementation; (3) The Union contribution and national co-financing paid to the financial instruments (4) Amounts of assistance paid to final recipients.*

[45] (European Commission 2012a), p.8

[46] (COM(2012) 496), Paragraph (15) of the Preambles

[47] "*[The]* Commission regards the scope and actions to be supported through financial instruments as proposed in Article 32(1) of the CPR as sufficiently broad, in as much as all potentially economically viable investments which are in line with the objectives of a programme could be supported through financial instruments" (European Commission, Financial Instruments – Overview of Delegations' Comments on CPR Regulation, 2012)



In particular, the following should be considered:

- The type of financial instruments used (e.g. already existing/newly created FEIs, tailored to specific conditions and needs or standardized instruments, complying with the standard terms and conditions laid down by the Commission);
- The entity dedicated to the FEIs implementation (as existing or newly created legal entities, EIB or EIF: financial institutions or other bodies).

The co-financing rate is also a highly important aspect for FEIs implementation. The maximum co-financing rate, at the level of a priority axis, can be increased by up to 10 percentage points, if the intervention at the priority axis level is delivered through financial instruments, or even up to 100% to support *only* operations implemented through financial instruments set up at Union level and managed directly or indirectly by the Commission.

Moreover, according to the draft general regulation, the design and the implementation of the initiatives **should consider first of all the needs arisen in the private sector, in order to increase the attractiveness and flexibility of instruments. They** should be able to "promote substantial participation by private sector investors and financial institutions on an appropriate risk-sharing basis".[48]

A more effective potentiating factor for addressing the issues of SMEs could be the supplementation of FEIs with other forms of assistance – i.e. non-financial, 'soft' support such as business advice. Current research papers tend to support this statement[49], suggesting, for instance, that just 4 to 12 hours of business advice (from a pool of professionals in the field of finance, marketing, law and other areas) can make a difference to the long term survival of business start-ups.

However, since studies in this area have not been conducted on Europe-wide representative samples, the above statement represents solely an indicative that further research in this area is needed. The validation of the statement (also accompanied by concrete measures) could ensure the way for a substantial increase in effectiveness in the use of FEIs.

MAIN CHALLENGES IN THE PROGRAMMING PERIOD 2014-2020

Widened scope

The new regulations do not set out any constraints in regards to sectors, beneficiaries, types of projects and activities that are to be supported. Consequently, the Romanian Authorities will gain more freedom of choice in the implementation of the FEIs, according to their own needs, within the thematic objectives covered by the specific OP.

Combination with grants

The implementation of FEIs in Romania can be mixed with other services to SMEs, aimed at improving the beneficiaries' access to financing, for example orienting them in the effective use of loans, and better achieving the goals of development and competitiveness

Ex ante assessment

The ex ante assessment provided by the Regulation can:

- stimulate a better design and implementation of the FEI, also avoiding overlaps and inconsistencies between funding instruments implemented by different actors at different levels
- provide useful suggestions in order to decide the optimal scope and characteristics of the initiative but also the most suitable option according to which the instrument should be implemented in Romania (e.g. type of financial instrument, entity dedicated to the implementation of FEIs)

Co-financing rate

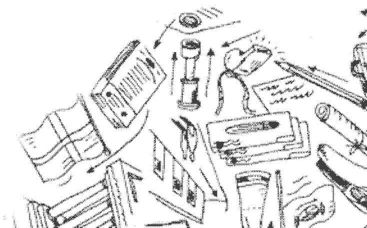
The maximum co-financing rate at the level of a priority axis can be increased by 10 percentage points, if the whole of a priority axis is delivered through financial instruments, or up to 100% to support only operations implemented through financial instruments set up at Union level and managed directly or indirectly by the EC

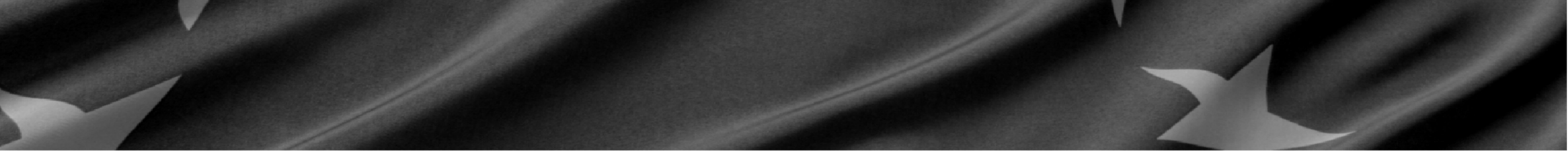
Private sector

The design and the implementation of the initiative should consider the instances arisen from the private sector, in order to be attractive and flexible instruments, able to "promote substantial participation by private sector investors and financial institutions on an appropriate risk-sharing basis"

[48] (COM(2012) 496), Paragraph (24) of the Preambles

[49] (European Commission 2012c), p.11, quoting work of Gabriel Pons Rotger and Mette Gørtz, "Evaluating the effect of soft business support to Entrepreneurs in North Jutland", published in 2009





Conclusions and further topics for study

As the JEREMIE initiative is the first financial engineering instrument implemented in Romania during the current programming period, both its success and lessons learned from its implementation are deciding factors related to the further use of such instruments in the 2014-20 programming period.

FEIs have a high potential to complement the current instruments (e.g. grant schemes), and enhance the support granted to enterprises and regions through the Cohesion Policy. As compared to grant schemes, FEIs has the advantage of having a *revolving* nature, enabling the intervention self-financing and implicitly the extension of the beneficiaries portfolio, without needing additional financing. Thus one ensures the premises for a mechanism capable to deliver results over a longer period of time.

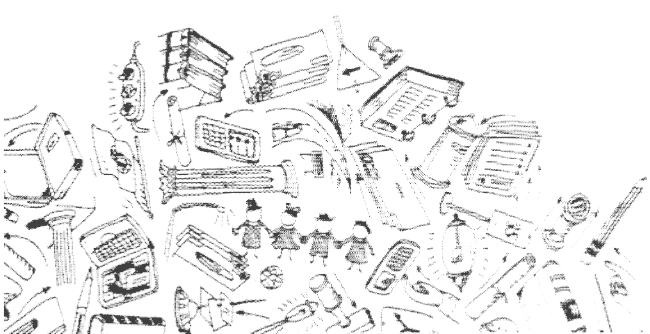
It is clear that grant schemes are massively required in Romania, however having the experience of the current programming period, decision and policy makers should be able to pinpoint those specific areas in which financial instruments could lead to significant improvements and notable impact. For this to materialize, thorough analyses have to be carried out, in order to deploy FEIs exactly where they are needed and in a form that would make them appealing, as to be the preferred solution, as opposed to grants.

Going further, since a large amount of knowledge has been acquired across many institutions and organizations, with regard to the implementation of grant schemes, there is the risk that **some stakeholder and institutions involved in the implementation of the Cohesion Policy may be reluctant to accept even a partial replacement of grants with FEIs**, unless they perceive the relevant benefits and accept the cost of the change. The conclusions of the Expert evaluation network's analysis of financial engineering instruments, performed in 2012, stresses out a series of concerns regarding the involvement of financial intermediaries in the support delivery mechanisms as they are deemed to be "less flexible in embedding in their practice the Cohesion Policy [in order to] contribute to the achievement of wider set of objectives, other than the financial performance."

Although the implementation of JEREMIE in Romania, during the current programming period could have been better mainstreamed, **valuable lessons were learned** by all parties involved (Managing Authority, Financial Intermediaries, down to final beneficiaries). In fact, these lessons should pave the way (and especially with regard to policy makers) and should constitute strong premises for modifications in the **strategy and implementation arrangements** regarding the use of FEIs in the future programming period.

Though JEREMIE implementation in Romania could have been better integrated in the Structural Instruments implementation system during the current programming period, all the stakeholders (the Managing Authority, Financial Intermediaries, final recipients) have learned important lessons. They may be the premises for the modification in the strategy and institutional arrangements for the FEIs during the next programming period.

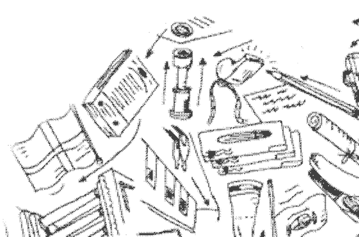
Moreover, the increase in the use of FEIs during the nest programming period is widely encouraged by the European Commission in its official communications. This should be a guarantee to the fact that institutional support shall be made available for the implementation of FEIs (through more detailed guidelines, examples of best practices, to be made available for the member States) aiming to streamline the use of grant-alternatives.

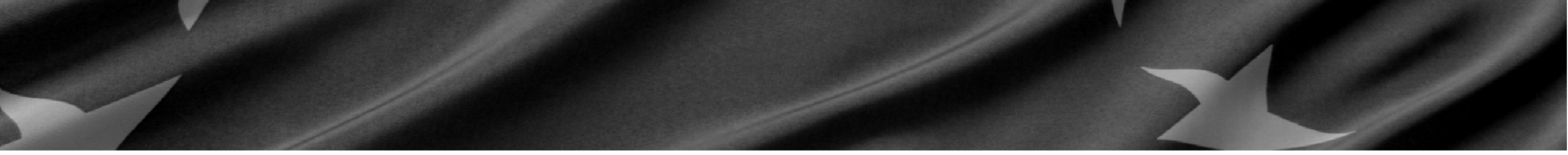


Annexes

Annex 1: List of abbreviations

AIR	Annual Implementation Report
COCOF	Committee of the Coordination of Funds
CSF	Common Strategic Framework
EC	European Commission
EIB	European Investment Bank
EIF	European Investment Fund
EoI	Expression of Interest
ERDF	European Regional Development Fund
ESF	European Social Fund
EU	European Union
FEI	Financial Engineering Instrument
JEREMIE	Joint European Resources for Micro to Medium Enterprises
JESSICA	Joint European Support for Sustainable Investment in City Areas
JHF	JEREMIE Holding Fund
MA	Managing Authority
NGO	Non-Governmental Organization
PA	Priority Axis
SCF	Structural and Cohesion Funds
SME	Small and Medium-sized Enterprise
SOP IEC	Sectoral Operational Programme Increase of Economic Competitiveness





Annex 2: Selected Bibliography

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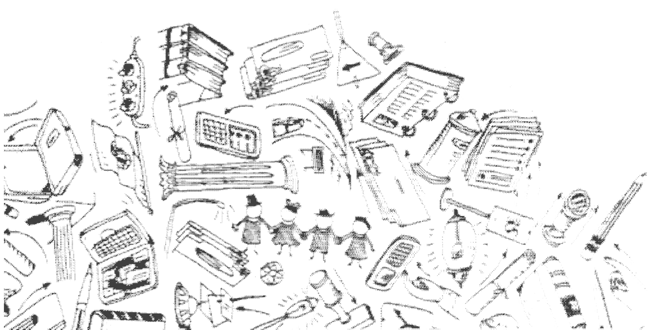

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"Regulation (EU) no 1310/2011 of the European Parliament and of the Council of 13 Dec. 2011 amending Council Regulation (EC) no 1083/2006 as regards repayable assistance, financial engineering and certain provisions related to the statement of expenditure."

Annex 3: Glossary of terms

Capital participation	Private capital invested or held in a firm in the form of equity instruments or instruments of equivalent ranking (e.g. convertible and subordinated loans).
“De minimis” state aid scheme	The state aid scheme is an act under which individual specific allocations may be granted to enterprises, according to the principles established by the European Council Regulation no. 659/1999 for the implementation of art. 93 of the Treaty Establishing the European Community, published in the Official Journal of the European Communities. No. L 83/1999. De Minimis aid represents a form of state aid which does not exceed in a determined period of time the ceiling imposed by the Community rules in force.
EIF	European Investment Fund - EIB Group’s specialist fund providing equity and guarantee instruments to SMEs.
Exit Policy	According to the GD 514/2008, in order to approve the Financing Agreement between the Romanian Government and the European Investment Fund with regard to the JEREMIE programme in Romania, a potential exit scenario would be: the reestablishment of a JEREMIE holding fund, with EIF or other insitution(s), or the transfer of available funds to another institution in relation to the SMEs.
Financial Engineering Instruments	Term used by the Commision to designate various repayable instruments offered by the Structural Funds in order to improve SME access to finance, urban development and energy efficiency.
Financial intermediary	Entity acting as an intermediary between sources of capital supply and demand (e.g. bank, holding fund, fund).
First loss guarantee product	The facility consists of a direct financial guarantee granted to a financial intermediary in order for the financial intermediary to be able to lend a certain type of clientele. This feature becomes activate when losses occur to the credit portfolio. Guarantee conditions and limits are established between the provider of warranty (e.g. EIF) and the financial intermediary.
Fund	A segregated portfolio of financial engineering instruments managed by one or several fund managers following defined investment policies and targets. A fund can be legally constituted or constituted as a separate block of finance within a financial institution. In the second case, the fund’s accounts and operations are separated from those of the related financial institution.
Fund administrator	The general partner or entity responsible for implementing a fund’s investment strategy and managing its portfolio of financial instruments, as set out contractually.
Grant	Non-reimbursable budgetary contribution from the EU or any Member State public institution. Also referred to as ‘public subsidy’.
Guarantee	A contract with or without a transfer of ownership, signed in order to guarantee financial obligations. The undertaking of the guarantee fund to bear at a predefined guarantee rate the principal and the interest due in case of default of a loan extended by a financial intermediary to an SME. A guarantee always leaves some of the risk with the lender and the SME remains liable for the loan.

* The definitions included in the glossary were summarized based on the Glossary of Terms of the Special Report no. 2 - Financial instruments for SMEs co-financed by the European Regional Development Fund, *European Court of Accounts (2012) and other documents*

Guarantee facilities for SMEs	The SME Guarantee Facility provides loan guarantees to encourage banks to make more debt finance available to SMEs, including microcredit and mezzanine finance, by reducing the banks' exposure to risk.
Holding fund	Legally constituted fund that has a controlling interest in several subsidiary equity funds, guarantee funds or loan funds.
Investment fund	Collective investment undertakings without legal personality.
JEREMIE	Joint European Resources for Micro to Medium Enterprises - is an initiative of the European Commission developed together with the EIB Group to improve access to finance for SMEs via Structural Funds interventions.
JESSICA	Joint European Support for Sustainable Investment in City Areas - is an initiative of the European Commission developed in co-operation with the European Investment Bank (EIB) and the Council of Europe Development Bank (CEB). It supports sustainable urban development and regeneration through financial engineering mechanisms.
Leverage Effect	The levarage efffect is a financial management technique aimed at increasing return on equity. Also, the leverage effect highlights the link between financial rate of return and economic rate of return. In the context of EU Cohesion Policy and FEIs, the leverage effect describes the additional funding generated by the initial contribution of funds from the EU budget and the EIB Group.
Loans with interest rate subsidies	A loan for which the interest rate is paid fully or partially by the state.
Residual fund	The unspent balance remaining in a sponsored account at the conclusion of the project. A residual fund occurs when the income or revenue is greater than the expense incurred upon completion of the project.
Revolving Fund	The concept that contributions to financial instruments, after a first utilisation (or cycle), get revolved (or reutilised, recycled). Resources returned to the Holding Fund from investments undertaken therein, loans repaid or left over after all guarantees have been honored and any interest generated by the Holding Fund's remaining balance can be used by the Holding Fund for microenterprises and SMEs.
Soft loans	Financing that offers flexible or lenient terms for repayment, usually at lower than market interest rates.
Venture capital	A specialist form of equity finance provided to new, small or risky unquoted firms.
Winding-up	A process that entails selling all the (holding) fund's assets, paying off creditors, distributing any remaining assets to the owners and dissolving the fund.

Project co-financed from the European Regional Development Fund through OPTA 2007-2013

Framework agreement for the Evaluation of Structural Instruments during 2011-2015 No. 45/08.12.2012 – LOT 2 Capacity Building in the Field of Evaluation

Subsequent Contract no.2 – Improve the use of evaluation in the policy-making and decision-making process in the field of structural instruments in Romania, SMIS 41649

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