Evaluation of EIF Own Resources Activity

European Commission
Directorate General for Economic and Financial Affairs

Specific Contract No. ECFIN-227-2011/SI2.603792
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A report submitted by GHK

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Charu Wilkinson
Principal
+44 (0)782 794 6021
charu.wilkinson@ghkint.com

ICF GHK
5em Etage
146 Rue Royale
Brussels
B-1000

T +32 (0) 2 275 01 00
F +32 (0) 2 275 01 09
brussels@ghkint.com

www.ghkint.com

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Document Title	Evaluation of EIF Own Resources Activity
Prepared by	Charu Wilkinson
Checked by	Nick Henry and James Leather
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List of Acronyms and Glossary of Key Terms

AECM	European Mutual Guarantee Association
CIP	Competitiveness and Innovation Framework Programme for 2007 - 2013
COP	Corporate Operational Plan
DG ECFIN	Directorate-General for Economic and Financial Affairs, European Commission
DG ENTR	Directorate-General for Enterprise and Industry, European Commission
DG REGIO	Directorate-General for Regional Policy, European Commission
DG RTD	Directorate-General for Research and Innovation, European Commission
EBAN	European Business Angels Network
EBF	European Banking Federation
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
EIF	European Investment Fund
EU	European Union
European Progress Microfinance Facility	This Facility was launched in 2010 to increase the supply of micro credit. It enables selected microcredit providers in the EU to increase lending, by (a) issuing guarantees, thereby sharing the providers' potential risk of loss; (b) providing funding to increase microcredit lending.
ERDF	European Regional Development Fund
ESF	European Social Fund
EVCA	European Venture Capital Association
FMO	Financierings Maatschappij Vor Ontwikkelingslanden, the Dutch development bank
GEEREF	Global Energy Efficiency and Renewable Energy Fund GEEREF is a fund of funds, providing global risk capital through private investment for energy efficiency and renewable energy projects in developing countries and economies in transition.
GIF	High Growth and Innovative SME facility. The GIF is part of the CIP Framework Programme. GIF invests in specialised venture capital/ risk capital funds in order to enhance the supply of equity and risk capital for SMEs.
GIF 1	GIF 1 provides risk capital for innovative SMEs in their early stages (seed and start-up)
GIF 2	GIF 2 provides risk capital for SMEs with high growth potential in their expansion phase
IFC	International Finance Corporation, a member of the World Bank Group
iVCi	Istanbul Venture Capital Initiative
JEREMIE	Joint European Resources for Micro to Medium Enterprises The JEREMIE (Joint European Resources for Micro to Medium Enterprises) initiative enables Member States/regions to set up tailor-made portfolios of financial instruments (loan, guarantee or venture capital funds) with money from ERDF and ESF for implementation directly or via a holding fund (optional) to support the creation and expansion of SMEs.
KfW	KfW banking group is a German government-owned promotional bank, originally called Kreditanstalt für Wiederaufbau.
MFF	Multiannual Financial Framework
MFG	Mezzanine Facility for Growth

	This Facility invests in hybrid debt/equity funds for the benefit of mature European small companies with strong market positions and further scope for growth, as well as high technology companies in their expansion stage.
PE	Private Equity
PPP	Public Private Partnership
PVCi	Portugal Venture Capital initiative
RCM	Risk Capital Mandate This is an evergreen venture capital facility; its core objective is to 'support the development of risk capital markets' in eligible countries. To this end, the EIF invests in venture capital funds or other vehicles (including in exceptional cases, fund of fund structures) established specifically to provide equity or other forms of risk capital to SMEs.
RoE	Return on Equity
RSI	Risk Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps. This pilot initiative was launched in 2011 - European Commission Decision TTC(2011) 8606 of 25 November 2011. The RSI is structured in the form of a guarantee scheme operated by the EIF using a combination of EIF own risk capacity and EU funding. Under RSI, EIF will provide guarantees to selected financial intermediaries. The guarantee will cover 50 per cent of the loss on each new eligible loan or lease that is originated during a two year period. The European Commission will take the first-loss position to cover expected losses and a portion of unexpected losses (20 per cent) while the EIF will assume second-loss position (80 per cent) using own risk capacity.
SME	Small and Medium sized Enterprises
SMEG	SME Guarantee Facility. SMEG is part of the CIP Framework Programme. It 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. SMEG provides co-, counter- and direct guarantees to financial intermediaries providing SMEs with loans, mezzanine finance and equity.
SPV	Special Purpose Vehicle
TEN	Trans-European Networks
UEAPME	European Small to Medium Enterprise Association
VC	Venture Capital

Executive summary

This is the Final Report for the *evaluation of the European Investment Fund's (EIF) own resources activity*. The evaluation was commissioned by the Directorate-General for Economic and Financial Affairs (DG ECFIN) in October 2011. The work was undertaken by GHK Consulting with inputs from three external experts: Professor Dr. Christoph Kaserer (private equity); Ian Callaghan (securitisation and SME lending); and, Dr. Frank Jan de Graaf (corporate governance).

Background and Context for this Evaluation

EIF was founded in 1994 as a 'Public Private Partnership' (PPP) between the European Investment Bank (EIB), the European Commission and a number of European public and private financial institutions, with an authorised capital of ECU 2 billion and a paid-in capital of ECU 400 million (paid-in ratio of 20 per cent).

The Fund was conceived as a self-sustaining, policy driven institution and this was reflected in its dual statutory objectives of supporting the delivery of EU policy objectives (Article 2) and earning an 'appropriate' return for its shareholders (Article 27)[1].

EIF's original policy mission was to foster investment in Trans-European Networks (TENs) and Small and Medium sized Enterprises (SMEs), in pursuit of EU policy objectives. Initially, this was through the provision of guarantees but, in 1996, it was decided to use the Fund's own resources to make investments in venture capital funds.

In June 2000, following a strategic review, EIF became the newly established EIB group's specialist risk capital arm, while maintaining its tripartite shareholder structure comprising the EIB (60 per cent), the European Commission (30 per cent) and financial institutions (10 per cent). Consequently, EIF's TEN guarantees portfolio was transferred to the EIB and, in return, the EIB transferred the management of its venture capital activities to EIF.

In 2007, the EIF General Meeting approved a 50 per cent increase in the Fund's authorised capital to allow the Fund to continue its own resources activity. As a result, EIF's total subscribed share capital increased from EUR 2 billion to EUR 3 billion; and, paid-in capital increased from EUR 400 million to EUR 600 million. The European Commission also participated in this capital increase in order to maintain its shareholding at 30 per cent.

Council Decision 2007/247/EC of 19 April 2007 on Community participation in the EIF's capital increase called for an evaluation of the Fund's own resources activity by 31 July 2012 (Article 3). The present evaluation meets this requirement.

Legal reasons aside, the timing of the evaluation is pertinent in the context of ongoing policy discussions relating to the next Multi-annual Financial Framework (MFF). The budget proposals tabled by the European Commission[2] emphasise the important role of financial instruments in mobilising public and private funding in pursuit of the EU 2020 goal of smart, sustainable and inclusive growth. Delivery of such financial instruments can be achieved through a variety of means – of which EIF own resources activity is but one. Moreover, discussions are underway regarding a potential increase in the capital of the EIB by EUR 10 billion to stimulate European economic recovery. This could potentially lead to additional resources being made available to the EIF under new or replenished EIB mandates.

In such a context, it becomes important from the European Commission's perspective to fully understand: (a) the added value and policy impact that it has derived (and continues to derive) from its shareholding in the EIF as a risk taking, policy driven and market orientated institution; and, (b) its

[1] Statutes of the European Investment Fund approved 14.06.1994. Official Journal L 173 , 07/07/1994 P. 0001 – 0011.

[2] COM(2011) 500 final – A Budget for Europe 2020.

See also COM(2011) 662 final - A framework for the next generation of innovative financial instruments - the EU equity and debt platforms.

continued ability to maintain and influence EIF's policy focus as a minority shareholder and within the framework of the Fund's dual statutory objectives.

Given the above, the Terms of Reference for the evaluation were to examine the following high level issues:

- The extent to which the objectives of EU shareholding in the EIF are being met;
- The added value and impact of EIF own resources activity (i.e. activity funded principally through the capital made available by its shareholders);
- Whether the current level of EU shareholding is sufficient for the European Commission to achieve EU policy objectives;
- Whether there are more effective and efficient alternative means of achieving EU policy objectives; and,
- The EIF's governance structure.

And on the basis of above, to provide pointers/ recommendations for:

- Enhancing the EU added value and policy impact of EIF own resources activity;
- The optimal level of EU shareholding in the EIF; and,
- EIF's governance structure including the role of EU representation on the EIF's Board.

The Role of the EIF Own Resources in delivery of EU Policy Goals

EIF's activities are funded from two main sources:

- *Its own balance sheet (referred to as own resources or own risk activity):* in accounting terms, own resources are the sum of capital paid in by shareholders adjusted for fair value, share premium account, statutory reserves and retained earnings. At the end of 2011, total equity (own resources) stood at just under EUR 1 billion[3];

- *Funds mandated to EIF by third parties (referred to as mandate or trust activity):* these are the funds available to EIF within the framework of mandates entrusted to it by shareholders and other third parties. At the end of 2011, total funds managed by the EIF on behalf of third parties amounted to just over EUR 11 billion[4].

The European Commission makes resources available to the EIF via both these channels:

- *Capital made available to the Fund through its shareholding.* As a shareholder, the European Commission has contributed EUR 224 million of capital to the Fund since its inception to date (initially, EUR 120 million in 1994 and a further EUR 104 million as part of the 2007 capital increase) while it has received more than EUR 44 million as dividends over the same period. Taking into account the dividends received, the net contribution of the EU budget amounts to around EUR 180 million for an investment currently valued at more than EUR 290 million[5].

- *Funds entrusted under mandates,* most notably a EUR 1.1 billion mandate to manage the high growth and innovative SME facility (GIF) and the SME Guarantee facility (SMEG) under the Competitiveness and Innovation Framework Programme 2007-2013 (CIP). The EIF also manages the Risk Sharing Instrument for innovative and research oriented SMEs and small Mid-Caps (RSI facility), and the European Progress Microfinance Facility on behalf of the European Commission. These funds are made available to the EIF from the EU General Budget via specific Community programmes which typically have a seven year programming cycle. Additionally, some Member States and regions have mandated EIF to manage their Cohesion policy financial instruments (i.e. JEREMIE Holding Funds).

[3] EIF Financial Statements for the year 2011.

[4] ibid

[5] According to the end-2011 valuation of the Replacement Share Purchase Undertaking granted by the EIB to other EIF shareholders.

The own resource activity of the EIF strongly reflects its establishment as a public private partnership – comprising the EIB, the European Commission and financial institutions as shareholders – including the joint expectation of a 'blended return' of policy and financial objectives. Notably, these include:

- That, as a policy-driven institution, the EIF is expected to deliver EU policy objectives (for example, invest against market failures and catalyse SME financing);
- That, as a market-orientated institution, the EIF is expected to demonstrate financial discipline, for example, in its credit rating status, operational sustainability and long run return on equity (RoE).

Given this, own resources are invested across the risk-return continuum to achieve a balanced portfolio that delivers both the agreed policy objectives as well as an appropriate financial return (RoE). This balancing is a critical element of own resources activity as 'trade-off' positions can often exist between policy return and financial return in certain market segments (for example, early stage venture capital, financing of research, development and innovation).

While resources mandated by the European Commission are also typically invested in a market orientated manner, financial returns on some European Commission mandates may be smaller and policy returns higher as compared to own resources activity of the EIF given the nature of market failures targeted (in terms of sector, geography, stage or activity focus) – an example is GIF 1 which targets early stage SMEs. However, there are other European Commission mandates with similar risk return characteristics to EIF own resources activity – for example, GIF 2 which targets SMEs in their expansion phase.

The evaluation was unable to compare the policy and financial returns generated by own resources activity with those generated by the European Commission mandates due to lack of detailed ex-post data on SMEs assisted, innovation outcomes, employment creation and deadweight (i.e. policy impacts) of own resources activity[6]. However, the evidence collected as part of this evaluation shows that mandates and own resources are not mutually exclusive alternatives for the European Commission. The financial return requirement might reduce the direct policy impact of own resources activity in certain instances (due to the need to pursue a balanced portfolio), but this return should be weighed against the broader return generated by own resources activity through a number of added value channels (as set out below).

The Added Value achieved by EIF Own Resources Activity

The added value of EIF own resources activity to the European Commission can be described as follows.

1) Delivery of SME financing by increasing the volume of risk and debt financing

Through the EIF, the European Commission seeks to increase the volume of risk capital and debt financing available to European SMEs to support EU growth and competitiveness objectives such as increased research and development (R&D), innovation and job creation.

To this end, the EIF utilises its balance sheet to carry out the following operations:

- *Guarantee operations.* EIF's own resources guarantee activity mainly comprises credit enhancement of SME securitisation transactions although in the past, the EIF has also used its balance sheet to provide guarantees in support of (a) portfolios of micro-credits or SME loans or leases (credit insurance) and (b) senior loan facilities granted to specialised investment funds that provide mezzanine finance and risk capital to SMEs (structured finance transactions). Box A briefly describes how the focus of EIF's own resources guarantee activity has changed over time.

[6] For Commission mandates, data is available for both financial returns and policy impact. For own resources activity, ex-post data on policy results and impacts such as business assist, innovation outcomes, job creation etc. is not available (for own resources equity operations, data is available on the number of SMEs assisted). However, financial data is available.

- *Equity operations.* EIF's own resources are typically co-invested in fund-of-funds or private equity/ venture capital (PE/VC) funds alongside mandates - mainly the EIB's Risk Capital Mandate (RCM) - to demonstrate alignment of interest with mandators. Co-investment represents 97 per cent of the EIF's own resources equity operations[7]. Only in a few cases has the EIF used its balance sheet for independent investments (3 per cent of own risk equity portfolio).

Box A The changing nature of EIF's guarantee operations

Over time there has been a shift in the ways the EIF's balance sheet has been used for supporting SME guarantee operations. In its early years (1996 to 2001), EIF's own risk guarantee operations focussed on credit insurance and structured finance transactions. Additionally, EIF's balance sheet was also used to support the European Commission's mandate activity. For example, under the Growth and Environment Pilot Project (implemented during 2000 and 2001), EIF provided a free guarantee to the financial intermediaries for loans extended to SMEs with the purpose of financing environmentally friendly investments. The ultimate risk from the guarantee lay with the Fund while the guarantee fees were paid out of the EU budget. Since 2004, the EIF's own risk guarantee operations have focused exclusively on credit enhancement of SME securitisation and, until recently, little was done to combine EU budget and EIF's own risk capacity to develop innovative guarantee products in support of policy goals[8]. Going forward, the EIF's guarantee strategy sets out two key areas of own risk activity: (i) credit enhancement of SME securitisation transactions and (ii) greater use of risk sharing mechanisms and shift to new ways of risk-sharing e.g. the RSI where the different risk taking capacities of the Commission (first loss piece) and the EIF (second loss piece) are combined to enhance the overall leverage capacity of the financial instrument. While the latter is a positive development, both these interventions need to be underpinned by assessments and evidence in terms of their capacity to address market failures and deliver the desired scale of policy and financial return.

Guarantee operations

Since its inception, EIF has committed EUR 7.3 billion to own-risk guarantee operations (this figure includes closed and outstanding guarantee transactions) – of which, credit enhancement represents 92 per cent. The current outstanding guarantees portfolio stands at EUR 3.6 billion and it is estimated to have supported EUR 40 billion of financing. Using the same dynamic multiplier as observed for outstanding transactions (11.18)[9], the total financing supported would be in the order of EUR 82 billion, if closed transactions are also included in the calculations[10].

The extent to which this financing has been channelled to SMEs remains, however, to be precisely determined. There exists a gap in data showing the extent to which capital freed-up via risk transfer transactions (also referred to as synthetic transactions) or funding accessed via true sale transactions has been redeployed for new SME financing (lending or leasing) by originators (banks and leasing companies).

EIF obtains ex-ante commitments in the form of declarations from originators that the funding accessed (or capital freed-up) via securitisation will be used for SME financing and, since 2010, all new transactions are subject to an ex-ante value added assessment to minimise the risk that benefits of securitisation are not passed by originators to SMEs. There is, however, no ex-post measurement or verification of policy impact by the EIF. To address this, EIF has recently developed a methodology to measure (ex-post) the policy impact of its SME securitisation activities.

In theory, SME securitisation should stimulate SME lending by increasing the lending capacity of originators (by providing access to term funding, by potentially lowering the cost of funding or by

[7] Based on equity data provided by the EIF.

[8] A recent example is the Risk Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps (RSI Facility) which was launched as a pilot scheme in 2011.

[9] Catalysed factor adjusted for replenishment of transaction. NB: in replenishment period, originator is allowed to include new loans in the securitised portfolio. The catalysed factor is the value of funding provided by the investors to a particular transaction due to EIF's involvement (funding transaction); regulatory capital relief that is directly/indirectly attributable to EIF (risk transfer transaction).

[10] The Technical Annex provides a detailed analysis of the EIF's guarantees and equity data.

providing capital relief)[11]. There is, though, scarce empirical evidence confirming the same. Moreover, there is also the risk that the lending is going to existing small business customers about whom the banks or leasing companies have strong prior knowledge rather than new SME clients (thus, not necessarily addressing the market failures arising from information asymmetry)[12]. The limited fieldwork undertaken as part of this evaluation and an analysis of the EIF's transactions data was inconclusive as regards the scale and nature of policy impact (measured in terms of SME financing) achieved through EIF's securitisation activity.

However, case studies in different Member States and interviews with EIF counterparties highlight the role of EIF in developing new markets and financial products. Examples include the first ever securitisation of SME-related assets in Portugal in 2003 and in Poland in 2006; the first multi-country and multi originator SME loan securitisation in Europe; the first micro loans securitisation transaction in Europe; and, the implementation of a variety of SME guarantee products and structures across Europe.

Equity operations

To date, EIF has co-invested EUR 577 million of own resources alongside mandates (primarily, EIB-RCM[13]) in 216 PE/ VC funds. Taking into account the mandate resources, overall EIF commitment (sum of own-resources and mandates) to these funds amounts to EUR 4.4 billion or just over EUR 20 million per PE/VC fund. With a leverage factor of 6.6[14], it is estimated that EIF commitment 9EUR 4.4 billion) has mobilised circa EUR 29 billion of equity financing over a 15 year period (1996 to 2011). EIF backed PE/VC funds have used these resources to invest in 2,719 companies (including 880 exited companies) over the same period.

Given its policy driven mission, EIF investment is expected to respond to market developments (and retrenchments) through a process of counter-cyclical investment; encouraging investments at times there are few and stepping back when the market is over-heated. This counter-cyclical role has been evident in a number of years, notably 2001, 2002, 2004, and 2009 to 2011. In 2006 and 2007, EIF investment patterns seem to have matched industry trends.

Counter-cyclical activity is one reflection of the EIF's public policy rationale i.e. to reduce and overcome market failures in SME financing. The targeting of market failures should also be evident at the level of risk capital funding placed within specific market segments (in terms of geographic, stage and sector focus). Aggregate analysis of the nature of SME finance markets supported by own resource equity activity suggests concentration in balanced[15]/ late stages[16] VC funds and the Lower Mid-Market[17] segment (71 per cent of own risk equity commitments) as well as non-technology sectors (47 per cent of own risk equity commitments). It should be noted that due to current co-investment rules, this investment was almost entirely determined by the EIB-RCM's investment patterns.

[11] See, for example, a study commissioned by DG Enterprise and Industry on Asset Backed Securities. EC (2004) Study on Asset-Backed Securities: Impact and Use of ABS on SME Finance.

[12] Although it should be noted that since the financial crisis and considering the new regulation for banks (capital requirement), an important challenge is also to make sure that banks maintain their SME lending volumes and keep financing their existing SME customers.

[13] But also the European Recovery Programme administered by the German Ministry BMWi and less systematically, alongside other mandates.

[14] Leverage factor = target fund size *divided by* EIF commitment. The leverage factor seeks to measure the EIF's role in attracting/ mobilising funds from other investors.

[15] A venture fund investing in portfolio companies at a variety of stages of development (Seed, Early Stage, Diversified, Later Stage).

[16] Financing provided for the growth and expansion of an operating company which may or may not be breaking even or trading profitably.

[17] Lower Mid Market (LMM) funds focus on growth and expansion capital as well as on transmission and consolidation opportunities, covering the equity gap of SMEs in the more mature phases of their life cycle.

2) Delivery of EU SME financing through a combination of policy and financial objectives

EIF has been conceived as a policy-driven institution, but one which is also deliberately market-orientated. Given this orientation, EIF own resources activity is further able to deliver:

- *Enhanced leverage:* market orientation implies that the EIF seeks to be viewed as a co-investor with the private sector (investing on a *pari passu* basis) in the financial landscape of SME finance - with commercial credibility, but greater flexibility to take riskier positions (than the private sector) which 'unlock' or catalyse private sector investment. Acting with greater market knowledge and at the 'tipping point' of investments provides the potential for enhanced leverage of investment volumes (see above).

- *Financial innovation:* EIF own resources provide the flexibility to develop, market test and pilot innovative financial instruments (which may subsequently be adopted by financial institutions and / or be replicated, and / or scaled-up, including via mandates) or operate in market segments not covered by mandates. Examples include guarantees or counter-guarantees for SME lending portfolios, SME securitisation, equity operations including fund-of-funds structures and technology transfer products.

- *A sustainable pan European platform for development of SME risk financing*: including organisational infrastructure, know-how and risk management. There are a number of benefits identified through the provision of such a pan European platform based upon the ability to spread knowledge, skills and risks across Member State borders, including:
  - Facilitation of multi-country transactions thus diversifying risk and obtaining critical mass;
  - Contribution to the development of less sophisticated markets;
  - A 'big picture', pan-European approach which maximises economies of scale and overall impact;
  - The increase of intermediary sophistication, while contributing to a less fragmented EU market; and,
  - Consistent application and promotion of best practices throughout the EU thus developing industry standards. For example, EIF requires its business partners to comply with anti-money laundering and anti-terrorist financing legislation; it promotes transparency and good governance in its operations; it promotes the use of internationally-recognised financial reporting standards etc.

  Ultimately, this support for a platform extends to the definition of the EIF as a centre of excellence, expertise and knowledge for policy driven SME financing activity in Europe.

- *Partnership benefits generated from the strong and recognised relationship between the European Commission and the EIF:* evidence exists of added value benefits for all sides generated by the partnership between the European Commission, the EIF and its other stakeholders. For example, for the European Commission, there is recognition of its position within the finance industry landscape achieved through its association with a credible, market orientated financial institution. On the other hand, the credibility of the EIF in the market and its 'AAA' credit rating benefit from the strong and stable support from the Commission.

3) Delivery of SME Financing within a 'self-sufficient' Financial Envelope

In its delivery of an appropriate financial return (which has been set at a long run RoE target ranging from 5 per cent to 7 per cent during different periods), own resources activity delivers current SME financing policy objectives from a position of 'self-sufficiency'. In other words, taking into account the small opportunity cost to the European Commission of its share of paid-in capital, policy impacts are achieved annually through recycling of the original investment – with no additional budgetary implications for the EU. As previously stated, the net contribution from the EU budget as a shareholder has, until now, been around EUR 180 million and this investment is currently valued at more than EUR 290 million.

Added Value of EU Shareholding

Whilst own resources activity provides a specific 'blended return' (reflecting the EIF's market orientated approach to delivery of policy impacts), further added value of EU shareholding in EIF can be identified in terms of:

- *Maintaining focus on EU policy objectives:* whilst the European Commission can be shown to possess several channels by which it can directly or indirectly influence the policy orientation of EIF activity (e.g. as a policy maker, as an EIF shareholder and as a client entrusting mandate activity to the EIF), EU shareholding can be demonstrated to be the most effective and active channel. In return for a 30 per cent shareholding, the European Commission achieves proportional representation on the EIF's Board of Directors (two out of seven Board seats) and related agenda setting (for example, determining the strategic and operational objectives of the EIF).
- *Working relationship with the EIB and other shareholders:* joint undertaking of Board activity with other shareholders, and the EIB in particular, supports greater organisational understanding and stronger working relationships between key stakeholders in the SME financing landscape.
- *Presence in a 'post crisis world':* that the continued 'status quo' of European Commission shareholding in the EIF sends a positive signal to the financial world of stability, financial commitment and regulatory oversight in a current period of financial uncertainty; and more broadly, reaffirms EU support for SMEs and innovation.
- *Supporting enhanced leverage and policy impacts through rating stability:* critically, the joint shareholding partnership of the EIB and the European Commission has formed the underlying basis for the AAA/Aaa rating of the EIF. A strong credit rating is needed for the EIF's guarantee activity (both own resources and mandates).

Enhancing the Added Value of European Investment Fund Own Resources Activity

Given the findings on added value, there exist a number of potential areas in which the policy impact of EIF own resources activity could be enhanced. These are set out below and organised under the following headings: relevance, effectiveness, efficiency and coherence.

Relevance

Evaluation evidence suggests that there remains a strong and valid case for EU shareholding in the EIF on the basis of its unique role and activity in European SME financing. EIF own resources activity is generally able to demonstrate achievement of policy objectives in terms of SME financing supported – and as set out in its Corporate Operational Plans (COPs).

Given developments in EIF, the time that has elapsed since capital expansion, and the post-crisis world, there is room for clarity of purpose for the shareholding investment to be (re)stated; in other words, the general, specific and operational objectives of EU shareholding in the EIF need to be clearly articulated. This, in turn, raises a number of considerations:

- *The process of setting of policy objectives:* little evidence exists of a systematic process for the setting and review of desired EU policy objectives for EIF own resources activity as enabled by its shareholding position. For example, EIF Board membership is utilised to improve the policy orientation of the EIF's COPs (but currently, for example, the COPs set out limited policy targets based upon outputs e.g. commitment and leveraged volumes; without reference to results or outcomes e.g. volume of financing reaching SMEs). Meanwhile, developments are on-going in the EIF's business processes to provide comprehensive assessment of market failures and financing gaps across SME finance markets and measurement of policy impacts as the basis for review of policy objectives.
- *The desired balance of financial and policy returns (as articulated in an 'appropriate return on capital'):* currently, EIF Board has agreed an appropriate return on capital to be a long run target RoE of 5 to 6 per cent. This is based on the historical performance of the EIF and what it considers achievable and acceptable to the full breadth of shareholders.

Evaluation evidence shows that:

- The main expectation of all shareholders is that the EIF delivers a minimum level of profit which at least matches inflation metrics and ensures capital preservation/ long–term financial viability;
- EIF has historically delivered a lower RoE. The long run average RoE achieved by the EIF (over the period 1996 to 2011) is 4.21 per cent or 3.57 per cent excluding the year 2001 (which was an exceptional year)[18];
- The present RoE target is not underpinned by a systematic analysis of the financial return required to ensure the long run viability of the institution and what can be achieved given the risk profile of its equity and guarantee operations and its treasury portfolio;
- While all peer institutions (such as EBRD, IFC, KfW and FMO) seek to be financially viable, EIF has an explicit statutory objective of generating an 'appropriate' return for its shareholders.

Articulation of the generic, specific and operational objectives of EU participation in EIF shareholding may usefully include assessment of the expected level of 'appropriate' return on capital, given the need for this rate to be balanced against policy impact.

- *Institutional diversity in a post crisis world:* evidence exists across Europe that the financial crisis and the aftermath of increased market failures in access to finance are at least partly related to the long run development of institutional mono-cultures in financial markets. Post-crisis regulatory responses in a number of Member States are incorporating the potential for alternatives to traditional bank based lending (such as investment funds providing debt finance, peer-to-peer lending networks, cooperatives, community based banks, saving bonds[19] etc.)[20]. Current EIF own resources activity includes the added value of the development of SME finance markets and ecosystems as part of its role as a pan-European support platform for SME finance.

Articulation of the generic, specific and operational objectives of EU participation in EIF shareholding may usefully include a consideration of the relevance of a long run objective to support institutional diversity as the basis for SME finance market development and the overcoming of systemic long run market failures in European SME financing.

Effectiveness

This evaluation has demonstrated the added value of EIF own resources activity in delivering European SME finance activity (risk capital and debt finance) including investment volumes achieved, development of innovative financial instruments, and the building of investment infrastructure and ecosystems based upon partnership and shared knowledge.

Nevertheless, the business processes within the EIF that might provide comprehensive assessment of market failures across SME finance markets and reporting of policy impacts should be developed further to better measure and evaluate own resources policy impact. For example, supported volumes of financing can be measured, but it is not possible to accurately assess the extent to which this financing is addressing market failures or the extent and nature of reach to SMEs (in the case of securitisation operations).

[18] EUR 60.5m of exceptional income resulted from the transfer of the activities to EIB, as part of the EIF Reform.

[19] Mini bonds are occasionally called 'shaving bonds' after an early bond designed and issued by King of Shaves in 2009. It is an unsecured bond issued by a company to an investor. The company promises to pay a fixed rate of interest to the investor for the life of the bond. Mini bonds are particularly suited for companies too small to make the cost of issuing corporate bonds worthwhile. A number of companies with a strong customer base are tapping retail demand directly to raise debt finance by issuing mini bonds.

[20] See for example, NESTA (2011) Beyond the Banks: The case for a British Industry and Enterprise Bond

Notwithstanding these limitations, certain operational practices suggest that current policy impacts could be enhanced, including:

- *Distribution of dividends:* given the EIF's unique role as a market orientated institution that demonstrates financial diligence, all shareholders have agreed a dividend policy. Any non-distribution of dividend would incur an additional accounting requirement ('impairment test') on the part of at least some shareholders and they would need to be 'compensated'. Such 'compensation' need not be exclusively financial. Shareholders also value the reputational benefits stemming from their association with a highly professional and credible EU institution, access to knowledge, networks and expertise, etc.

  Whilst the amount of dividend received is financially insignificant for most financial institution shareholders, given the low number of shares they hold[21] in monetary terms (ranging from a few hundred to a few thousand euros per shareholder per year), the practice of distributing 40 per cent or more of annual profits as dividends represents a 'leakage' of resources which could potentially be recycled (within a blended returns framework) to support SME financing. This practice of distributing such a high share of profits as dividends also stands out in comparison to peer group organisations that typically retain their profits[22].

- *Automatic co-investment rule:* a substantial and majority percentage of EIF own resources equity activity is required to be invested alongside the EIB-RCM mandate managed by the EIF. Whilst this requirement matches financial investment norms in ensuring that those responsible for managing funds have 'skin in the game', the current requirement of 10 per cent is substantially greater than the industry norm (closer to 1 per cent); and is inconsistently applied (for example, it does not apply to the EIB's Mezzanine Facility for Growth). Moreover, the 'skin in the game' argument is less valid when the mandator is a majority shareholder (as logically, one would expect alignment of interest between an organisation and its majority shareholder), but can be justified in the case of minority shareholders and other third party mandators. The automatic co-investment rule substantially reduces the flexibility and visibility of EIF own resources activity; and it has little added value. However, co-investment in the form of risk sharing arrangements (such as the RSI) which can enhance the leverage capacity of an instrument has demonstrable added value.

- *Development of expertise, excellence and partnership in European SME financing:* the distinctive 'blended returns' framework utilised by EIF demonstrates the tripartite shareholder structure of EIF – EIB, European Commission and financial institutions – but care should be taken to avoid reification of shareholder interests to financial objectives and investment volumes generated alone. Shareholder interviews highlight the substantial and continued interest retained by financial institutions invested in EIF in the expertise, excellence and partnership benefits of EIF partnership rather than any financial or policy returns per se. Care should be taken that such returns are not the 'poor relation' or 'cinderella' of EIF added value alongside direct policy and financial targets.

Efficiency

EU shareholding is efficient as the current value of EU shareholding largely exceeds the cash contribution provided by the EU budget; but, its efficiency can be enhanced. Efficiency includes the added value achieved by the limited budgetary commitment currently supporting EIF own resources activity undertaken on a 'blended returns' investment approach (for example, leverage, innovation and market development) and the particular additional value achieved by a shareholding approach (for example, enhanced leverage and credibility and position amongst financial institutions, markets and partners).

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[21] Most of the shareholders hold less than 10 shares.

[22] Among EIF's 'peers' (EBRD, IFC, KfW and FMO), only FMO distributes a dividend - although it should be noted that FMO is required to set aside most of its net profits (95 per cent) in its contractual reserve. Therefore this profit is not distributable. The distributable element of the net profit effectively amounts to a maximum of 5 per cent.

Enhanced results are achievable principally because of the lack of fully systematic consideration of the policy impacts potentially achievable under a 'blended returns' framework. This is demonstrated, for example, in limited setting of policy objectives, lack of continuous and determined consideration of maximising of policy returns within investment and distribution policy, and currently limited impact reporting systems.

The evaluation demonstrates that European Commission mandates should not be viewed as a direct 'alternative' to EU shareholding in the EIF. Moreover, EIF own resources activity generated through paid-in capital supports the ability of mandates to deliver policy impacts – including the financial instrument utilised, the quality of transactions achieved and the maximum leverage attainable.

A further alternative would be for the European Commission to collaborate directly with promotional institutes to support SME financing but, for example, whilst possible and evident in certain Member States, their geographical coverage (typically national) and the need to deal with multiple institutions (rather than the EIF alone) highlight immediate limiting factors. Besides, not all Member States have promotional institutes.

Overall, any calculation of policy benefits and impacts which might be realised through the re-allocation of EU shareholding capital to alternative delivery mechanisms for SME finance would need to strongly consider the impact of a reduction in the scale and scope of added value of own resources activity not only within the remit of own resource activities but, additionally, across the broader activities of EIF including mandate activity.

Coherence

Within the current financial perspectives, EIF has developed a deal allocation policy to avoid overlaps between EU financial instruments, mandates and own resources activity. However, the deal allocation policy is lacking in detail and does not take full account of potential overlaps – it appears to be based on a conceptual assessment of overlaps between the various mandates and own resources rather than a thorough analysis of actual/ perceived overlaps based on feedback 'from the ground'. Moreover, interviews with the European Commission imply that parallel contacts between the EIF and several Commission services have led to a fragmentation of EU financial instruments. However, this is not entirely a matter for the EIF to address; it is also the European Commission's responsibility to ensure coordination between the different DGs when developing financial instruments. For the next programming period, the European Commission has set up an expert group on financial instruments to coordinate activity at an EU level. This is a step forward in ensuring coherence in the design and delivery of EU financial instruments. Moreover, it is noted that internal coordination within the European Commission has already been strengthened as prior to each EIF Board meeting, the DGs concerned, are consulted on relevant Board documents. Furthermore, after each EIF Board meeting, an ex-post report, summarising the main discussions and approvals, is sent to the hierarchy of DG ECFIN as well as to relevant DGs (e.g. DG RTD, DG ENTR).

As regards coherence with Member States' financial instruments, stakeholder interviews have indicated that there is scope to improve coordination between the EIF and national promotional institutes/ development banks to avoid overlap or duplication and competition with national institutes.

Recommendations

In summary, EU shareholding in the EIF and EIF own resources activity remains relevant in pursuit of SME financing policy objectives and generally effective in delivery of policy impacts – notwithstanding limitations in the EIF's ability to demonstrate optimal policy impacts.

Added value and impact of EIF own resources activity for the European Commission comprises the value achieved by policy activity undertaken within a 'blended returns' framework, activity supported by specific shareholding positions and additional benefits resulting from other (mandate) activity of the EIF which supports EU policy objectives. Given this, other more efficient policy mechanisms are not immediately evident.

A number of recommendations to support enhanced policy impacts and maximise added value whilst retaining an 'appropriate rate of return' can be proposed.

Recommendation 1: The re-affirmation and articulation of the general, specific and operational objectives of EU participation in EIF shareholding.

Current EU policy objectives (as the basis of, ultimately, target setting by the EIF Board as reflected in the COPs) remain under-specified given substantial developments over time in the context for and the activities of EIF. A specific objective setting process would be beneficial; potentially, this process could be undertaken through a number of activities and with a choice of stakeholders. Some initial considerations on the objectives of EU shareholding in the EIF are outlined below.

Initial Considerations on the Objectives of EU Shareholding in the EIF

General objective	Specific objectives	Operational objectives
To enhance SME access to finance	To increase the supply of debt finance by taking mezzanine or subordinated positions	To enhance the banking sector's capacity to lend to SMEs
		To support non-bank channels of debt finance
		To support institution building in less developed markets
		To support institutional diversity in mature markets
	To increase the supply of equity and equity-like debt instruments for SMEs	To invest in early stage venture capital
		To support the development of SME equity markets
		To nurture embryonic markets
		To support mature markets in difficult economic conditions
	To develop and spread innovative financing	To develop and prove new and pioneering financial instruments and structures
		To diffuse successful financial instruments and structures across European financial markets
	To support market best practice and intelligence in innovative financing and to build market know-how	To contribute to the development of best practice, experience and expertise in innovative financing
		To use the EIF's market proximity as the basis for generating market intelligence and continuous feedback for policy development

EIF should be adequately capitalised to deliver its policy mission and reflecting its product mix. For example, guarantee operations by nature are more capital intensive than equity operations; equity operations can be delivered entirely through mandates whereas guarantee operations require EIF to have its own capital.

Recommendation 2: Maintain the tripartite ownership structure of the Fund

2a The Commission should maintain a substantial shareholding in the EIF (in the order of the current shareholding of 30 per cent)

2b Efforts should be made to prevent a further decline in the share of financial institutions and, ideally, return to a more balanced ownership structure by increasing the shareholding of financial institutions with aligned goals while maintaining the EIB as the main/majority shareholder

EIF was initially conceived as a Public Private Partnership with a shareholder split of 40 per cent EIB, 30 per cent European Commission and 30 per cent financial institutions. The evaluation has illustrated the range of added value of this tripartite structure in supporting EIF as a policy-driven, market orientated institution, notwithstanding the subsequent move to a 60:30:10 shareholding position (EIB, European Commission and financial institutions respectively). A further decline in the share of financial institutions (over time, for example, the share of commercial banks has declined to a mere 2 per cent) would have a detrimental signalling effect (signalling a lack of confidence in the PPP structure) and would diminish the benefits associated with industry knowledge, relationships and presence.

Given the distinctive and demonstrable value of each shareholder group in contributing to the full added value of EIF, efforts should be made to fully maintain the tripartite structure of the Fund – including preventing further decline in the ownership share of financial institutions and, ideally, increasing their share. Arguably, it is more pressing to support renewed joint efforts and operations with financial institutions within the 'post-crisis' financial world.

Nevertheless, the EIB should remain the main/majority shareholder of the EIF to continue boosting cooperation between the two institutions and thereby facilitating the development of joint instruments.

Recommendation 3: A more strategic and representative governance structure

3a Reinforce the strategic orientation of the Board

An overarching conclusion that can be drawn from the evaluation is that strategic and foresight activity could be stronger given a number of findings and conclusions on consideration of strategic issues (for example, policy objectives and target setting, RoE, dividend policy, policy impact of EIF, role and added value of EIF in a post-crisis financial world). Board minutes and interview testimonies indicate that considerable time is spent on discussing individual operations, whereas strategic matters are only discussed in the context of the COP and few other policy documents.

3b EIF shareholders should consider the reputational and strategic benefits that would be brought to EIF through the appointment of stakeholder representatives to the Board of EIF

Since EIF's creation, there have been substantial developments in best practice models of governance for institutions, including incorporating issues of transparency, scrutiny, clarity of role and demonstrating legitimacy. This governance movement is, if anything, even more pertinent currently in two arenas – financial institutions and EU institutions – and its impact is evident in the breadth of stakeholder representation on peer institution boards.

EIF has met many of these developments in the evolution of its governance structure (such as introducing the requirement for Board members to act independently in the interests of the Fund in 2000), but arguments remain for a more representative board, for example:

- EIF is predominantly a publically funded organisation that is supporting financial institutions to achieve certain policy/ societal objectives. The Board composition could legitimately be expected to reflect these societal objectives (for example, representatives of those who are the policy object, such as European SMEs or those with specific expertise in finance);
- To display the social role of finance and to legitimise public money in private markets;
- Stakeholders can support critical reflection on corporate policies and achievement of societal mission including supporting a 'checks and balance' process to ensure that Board members nominated by shareholders act in an ad personam capacity.

Recommendation 4: (given Recommendation 1), **A process of awareness raising of the Commission and EIF partnership and the added value generated through this unique policy instrument**

The process of this evaluation has highlighted a number of perceptions, misconceptions and perspectives across different stakeholder groups as to the role and value of EIF which could be addressed through a process of improved communication, information provision and engagement.

Recommendation 5: An expansion of the current level of internal resources committed by EIF to business processes associated with the delivery of policy objectives

This evaluation has highlighted that the systems and processes in place to support the monitoring, reporting and evaluation of policy impacts – and in contrast to those dedicated to financial objectives - could and should be developed further. Examples exist across the policy cycle: from setting policy objectives to articulation of investment rationales based on market failures to ex-ante and ex-post assessment. Comparison with peer institutions provide pointers on how such expansion might be brought forward, including the creation and / or use of better performance metrics and an independent evaluation function.

Recommendation 6: Seek further assurances and undertaking for destination of investment funds released through securitisation activity

SME securitisation activity constitutes a key mechanism for the delivery of policy impact via own resources activity (by enhancing the lending capacity of originators and making SME financing more profitable for them). Value added assessment of the policy impact of the EIF's SME securitisation operations is primarily undertaken by an ex-ante analysis which is essentially subjective and qualitative in nature. Given the historical and expected future role of SME securitisation operations in overall EIF activity, it is recommended that EIF should put in place practical measures to track and report the recycling of funding or capital relief into new SME lending and, ultimately to support judgements of policy impact.

Recommendation 7: The European Commission should seek a review at Board level of the rationale behind the current setting of the Return on Equity target under the blended returns approach of EIF own resources activity, taking into consideration the prime objective of the EIF to contribute to the achievement of EU policy objectives

Currently, the RoE target setting is not based on a systematic analysis of the risk-reward profile of EIF's operations or business simulations to determine the RoE required for long term sustainability. Shareholder expectations set a threshold level – at least matching long run inflation metrics and self-sufficiency – whilst the current expected RoE of 5 to 6 per cent, according to the EIF, is based on historical performance and what is achievable given the dual statutory objectives.

EIF's historical RoE performance from 1996 to 2011 (excluding 2001) is 3.57 per cent, the short to medium term outlook is of reduced commercial market returns and peer review demonstrates that market credibility can be achieved without an explicit RoE target.

Given the key weighting given to RoE as a Key Performance Indicator for own resources activity, the European Commission should seek a review of the RoE target by the EIF Board as to whether or not it is reasonable and adequate to ensure financial viability of the Fund and given its policy objectives.

Recommendation 8: The European Commission should seek a change in the current dividend distribution policy practised by EIF

A reduction in dividends paid would provide additional investment funds for recycling – for example, into a higher risk capital pot, but still within the agreed blended returns framework. Such a decision must, however, be approved by all shareholders.

Recommendation 9: Automatic co-investment rule under mandates should be reviewed

Substantial levels of own resource investment are required to meet the 'automatic' 10 per cent co-investment rule of the RCM. Whilst 'skin in the game' is good practice, the level set is substantially higher than the industry norm. Mandators should reduce 'automatic' co-investment requirements to industry standards.

Ideally, own resources should only be used for co-investment where it has clear added value, for example: (a) where the mandator is a non-shareholder third party or has a minority shareholding in the EIF and thus, requires additional demonstration of alignment of interest; or, (b) it enhances the leverage capacity of an instrument through risk sharing arrangements by providing capital relief to intermediaries (as in the case of the RSI facility).

Recommendation 10: Continued development of the EIF as a centre of expertise and excellence in the design, implementation, standardisation and diffusion of innovative financial instruments

The added value generated by EU shareholding in the EIF includes the expertise and excellence generated within EIF and available to support the development of European SME finance markets. Indeed, financial institution shareholders strongly value such additional benefits as a balance against reduced commercial returns. The strategic importance of this 'soft' added value to both shareholders and stakeholders alike should be subject to full recognition and strategic development.

Recommendation 11: Strengthening of internal procedures for mandate development and deal allocation policy

The mandate development process and deal allocation policy should be based on a more thorough examination of market gaps, overlaps and risk-reward profiles of potential mandates and existing activity in order to maximise complementarity between mandates and own risk activity.

1 Introduction

This is the Final Report for the *evaluation of the European Investment Fund's (EIF) own resources activity*. The evaluation was commissioned by the Directorate-General for Economic and Financial Affairs (DG ECFIN) in October 2011. The work was undertaken by GHK Consulting with additional inputs from three external experts: Professor Dr. Christoph Kaserer (private equity); Ian Callaghan (securitisation and SME lending); and, Dr. Frank Jan de Graaf (corporate governance).

The evaluation was designed to be both summative (i.e. taking stock of achievements to date) and formative (i.e. looking ahead). To achieve this, quantitative and qualitative evidence was drawn from a range of sources: desk research; semi-structured interviews with relevant stakeholders such as the European Commission, EIF shareholders, EIF Board members, EIF management and team, EIF's counterparties and industry bodies; mini case studies; peer group analysis; and, expert opinion. The evaluation was an iterative and participative process: two validation and feedback workshops were organised in May 2012 with key stakeholder groups to subject the emerging findings to critical review and challenge.

The Final Report details the work undertaken and provides a synthesis of the evidence collected within the framework of this evaluation. It also sets out the conclusions reached in response to each evaluation question contained in the Terms of Reference issued by DG ECFIN; and provides a series of recommendations to improve the added value and policy impact of EU shareholding in the EIF going forward.

1.1 Background and Context for the Evaluation

The EIF was founded in 1994 as a Public Private Partnership (PPP) between the European Investment Bank (EIB), the European Commission and a number of European public and private financial institutions with an authorised capital of ECU 2 billion and a paid-in capital of ECU 400 million (paid-in ratio of 20 per cent).

The Fund was conceived as a self-sustaining, policy driven institution and this was reflected in its dual statutory objectives of supporting delivery of EU policy objectives and earning an 'appropriate' return for its shareholders.

EIF's original policy mission was to foster investment in trans-European networks (TENs) and Small and Medium sized Enterprises (SMEs), in pursuit of EU policy objectives[23]. Initially, this was through the provision of guarantees but, in 1996, it was decided to use the Fund's own resources (see section 1.3 for a definition of own resources) to make investments in venture capital funds.

In June 2000, following a strategic review, EIF became a subsidiary of the EIB while maintaining its tripartite shareholder structure comprising the EIB (60 per cent), the European Commission (30 per cent) and financial institutions (10 per cent[24]). At an operational level, EIF's TEN guarantees portfolio was transferred to the EIB and, in return, the EIB transferred the management of its venture capital activities to the EIF. EIF effectively became the newly-established EIB Group's[25] specialised venture capital and SME guarantee arm.

In 2007, the EIF General Meeting approved a 50 per cent increase in the Fund's authorised capital to allow the Fund to continue its own resources activity. The statutes of the Fund (Article 26) limit the amount of guarantees that can be extended by the EIF at its own risk to

[23] Council Decision of 6 June 1994 on Community membership of the European Investment Fund, 94/375/EC.

[24] A number of smaller financial institutions decided to sell their shares to the EIB at this stage – reducing the number of financial institution shareholders from 58 to 35.

[25] In 2000, the EIB Group was established comprising EIB and EIF.

three times the subscribed capital[26]. The ceiling decided by the General Meeting pursuant to Article 12 and Article 26 of the Statutes and presently applied to the Fund's equity operations (excluding commitments made by the Fund on behalf of third parties) is 50 per cent of own resources[27]. Owing to the fact that these ceilings were almost reached, a capital increase was necessary in 2007 in order for the EIF to continue its own risk activity. Consequently, the amount of subscribed capital was increased from EUR 2 billion to EUR 3 billion; and, the paid-in capital was increased from EUR 400 million to EUR 600 million. The Commission also participated in this capital increase in order to maintain its shareholding at 30 per cent.

The Council Decision[28] approving the Community's participation in the capital increase called for an evaluation of the own resources activity of the Fund by 31 July 2012 (Article 3 of Council Decision 2007/247/EC). Aside from the legal obligation to evaluate, the timing of the evaluation is also pertinent in the context of the ongoing policy discussions relating to the next Multi-annual Financial Framework (MFF) and wider debates on the role of public sector in financial markets in a post-crisis world.

In particular, budget proposals recently tabled by the Commission[29,30] emphasise the important role of guarantees and risk sharing arrangements in enhancing the leverage capacity of EU funding in pursuit of the EU 2020 goal of smart, sustainable and inclusive growth. Delivery of such guarantees and risk sharing arrangements can be achieved through a variety of routes – of which EIF own resources activity is but one. Moreover, discussions are underway regarding a potential increase in the capital of the EIB by EUR 10 billion to stimulate European economic recovery. This could potentially lead to additional resources being made available to the EIF under new or replenished EIB mandates.

In such a context, it becomes important from the Commission's perspective to fully understand the added value and policy impact that it is currently deriving from its shareholding in the EIF as a risk taking, policy driven and market orientated institution; and its continued ability to maintain and influence the EIF's policy focus going forward (and within its dual statutory objectives).

1.2 Evaluation Objectives

Against the above background, the overarching objectives of this evaluation were twofold:

1. To derive robust answers to the following high level questions:

   - What are the objectives of EU shareholding in the EIF?
   - To what extent have these objectives been achieved?
   - What is the added value and impact of EIF own resources activity?
   - Is the EIF's governance structure fit for purpose?
   - Is the EU shareholding level sufficient/appropriate for the Commission to achieve EU policy objectives?
   - Is the EU shareholding level sufficient/appropriate for the Commission to achieve EU policy objectives?
   - Are there more effective and efficient ways of achieving the desired policy objectives?

[26] This ceiling may be raised by decision of the General Meeting up to a maximum of five times the subscribed capital; and, if the reserves of the Fund are equal to or exceed 7.5 per cent of the subscribed capital, this ceiling may be further raised up to a maximum of eight times the subscribed capital.

[27] EIF Annual Report 2010, p.79

[28] Ibid

[29] COM (2011) 500 final – A Budget for Europe 2020.

[30] COM(2011) 662 final - A framework for the next generation of innovative financial instruments - the EU equity and debt platforms

2. To provide pointers/ recommendations for the future as regards:
   - Use of EIF own resources to maximise EU added value and policy impact.
   - The optimal level of EU shareholding in the EIF;
   - EIF's governance structure including the role of EU representation on the EIF's Board.

1.3 Scope of the Evaluation

EIF's activities are funded from two main sources:

– *Its own balance sheet or own resources:* in accounting terms, own resources are the sum of paid-in capital adjusted for fair value, share premium account, statutory reserves and retained earnings – see Table 1.1.

Table 1.1 EIF Own Resources, EUR

	31.12.2011	31.12.2010
Paid-in capital	600 000 000	600 000 000
Share premium	152 185 703	152 185 703
Statutory reserve	141 427 997	138 535 177
Retained earnings	147 529 511	146 084 055
Fair value reserve	(58 768 088)	(27 550 423)
Profit/ (loss) for the financial year	(10 217 928)	7 232 055
Total equity (own resources)	972 157 195	1 016 486 567

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– *Funds entrusted by third parties:* the principal sources of mandated funds are the EIF's main shareholders, namely, the EIB and the European Commission; however, some additional resources are also derived from EIF's partnerships with public and private bodies. These third party mandates do not appear on the EIF's balance sheet (these are classified as 'off balance sheet items') and the risk is not borne by the EIF. In return for managing the portfolios under these third-party mandates, the EIF receives management fees (Table 1.2).

Table 1.2 Funds Managed by the EIF on behalf of Third Parties

	Year Signed	End of Commitment Period	Total Resource (EUR million)
EIB Mandates			
Risk Capital Mandate (RCM)	2000	Revolving	5,000
Mezzanine Facility for Growth (MFG)	2009	2013	1,000
sub-total			**6,000**
EC Mandates*			
G&E	1998	2002	283
MAP	2001	2006	504
CIP	2007	2013	1,129
Risk Sharing Instrument (RSI) Pilot	2012	2015	120
Progress Microfinance	2010	2013	100
sub-total			**2,135**
Other third party/ private mandates - Fund of Funds			
European Recovery Programme (ERP)	2004	Revolving	1,000
NEOTEC	2006	2012	183

	Year Signed	End of Commitment Period	Total Resource (EUR million)
Istanbul Venture Capital Initiative (iVCi)	2007	2012	160
Portugal Venture Capital Initiative (PVCi)	2007	2012	111
LfA-EIF Facility	2009	2016	100
UK Future Technologies Fund (UK FTF)	2010	2014	231
sub-total			**1,785**
Other third party mandates -Regional business development			
JEREMIE Holding Funds (14 funds)	2007 - 2011	2013	1,222
Greater Anatolia Guarantee Facility (GAGF)**	2010	2012	32
G43 Anatolian VC Fund - IPA**	2011	2017	16
sub-total			**1,270**
Other third party mandates –microfinance			
European Parliament Preparatory Action (EPPA)	2010	2013	4
Technical Assistance under the JASMINE Initiative	2009	2011	50
sub-total			**54**
Total third party funds managed by the EIF			**11,244**

*Source: EIF Annual Report 2011; *GHK (2009) Interim Evaluation of the Entrepreneurship and Innovation Programme; **funds made available via the Instrument for Pre-Accession (IPA)*

This evaluation covers only the own resources activity of the Fund which comprises:

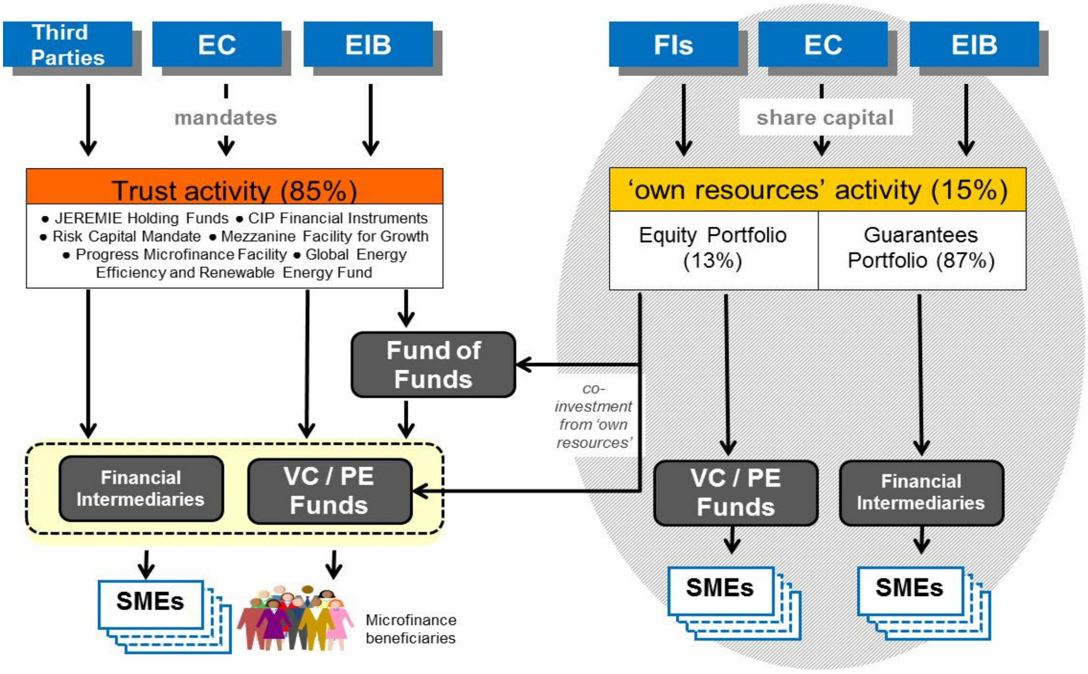
- *Equity operations:* EIF's own resources are typically co-invested in fund-of-funds or PE/VC funds alongside mandates - mainly the EIB's Risk Capital Mandate (RCM) - to demonstrate alignment of interest with mandators by 'putting skin in the game'. Co-investment represents 97 per cent of the EIF's own resources equity operations. Only in a few cases has the EIF used its balance sheet for independent investments (3 per cent of own risk equity portfolio)[31].
- *Guarantee operations:* which consist of credit enhancement (94.5 per cent of the own risk guarantee portfolio in 2010), credit insurance i.e. loan guarantees and counter-guarantees (5.3 per cent), and structured transaction product lines (0.2 per cent)[32].

The evaluation does not cover mandate or trust activity which represents the bulk of the EIF's overall activity (see Figure 1.1 and Table 1.3).

[31] Based on data provided by the EIF

[32] EIF Annual Report, 2010

Figure 1.1 Overview of EIF's Activities



Note: Percentage split between activities and product lines based on outstanding commitments (2010 data)

Table 1.3 EIF's Outstanding Commitments, EUR million

	2006	2007	2008	2009	2010
Equity commitments*	3,274	3,480	3,534	4,103	5,367
of which own resources	*287*	*331*	*317*	*340*	*389*
own resources as % of equity commitments	*9%*	*10%*	*9%*	*8%*	*7%*
Guarantee commitments	10,385	10,919	12,334	13,594	14,701
of which own resources	*3,050*	*3,607*	*3,838*	*2,893*	*2,580*
own resources as % of guarantee commitments	*29%*	*33%*	*31%*	*21%*	*18%*
Total outstanding commitments	13,659	14,399	15,868	17,697	20,068
of which own resources	*3,337*	*3,938*	*4,155*	*3,233*	*2,969*
own resources as % of total commitments	*24%*	*27%*	*26%*	*18%*	*15%*

*Source: Standard and Poor's Rating Report 2011; * Sum of drawn (minus capital repayment) and undrawn commitments*

1.4 Evaluation Methodology

The study team utilised a combination of quantitative and qualitative research methods to meet the objectives of the evaluation. Table 1.4 provides an overview of the methods used, also highlighting any limitations and caveats where applicable. It should be noted that although the interviews with EIF counterparties (PE/VC fund managers and originators) are not considered statistically significant due to the limited number of interviewees, when reviewed in conjunction with desk research and wider stakeholder interviews, the interviews provide useful insights (and the basis for triangulation of observations drawn from other pieces of evidence) regarding the role and added value of EIF own-resource investments.

The evaluation methodology and the evidence base are further detailed in the Technical Annex.

Table 1.4 Overview of Research Methods used for the Evaluation

Research Method	Scope	Caveats/ Limitations
Desk Research	– Literature and data on market failures in the area of SME financing – European Commission policy documentation – Documentation relating to creation of the EIF – 2000 Strategic Review of EIF – Documents relating to EU participation in EIF capital increase – EIF Board papers and minutes of the meetings – EIF activity data – EIF Annual Reports – EIF market research reports – EIF corporate plans and strategies	– Data available on the policy impact (i.e. results, outcomes and impacts) of EIF own resources activity is limited. For example, the EIF does not collect data to determine the extent to which freed-up capital/ new funding accessed via securitisation is actually used by the originators (such as banks and leasing companies) for new SME lending/leasing. For equity operations, data is not available on co-investment from other sources in portfolio companies, innovation and employment outcomes etc. – In the case of equity operations, EIF commissioned an assignment in October 2011 to conduct an ex-post impact assessment of the equity funds at different levels (fund-level, investee-level and market-level effects). The results of this assignment were not made available to the study team. – EIF data on PE/VC fund size, leverage etc. has been taken at face value. It has not been checked / adjusted for factors such as deadweight and it has been assumed that the data is accurate.
Interviews – European Commission	– DG Economic and Financial Affairs – DG Enterprise and Industry – DG Research – DG Regional Policy	
Interviews – EIF Board Members	– All seven Board Members plus one alternate member	
Interviews – EIF	– CEO – Deputy CEO – Finance – Mandate Management – Guarantees and Securitisation – Risk Management – Private Equity – Legal and Corporate Secretariat	– EIF appointed a central point of contact to co-ordinate EIF support for the evaluation, including provision of documentation and data, presence at all individual EIF interviews and workshops, and presentation of written comments.

Research Method	Scope	Caveats/ Limitations
Interviews – EIF shareholders	– A representative mix of 8 promotional / development banks and commercial banks	– Shareholders who have exited the Fund were not interviewed.
Interviews – Fund Managers	– A sample of 16 PE fund managers	– As only 16 out of 216 funds were included in the study, this exercise was not intended to be statistically representative of the 'population' of EIF-backed funds as a whole. – The team only interviewed funds where EIF has invested own resources (in all but one cases in conjunction with mandate resources). The specific role of 'own resources' in attracting co-investment from other sources could not be isolated from overall EIF support. As fund managers receive one 'pot of money' from the EIF they were only able to comment on the overall impact of EIF investment. This poses problems in isolating the effect of own resources equity activity. – Funds exclusively backed by mandate resources, or funds not backed by the EIF at all, were not covered by the research. They might have had different views on the role and added value of EIF support. – Ideally, other co-investors/ institutional investors (investing alongside the EIF) would have been interviewed to further determine the 'catalytic' role of the EIF. This was not feasible within the study timetable and budget.
Interviews – Financial Intermediaries	– Originators involved in EIF's securitisation operations representing different transaction types, Member States and intermediary type – Interviews with a limited set of market participants (an investor, a credit rating agency and an arranger) to obtain wider perspectives	– A total of 18 out of 49 originators were consulted. This exercise was not intended to be statistically representative of the 'population' of EIF supported SME securitisation transactions as a whole.
Interviews – Industry Bodies	– European Small to Medium Enterprise Association – Eurochambres – European Small Business Alliance (ESBA) – European Venture Capital Association (EVCA) – The Association for Financial Markets in Europe (AFME)	
Mini Case Studies	Six mini case studies on the following themes: – Role and added value of EIF in SME securitisation in Germany	– Mini case studies are of limited depth as they were based mainly on desk research and a small number of interviews.

Research Method	Scope	Caveats/ Limitations
	– Role and added value of EIF in SME securitisation in Italy – Role and added value of EIF in SME securitisation in Poland – Role and added value of EIF in equity markets in France – Added value and impact of EIF investment in Fund of Funds structures – Implementation of guarantee products under CIP, JEREMIE and own resources	
Peer Group Analysis	Comparative analysis with four financial institutions who have a policy purpose (such as SME financing) and aim to be self-sustainable – European Bank for Reconstruction and Development (EBRD) – KfW Bankengruppe – International Finance Corporation (IFC) – FMO – entrepreneurial development bank of the Netherlands	– The nature and risk profile of EIF's operations are not directly comparable to any other financial institution – Limited access to data on individual operations of other financial institutions
Expert opinion	Opinions and judgments of experts on the following: ▪ EIF's private equity activity ▪ EIF's securitisation activity ▪ Corporate governance	

1.5 The Structure of this Report

This Report continues in the following sections:

- Section 2 describes the origins, evolution of the EIF and an overview of its own resources activity by way of background information for the evaluation;
- Section 3 provides a synthesis of the evidence collected and analysed in response to each evaluation question;
- Section 4 sets out the recommendations emerging from this evaluation.

The main report is supplemented by a Technical Annex which contains the detailed evidence base for the evaluation and is structured as follows:

- Annex 1: Overall methodological framework for the evaluation;
- Annex 2: Intervention logic of EU shareholding in the EIF;
- Annex 3: Synthesis of the interviews carried out with fund managers;
- Annex 4: Synthesis of information collected from the interviews with financial intermediaries;
- Annex 5: Mini case studies;
- Annex 6: Peer group analysis;
- Annex 7: Analysis of EIF's equity operations;
- Annex 8: A review of the EIF's SME securitisation activities;
- Annex 9: List of persons interviewed;
- Annex 10: List of documentation assembled and reviewed.

2 Origins and Evolution of the EIF

This section describes the original rationale for creating the EIF, its evolution over time and provides an overview of the EIF's present day objectives, by way of background information for the evaluation.

2.1 The Rationale for creating EIF

In the early 1990s, there was a growing recognition within the European Commission and the EIB of the need to create a new financial institution that could take more risks (than the EIB) in support of EU policy objectives. In 1992, the European Commission and the EIB prepared a joint report[33] illustrating the main orientations of a 'European Investment Fund' and its technical feasibility. The report envisaged EIF as a market orientated institution that 'would operate on the basis of banking principles, in favour of sound investments for the balanced development of Europe' focusing on two priority areas:

- *Trans-European Networks (TENs)* – where the role of the EIF would be to attract private capital to projects facing particular barriers or constraints in attracting market financing such as those with long payback periods, major cross-border projects or those located in less developed or lagging areas.
- *Small and Medium sized Enterprises (SMEs)* – where the EIF would contribute to lowering the cost and increasing the availability of market sources of finance by helping to spread risk and increasing the availability of flexible financing packages.

The EIF was formally established on 14 June 1994 in Luxembourg as a Public Private Partnership between the European Commission, the EIB and a group of financial institutions representing all Member States of the EU. The EIF was set up with an authorised capital of ECU 2 billion. Its subscribed capital was ECU 1.79 billion (ECU 201 million of the authorised capital remained unallocated during the early years), of which 20 per cent was paid in. The intention was to have a 40:30:30 split between the three groups of shareholders, but the tranche reserved for financial institutions was not fully taken up: 58 financial institutions subscribed 20 per cent of the shares, leaving 10 per cent unsubscribed[34].

The Fund's governance structure consisted of three managing 'organs':

- A General Meeting;
- A Supervisory Board comprising seven members representing the EIB (three), the European Commission (two) and the Financial Institutions (two);
- A Financial Committee chaired by an EIB representative.

The Financial Committee was, inter alia, responsible for authorising all investments up to ECU 3 million. The Supervisory Board approved investments that exceeded this threshold and decided on guarantee operations over ECU 30 million.

The EIF's original mission was to foster investment in trans-European networks (TENs) and Small and Medium sized Enterprises (SMEs), initially through the provision of guarantees. In May 1996, the Fund was authorised to conduct venture capital operations in favour of SMEs.

2.2 The EIF over Time

In 2000, following a strategic review (called the 'Millennium Review'), the EIB put forward proposals to 'strengthen' the EIF by purchasing its unallocated shares and becoming a

[33] Joint EIB/ Commission Report (1992) *Creation of a European Investment Fund*, Document 92/086, dated 252524/25 February 1992

[34] EC (2000) *Reform of the EIF*. Background note for ECOFIN dated 5 June 2000. Luxembourg: European Commission

majority shareholder. The proposed acquisition of the EIF was driven by the following considerations:

- *Overlapping of venture capital activities* – the EIB was originally not set up to provide risk capital however, following an invitation by the Amsterdam European Council meeting in June 1997, the EIB developed its own venture capital activities with a much larger financial envelope (EUR 1 billion). This created an overlap between the venture capital operations of the two institutions;
- *Problems in building-up EIF's TEN-guarantee portfolio* – the originally foreseen deal flow did not materialise for the EIF for various reasons; notably, its narrow focus on TEN (excluding other infrastructure projects), use of a single instrument (namely, guarantees), some overlaps with EIB's operations and wider market developments.

Following the Millennium Review, EIF became a subsidiary of the EIB in 2000, while maintaining its tripartite shareholder structure comprising the EIB (60 per cent), the Commission (30 per cent) and financial institutions (10 per cent[35]). The EIB also obtained the right (and obligation) to acquire shares held by other shareholders and a right of first refusal in case another shareholder wanted to sell its shares.

At an operational level, the EIF's TEN guarantees portfolio was transferred to the EIB and, in return, the EIB transferred the management of its venture capital activities to the EIF. EIF effectively became the newly-established EIB Group's[36] specialised venture capital and SME guarantee arm. The EIB, however, retained its existing programme of lending to banks for on-lending to SMEs (Global Loans Facility[37]).

The change in EIF's ownership structure was accompanied by a change in the institution's governance structure[38]. The EIB, as the majority shareholder, proposed a governance structure akin to the arrangements in place at the Bank itself, where all loans have to be approved by the full Board at its monthly meetings. In that context, it was argued that the Financial Committee had become redundant and should be replaced by a Chief Executive acting under the authority of the Board. The EIB's proposals for a new governance structure were eventually accepted by other shareholders in the context of the Millennium Review. The Financial Committee and the Supervisory Board were thus replaced by a Board of Directors and a post of Chief Executive was created in 2000. Under this governance structure, the Chief Executive was made responsible for the day-to-day management of the EIF, while the Board of Directors was assigned the responsibility for approving all operations of the Fund and strategic oversight. At the same time, it was decided that the Board members should act independently in the interests of the Fund or, in other words, in an ad personam capacity (Article 15.2 of the statutes).

In 2007, the Fund's subscribed capital was increased from EUR 2 billion to EUR 3 billion in order for the EIF to continue its own resources activity as it was reaching its statutory limits. The European Commission also participated in this capital increase in order to maintain its shareholding at 30 per cent.

In 2008, a new post of Deputy Chief Executive was created. The Deputy has overall responsibility for the divisions of Finance, Risk Management and Compliance. The EIB formally has the power to nominate the person concerned (who is then eventually appointed

[35] A number of smaller financial institutions decided to sell their shares to the EIB at this stage – reducing the number of financial institution shareholders from 58 to 35.

[36] In 2000, the EIB Group was established comprising EIB and EIF.

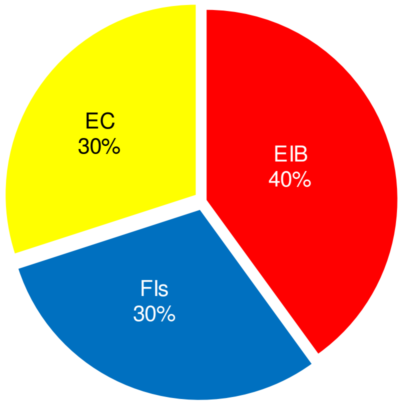
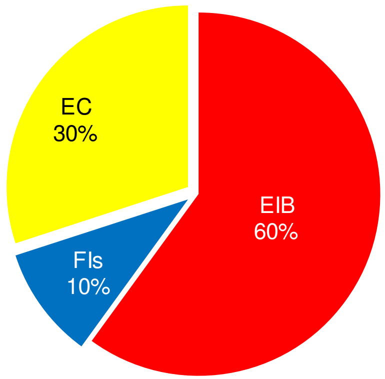
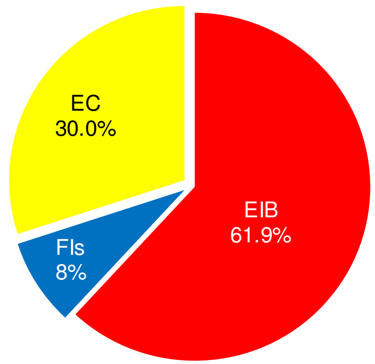
[37] Replaced by 'Loan for SMEs' in 2008. The 'Loan for SMEs' is the Bank's main SME financing mechanism. The Bank signed EUR 10.5 billion of loans for SMEs in 2011, of which EUR 9.5 billion in the EU. Source: EIB (2012) Report on Activities supporting SMEs 2011.

[38] Statutes of the European Investment Fund approved 14.06.1994 and amended on 19.06.2000 , 31.11.2007 and 8.03.2012 by the General Meeting. [online] Available at: http://www.eif.org/attachments/publications/about/EIF_Statutes_2012.pdf

by the Board of Directors). Informally, it was agreed that the decision would be based on consensus and that the selection board for this new post would be chaired by the EIB, but would include a representative each of the Commission and other shareholders.

The evolution of EIF since its inception is depicted in Table 2.1.

Table 2.1 Changes in Ownership and Governance Structure of the EIF over time

	1994 to 1999	2000 to 2006	2007 to present
Key Milestone	1994: EIF is created	2000: EIF becomes part of the EIB Group	2007: Capital increase
Mission	Provision of guarantees for TEN and SME financing VC operations for SME financing (1996)	SME financing through provision of guarantees and equity operations	SME financing through provision of guarantees and equity operations
Capital	Authorised: ECU 2000m Paid-in: ECU 400m (359.8m by 1999)	Authorised: EUR 2000m Paid-in: EUR 400m	Authorised: EUR 3000m Paid-in: EUR 600m
Ownership Structure	 *NB: 10% of the capital was unsubscribed*	 	 *NB: FIs mainly comprise promotional banks/ national development banks. Private commercial banks represent c.2% of EIF's shareholding*
Governance Structure	– General Meeting – Supervisory Board comprising seven members – Financial Committee comprising three members: one member each appointed by the EIB, the European Commission and the Financial Institutions	– General Meeting – Board of Directors comprising seven members: EIB (4), European Commission (2), Financial Institutions (1) – Chief Executive nominated by the Fund's largest shareholder and appointed by the Board of Directors	– General Meeting – Board of Directors – Chief Executive – Deputy Chief Executive (2008 onwards) nominated by the Fund's largest shareholder and appointed by the Board of Directors See also Box 1

Box 1 Overview of the EIF's current Governance Structure

The Statutes of the EIF[39] set out the management structure of the Fund. There are four principle authorities: the Chief Executive; the Board of Directors; the General Meeting; and, the Audit Board.

Management of the EIF is led by the **Chief Executive**, under the supervision of the Board of Directors. The Chief Executive is responsible for the day-to-day management of the EIF, while the **Board of Directors** is responsible for[40]:

- Deciding on EIF operations;
- Adopting guidelines and directives for the operations and management of the EIF;
- Drawing up proposals for submission to the General Meeting;
- Fixing the general conditions for participation;
- Setting return criteria for the Fund's operations;
- Determining the objectives and the limits of the Fund's borrowing operations;
- Appointing the Chief Executive and his/her deputy, if any;
- Supervising the Chief Executive and his/her deputy and ensuring that the Fund is managed in accordance with its statutes and the guidelines and directives adopted by the Board;
- Submitting the annual accounts and the annual report on the activities of the Fund to the General Meeting;
- Convening General Meetings of the Fund;
- Taking decisions on any other matters falling outside the competence of the Chief Executive.

The EIF Board of Directors comprises seven members appointed by the General Meeting. Four of them are designated by the EIB, two are designated by the Commission and one by the Financial Institutions[41]. The Board is accountable to the General Meeting only.

[39] EIF (2012) Statutes of the European Investment Fund, op cit.

[40] Ibid.

[41] Article 14 of the Rules of Procedure of the European Investment Fund. Available at: http://www.eif.org/attachments/publications/about/Rules%20of%20Procedure.pdf

The **General Meeting** is composed of one representative of the European Investment Bank, usually its President or a Vice-President, one member of the European Commission representing the European Union[42], as well as a representative from each Financial Institution. The General Meeting meets at least once a year to vote on all major decisions. The responsibilities of the General Meeting include [43]:

- Authorising the Fund to conduct its operations;
- Approving the Rules of Procedure of the Fund;
- Approving the admission of new members;
- Approving the annual report submitted by the Board of Directors;
- Approving the annual balance sheet and profit and loss account;
- Appropriation and distribution of the net income of the Fund.

All shareholders are entitled to attend the General Meetings, but voting power is proportional to their weight in the capital, which means that in practice the EIB and the European Commission retain full power in the EIF's governance.

The **Audit Board** is appointed by, and is directly accountable to, the General Meeting. It is an independent body, consisting of three members each nominated by the EIB, the European Commission, and the financial institutions. The Audit Board meets at least six times a year, and meets with the Board of Directors at least once a year. It has the statutory responsibility of auditing the accounts of the EIF; for checking and confirming that the EIF's operations have been executed in compliance with the EIF's Statutes and Rules of Procedure; that the financial statements give a true and fair view of EIF's financial position as regards its assets and liabilities and of the results of its operations for the financial year under review.

[42] The European Commission's representative in the General Meeting is the Commissioner for Economic and Monetary Affairs (or his or her delegate).

[43] EIF Statutes. Op cit.

2.3 Statutory Objectives of the EIF

The present day statutory objectives[44] of the Fund are: (a) to support the achievement of EU policy objectives (Article 2 of the EIF's Statutes) and; (b) to generate an appropriate return on its resources (Article 24).

These high-level, statutory objectives are operationalised through a series of medium-term objectives which are set-out in the EIF's Corporate Operational Plan (COP). The COP is a rolling three year plan setting out the specific targets for year N as agreed between the management team and the Board and indicative targets for years N+1 and N+2.

The policy targets are set in terms of:

- Commitment volumes (Table 2.2) broken down by product line/ source of funds (Tables 2.3 and 2.4);
- Leverage i.e. estimated 'catalysed' volume by product line (Table 2.2);
- Business development and mandate management (a qualitative target).

Table 2.2 EIF Policy Targets: 2012 – 2013[45]

Key Policy Indicator	2012	2013
Equity		
Commitment volumes, EUR million	1,313	1,260
Leveraged volumes, EUR million	6,900	6,500
Leverage factor*	5.26	5.16
Guarantee and Microfinance		
Commitment volumes, EUR million	1,305	1,245
Leveraged volumes, EUR million	6,235+	6,080+
Leverage factor*	4.78+	4.88+

*EIF Corporate Operational Plan 2012 – 2013, p.6 and p.8.; *calculated as Leveraged volumes / Commitment volumes*

Table 2.3 Equity Commitments by Source

Source of Funds	EUR million		As % of Total	
	2012	2013	2012	2013
MFG	270	270	21%	21%
RCM	438	439	33%	35%
EIF own resources	48	48.00	4%	4%
CIP	105	103	8%	8%
JEREMIE (equity funds)	142		11%	0%
ERP-LfA	80	80	6%	6%
Third party/private	230	320	18%	25%
Total	1,313	1260	100%	100%

EIF Corporate Operational Plan 2012 – 2013, p.6

[44] Statutes of the European Investment Fund approved 14.06.1994 and amended 19.06.2000 and 30.11.2007 by the General Meeting. Available at: http://www.eif.org/attachments/about/management/EIF_Statutes_30_11_2007.pdf

[45] The 2012 to 2013 Strategy exceptionally covers a two year period to achieve alignment with the Commission's budgetary cycle.

Table 2.4 Guarantee and Microfinance Commitments by Source

Source of Funds	EUR million		As % of Total	
	2013	2014	2013	2014
CIP - SMEG	95	95	7%	8%
EIF own resources	750	800	57%	64%
JEREMIE (debt)	210		16%	
RSI - Pilot	200	300	15%	24%
of which EIF own resources	*160*	*240*		
Microfinance	50	50	4%	4%
Total	1,305	1,245	100%	100%

EIF Corporate Operational Plan 2012 – 2013, p.6

The main financial targets relate to operating profit; cost to income ratio; and, long run Return on Equity (RoE) (see Table 2.5). As per the current COP, the statutory objective of generating an appropriate return has been interpreted by the EIF Board, management and shareholders as meaning that the Fund generates a long run RoE of 5 per cent to 6 per cent.

Table 2.5 Key Financial Targets

KPI	2009- 2011	2010-2012	2011-2013	2012-2013
Operating Profit	:	EUR 90m	EUR 70 – 80m	:
Cost to income Ratio	:	40% – 45%	40% – 45%	:
Long run RoE	5% -7% *	5%	5% - 6%	5% - 6%

EIF Corporate Operational Plans: 2009-2011, 2010-2012, 2011-2013, 2012-2013
*: Not specified; *Board version, p.3*

3 Evaluation Findings and Conclusions

This section presents a synthesis of the evidence collected in response to each evaluation question. The findings and conclusions have been organised around four core themes raised in the Terms of Reference namely, the relevance, effectiveness, efficiency and coherence of EU shareholding in the EIF - and, within these, the specific evaluation questions set by DG ECFIN.

3.1 Relevance

3.1.1 To what extent are the objectives of the EU participation in the EIF capital and the recent capital increase pertinent, to broader EU policies and strategies, in particular in the aftermath of the financial crisis?

The EIF was created in 1994. Since then, both the mission of the EIF as well as the objectives of EU shareholding in the EIF have evolved in response to a changing policy and economic context.

The initial aim of EU participation in the EIF's capital (in 1994) was to create an institution that would take risks in support of EU policy objectives, initially through the provision of guarantees for SMEs and TENs. The main policy driver for the creation of the EIF was the adoption of the Maastricht Treaty in 1992. Within the framework of the Treaty, the Community, inter alia, made commitments to contribute to the establishment and development of TENs in the areas of transport, telecommunications and energy infrastructures (Article 129) via the provision of loan guarantees among other things; to enhance the conditions in which SMEs operate (Article 130); and, to foster better exploitation of research and technology development (Article 130).

The Amsterdam Summit in June 1997 gave the Fund, in conjunction with the EIB, a greater role in developing instruments to support investment in SMEs:

'(...) we recognise the important role of the European Investment Bank and the European Investment Fund in creating employment through investment opportunities in Europe. We urge the EIB to step up its activities in this respect, promoting investment projects consistent with sound banking principles and practices, and more in particular - to examine the establishment of a facility for the financing of high-technology projects of small and medium-sized enterprises in cooperation with the European Investment Fund, possibly making use of venture capital with involvement of the private banking sector (...)'

Following the Amsterdam Resolution, the Bank elaborated the Amsterdam Special Action Programme (ASAP, June 1997) which included interventions in SME financing as well as in other sectors. The ASAP created a special 'SME window' to use part of the annual surplus of the Bank to provide support for different types of instruments, including venture capital for financing rapidly growing high technology SMEs[46]. The 'SME window' comprised two elements:

- Venture capital operations carried out directly by the EIB. The Bank set aside a EUR 1 billion reserve from its operating surpluses to offset the risks associated with such operations (initially, EUR 500 million were drawn from the Bank's 1998 operating surplus);
- Venture capital operations carried out by the EIF under mandate from the EIB. The EIB endowed the EIF with a EUR 125 million package (to be committed over a three year period) towards setting up the European Technology Facility (ETF 1). In May 1999, the EIB Board authorised a doubling of the Bank's allocation to ETF, from EUR 125 million to EUR 250 million;

[46] EIB Annual Report, 1999

As previously mentioned in section 2.2, the EIB's move into venture capital created some overlap and competition with the EIF's existing activities in this area (the EIF had begun its VC operations in late 1996 – prior to the creation of the Bank's 'SME window'). This, together with the overlap in guarantee operations, prompted the Millennium Review which led to a change in the EIF's ownership and governance structure in 2000 and the emergence of the EIB as a substantial majority shareholder in the tripartite structure.

The Commission participated in the 2007 capital increase in order to maintain its 30 per cent shareholding and to ensure adequate representation in the governance structure of the Fund. The objectives of EU's participation in the 2007 capital increase were as follows:

- To ensure that the EIF remained focused on 'evolving EU policies';
- To support delivery of EU policies in the fields of job creation, innovation, research and development, cohesion and regional policy and enlargement by increasing the financing available for SMEs and growth-enhancing investments by SMEs in innovation and R&D. To this end, the specific objectives of EU shareholding were to increase the investment volumes of risk capital funds and to increase the volume of debt finance available to SMEs[47].

These high level objectives of EU shareholding in the EIF remain valid today. Enhancing SME access to finance remains a key EU policy objective (see Box 2) and it has been further reinforced by the financial crisis and the economic recession which has produced an environment of fiscal austerity where the public sector is having 'to do more with less'.

Box 2 Overview of EU Policy Context for SME Financing

The Europe 2020 Strategy

The Europe 2020 strategy, launched in 2010, is the successor to the Lisbon Agenda. It provides an overarching strategic framework for EU action over the period 2011 to 2020. The overall aim of the strategy is to turn the EU into a '**smart, sustainable and inclusive'** economy delivering high levels of employment, productivity and social cohesion[48]. The success of Europe 2020 will be benchmarked against the following headline targets:

- Meeting the 20-20-20 climate/energy target (including an increase to 30 per cent of emissions reduction if the conditions are right);
- Raising the employment rate to 75 per cent of the working age population i.e. aged 20-64 years (presently this figure is around 69 per cent on average);
- Investing 3 per cent of the EU's GDP in R&D;
- Improving education levels by reducing school drop-out rates to less than 10 per cent and by increasing the share of 30-34 years old having completed tertiary or equivalent education to at least 40 per cent;
- Promoting social inclusion by aiming to lift at least 20 million people out of the risk of poverty and exclusion.

Within this overarching strategic framework, a series of flagship initiatives have been launched to contribute to each of the following three themes: smart growth; sustainable growth and inclusive growth. The two key flagship initiatives addressing SME access to finance are:

- 'Innovation Union' under the theme of smart growth;

[47] SEC (2006) 1347 - Annex to the Proposal for a Council Decision on the Community participation in the capital increase of the European Investment Fund.

[48] European Council Conclusions, 17 June 2010, Brussels. Available at: http://ec.europa.eu/eu2020/pdf/115346.pdf

- ‘An industrial policy for the globalisation era’ under the theme of sustainable growth.

Innovation Union: Improving the Conditions for Innovation[49]

The Innovation Union sets the following specific target for enhancing access to finance to be achieved by 2014:

‘On the basis of Commission proposals, the EU will put in place financial instruments to attract a major increase in private finance and close the market gaps in investing in research and innovation. Contributions from the EU budget should create a major leverage effect and expand on the success of FP7 and CIP. The Commission will work with the European Investment Bank Group, national financial intermediaries and private investors to develop proposals addressing the following critical gaps: (i) investment in knowledge transfer and start ups; (ii) venture capital for fast growing firms expanding on EU and global markets; (iii) risk sharing finance for investments in R&D and innovation projects; and (iv) loans for innovative fast growing SMEs and midcaps. The proposals will ensure a high leverage effect, efficient management and simple access for businesses.’

An Integrated Industrial Policy for the Globalisation Era: Putting Competitiveness and Sustainability at Centre Stage[50]

"An integrated industrial policy for the globalisation era" adopted by the European Commission on the 28th of October 2010 sets out a strategy that aims to boost growth and jobs by maintaining and supporting a strong, diversified and competitive industrial base in Europe offering well-paid jobs while becoming less carbon intensive. One of the key EU priorities set out in this strategy is to improve access to finance for businesses.

Single Market Act: Twelve levers to boost growth and strengthen confidence[51]

The Single Market Act, adopted by the European Commission in April 2011, puts forward 12 key priority actions to revive the single market. These 12 drivers for growth, competitiveness and social progress include financing for SMEs, facilitating workers’ mobility, consumer protection, as well as taxation, European transport and energy networks, and the Digital Single Market. The measures set out in the Single Market Act provide ‘*a coherent political response to the gaps in the Single Market by presenting a model for sustainable, smart and inclusive growth in the framework of the Europe 2020 Strategy*’.

An action plan to improve access to finance for SMEs[52]

In follow-up to the Single Market Act, the Commission published an Action Plan in December 2011 setting out the various measures that it will pursue to make access to finance easier for European SMEs. These are:

Regulatory measures

- Improving the regulatory framework for venture capital;
- Making State aid rules relevant for SME access to finance;
- Improving SME access to capital markets;
- Reviewing the impact of bank capital requirements for SMEs;
- Accelerating the implementation of Late Payments Directive.

EU financial measures for SMEs

- Measures to improve lending to SMEs;
- Measures to improve access to venture capital and other risk forms of risk financing.

In this context, the Commission has introduced the concepts of debt and equity platforms that will

[49] COM(2010) 546 final

[50] COM(2010) 614 final

[51] COM (2011) 206 final

[52] COM(2011) 870 final

standardise the common mechanics of the instruments, streamline relations with financing partners and foster administrative efficiency[53].

Other measures to improve the environment for SMEs

- Better information for SMEs;
- Improve monitoring of the SME lending market;
- Promote the use of qualitative rating as a tool to complement the standard quantitative assessment of SMEs' creditworthiness;
- Stimulate the activity of "Business angels" and cross-border investments;
- Promote information on SME access to capital markets;
- Policy coordination and implementation.

Since the crisis, debt financing has become even more expensive and difficult for SMEs[54] reflecting:

- *Tight credit supply* – caused by the stagnation in inter-bank lending, the increased cost of capital for banks, balance sheet constraints (as banks try to preserve or strengthen their capital base) and wariness about advancing fresh funds in a period of economic uncertainty. Moreover, the costs of customer acquisition and subsequent due diligence have become so high that smaller sized loans (of the kind that small businesses typically seek) are no longer a profitable segment for many banks. This in effect means that banks can lend profitably only to existing small business customers about whom they have decent prior knowledge;
- *Weak credit demand* – in parallel, businesses are also shrinking and strengthening their balance sheets as part of the general deleveraging process across the economy.

Overall, there has been a general withdrawal from lending/borrowing by banks and small businesses, and a re-pricing of risk by lenders in the years since the credit crunch, with the smallest businesses the worst affected – although some economists and experts argue that this simply marks a return to more normal conditions after the bursting of a credit bubble when 'too much money was chasing too little business' at the cost of credit quality.

The difficult economic conditions have also affected all stages of the private equity cycle, notably fund raising, investment activity and divestment. In recent years, the 'time on the road' (i.e. average time taken for funds to achieve final close) has steadily increased - from an average of 12 months for funds closed in 2007 to 15 months in 2008 and to an average of 18.6 months in 2009[55].

Moreover, there was a dramatic slump in fundraising in 2009, when under EUR 20 billion was raised (compared to a peak of c.EUR 108 billion in 2006) and private equity investments fell sharply, amounting to just EUR 24 billion in 2009 (compared to EUR 72 billion in 2006 and 2007) – see Figure 3.1. Following a short period of recovery in 2010 (when investments totalled c.EUR 43 billion), investment again fell in 2011, the first three quarters of which saw just EUR 30 billion of investment (i.e. similar to 1999-2003 levels)[56]. The venture capital segment of the market was particularly badly hit. Since the financial crisis, venture capital investment has declined significantly, reaching a low of just EUR 3.5 billion in 2010. Indications for 2011 suggest that the market is still struggling.

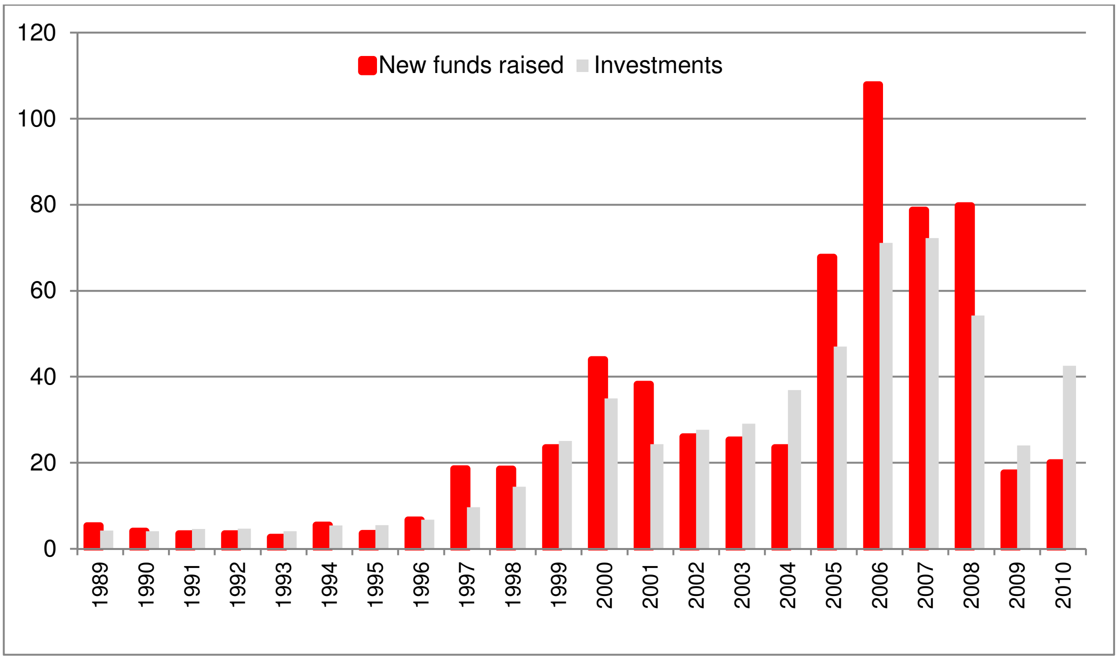
[53] COM (2011) 662 final

[54] SEC(2011) 1527 final - Commission Staff Working Paper accompanying the Communication from the Commission to the Council, the European Parliament, the Committee of the Regions and the European and Social Committee: An action plan to improve access to finance for SMEs.

[55] EVCA (2010) The European Private Equity Market Outlook

[56] EIF (June 2011) EIF Equity Strategy in the 2020 Framework - update

Figure 3.1 New Funds raised by European PE/VC Industry, € billions, 1997 - 2010



Source 1988-2006: EVCA/Thomson Financial/PricewaterhouseCoopers; 2007-2010: EVCA/PEREP_Analytics

In a context of continuing weakness in the supply of risk capital and debt finance to the SME sector and a general focus on fiscal austerity (limiting the scope for direct public intervention), financial instruments - due to their catalytic effect – have assumed added significance within the forthcoming Multi-annual Financial Framework[57]. Financial instruments delivered by the EU institutions (notably, the EIB and the EIF) have a unique role and added value in the overall EU financial architecture. Their added value arises from their pan-European perspective which *inter alia*, enables them to:

- Intervene in all EU countries;
- Transfer skills and knowledge across borders;
- Adopt a ‘big picture’, pan-European approach which maximises economies of scale and overall impact;
- Facilitate multi-country transactions thus diversifying risk and obtaining critical mass;
- Increase intermediary sophistication, while contributing to a less fragmented EU market;
- Apply and promote best practices throughout the EU thus developing industry standards;
- Contribute to the development of less sophisticated markets.

The Commission makes resources available to the EIF via two channels to deliver financial instruments in support of EU policy objectives (including the ultimate option to choose between the balance of the two channels in terms of efficacy of achievement of policy objectives and added value):

[57] COM(2011) 500 final – A Budget for Europe 2020
See also COM(2011) 662 final - A framework for the next generation of innovative financial instruments - the EU equity and debt platforms, dated 19 October 2011.

- *Capital made available to the Fund through its shareholding.* As a shareholder, the Commission has contributed EUR 223 million of capital to the Fund over the period 1994 to present (initially, EUR 120 million in 1994 and a further EUR 104 million as part of the 2007 capital increase), while it has received more than EUR 44 million as dividends over the same period. Taking into account the dividends received; the net contribution of the EU budget amounts to around EUR 180 million for an investment currently valued at more than EUR 290 million[58];
- *Funds entrusted under mandates*, most notably a EUR 1.1 billion mandate to manage the high growth and innovative SME facility (GIF) and SME Guarantee facility (SMEG) under the Competitiveness and Innovation Framework Programme 2007-2013 (CIP)[59]. The EIF also manages the Risk Sharing Instrument for innovative and research oriented SMEs and small Mid-Caps, and the European Progress Microfinance Facility on behalf of the Commission. Additionally, some Member States and regions have mandated EIF to manage their Cohesion policy financial instruments (i.e. JEREMIE Holding Funds).These funds are made available to the EIF from the EU Budget via specific Community programmes which typically have a seven year programming cycle.

While some European Commission mandates tend to focus primarily on policy objectives, own resources have a dual objective of delivering a policy and financial return to ensure capital preservation and the long term viability of the institution. As such, own resources are invested along the risk-return continuum in order to achieve a 'balanced portfolio' delivering agreed policy objectives and an adequate level of financial return (RoE). This remains a key balancing process across market failure segments where 'trade-off' positions can often exist between policy impacts and financial return. For example, European Commission mandates often tend to focus on high risk-low financial return–high policy return segments such as early stage venture capital where financial returns are negative but economic (societal returns) are high[60] (e.g. GIF 1). Others, however, have similar risk return characteristics to EIF own resources activity (e.g. GIF 2).

The evaluation was unable to determine the detailed aspects of this portfolio balancing act for own resources activity as (unlike with European Commission mandates) detailed ex-post data on SMEs assisted, employment creation and deadweight (i.e. policy impacts) of own resources activity was not available.

The evidence collected as part of this evaluation does, however, show that mandates and EIF capital are not mutually exclusive alternatives for the European Commission. The financial return requirement might reduce the direct policy impact of own resources activity, but this return has to be balanced against the broader return generated by own resources activity through the following channels:

[58] According to the end 2011 valuation of the Replacement Share Purchase Undertaking granted by EIB to other EIF shareholders.

[59] The Competitiveness and Innovation Framework Programme 2007-2013 (CIP) is the successor to the Multi Annual Programme for Enterprise and Entrepreneurship 2001-2006 (MAP). MAP comprised two main financial instruments: a Start-up Scheme of the European Technology Facility (ETF Start-up); and SME Guarantee Facility (with four windows – Loan, Micro-credit, Equity and ICT loans, the last one was discontinued due to lack of demand). MAP was preceded by the Growth and Employment Initiative 1998 - 2001(G&E) which included the ETF Start-up Facility and SME Loan Guarantee (SMEG) Facility . Both MAP and G&E financial instruments were also operated and managed by the EIF on behalf of the Commission

[60] In theory, one would expect a positive correlation between risk and return (the risks are higher, but so is the upside potential - in both financial and policy terms). However, this relationship does not seem to apply in practice. Empirical evidence show that VC funds , even though more risky than buyout funds, generate smaller financial returns but higher economic returns. See Diller, C. and Kaserer, C. (2009) What Drives Private Equity Returns? Fund Inflows, Skilled GPs, and/or Risk?

Multiplier effect

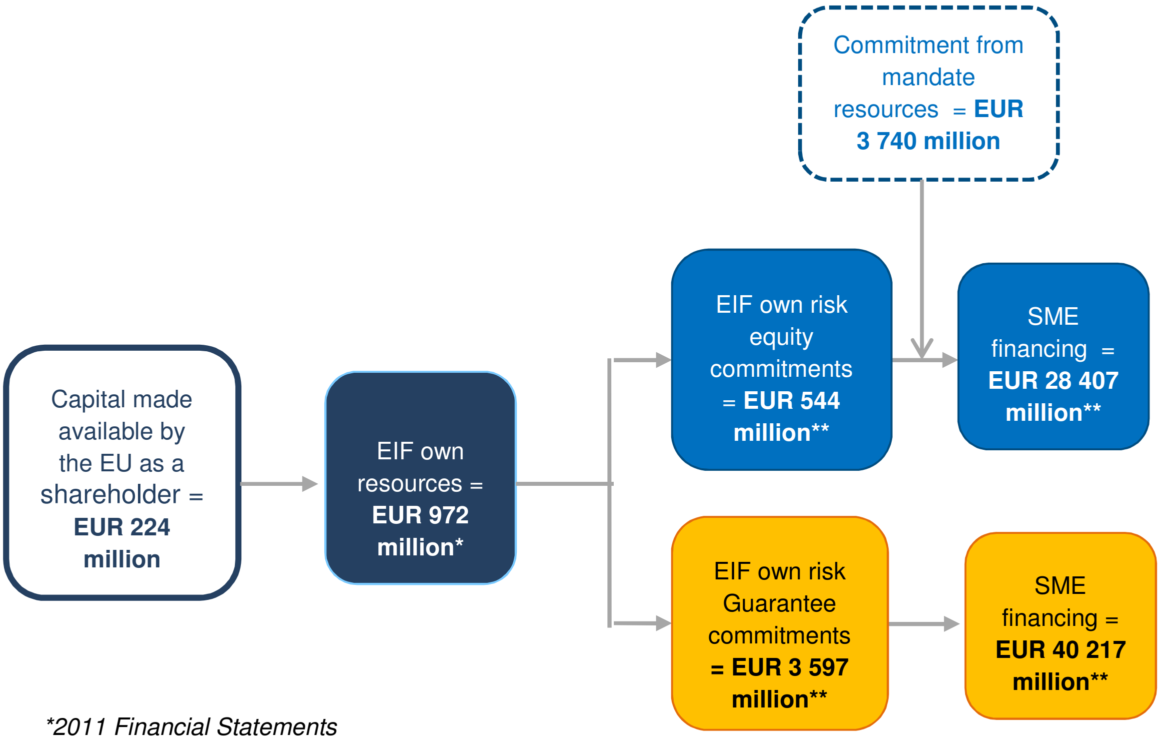
Since its inception, the EU has invested EUR 224 million in the Fund as a shareholder. The net contribution of the EU budget amounts to EUR 180 million when the dividends received (EUR 44 million) are also taken into account. Taking into consideration, the total capital paid-in by all shareholders, the share premium account, reserves and retained earnings, EIF's own resources presently stand at c. EUR 1 billion[61].

These own resources have provided the basis for the EIF to[62]:

- Invest EUR 544 million of own resources in equity operations;
- Commit EUR 3 597 million to guarantee operations.

EIF's own resources investments is estimated to have supported over EUR 28 billion of equity financing and over EUR 40 billion of debt finance (NB: these estimates are only based on outstanding commitments. The figures would be much higher if closed transactions/ funds are also included). Thus, 1 euro of EU investment as a shareholder is estimated to have mobilised over 200 euros of SME financing (although it should be noted that evidence does not exist to calculate the exact amount of financing that has actually gone to the SMEs).

Figure 3.2 Multiplier Effect of EU Shareholding in the EIF



**2011 Financial Statements*
***source: EIF data on outstanding transactions*
Note: EIF own risk equity investments are co-invested alongside mandates (typically RCM). EIF own resources of EUR 554 million have been co-invested alongside mandate resources (EUR 3.74 billion). The sum total of this investment i.e. own resources + mandates (EUR 4.28 billion) has supported EUR 28.41 billion of SME financing.

In addition, the current value of the EU shareholding largely exceeds the paid in amounts provided via the EU budget – as noted on page 24, EU investment is currently valued at more than EUR 290 million.

[61] EUR 972 157 195 as of 31.12.2011

[62] Each PE/VC operation is backed by the full amount of capital required for the drawdowns. For guarantees, a risk weighted capital allocation is set aside, based on risk grading.

Added value

EU shareholding in the EIF has a distinctive added value that should be viewed from a longer-term and strategic perspective:

- EIF capital base provides it with the means to **develop, pilot and test innovative financial instruments** which may subsequently be replicated or scaled up via mandates or **operate in market segments not covered by mandates**:
  - EIF has developed guarantees, structured finance products, equity operations including fund-of-fund structures, and technology transfer products through its own resources and is now transferring this experience and expertise to mandates. For example, an SME guarantee window (providing guarantees and counter-guarantees on loan portfolios) was launched in the European Commission's Growth and Employment mandate (and continued under MAP and CIP); the CIP mandates includes a securitisation window; the new RCM mandates includes support for technology transfer;
  - EIF is piloting/ developing new financial innovations such as a European Angels Fund and a Corporate Innovation Platform (see Box 3).

Box 3 Examples of Innovative Financial Instruments developed by the EIF

The European Angels Fund

Available research estimates that 60 per cent to 70 per cent of the deals (in numbers) in start-up/ early stage segments are undertaken by business angels and non-institutional investors. EIF previously tried to "institutionalise" business angels in the context of CIP by investing into traditional VC funds managed by a team composed of business angels. This did not work well and to catalyse this segment, the EIF has decided to apply the same business model that it applies to support VC/PE funds, but adapted to Business Angels' investment style and needs, thus providing significant financial support while granting a maximum amount of freedom to each Business Angel.

The European Angels Fund was developed to provide equity to Business Angels and other non-institutional investors for the financing of innovative companies in the form of co-investments. The European Angels Fund enters into long-term contractual relationships with Business Angels, instead of granting co-investments on a deal-by-deal basis. Co-investment framework agreements (CFAs) are established through which the European Angels Fund grants a predefined amount of equity for co-investments upfront to each Business Angel for future investments. For ease and speed, these CFAs are generally standardised while leaving room for adaption to the specific requirements of individual Business Angels. Such elements include, for example, timeframe, sector focus, number of investments, etc.

All investment decisions are taken by the Business Angels and their investments are matched on a pari passu basis by the European Angels Fund. The volumes available in total under an individual CFA range between EUR 250k and EUR 5m. The European Angels fund does not pay a management fee to the Business Angel but shares investment-related costs on a pro-rata basis.

The European Angels Fund is currently being piloted in Germany in close cooperation with Business Angels Netzwerk Deutschland (BAND) and the ERP EIF Dachfonds and is managed by the EIF. First talks have been held with a family office confirming the potential interest of such private investors to join a Business Angels Fund managed by EIF. It will eventually be extended to other European countries and/ or regions in view of a pan-European coverage. Once rolled out, the European Angels Fund will foster and support cross border collaboration between Business Angels. It will also contribute to the establishment of European Angels and Family Offices as an attractive alternative asset class.

Several Member States/ regions have expressed interest to launch additional pilots. A scheme for Benelux is in the pipeline.

Corporate Innovation Platform

These platforms will provide a collaborative structure for bringing together venture capitalists, corporate investors and start-ups. Corporate/strategic investors will be offered a managed and privileged access to VC funds investing in the sectors of strategic interest to the corporate. This would enable the corporate/ strategic investor to cover part of their “open innovation” or innovation sourcing strategies through one investment and relationship covering all of Europe in a selected sector. A EUR 300 million pilot scheme is expected to be launched in 2012.

- EIF **spreads best market practice** by applying high standards in its operations (e.g. anti-money laundering and anti-terrorist financing, transparency, value added reporting).
- There exists a **symbiotic relationship between own resources activity and mandates which supports greater added value for EIF’s access to finance policy offer**. The cross-fertilisation between own resources and mandates increases the depth of financial sophistication of certain markets while at the same time strengthens EIF’s regional network and track record. For example:
  - In 2003, MAP was open to central and eastern European countries. EIF was able to invest MAP resources in this region. This helped the EIF establish market contacts, track record and market presence in the region. Now, own resources activity is slowly spreading to this region.
  - The very first transactions in microfinance were guarantees provided through MAP. Now, EIF has successfully concluded the first ever securitisation of a multi-country microfinance portfolio on its balance sheet.
  - Market contacts and business relationships developed through own resources transactions are used to support the delivery of mandate activity, where appropriate. For example, EIF has concluded three own resource transactions with subsidiaries of ProCredit Holding. On the back of this collaboration, when EIF was mandated to implement the JEREMIE initiative in Bulgaria, ProCredit expressed an interest to participate and was selected as one of the five partner institutions in the country.
- EIF capital helps the Fund to **fulfil co-investment obligations** (i.e. ‘put skin in the game’) set by mandators and/or private investors (e.g. RCM) and to enter into **risk sharing arrangements** with mandators (for example, RSI – see Box 4).

Box 4 Risk Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps (RSI Facility)

The RSI Facility is a joint pilot guarantee scheme of the EIF, EIB and the European Commission. It has been designed to support access to debt finance by innovative SMEs and Small Mid-caps investing in research, development and/or innovation (RDI) projects. Under this facility, selected financial intermediaries will be able to offer loans and financial leases of between EUR 25 000 and EUR 7.5 million with loan/lease periods of from two to seven years, and with risk finance covering investments in assets (tangible or intangible) and/or working capital.

Selected financial intermediaries will be provided a financial guarantee (in return for a fee) on part of their new loans and leases, against eligible defaults. For each loss incurred by the financial intermediary due to a default, acceleration or restructuring of the eligible loan/lease included in the portfolio, the financial intermediary would receive 50 per cent of the loss amount, i.e. 50 per cent of the unpaid principal and/or interest as a result of the default, acceleration or restructuring of the eligible transaction.

Under the RSI facility, the European Commission will take the first-loss position to cover expected losses and a portion of unexpected losses (20 per cent) while the EIF will assume second-loss position (80 per cent) using own risk capacity. During its pilot period 2012-2013, EIF will aim at selecting approximately 10 to 15 financial intermediaries and achieving EUR 800 million of the total loan/lease volume, with an ultimate target of EUR 1 billion.

- Institutional backing from the European Commission is one of the factors underpinning **EIF's AAA/Aaa rating status** which is essential for its guarantee operations (both, for own resources and for delivering mandate activity). A review of the credit rating agencies' reports suggest that backing from two EU institutions (European Commission and the EIB) provides greater rating stability to the EIF than it would have with the backing of just one EU institution – see Box 5.

Box 5 Key Rating Considerations

Fitch Rating Report (July 2011):

'The ratings of the European Investment Fund (EIF) are primarily based on the strong support that it derives from its shareholders, its conservative risk management policies and its comfortable capitalisation.'

'The EIF's ratings are primarily linked to those of its shareholders.'

Standards and Poor's (31 October 2011):

- A solid financial profile, including a debt-free balance sheet.
- Strong shareholder support.
- Prudent statutory and policy controls.
- 'AAA' rated callable capital equalling 223% of shareholders' equity.

Moody's (10 November 2010):

'Moody's rates European Investment Fund Aaa. This rating is based on EIF's multilateral development bank (MDB) status and the support of its highly-rated shareholders, as indicated by its solid capital base.'

'Callable capital is a full faith and credit obligation of shareholders. Inter alia as more than 90% of callable capital is owned by Aaa- or Aa-rated institutions, Moody's assigns its highest possible Aaa rating to EIF.'

Overall conclusions

The overall objectives of EU shareholding in the EIF are to increase the supply of risk capital and debt finance to SMEs. These objectives are strongly aligned with the high level EU policy objective of enhancing SME access to finance which is enshrined in key EU strategies such as EU 2020, the Single Market Act and flagship initiatives such as Innovation Union and Industrial Policy for the Globalisation Era.

The political urgency of this SME policy objective has increased following the financial crisis (which has sharply reduced SME access to finance) and the economic crisis (which has created an urgent need to stimulate growth and employment). Moreover, the fiscal crisis (which has constrained public finances) has increased the importance of financial instruments as a means to achieve this objective.

In this context, there remains a strong and valid case for EU shareholding in the EIF given its unique role as an EU institution with a pan-European reach and operations, its multiplier effect and the added value of own resources activity in enhancing the breadth and depth of financing available to SMEs. Evaluative evidence shows that a key element of the added value of EIF own resources activity is that it supports the delivery of European Commission mandates via the range of financial instruments that can be utilised, the quality of transactions than can be achieved and the leverage effect that can be attained.

3.1.2 To what extent has the EU participation in the EIF capital helped to influence the EIF strategy to focus its own resources activity on EU policy objectives?

The European Commission has four channels via which it can influence the policy orientation of EIF own resources activity: as a policy maker; as an EIF shareholder, as an EIB Board member and as a client of the EIF. The table below (Table 3.1) summarises the levels of influence currently exercised by the European Commission through each of these channels and the scope for further strengthening this influence.

Table 3.1 shows that the EU shareholding (and the proportionate Board representation it offers i.e. two out of seven Board seats) is, by far, the most effective and active channel through which the European Commission can reinforce the policy orientation of EIF own resources activity. In-depth analysis of the minutes of the EIF Board meetings and various readings of the strategic documents illustrates the nature and extent of influence exercised by the Commission via this channel. Some examples include:

- Improving the policy orientation of the EIF's Corporate Operational Plans;
- Introduction of value added assessment methodology in 2010 and its further development during 2011/12 to demonstrate the policy impact of EIF investments;
- Development of a Community Objectives Dashboard in 2010 to report progress (twice a year) against achievement of EU policy objectives;
- Development of a deal allocation policy in 2009 by the EIF;
- Maintaining focus on cost to income ratio;
- Improvement of the bonus structure so that it is 50 per cent linked to policy impact.

The evaluation finds that, while the EU shareholding is an effective channel for reinforcing the policy orientation of EIF own resources activity, the level of influence exercised through this channel could be strengthened through better articulation, measurement and communication of the policy objectives that the European Commission seeks to achieve through its shareholding. Little evidence exists of a systematic process for the setting and review of desired EU policy objectives for EIF own resources.

For example, while the EIF has developed a Community Objectives Dashboard to report progress against achievement of EU policy objectives, the EU policy objectives are inadequately specified as two quantitative indicators (EIF commitment volumes and financing catalysed) and one qualitative indicator relating to business development activities. Commitment volumes, for example, are 'output' indicators which do not reflect policy goals (rather they are a means to an end). Although catalysed volumes of financing are adjusted on the basis of value added assessments[63] – these assessments are carried out *ex-ante* at the level of individual transactions. There is limited assessment of the extent to which, as a policy question, EIF own resources activity is addressing specific market failures and financing gaps through its capital and whether the economic rationales and policy outcomes that justify EIF activity in specific segments still apply. The role of the EIF is to operate in difficult market segments/ conditions where the private sector will not go without incentives

[63] For equity operations: Total equity financing catalysed (fund size) = EIF investment (i.e. own resources and mandates) + co-investment from other sources. A corrective factor is then applied to the calculated leverage to accurately capture EIF's role and value added i.e. the calculated leverage is either left unchanged or discounted to reflect the extent to which the funding catalysed can be attributed to the EIF. This adjustment is based on a qualitative assessment of factors such as maturity of the fund manager, the degree to which EIF facilitates first closings or achieve target/ viable fund size through participation in subsequent closings (in difficult financial environment), role of EIF in attracting new investor classes, etc. For own risk guarantee operations, catalysed volumes are the size of the total portfolio which is then adjusted to reflect: (a) the extent to which investment in securitised tranches is driven by EIF's participation; (b) replenishment features of the underlying portfolio.

or some form of risk-sharing and which will generate clear benefits to society. A priori, these segments should be identified and then verified *ex-post*.

Overall, there are a limited set of business processes within the EIF and the European Commission to provide a comprehensive assessment of market failures across SME finance markets (across different segments and geographies) and the reporting of policy impacts as the basis for review of policy objectives (by the European Commission and EIF). For example, the EIF does not have its own independent evaluation function. The evaluation function as it currently exists is 'outsourced' to the EIB but, has, so far, evaluated only certain elements of EIF mandate activity (namely, ETF and RCM). The policy impact of EIF's own risk activities has not been systematically evaluated. For example, there has been no evaluation of own risk guarantee operations, which represents 85 per cent of own resources activity. Although the evaluation takes note of and acknowledges the ongoing development of value added and ex-post impact assessment methodologies by the EIF as a step forward.

Similarly, the European Commission has not evaluated EIF own resources activity previously. This is the first ever evaluation of EIF own resources activity (although the European Commission regularly evaluates the financial instruments managed by the EIF on its behalf).

Table 3.1 The Channels through which the EU can Influence the Policy Orientation of EIF Own Resources Activity

Channel of Influence	Nature of Influence	How does the EC influence the policy orientation of EIF own resources activity through this channel?	Is there scope for increasing influence via this channel?
As a policy maker	The European Commission sets the EU policy agenda	Medium- influence is indirect as the European Commission in its role as a policy maker (a) Sets high level EU objectives (b) Cannot directly influence EIF's own resources activity	– Sharpen policy objectives – Improve monitoring, reporting and evaluation of own resources activity – Sharpen societal and political profile of EIF as an EU investment by submitting regular communications to the Council and the Parliament
As an EIF shareholder	In return for 30 per cent stake, the European Commission gets two seats on the Board although in line with good corporate governance practice, Board members are expected to act independently in the interests of the Fund (i.e. in an ad personam capacity) One member of the Audit Committee Representation on the General Meeting	High – the Board approves EIF's strategic orientations, bonus envelope and individual operations. A review of Board papers and minutes shows that the Commission actively and systematically uses this channel to reinforce EIF's policy mission. However, the level of influence is constrained by three factors: (a) Lack of clearly specified policy objectives (b) The Commission's position as a minority shareholder (c) Time devoted by the Board on discussing individual investments instead of strategic issues	– Point a can be addressed by sharpening the policy objectives desired for EIF and their systematic evaluation – Point b can be addressed by increasing EU shareholding, but that would undermine the institutional independence of the EIF and its role in the market. – Point c is addressed under section 3.3.3
As an EIB Board member	One Director on the EIB Board is nominated by the European Commission	Very limited and indirect as the EIB Board only considers EIF related matters when dealing with matters involving the EIB as for the renewal of the Risk Capital Mandate.	
As a customer	As a mandator, the Commission can introduce co-investment (alongside less risky mandates) or risk sharing requirements	Limited- co-investment of own resources alongside CIP is allowed, but it is not mandatory. Practically, the scope for co-investment is limited given the different risk profiles of CIP and own resources. CIP focuses on	Greater use of risk-sharing instruments within the constraints of market absorption capacity and the EIF's risk taking capacity

Channel of Influence	Nature of Influence	How does the EC influence the policy orientation of EIF own resources activity through this channel?	Is there scope for increasing influence via this channel?
	requiring EIF commitment from own resources	emerging managers and early stage investments while the own resources are not normally invested in new teams or higher-risk start-up or early-stage finance[64]. Moreover, Commission mandates often have specific conditions attached to them (specific eligibility criteria and conditions for example) which also limits the scope for co-investment. Under the RSI facility, the Commission retains the first loss position and the EIF takes the second-loss position using own risk capacity.	

[64] EIF (2011) EIF Equity Strategy in the 2020 Framework – update, Document 11/320 dated 20 June 2011, p.29

Overall conclusions

There is evidence to demonstrate that EU participation in the EIF has shaped the EIF's strategy and helped maintain its focus on EU policy objectives. EU policy objectives do, however, need to be better articulated/ specified so that the European Commission (as well as the Board) has the tools to determine the extent to which the EIF is meeting its statutory objective relating to delivery of EU policy objectives. The processes for taking stock of policy objectives in light of evolving market failures and of evaluating policy impact are also weak.

3.1.3 To what extent is EIF own resources activity addressing the objectives set by the EIF Board of Directors?

The objectives set by the EIB Board are outlined in the EIF's COPs. The policy targets are specified in terms of commitment volumes; leverage volumes; and business development and mandate management activities (the latter is a qualitative target). The main financial targets relate to operating profit; cost to income ratio; and long run RoE. This section examines EIF's recent performance against the policy and financial targets set by the Board.

3.1.3.1 Achievement of Policy Objectives

Commitment volumes

Table 3.2 illustrates EIF's recent performance vis-á-vis its policy target for commitment volumes. Although the COP contains targets relating to commitment volumes for different mandates, these targets are actually set by the mandators and are therefore, not 'owned' by the Board. Moreover, any issues relating to absorption/implementation of mandates while monitored and assessed by the Board, are addressed bilaterally between the EIF and the mandatory concerned.

<u>Equity commitments</u>

Due to a difficult fund raising environment, the global equity targets were not achieved in 2009 and 2011. In 2010, the equity target was met and exceeded. In terms of sources of funds, equity commitments from own resources and EIB mandates (particularly the RCM) have generally exceeded expectations; however, market absorption of Commission mandates - particularly, JEREMIE equity funds - has fallen short of targeted levels (except for 2011, when the CIP equity target was exceeded).

<u>Guarantee and microfinance commitments</u>

It has been a particularly challenging period for securitisation business: there was no securitisation activity in 2009. The securitisation market was effectively closed in 2009 due to the absence of cash investors in the market. In July 2010, Lloyds TSB re-opened the SME securitisation market with the first term transaction after the crisis which was actually placed with private sector investors. The securitisation comprised a portfolio of UK SME loans and the purpose of the transaction was to provide additional funding for Lloyds TSB. EIF supported this market-opening deal with a guarantee over EUR 60 million for a mezzanine tranche. EIF significantly contributed to the reopening of the SME securitisation market in 2011 by participating in most of the transactions originated in support of long-term funding of SME lender in Europe. Feedback from market participants confirms that the EIF's credit enhancement activity is supporting market recovery and facilitating deal execution in the current, difficult environment.

Market uptake of guarantees and counter-guarantees (CIP financial instruments) either exceeded or was in line with expectations. After a slow start, commitment volumes under JEREMIE guarantee/ loan funds picked up during 2011.

Table 3.2 EIF Commitment Volumes, 2009 – 2011, EUR million unless otherwise stated

		2009			2010			2011		
		Target	Actual	% Target Achieved	Target	Actual	% Target Achieved	Target	Actual	% Target Achieved
equity	Own resources	30	40	133%	34	47	138%	43	50	116%
	RCM	300	365	122%	307	356	116%	407	454	112%
	MFG	200	160	80%	205	224	109%	210	235	112%
	CIP	90	42	47%	80	72	90%	102	127	125%
	JEREMIE	70	0	0%	121	82	68%	200	39	20%
	Third party/ private mandates*	150	123	82%	124	150	121%	348	221	64%
	sub-total***	840	730	87%	871	931	107%	1310	1126	86%
Guarantees & microfinance	Own resources	230	0	0%	400	260	65%	750	932	124%
	CIP	90	116	129%	100	97	97%	110	107	97%
	Joint Group Operations*	50	0	0%	75	26	35%	9	0	0%
	JEREMIE	235	75	32%	444	229	52%	393	383	97%
	Microfinance		2		45	8	18%	99	106	107%
	sub-total	605	193	32%	989	594	60%	1352	1528	113%
	Total	1445	923	64%	1860	1525	82%	2662	2654	100%

Sources: COP 2010 – 2012, p.8 &13 (2009 target); COP 2011-2013, p.14 & 21 (2010 target and actuals, 2011 target) ; COP 2012-2013; EIF Quarterly Report – Q4 2011 (2011 actual volumes)
**Includes ERP, NEOTECH, iVCi, PVCi, LfA, TTA, UKFTF, GAP VC*
***2010 onwards, included in own resources and therefore not separately added to the totals figure*
****sub-total for equity adds up to EUR 931 million in the table but is reportedly EUR 930 million due to rounding off*
According to the EIF Quarterly Report – Q4 2011, total commitments in 2010 amounted to EUR 1,549 million (equity: EUR 930 million; Guarantees: EUR 611 million and micro finance: EUR 8 million). However, according to the figures reported on pages 7 and 14 of the COP for 2011 – 2013, guarantee commitments in 2010 were EUR 586 million

Estimated Catalysed Volumes

Table 3.3 shows the catalytic effect of EIF investment. It should be noted that the EIF started measuring its catalytic effect 2010 onwards and that targets for catalysed volumes were only established 2011 onwards. EIF more or less met the target set by the Board for SME financing catalysed in 2011.

The catalytic effect reflects the role of EIF in mobilising additional capital for SME financing, for example, by attracting co-investment from other sources (equity operations) and by facilitating placement of securitisation transactions. The catalytic effect is calculated by EIF using an in-house leverage methodology. From an evaluation perspective, how much of the additional capital might be expected to have been mobilised or catalysed in the absence of EIF support (the so called 'deadweight' effect) could not be independently verified (due to the limitations explained in Table 1.1).

Table 3.3 Catalytic Effect of EIF Investment, 2010 – 2011

	Catalysed volumes (EUR million)				Catalytic factor		
	2011			2010	2011		2010
	Target	Actual	% Target Achieved	Actual	Target	Actual	Actual
Equity/ mezzanine	6,210	6,061	98%	4,470	4.7	5.4	4.8
Guarantees	7,860	7,626	97%	2,578	6.3	5.4	4.4
Microfinance	150	140	93%	32	1.5	1.3	4.0
Total	14,220	13,827	97%	7,080	5.3	5.2	4.6

Source: EIF Quarterly Report – Q4 2011

Business Development and Mandate Management

Policy objectives agreed between the Board and the management include a set of qualitative targets relating to business development. It is not easy to follow the assessment of the achievement of business development objectives reported in the Quarterly Community Objectives Dashboard against the targets set out in the COP. Table 3.4 tries to map the reported achievement against the COP targets. The achievement of objectives is rated on a 0-25-50-75-100 scoring scale, but the rationale for the score assigned to a particular objective is not always clear.

Table 3.4 Achievement of Policy Objectives relating to Business Development

	COP Objectives (2011-2013)	Reported Achievement (2011)	Score
Business development			75%
EU 2020	Segment the market in line with the EU 2020 strategy	Regular and active participation in the relevant working groups on EU policy developments Contributions to the frameworks (drafting of EU platform policy), strategic papers (E.g. Research & Innovation, DG ENT), communications, and actions plans, budget proposals, regulations and evaluations/audit. Continuous dialogue with the relevant EU counterparts and active participation in the EIB working group	
	Work intensively with the European Commission on the most effective Instruments	Advisory to the EC on new planned financial instruments	

	COP Objectives (2011-2013)	Reported Achievement (2011)	Score
	Work with the EC to adapt the Structural Funds regulation to align it better with the constraints of market based financial instruments, ensuring that convergence funds can be efficiently deployed	Intensive work with DG REGIO on a draft new framework for Structural Funds	
Debt and equity strategies	Deliver on the renewed EIF Equity and Guarantee strategies to better respond to market needs	Following the presentation and approval of the strategy for equity and guarantees, 2011 focussed on the product rollout plan	
Business capacity			100%
Equity		LfA increase signed - additional EUR 25m. RCM additional EUR 1bn capacity with a new agreement establishing a revolving facility concept and clarifying policy and financial objectives	
Guarantees		Maintain of AAA rating with stable outlook, allowing to keep financial added-value for securitisation deals Signature of RSI in December Key role in the Greek task force to develop instruments for SME support	
Regional business		New JEREMIE Holding Funds in France (PACA + 20m), Italy (Calabria + 45m) and increase in Bulgaria (+150m).	
Business development and Member State relationship			75%
New co-investment structures	Disseminate EIF knowledge, experience and performance and build co-investor relations	Development of pilot initiatives to attract new investors and test innovative schemes for EU2020	
	To incubate new activities as presented in EIF´s equity strategy	Some delays vs. COP (BioE and Business Angels), but new opportunities being discussed in depth with respective governments (Baltic, IFL with Luxembourg, DVI (NL), and MDG with Germany (ERP mezzanine)	
		Preparatory work for the European Social Innovation and Entrepreneurship Facility - ESIEF.	
Regional business		New Holding Funds and potential increase of existing ones under negotiation. ESF - product definition and successful call. Cyprus Guarantee Fund in the pipeline: new mandate based on public funds. Smooth handover of Latvian JEREMIE Holding Fund and development of local expertise. Baltic equity fund in substitute expected. SME Envoy initiatives: joint development of Envoy network with DG ENT. Western Balkan mandate approved by the Board	

COP 2011-2013, Quarterly Report Q4 2011

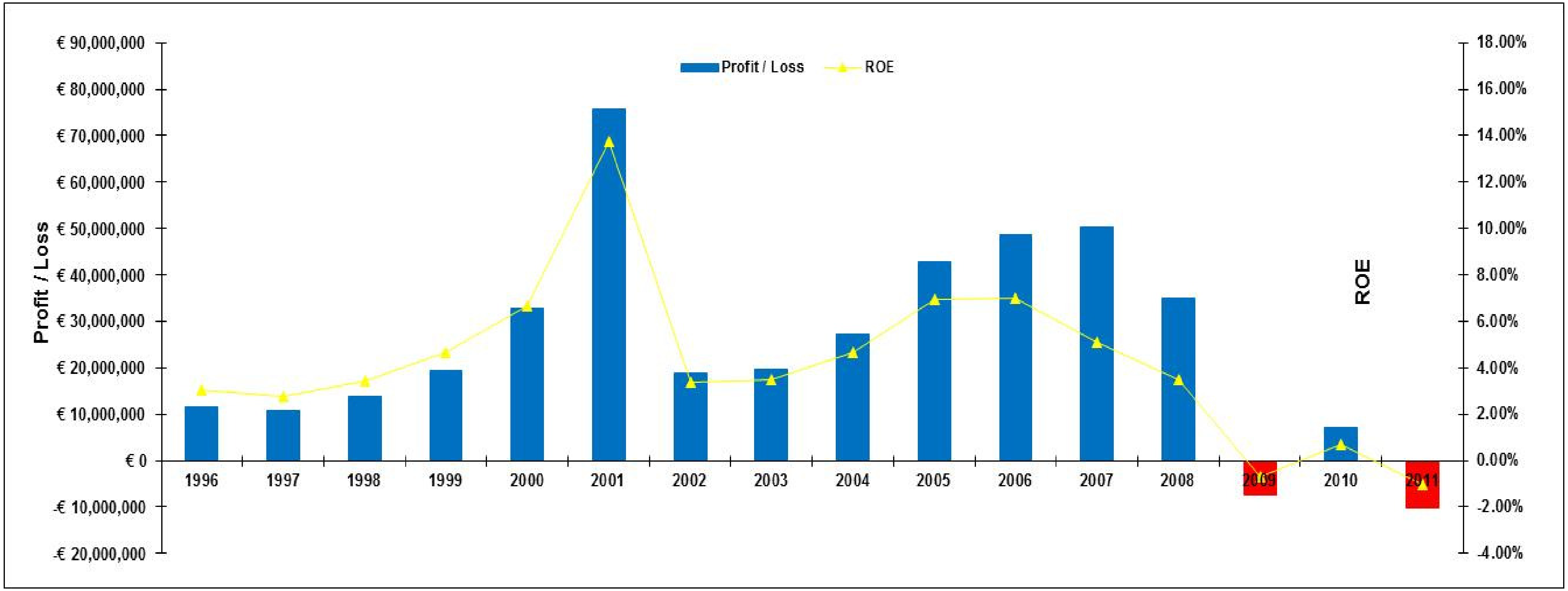
3.1.3.2 *Achievement of Financial Objectives*

Operating profit and RoE

EIF has generally posted healthy returns and generated a profit in each year of its existence except for the years 2009 and 2011 (see Figure 3.3). Table 3.5 provides an annual summary of EIF's income and expenditure for the period 2001 to 2011. It can be seen from Table 3.5 that EIF's profits are increasingly being driven by treasury income and guarantee commissions/ mandate fees. It is also noted that EIF normally distributes 40 per cent of its profits as dividends.

EIF has historically not achieved its long run RoE target of 5 to 6 per cent. The average RoE delivered by EIF over the period 1996 to 2011 (excluding 2001) is 3.57 per cent. This does not necessarily reflect under-achievement, but suggests that the target setting process can be improved. For example, the RoE target is not underpinned by an analysis of the financial return required to ensure the long run viability of the institution and what can be achieved given the risk profile of its equity and guarantee operations.

Figure 3.3 Profits and RoE delivered by the EIF, 1996 to 2011



	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Profit / Loss	€ 11,506,907	€ 10,721,187	€ 13,712,090	€ 19,359,621	€ 32,700,399	€ 75,742,580	€ 18,770,140	€ 19,737,700	€ 27,203,439	€ 42,860,864	€ 48,575,466	€ 50,402,337	€ 35,111,080	-€ 7,373,506	€ 7,232,055	-€ 10,217,928
Equity	€ 376,351,215	€ 389,704,571	€ 399,818,661	€ 413,781,282	€ 488,625,654	€ 551,869,524	€ 555,039,664	€ 567,277,363	€ 586,586,802	€ 618,567,666	€ 692,519,687	€ 985,365,315	€ 1,014,072,536	€ 1,028,734,404	€ 1,016,486,567	€ 972,157,195
ROE	3.06%	2.75%	3.43%	4.68%	6.69%	13.72%	3.38%	3.48%	4.64%	6.93%	7.01%	5.12%	3.46%	-0.72%	0.71%	-1.05%

Source: EIF Financial Reports

Table 3.5 Overview of Income, Expenditure and Profits, 2001 - 2011

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
INCOME											
Net interest and similar income	24,759,424	23,837,716	22,451,050	22,256,429	22,816,676	23,645,288	30,231,070	38,494,827	28,617,478	31,483,224	34,953,522
Income from investment in shares/securities	6,332,804	1,943,526	126,868	890,120	1,893,192	6,902,149	6,674,654	4,598,262	932,384	10,878,493	3,758,414
Net result from guarantee operations					12,174,548	16,288,735	21,349,024	18,492,375	-20,341,639	-24,918,778	-31,727,489
Commission income	15,872,131	20,575,145	24,463,235	28,565,954	17,923,659	26,277,510	29,072,382	23,405,855	26,844,238	37,149,456	43,175,030
Net profit/loss on financial operations	-491,187	-403,108	-1,632,761	-691,592	479,201	-524,335	-1,908,880	-5,081,325	-1,351,432	2,180,690	-74,237
Other operating income	3,897	24,780	221,713	27,319	25,329	9,062	18,955	24,675	34,687	335,157	669,495
Extraordinary result*	20,500,000										
Total Income	**66,977,069**	**45,978,059**	**45,630,105**	**51,048,230**	**55,312,605**	**72,598,409**	**85,437,205**	**79,934,669**	**34,735,716**	**57,108,242**	**50,754,735**
EXPENDITURE											
General administrative expenses											
Staff costs:											
- Wages and salaries	5,691,120	6,682,869	6,704,911	8,578,721	10,828,562	14,614,519	17,317,160	19,241,179	25,636,186	30,118,764	33,705,121
- Social security and contribution costs	298,743	411,537	810,554	1,008,265	408,167	1,123,415	2,130,900	3,237,576	3,890,535	4,990,135	7,503,803
Other administrative expenses	2,277,584	4,766,928	3,369,950	3,975,887	4,758,224	5,862,253	6,665,063	7,546,298	6,832,821	8,470,136	13,452,860
Depriciation and amortisation	377,774	384,189	348,031	600,295	1,150,118	1,277,236	1,219,062	894,486	552,813	1,763,626	1,204,822
Impairment losses					1,419,961	1,145,520	7,702,683	13,904,050	5,196,867	4,533,526	5,106,057
Value adjustments in respect of shares and other variable income securities	2,924,364	11,340,972	10,922,598	5,392,432							
Provisions for commitments*	-20,335,096	3,621,424	3,736,361	4,289,191							
Total Expenditure	**-8,765,511**	**27,207,919**	**25,892,405**	**23,844,791**	**18,565,032**	**24,022,943**	**35,034,868**	**44,823,589**	**42,109,222**	**49,876,187**	**60,972,663**
PROFIT/ LOSS for the financial year	**75,742,580**	**18,770,140**	**19,737,700**	**27,203,439**	**36,747,573**	**48,575,466**	**50,402,337**	**35,111,080**	**-7,373,506**	**7,232,055**	**-10,217,928**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Dividends declared	15,600,000	7,500,000	7,894,000	10,880,000	17,144,000	19,430,000	20,160,030	14,044,432	0	2,893,779	0
Dividend payment as % of Profit	21%	40%	40%	40%	47%	40%	40%	40%	0%	40%	0%

Source: EIB / EIF Annual Reports. EU GAAP 2001-2006 and IFRS 2007-2012.

** The risks and rewards of the TEN guarantee portfolio were transferred to the EIB effective 1 January 2001. The EIB paid the Fund a lump sum amount of EUR 20.5 million in consideration thereof. The total risk provision for TEN guarantee operations which amounted to some EUR 40 million at 31 December 2000 was released to profit and loss as at 1 January 2001.*

Cost to income ratio

The Board has set a cost to income target of 40 to 45 per cent for the EIF. For 2011, it was changed to 46 per cent following the first reading of the COP in October 2011.

The cost to income target was met in 2009 and 2010, but was missed in 2011 (Table 3.6)

Table 3.6 Cost to Income Ratio, EUR million unless otherwise stated

	2009	2010	2011
Guarantee and microfinance income	38	33	30
Equity income	21	33	28
Advisory and regional mandates	8	12	13
Treasury	29	34	33
Other income			1
Income	95	111	104
Staff costs	29	34	37
Expenses	8	12	14
Costs	37	45	51
Cost to income ratio	39%	41%	49%

Source: EIF Annual Report 2010, Quarterly Report, 4th Quarter 2011. Note that although the COP sets a cost to income target of 40 to 45%, the Quarterly report states it as 46%

There has been a significant year on year increase in the EIF's staff costs, reflecting the substantial increase in EIF's mandate activity in recent years. Staff costs more than doubled over the last five years (2007 to 2011) – Table 3.6. Minutes of the Board meetings show that the cost to income ratio is an issue that is regularly scrutinised by the Board.

Overall conclusions

A review of EIF's performance in recent years shows that the EIF is generally able to demonstrate achievement of targets set by the Board of Directors, although substantial volatility is evidenced in recent years given the financial crisis.

More strategically, the evaluation has demonstrated in earlier sections that there remains room for improvement in the objective setting process – including the setting of policy objectives and the balance of financial and policy returns (and potentially including stronger recognition of the added value related to partnership benefits across the shareholder community; for example, its own COP target).

3.1.4 What are the risks (financial, reputational etc.) for the Commission attached to the EU shareholding in the EIF?

The specific risks attached to EU shareholding in the EIF are set out in Table 3.7.

Table 3.7 Risk Assessment of EU Shareholding in the EIF

Risk Category	Nature of Risk	Likelihood	Potential Impact	Gross Level of Risk (Likelihood x Impact)	Explanatory Text for likelihood Rating
Strategic risk	The risk that EIF own resources activity could create market distortions, ineffective market structures or supports inefficient firms	Low	High	Medium	Market orientated approach that seeks to bring private investors on board. However, small risk of crowding out effect
	The risk of Financial Institution shareholders exiting the Fund thus decreasing the relative shareholding of EU and reducing profile of PPP	Medium	Medium	Medium	The share of Financial Institutions and particularly, commercial banks in EIF's capital has steadily declined over time
Financial risk	The risk of loss of paid-in capital	Low	Medium	Low	Sound financial management and conservative approach to risk taking by the EIF
	The risk that additional capital will be called to cover unexpected losses	Low	High	High	Sound financial management and conservative approach to risk taking by the EIF
	Risk of loss of AAA rating status and consequent impact on guarantee operations	Low	High	High	Sound financial management and prudent approach to risk taking by the EIF
Reputational risk	The risk that EIF operations will harm the Commission's image	Low	High	High	The EIF has high credibility and a good reputation on the market
Operational risk	The risk that financial objectives are given more importance than policy goals	Low	High	Medium	Tripartite structure with significant Commission representation in the governance structure reinforcing policy objectives
	The risk of drift from public policy mission	Low	High	Medium	Tripartite structure with significant Commission representation in the governance structure reinforcing policy objectives
	The risk of policy benefits not materialising (e.g. EIF operations being more beneficial for the banks and fund managers as opposed to the SME sector)	Medium	High	High	Inadequate monitoring and evaluation of policy impact

3.2 Effectiveness

3.2.1 To what extent have the expected benefits from the EU shareholding in the EIF been attained?

The expected benefits of the Commission's shareholding in the EIF are as follows:

- To ensure that the EIF remains focused on supporting evolving EU policies in the field of SME financing;
- To provide a mechanism to increase the infrastructure and capacity for, and investment volume of, risk capital funds in Europe; and,
- To provide a mechanism to increase the infrastructure and capacity for, and volume of, debt finance available to SMEs in Europe.

The extent to which these benefits have materialised is considered below.

3.2.1.1 To ensure that the EIF remains focused on evolving EU policies in the field of SME financing

EIF was initially established to deliver EU policy objectives relating to infrastructure and SME financing. Over time, and for reasons previously explained, EIF's mission evolved to focus exclusively on SME financing. Overall EU polices in the areas of SME financing have evolved little in terms of the issues that they seek to address and the objectives that they seek to achieve - given the persistent nature of market failures and deficiencies in SME financing. What has changed over time are the means deployed (scale of resources and types of instruments) to achieve these objectives. For example, there is a growing trend of replacing grants based support with innovative financial instruments to achieve policy goals in the area of SME financing and, in this context, EIF's role as a delivery vehicle for EU policy has become more pertinent and significant over time.

Given the dual statutory objectives of the EIF, a particular objective of the EU shareholding is to ensure that the EIF does not subordinate policy objectives (which are essentially long term in nature) to financial objectives (the ongoing objective of ensuring financial viability). The previous sub-sections show that the balancing of policy and financial objectives is an ongoing challenge, but the European Commission, via its shareholding and presence on EIF's Board, has been broadly successful in maintaining EIF's focus on EU policy objectives (although the policy objective setting process itself can be improved).

3.2.1.2 To increase the investment volumes of risk capital funds

To date, the EIF has invested EUR 577 million (own resources) in 216 private equity/ venture capital (PE/VC) funds. Considering that the EIF typically co-invests own resources alongside mandates – primarily, the EIB-RCM[65] - this corresponds to a total EIF commitment of EUR 4.4 billion (sum of own-resources and mandates)[66]. With a leverage factor of 6.6, it is estimated that an EIF commitment of EUR 4.4 billion has mobilised circa EUR 29 billion of equity financing over a 15 year period (1996 to 2011). EIF backed PE/VC funds have so far, invested in 2,719 underlying portfolio companies (including 880 exited companies)[67].

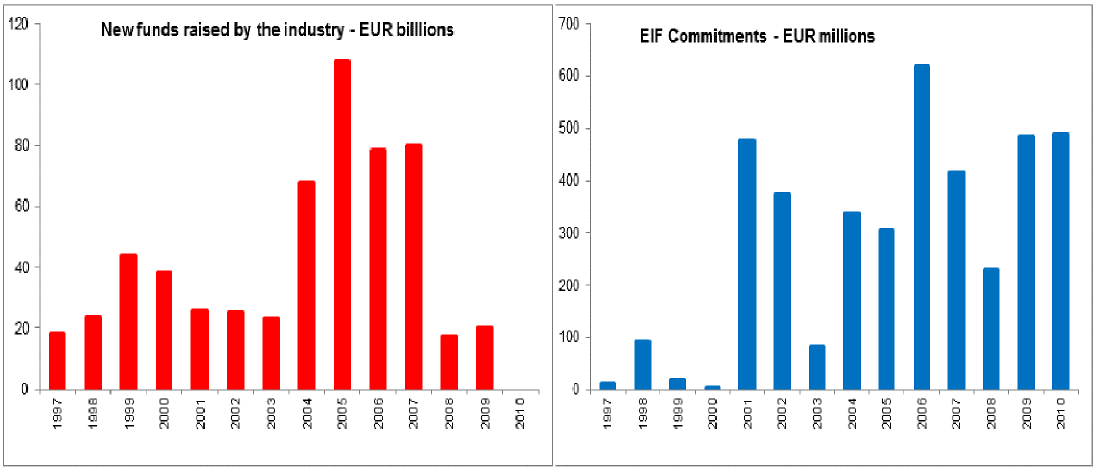
Given its policy driven mission, EIF investment is expected to respond to market developments (and retrenchments) through a process of counter-cyclical investment; encouraging investments at times there are few and stepping back when the market is over-heated. This counter-cyclical role has been evident in 2001-2002, 2004, and 2009-2010. In 2006-2007, the EIF seems to have matched industry trends (Figure 3.4).

[65] But also the European Recovery Programme administered by the German Ministry BMWi and less systematically, alongside other mandates.

[66] Based on data provided by EIF

[67]

Figure 3.4 Countercyclical Role of the EIF



Source: EVCA; EIF Data. NB: EIF commitments includes own resources and co-investment from mandates

To further (qualitatively) explore the role and added value of EIF own resources activity in equity markets, the study team spoke to 16 fund managers backed by the EIF. The interviews reveal that the EIF contributed towards the first close in 15 of the 16 funds included in this evaluation. EIF had typically acted as a 'cornerstone' or 'anchor' investor, accounting for a relatively large share of the first close and, in doing so, attracted other investors through its certification ('stamp of approval') and signalling effect.

Where the funds had undertaken subsequent closings (11 of the 16 funds studied), most fund managers believed that the EIF's *initial* support had still provided an important catalytic role by attracting further investors; a total of 9 of the 11 interviewees stated that the EIF had helped facilitate successful subsequent closings of their fund.

To explore the extent to which EIF involvement helps catalyse private investment, or whether it displaces or 'crowds out' private investment, fund managers were asked to indicate what would have happened if they had not received backing from the EIF. Firstly, interviewees were asked whether, on balance, they thought that they could have secured the investment that they received from the EIF from an alternative source. Almost all interviewees – 13 out of 16 individuals – believed that they would not have been able to do so. Difficulties in attracting private investors, it was argued, meant that the catalysing effect of EIF support was crucial, and that there were no other parties that could have performed a similar role. Only three funds believed they would have secured funding from alternative sources.

Secondly, fund managers who believed that they would not have secured alternative funding were asked what would have happened in the absence of EIF support. Of these 12 fund managers (out of 13): one fund manager reported that they would not have been able to set-up their fund at all; and two fund managers reported that they would have significantly changed the size/nature of the fund. The remaining nine managers believed that they would have proceeded, but at a much smaller scale.

The interviews also demonstrated that the impacts of EIF investment in a fund went beyond the value of the financial input, and extended to the provision of advice and support about fund operations and performance. This consisted of:

- Stipulations and requirements made as part of the contract negotiation stage which indirectly assisted fund managers as they learned from the process;
- The direct provision of advice and support to PE/VC teams during and after contract negotiations. 13 out of 16 fund managers interviewed, described EIF as an 'active' investor, in that they had a presence on some form of 'advisory' committee that

provided oversight of fund operations and acted as a platform for the provision of support (a further two interviewees did not feel able to comment, and one interviewee saw EIF as neither noticeably passive nor active).

The areas of fund operations where EIF typically provided support included:

- The breadth and depth of due diligence arrangements;
- Other contractual issues (e.g. liquidation arrangements);
- Governance arrangements (e.g. the roles/responsibilities of the Limited Partners and fund managers particularly in relation to investment decision-making etc.);
- Team composition (e.g. the number and profile of the individuals within an investment team); and,
- Performance monitoring (e.g. a requirement for quarterly reporting and regular team meetings).

For the most part, interviewees were appreciative of this support. This was particularly true of less experienced teams, such as first-time teams and teams who were moving into new markets where they had less expertise and exposure.

Overall, all fund managers interviewed were positive about the effect that the EIF had had in terms of providing finance over the course of a 'dreadful' period in the history of European PE/VC. Without the EIF, it was noted, the sector would be facing serious problems, due to lack of investment in the sector. The reputation of the EIF amongst investors was thought to be good, with a widespread perception that they are professional and commercially minded (though note that this is the view of funds, not other investors). This reputation has been important in terms of raising the profile of the European PE/VC sector. Whilst there are still negative perceptions about the rates of return that can be made in European PE/VC, a number of interviewees expressed the view that these perceptions would be worse in absence of EIF. Through its good practice sharing arrangements, the EIF has also improved standards within the sector, including better reporting standards and improved governance structures.

The overall visibility, flexibility and added value of EIF own resources equity activity is however, diminished by co-investment requirements set by mandators. A substantial portion of EIF own resources activity is invested alongside mandates managed by the EIF (notably, the EIB-RCM which has a 10 per cent co-investment rule). Whilst this requirement matches financial investment norms in ensuring that the fund manager has 'skin in the game' and prevents EIF from 'cherry picking' deals, the current requirement of 10 per cent is considerably greater than the market norm (typically, 1 per cent). Morevover, the co-investment requirement substantially reduces the investment portfolio flexibility for EIF own resources activity and has even led to a concentration of investment in balanced[68]/ late stages[69] VC funds and the Lower Mid-Market[70] segment (71 per cent of own risk equity commitments) as well as non-technology sectors (47 per cent of own risk equity commitments). According to a recent evaluation of RCM carried out by the EIB: '...*Stage and sector focus* [of the RCM] *has diminished over time, mainly due to the "rebalancing" strategy* [pursued by the EIF] *aimed at improving financial performance. Geographical coverage has not significantly evolved and is concentrated in few countries*'.

The added value of EIF own risk equity operations in addressing market failures is sometimes questioned by stakeholders who would like to see more EIF investment in under-

[68] A venture fund investing in portfolio companies at a variety of stages of development (Seed, Early Stage, Diversified, Later Stage).

[69] Financing provided for the growth and expansion of an operating company which may or may not be breaking even or trading profitably.

[70] Lower Mid Market (LMM) funds focus on growth and expansion capital as well as on transmission and consolidation opportunities, covering the equity gap of SMEs in the more mature phases of their life cycle.

developed/ embryonic equity markets, early stages and technology sectors. However, the requirement to generate steady profits from the equity portfolio as a whole has led the EIF to emphasise late stage investing in order for it to comply with its dual statutory objectives. Calculations by Venture Economics indicate that from the beginning of the VC industry in Europe in the early 1980s until 2007, the average European VC fund had an annual return of minus 4 per cent (the comparable figure for US based funds over the same period is 16 per cent)[71]. This suggests that if the EIF were to invest a significant portion of its own resources in this segment, it would not be able to deliver a positive financial return to its shareholders.

3.2.2 To increase the volume of debt finance available to SMEs

Since its inception, EIF has committed EUR 7.3 billion to own-risk guarantee operations (this figure includes closed and outstanding guarantee transactions),of which credit enhancement represents 92 per cent. The current outstanding guarantees portfolio stands at EUR 3.6 billion and it is estimated to have supported EUR 40 billion of financing. Using the same dynamic multiplier (11.18) as observed for outstanding transactions, the total financing supported would be in the order of EUR 82 billion, if closed transactions are also included in the calculations[72]. [NB: The Technical Annex provides a detailed analysis of the EIF's guarantees data].

The extent to which the benefits of SME securitisation have translated into enhanced SME financing remains to be precisely determined in the absence of data showing the extent to which capital freed-up via risk transfer transactions (also known as synthetic transactions) or funding accessed via true sale transactions has been utilised for new SME lending/leasing by originators (banks and leasing companies). EIF obtains ex-ante commitments / declarations from the originators that funding/ freed-up capital will be recycled for SME lending/ leasing and, since 2010, all new transactions are subject to an ex-ante value added assessment to minimise the risk that benefits of securitisation are not passed by originators to SMEs. It is not known whether undertakings given to EIF in return for support for SME securitisation transactions are actually observed and this is not monitored rigorously by the EIF. To address this, EIF has recently developed a methodology to estimate the policy impact of its SME securitisation activities.

While it is clear that SME securitisation has benefitted banks and financial intermediaries (access to term funding, regulatory/ economic capital relief); it is not always clear that these benefits are being passed on to SMEs. Where SMEs are a core client group of a bank or a leasing company, it is highly likely that their securitisation activities have helped increase or maintain the volume of debt finance available to SMEs. Even in these cases, however, the policy impact remains uncertain as it is quite possible that SME securitisation has been used to support lending to the existing client base of the originator (thus not necessarily addressing market failures). Although, since the financial crisis and considering the new/ forthcoming banking regulations (e.g. Capital Requirements Directive, Basel III), an important policy challenge is also to ensure that banks do not reduce their overall SME lending volumes and that they continue to maintain the credit lines to their existing SME customers.

In the case of big banks, where SME financing comprises a fraction of the bank's overall lending portfolio, the policy impact is particularly uncertain and unverifiable. The larger commercial banks interviewed as part of the evaluation were unable to provide estimates of the extent to which the funding accessed (or capital freed-up in case of risk transfer transactions) via SME securitisation was recycled for SME lending.

There is, however, plenty of evidence to demonstrate the pioneering role of EIF in SME securitisation. EIF was involved in a number of first transactions in smaller or peripheral markets, for example Greece, Portugal and Eastern Europe. It was also involved in the first

[71] Lerner, J. (2009) Boulevard of Broken Dreams

[72] The Technical Annex provides a detailed analysis of the EIF's guarantees and equity data.

multi-country SME securitisations, and in the first securitisation of microloans in 2005 (see Box 6).

The interviews with originators, analysis of EIF securitisation transactions and mini case studies provide some insight into the role and added value of EIF in supporting SME securitisation in Europe:

- EIF took lower rated mezzanine (BB-rated) risk at a time when private markets would not absorb this risk, or would only do so at high cost;
- EIF had structuring expertise which was particularly valuable in new markets;
- EIF was keen to support innovation, including in wholly synthetic risk transfer structures;
- Prior to the financial crisis, EIF involvement was seen as critical by small regional banks, banks in new Member States, leasing companies, or where the underlying portfolio was complex. In the case of larger commercial banks in Member States with well-established financial markets (e.g. UK), EIF involvement was 'nice to have', but not critical;
- The SME securitisation market has changed dramatically since the crisis. Without an EIF guarantee, it would not be possible to place notes with investors in the present circumstances;
- EIF has played a key role in bringing investors back to the market e.g. NRW bank;
- EIF has provided added value in facilitating multi-country transactions.

Box 6 Pioneering aspects of the EIF's Role in developing SME Securitisation Markets

- AR Finance I PLC operation signed in 2003 was the first securitisation of SME financing in Portugal;
- European venture partners II (2004) was the first multi-country SME guarantee transaction (EVP II) signed by the EIF;
- In 2004, EIF supported Banco BPI, one of the top four Portuguese banking groups, to structure and place its first ever SME loan securitisation transaction;
- The Microfinance Loan Obligations (MFLO 2005) is one of the first micro loans securitisation transactions in Europe;
- EIF supported the first multi-country and multi originator SME loan securitisation in the Czech Republic and Poland sponsored by Raiffeisen Bank International in 2006. In the same year, Raiffeisen Leasing Polska also cooperated with EIF as a cornerstone investor in the first securitisation of SME leases in Poland;
- ANAPTYXI 2006-1 PLC was the first small business loans securitisation transaction from a Greek bank. EIB supported this transaction as an investor in the Class A notes and EIF guaranteed part of EIB investment.

From the above discussion, it follows that policy impact can be ensured through careful selection of intermediaries (who focus mainly on the SME sector), by supporting transactions originated by smaller institutions and in new / peripheral markets, and by improving the tracking and reporting of recycling of funding or capital relief into new SME lending.

Finally, it should be noted that, over time, there has been a marked shift in the ways the EIF's balance sheet has been used for supporting SME guarantee operations. In its early years (1996 to 2001), EIF's own risk guarantee operations focussed on credit insurance and structured finance transactions. Moreover, the EIF used its balance sheet to support the European Commission's mandate activity. For example, under the Growth and Environment Pilot Project (implemented over 2000 to 2001), the Fund provided a free guarantee to selected financial intermediaries for loans extended to SMEs with the purpose of financing environmentally friendly investments. The ultimate risk from the guarantee lay with the Fund, while the guarantee fees were paid out of the EU budget. Since 2004, EIF's own risk guarantee operations have focused exclusively on credit enhancement of SME securitisation and, until recently, little was done to combine EU budget and EIF's own risk capacity to develop innovative guarantee products in support of policy goals[73]. Going forward, the EIF's guarantee strategy sets out two key areas of own risk activity: (i) credit enhancement of SME securitisation transactions and (ii) greater use of risk sharing mechanisms. While the latter is a positive development, both these interventions need to be underpinned by concrete evidence in terms of their capacity to address market failures and deliver the desired scale of policy impact.

Overall conclusions

The evaluation has demonstrated that EU shareholding is delivering the expected benefits in terms of maintaining the EIF's focus on EU policy objectives and mobilising SME finance (risk capital and debt finance). However, the scale of the benefits resulting from EU shareholding can be enhanced by: (a) improving the policy objective setting and measurement processes; (b) reviewing the co-investment requirements set by mandators; (c) taking stock of the role of the EIF in European PE/ VC markets; (d) seeking further assurances and undertaking for the use of capital released/ funding accessed through securitisation activity for SME lending; (e) targeted selection of transactions/ originators for SME securitisation activities.

3.2.3 Is the EU shareholding level sufficient/appropriate for the Commission to achieve EU policy objectives? How would it be possible to increase the added value of the EU shareholding?

The previous section shows the added value of EU shareholding in the EIF as a means for delivering EU policy objectives relating to SME financing, although the evaluation notes that there is room for some enhancement of the scale and scope of these policy achievements and added value more broadly.

Consideration of enhancement of policy achievements within the evaluation illustrates a number of mechanisms by which this could be achieved – objective setting, dividend policy, ex-post measurement of impact, etc. Critically, implementation of such measures would not require any increase in the EU's shareholding position. On the other hand, a reduction in EU shareholding would not be desirable as the presence of EU on the EIF's Board creates a direct link between policy making and policy execution. Additionally, EU shareholding contributes to EIF's rating stability.

However, the evaluation notes that the broader added value of EU shareholding in EIF is strongly and intrinsically related to the advantages derived from its tripartite shareholder structure. Particularly, perceptions and understandings of EIF's market orientation and credibility in SME financing markets is strongly supported by the position of financial institutions as shareholders in EIF.

Since its creation – with the initial desire for 30 per cent shareholding by financial institutions – financial institutional shareholding has reduced to less than 10 per cent, and the share of commercial banks to a mere 2 per cent. To compensate, EIB shareholding has increased to over 60 per cent. This trend threatens the basis of the EIF's tripartite structure in letter, spirit and activity and, if continued, will diminish the unique position of EIF and the added value that it derives from this position.

Arguably, evidence can already be discerned with, for example, clear financial and policy objectives set under COP as against objectives related to EIF as a centre of expertise, excellence and partnership – and which financial institutions identified in interviews as of particular value, and indeed balanced against any financial or policy returns of EIF shareholding per se.

Diminution of the breadth of EIF added value through the continued loss of financial institutions as shareholders would diminish the added value for EU of EIF shareholding.

[73] A recent example is the Risk Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps (RSI Facility) which was launched as a pilot scheme in 2011.

Simple contemplation of scenarios of loss of tripartite structure further contextualise the value and importance of financial institutions as shareholders. EIF was created deliberately 'at arms-length' from the EIB to allow greater risk-taking in the first place and European Commission shareholding as it currently stands, allows EIF to be perceived as an institution free from political interference by the Member States and able to demonstrate dedicated expertise flexibly and quickly as a market orientated institution.

Overall conclusions

In summary, EU shareholding as it stands is appropriate to achieve policy objectives and further moves to enhance policy impact are attainable at this shareholding level. Consideration of added value of EU shareholding more broadly is, however, based upon tripartite shareholding positions – and which is diminishing over time. The full added value of EU shareholding in EIF is dependent on shareholding by financial institutions which should at a minimum be maintained and, ideally, expanded to support development of the full range of added value themes evident through EIF shareholding (i.e. policy, financial and industry-related partnerships, knowledge sharing, disciplinary factor and market presence). Nevertheless, the EIB should remain the main/majority shareholder of the EIF to continue boosting cooperation between the two institutions and thereby facilitating the development of joint instruments.

3.2.4 To what extent can the different objectives (policy versus financial objectives) of the shareholders lead to conflicts of interest and how can a better alignment of interest be achieved?

The table below provides an indication of the policy and financial objectives expressed by different shareholder groups.

Table 3.8 Financial and Non-Financial Objectives expressed by Different Shareholder Groups

	Financial Objectives	Policy Objectives	Other non-financial objectives/ expectations
EIB	Financial viability – to generate a return that covers inflation and protects EIF's AAA/Aaa rating	To support risky activities in the area of SME financing	To ensure close cooperation between the EIB and EIF
European Commission	Financial viability – capital preservation	Enhance SME access to finance	To ensure close cooperation between the European Commission and EIF in design and delivery of financial instruments for SME financing To maintain a 'presence' in the European financial sector
FIs- public	Financial viability – capital preservation	Enhance SME access to finance	Information exchange and knowledge sharing with partner institutes To better understand the nature and availability of EU instruments for SME financing To increase cooperation with EU institutions To gain access to know-how and best practice
FIs- private	Financial profitability	None specified	To maintain existing relations with the EIB To be associated with an EU institution (image

	Financial Objectives	Policy Objectives	Other non-financial objectives/ expectations
			building and Corporate Social Responsibility agenda) For information exchange and knowledge sharing To get access to know-how and best practice

All shareholders share common goals in terms of enhancing SME access to finance and utilising the experience and expertise of the EIF for the benefit of the European financial sector. All shareholders recognise the dual objectives of EIF as a policy driven and market orientated institution. However, as the table above shows, these objectives are understood slightly differently by different shareholder groups. There is no evidence to suggest that this creates a conflict of interest; on the contrary, it creates what some shareholders refer to as a ‘healthy tension’ which leads to effective balancing of the dual objectives.

Potential ways of achieving further alignment of interest between the EIF and its shareholders are as follows:

- Greater alignment between the financial institutions and the EIF through more systematic information sharing. Presently, minority shareholders hold two meetings per year, notably the Annual General Meeting (generally held in the month of May) where the results of the previous financial year are presented along with the plans for the coming year including a presentation of EIF products; and, a meeting in November, where EIF’s mid-term results and information on new products and programmes are analysed and discussed. Minority shareholders interviewed for this evaluation expressed a wish for greater engagement, knowledge and information sharing, although not necessarily through additional meetings, but possibly through greater use of technology such as web- or tele-conferencing;
- Cooperation in the development of financial instruments – more cooperation ‘on the ground’ between EIF and financial institutions in order to avoid/ reduce any duplication of activity, to provide the basis for developing complementary activities and alignment of these activities with EU policy objectives;
- Developing a common understanding of policy and financial objectives. This is presently done through the COP process; however, as previously mentioned, the objective-setting and verification process can be improved.

Overall conclusions

The different emphasis placed by shareholders on the EIF’s policy and financial objectives create what can be described as a ‘healthy tension’ rather than a conflict of interest. However, greater alignment of interest between different shareholder groups can be achieved through clarification of policy and financial objectives; and, more proactive communication, information sharing and engagement with the minority shareholders.

3.2.5 Are there any significant spill over effects (e.g., knowledge diffusion within the Commission) from the EU shareholding in the EIF to other areas of responsibility?

The evaluation found limited evidence of knowledge spill overs specifically associated with the EU shareholding in the EIF. There is some information exchange. For example, before each Board meeting, various DGs are consulted on relevant Board documents. Furthermore, after each EIF Board meeting, an ex-post report, summarising the main discussions and approvals, is sent to the hierarchy of DG ECFIN as well as other DGs concerned by EIF activity (e.g. DG RTD, DG ENTR).

Some European Commission representatives consider that the market intelligence function of the EIF is currently under-developed and can be enhanced. In their view, the EIF, due to its proximity to the market, is well placed to provide continuous feedback to the European Commission for policy development.

Knowledge spill overs are driven more by the EU's relationship with the EIF as a client. For example, interviews with DG REGIO suggest that the First Loss Portfolio (FLP) guarantee developed by the EIF under the current programming period has been a particularly successful product which will continue to be used in future programmes. This represents a step change in the manner in which Cohesion policy support is delivered to SMEs. Moreover, in terms of positive spill overs, EIF has advised the European Commission on the new financial regulation with a view to making it more conducive to financial engineering. New market orientated models are also being tested in the current programming period in conjunction with the EIF which, if successful, will be rolled out in the next programming period.

Finally, the EU being a shareholder means that the management fees charged by the EIF on European Commission mandates are based on cost recovery plus a tiny margin (fees are market based for third party mandates). The profit element helps the EIF to do business development work (research, testing etc.).

Overall conclusions

The evaluation found limited evidence of spill overs stemming from EU shareholding in the EIF. There is some knowledge diffusion: both before and after each Board meeting, various services of the Commission are consulted and informed about relevant documents on the agenda. In addition, the European Commission, by virtue of its shareholding position, is charged lower management fees by the EIF for managing its mandates.

Knowledge spill overs are mainly attributable to the European Commission's relationship with the EIF as a client. Some (client) DGs have benefitted from their interaction with the EIF, as a result of which they now have a better technical understanding of financial instruments such as guarantee products.

3.2.6 What is the added value of the current use of EIF own resources (regular co-investment with RCM and securitisation transactions)? Is it possible to assess the catalytic effect and whether they are additional to other sources available on the market?

This question has been answered under section 2.2.1.

3.2.7 How can the effectiveness of EIF own resources activity be rated / compared to its peer group (e.g. EBRD, KfW Bankengruppe etc.)?

A meaningful comparison of the effectiveness of EIF own resources activity against a peer group cannot be carried out for two reasons: (a) the operations of the EIF are not directly comparable to any other financial institution given their different risk profiles and roles in specific transactions; and, (b) lack of access to data on individual operations of other financial institutions. For these reasons, it was a decided, during the Inception Phase of the study, that the peer group analysis would focus on comparing the ownership and governance structures and business models of select financial institutions (i.e. financial institutions with a policy mandate) with those of the EIF in order to highlight similarities and differences and, in the process, identify approaches and outcomes that could potentially support EIF in its role and activities.

Table 3.9 summarises the results of the peer group analysis. The detailed results are available in the Technical Annex.

The following observations can be drawn from Table 3.9:

- Ownership structure – EIF and FMO have PPP structures; FMO is 42 per cent owned by commercial banks. The EBRD, KfW and IFC are entirely public in nature i.e. fully owned by Governments;
- Governance structure– all institutions (except for the EIF) have a two-tier governance structure comprising a Supervisory Board and a Board of Directors. The Boards of

EBRD and IFC mainly comprises policy makers; whereas the Boards of KfW and FMO are more representative as they include a broad range of stakeholder groups;

- Financial objectives – all institutions are policy driven and market orientated. As such, all institutions seek to be financially sound, but the precedence of policy objectives over financial objectives is clearly established in their legal bases. In the case of the EIF, the statutes do not establish the precedence of policy over financial objectives;
- Profitability - the RoE delivered by the EIF's peer group is higher than EIF achievement notwithstanding the fact that they do not set explicit financial return targets (although this is likely to be a reflection of differences in the risk profiles of these institutions);
- Dividend policy - only the EIF and FMO distribute dividends. However, FMO distributes a very small share of its profits as dividends (it has to retain 95 per cent of its profits). In contrast, the EIF has traditionally distributed around 40 per cent of its profits as dividends;
- Measurement of policy impact - the peers demonstrate a range of substantially developed approaches to monitoring and evaluation of policy impact as compared to the EIF.

Table 3.9 EIF Peer Group Analysis

	EIF	EBRD	KfW	FMO	IFC *
Year of Establishment	1994	1991	1948	1970	1956
Status	Multilateral Development Bank	Multilateral Development Bank	National Development Bank	Bilateral Development Bank	Multilateral Development Bank – part of the World Bank Group
Mission Statement	To be Europe's leading developer of risk financing for entrepreneurship and innovation.	EBRD was established to support primarily private sector clients whose capital requirements cannot be fully met by the market. EBRD operates in 'transitional' countries with the aim of promoting well functioning market economies in these countries.	KfW's stated mission is 'to apply expertise and strength to sustainably improve the economic, social and ecological conditions of people's life in both, Germany and abroad'.	FMO aims to stimulate, enable and support the growth of the private sector in developing markets.	To enable people to escape poverty and improve their lives by mobilising alternative financing and other type of assistance for private enterprises, promoting open and competitive markets in developing countries, helping create productive jobs and deliver essential services to the poor and the vulnerable
Policy objectives	To contribute to the pursuit of Community objectives (Article 2 of the Statutes).	According to Article 1 of the Agreement establishing the European Bank for Reconstruction and Development: 'contributing to economic progress and reconstruction, the purpose of the Bank shall be to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics'.	KfW Bankengruppe has a mandate of economic promotion and development. KfW Bankengruppe supports development in Germany, Europe and throughout the world. Domestically, KfW's objective is to remain a leading provider of financing for SMEs, promotional activities, and export and project development. Internationally, KfW helps the government implement economic and international development policies. Recently, KfW has played a central role in implementing	FMO's policy objective is to contribute to the advancement of productive enterprises in developing countries, to the benefit of economic and social advancement of those countries, in accordance with the aims pursued by their Governments and the policy of the Netherlands Government on development cooperation. FMO's strategy (strategy 2009-2012: Moving Frontiers – Creating access to finance, housing and energy) focuses on partners, selected sectors and sustainability. In other words, FMO focuses on key sectors	IFC promotes sustainable investments in developing and transition economies with the aim of developing private sectors for growth and reduced poverty. IFC strategy focuses of five areas: frontier markets (IDA countries, fragile and conflict affected situations, and frontier regions of middle-income countries); climate change and environmental and social sustainability; infrastructure, health and education, and the food supply chain; local financial markets; and client relationships.

	EIF	EBRD	KfW	FMO	IFC *
			economic policy goals of the government as recently evidenced by its role in implementing the government's crisis response (incl. fiscal stimulus and bail-out packages).	(access to finance, energy and housing) yielding high benefits in terms of economic, social and environmental progress associated with good financial return. FMO's strategy is also to partner with others (commercial banks, other development finance institutions, local entrepreneurs and financial institutions in the countries where we are active, as well as private equity fund managers), to create synergies and all the more in the sectors outside its area of expertise.	
Financial Objectives	Article 24 of the Statutes: 'the level of remuneration or other income sought by the Fund in connection with its activities pursuant to these Statutes shall be determined in such a way so as to reflect the risks incurred, to cover the operating expenses, to establish reserves commensurate with the said risks and to generate an appropriate return on its resources'.	According to Article 13 of the Agreement Establishing the European Bank for Reconstruction and Development , 'the Bank shall apply sound banking principles to all its operations'. This in effect means that the Bank targets a sustainable level of profitability without maximising income.	KfW does not have any explicit financial targets. As a development bank, KfW's strategy is not to maximise profit, but to fulfil its developmental and promotional mandate. Its financial objectives are limited to maintain sufficient profitability, to allow suitable provisions for recognisable risks, strengthening of its equity base, and the maintenance of its subsidised loan programmes.	Article 2 of Agreement State - FMO of 16 November 1998 'Partly with a view to safeguarding FMO's continuity, the finance which FMO provides pursuant to Article 1.1, under a and b, shall be provided on normal terms and conditions as applied in the financial sector.' Achieving development objectives is a priority whereas profitability, although essential, plays subordinated role. FMO Annual Report 2005 states that the 'target return on equity is at least equal to Dutch Government bond returns'.	IFC Articles of Agreement specify in article III that 'IFC shall undertake its financing on terms and conditions which it considers appropriate, taking into account the requirements of the enterprise, the risks being undertaken by the Corporation and the terms and conditions normally obtained by private investors for similar financing'. Statutory role as a development finance institution prevails profitability.

	EIF	EBRD	KfW	FMO	IFC *
Ownership Structure	Public / private ownership structure: EIB (61.2%); the EU (30.0%) ; and 28 financial institutions (8.8%).	27 EU Member States (57% of the voting rights), 36 other member countries, and two institutions: the EU and the EIB.	Federal Republic of Germany (80%) and the federal states (20%).	Public / private ownership structure: Dutch government : 51% stake. Other shareholders: large Dutch banks including ABN AMRO, ING and Rabobank (42%), employers' associations, trade unions and individual investors(7%).	182 member countries. five largest shareholders: the U.S. (23.6%); Japan (5.9%); Germany (5.4%) ; France (5%) and the U.K. (5%).
Governance Structure	Board of Directors comprising seven members of which 4 are designated by the EIB, 2 are designated by the Commission and 1 by the Financial Institutions General Meeting Audit Committee Chief Executive + Deputy Chief Executive (2008 onwards).	EBRD has a dual board structure. Its governing structure comprises: Board of Governors representing 63 shareholders; Board of Directors comprising 23 directors (each director represents one or more shareholders) who are responsible for day-to-day operations and policies The Bank's President, Vice Presidents and three Board Committees (Audit; Budget and Administrative Affairs; Financial and Operations Policies) assist the Board of Directors.	KfW has dual board structure: Board of Supervisory Directors comprising currently 37 members representing Federal Government, the regional Governments, financial institutions and businesses. Board of Managing Directors (6 members). Board of Supervisory Directors is assisted by the Audit Committee, Credit Committee and Executive Committee. Position of Chairman is hold by Federal Minister of Economic and technology. The KfW also has a Mittelstandsrat (SME Advisory Council) whose role is to deliberate and take decisions on proposals for the promotion of SMEs, taking into consideration the overall business planning of the Institution.	Two tier board: Supervisory Board consisting 6 members appointed during general meeting of shareholders. Management Board composed of 3 Directors (elected by the Supervisory Board) Supervisory Board has mainly scrutinising functions whereas day-to-day operations are the responsibility of the Management Board. In addition, the Supervisory Board is assisted by two committees: the Audit and Risk Committee and the Selection, Appointment and Remuneration Committee.	Governance structure consists of the Board of Governors, the Board of Directors and two auditing bodies: Office of Compliance Advisor/Ombudsman and an Independent Evaluation Group. The Board of Governors is composed of Governors elected by member countries and representing their interests. The Board of Directors consists of the President and 25 directors.

	EIF	EBRD	KfW	FMO	IFC *
Dividend policy	EIF usually pays a cash dividend to its shareholders (normally, 40 per cent of its net profits).	The Agreement in its Article 36 specifies that EBRD is not allowed to pay a dividend to its members until its unrestricted general reserve is equal to at least 10% of its authorised capital stock .	Article 10 of the Law Concerning the KfW stipulates that there will be no distribution of profits . KfW allocates profits to statutory and special reserves.	Article 6 of Agreement State - FMO of 16 November 1998 FMO is required to set aside a fraction of its net profits in its contractual reserve. The formula given means the fraction amounts to around 95%. What part of the remaining 5% will be distributed to shareholders is decided by the General Meeting.	In principle, distributing a dividend is permitted as article IV of Articles of Agreement stipulate that "the Board of Governors may determine from time to time what part of the Corporation's net income and surplus, after making appropriate provision for reserves, shall be distributed as dividends." In practice, IFC does not issue dividends and profit is kept as retained earnings.
Policy principles / investment criteria	The EIF carries out an ex ante analysis of each investment/ transaction as per its value added methodology. It also applies restrictions to its operations in relation to certain economic sectors ("EIF Restricted Sectors"). Mandates might include additional and/or stricter investment criteria.	EBRD investments must meet three essential criteria: – Transition impact,; – Additionality; and, – Sound banking. These criteria are complemented by a number of policies and procedures including Environmental and Social Policy and Environmental and Social Exclusion List, Fraud and corruption - guidelines for private sector operations, etc.	Each programme has its own specific investment criteria but generic principles include environment, social and governance criteria, exclusion criteria and engagement.	FMO is required to test all of its investments against three policy principles: – *Catalytic role:* maximising the flow of finance to FMO's target group; – *Additionality:* only providing financial services which the market does not provide, or does not provide on an adequate scale or on reasonable terms; – *Good governance:* adherence to the principles of good governance in the widest sense (environmental, social, governance). E.g. FMO has introduced exclusion criteria (e.g. child labour, drift net fishing).	IFC applies the following checklist for eligibility: – Be located in a developing country that is a member of IFC; – Be in the private sector; – Be technically sound; – Have good prospects of being profitable; – Benefit the local economy; – Be environmentally and socially sound, satisfying IFC environmental and social standards as well as those of the host country. IFC also has a policy on additionality.

	EIF	EBRD	KfW	FMO	IFC *
Measuring, evaluating and demonstrating policy impact	Three indicators are used to demonstrate policy impact : – EIF total commitments to equity, guarantees and microfinance; – The (ex-ante) catalysed volume of SME financing of EIF's equity and guarantee commitments; – Business (i.e. mandate) development and management.	Indicators used to monitor and evaluate performance include: – Performance on transition impact; – Environmental performance and change; – The Bank's additionality, – Project and company financial performance; – Fulfilment of project objectives; – The Bank's investment performance; – Bank handling. EBRD operations, programmes, strategies and policies are subjects to the scrutiny of the Evaluation Department (EvD). It is fully independent body which reports directly to the Board of Directors, mainly through the Audit Committee. EvD selects a random sample of projects ready to evaluate in a given year. Project is considered as ready for evaluation one to two years after full disbursement of funds . In practice, EvD usually covers more than 50% of all projects. EvD assigns each project an overall performance rating. This rating gives a high weighting to 'transition impact' but also contains other performance indicators such as the fulfilment of the project	Indicators vary between the Group's units. While KfW Entwicklungsbank which operates abroad focuses on development outcomes, KfW Mittelstandsbank monitors and reports data such as inflow of applications, amount of financing delivered to SMEs and total commitment over a defined period of time. Once comprehensive data is collected, the Accounting Department sends periodic reports to the Research and Economic Department which thereafter conducts impact assessment analysis focusing on results and impact metrics including jobs created, volume of co-financed investments, reduction of Green House Gases (GHG) emission or number of innovative projects supported. As a final result, the Research and Economic Department produces reports which are delivered to the Federal Ministry of Finance and Federal Ministry for Economics and Technology and which constitute an important factor in influencing the Government's policies related to financing of SMEs, innovation, or eco-investments.	Evaluation of the FMO's performance is based on 3 main areas: (i)Project development outcomes (ii)Project investment outcomes (iii)Overall FMO's assessment (mainly qualitative character) in the context of Development Finance Institution characteristics. FMO's internal evaluation unit selects a random sample from all projects for ex post evaluation, with the overall aim of covering at least 50 per cent of the operations.	<u>For development outcome of projects</u>: financial performance indicators (i.e. ROI), economic performance indicators (i.e. new jobs, increase in loans to SMEs), environmental and social performance indicators (i.e. reduction in CO2 emission), private sector development impact indicators (i.e. engagement of other companies using similar approach). <u>For advisory services</u>: strategic relevance indicator (i.e. degree of alignment with country strategy), efficiency indicator (i.e. implementation of a given project on time), effectiveness indicator (i.e. number of jobs created). IFC uses Development Outcome Tracking System (DOTS). DOTS was established in 2005 and covers all active projects in the IFC's portfolio, although those which are subject of the evaluation must be mature enough. A random sample of projects is also examined by Independent Evaluation Group (IEG) - an independent three-part unit within the World Bank Group . The measurement system

	EIF	EBRD	KfW	FMO	IFC *
		objectives, financial performance, environmental performance and additionality.			applied by IFC is in line with specific guidelines for multilateral development banks established by Evaluation Cooperation Group.
Sector focus	No specific sectors	Agribusiness, Energy, Financial, Manufacturing, Municipal and Environmental Infrastructure, Natural Resources, Property and Tourism, Telecommunications, IT, Transport.	Finance, Energy, Manufacturing, Infrastructure, Municipalities, High-Tech	Financial institutions, energy and housing, food and water, agribusiness	Infrastructure, health, education and food supply-chain
Geographical focus	EU Member States, EU candidate and potential candidate countries and European Free Trade Association (EFTA) countries	29 countries of Central Europe and Central Asia (as of 2012). EBRD assists only those countries that 'are committed to and applying the principles of multi-party democracy [and] pluralism'[74].	KfW Mittelstandsbank – all German Länder, albeit with significant variations in financing intensity. Also some activity outside Germany e.g. KfW Entwicklungsbank	Development countries in Asia (including Central one), Africa, Latin America and Caribbean, and Eastern Europe.	Developing countries in Latin America and the Caribbean, Europe and Central Asia, Sub-Saharan Africa, Middle East and North Africa, East Asia and the Pacific, South Asia.
Instruments to support SME financing	– Equity (private equity / venture capital); – Guarantees (loan guarantees and counter-guarantees, securitisation and credit enhancement); and, – Microfinance.	– Credit lines to existing commercial banks (so called 'partner banks') focused on SMEs; – Loans to specialised microfinance banks; – Loans to non-bank microfinance institutions; – Non-financial support directly to enterprises.	– Loans; – Equity finance; – Mezzanine finance.	– Equity; – Mezzanine; – Direct Loans; – Syndicated Loans; – Guarantees.	– Loans; – Syndicated loans; – Equity; – Guarantees; – Risk management products and structured finance.

[74] Article 1, The Agreement establishing the European Bank for Reconstruction and Development: < http://www.ebrd.com/downloads/research/guides/basics.pdf>

	EIF	EBRD	KfW	FMO	IFC *
Authorised Capital, *EUR million*	3,000	30,000 (as of 2011) - (increase from 21,000 in 2010)	N/A	45	1850
Subscribed Capital , *EUR million* (2010)	3,000	20,793	3,750	9.4	1,790
Paid in Capital, *EUR million* (2010)	600	6,197	3,300	9	1,790
Total income, *EUR million* (2010)	111	1,754	2,302	225	1,635
Payment of taxes	No	No	No	Yes	No
Profit/ loss, *EUR million* (2010)	7.2	1,377	2,631	126	1,317
Return on Equity - % (2010)	0.7	11	18.2	8.9	12.1
Headcount (2010)	215	1,526	3,543	270	3,400
Turnover per Head, *EUR thousands* (2010)	516	1,149	650	833	480
Average personnel cost per head *EUR thousands*	158	105	126	138	132

	EIF	EBRD	KfW	FMO	IFC *
(2010)					
Credit rating	AAA/Stable/A-1+	AAA/Stable/A-1+ (S&P - December 16, 2011)	AAA/Stable/A-1+ (S&P - January 17, 2012)	AAA/Watch Neg/A-1+ (S&P - December 14, 2011)	AAA/Stable/A-1+ (S&P - January 31, 2011)
Key Rating Considerations	**Strengths:** – A solid financial profile including a debt-free balance sheet; – Strong shareholder support; Prudent statutory and policy controls; – AAA rated callable capital equaling 223% of shareholders' equity. **Weaknesses:** – High embedded risk in EIF's portfolio of loan guarantees and venture capital investments.	**Strengths:** – Extremely strong capital position and ample liquidity; – Prudent financial management and policies; – Excellent franchise value, reflecting EBRD's status as the largest multilateral provider of financing to its countries of operations. **Weaknesses:** – A riskier portfolio of development-related exposure than most other multilateral development finance institutions, due to predominant private-sector focus and large equity exposure.	**Strengths:** – An explicit guarantee from the Federal Republic of Germany covers KfW's liabilities, and KfW benefits from the Government's legal maintenance obligation (Anstaltslast); – An 'almost certain' likelihood that KfW would receive timely and sufficient extraordinary support from the German Government in an event of financial distress; – A critical public policy role and integral link with the Government because KfW supports the Government's economic policy objectives. **Weaknesses:** – The rating is contingent on government support through the maintenance obligation and federal guarantee.	**Strengths:** – Almost certain Government support in the event of financial distress; – The State's maintenance obligation and guarantee of FMO's financial commitments (Sovereign support was formally codified in the 1998 agreement between FMO and the state. Under Article 8 of the agreement, the state is legally required to enable FMO to meet its obligations on time. The duration of the agreement is indefinite and its termination requires 12 years' notice by either party); – Historically strong financial profile. **Weaknesses:** – An income stream characterised by significant volatility; – High-risk lending profile.	**Strengths:** – Strong financial risk profile, including ample capital and liquidity; – Conservative statutory and management policies; – High geographic diversification of its loans and clients' debt securities, equity investments, and guarantees (development-related exposure); – Membership in the World Bank Group and expected treatment as a preferred creditor. **Weaknesses:** – Higher-risk, private-sector focused mandate than most multilateral development finance institutions (MDFIs), with equity markets influencing income strongly.

3.2.8 What are the barriers to effectiveness, if any? What, if anything, could be done to render the use of EIF own resources more effective as a means to achieve the EU policy objectives?

Previous sections of the report highlight several issues limiting the effectiveness of own resources activity, notably: weak specification, measurement and reporting of policy impacts; lack of formal systems for collecting market intelligence on SME financing gaps and feeding this information into the policy making function of the European Commission; distribution of a relatively high share of profits as dividends; and, the automatic co-investment rule reducing the visibility and added value of equity operations.

These constraints can be addressed as follows:

- Sharpening EIF's policy objectives;
- Introducing a stronger evaluation function as a strategic business process;
- Improving tracking and reporting of policy impact of SME securitisation activities;
- Improving tracking and reporting of policy impact of SME securitisation activities;
- Reviewing the dividend distribution policy;
- Reviewing the automatic co-investment requirement and instead using own resources in the development of risk sharing financial products;
- Developing the market intelligence function and linking it to policy development.

These suggestions are further elaborated in section 4 which sets out the recommendations emerging from this evaluation.

3.2.9 Is the governance (including reporting requirements) of the EIF effective to ensure that EU policy objectives are achieved? What could be done to render it more effective?

Box 7 provides an overview of the typical governance structures of financial institutions in Europe that combine policy objectives with certain financial objectives. EIF's governance structure deviates from the norm in two main ways: (a) it has a single-tier board structure (i.e. a single Board of Directors); and, (b) the EIF's board exclusively comprises its shareholders' representatives and board representation is directly proportionate to the level of shareholding – circa 14 per cent shareholding equates to one 'seat' on the board. This is in sharp contrast to the governance structures in place at the EIF's peer institutions as they tend to have a wide breadth of stakeholders on their boards.

Box 7 Overview of typical Corporate Governance Models prevalent among Financial Institutions in Europe

Most financial institutions in Europe that combine policy objectives with certain financial objectives – for example development banks - make a clear distinction between non-executive board members and executive board members.

Mostly a two tier board structure is applied, even in a 'one-tier board country' like the UK. In a two tier system a more or less 'independent' supervisory board oversees the execution of the strategy by the executive board and evaluates executive board performance. Examples of this are the German KfW and the British CDC. Independent means that the Board is first and foremost responsible for the company, not for a specific group of stakeholders, for example the shareholders.

Under Dutch law, for example, even the supervisory board of publicly listed companies has to act first and foremost in the interest of the company. That is not always the same as to act in the interest of shareholders. For organisations that combine a financial objective with a social-economic objective, an orientation on the corporate goals is probably even more critical than for a private company. This is further strengthened by a stakeholder orientation of the board, which most often means that persons that have ties with a wide variety of stakeholders have a board seat.

More or less independent means that 'outsiders' – no (former) company executives - are appointed as members of the supervisory board – for example with a certain background in finance, economics and other areas of society which is related to the area the organisation is active in; that are accountable for the long term strategic objectives of the company. Each board member has to act in the interest of the company, not the stakeholders or shareholders that s/he represents.

A clear difference between non-executives, most often called a supervisory board or the board of supervisory directors, and the executive board is best-practice in all corporate governance codes around the world. For example, KfW reference the German Code for Good public corporate governance as the basis for its board structure.

The main reasons for this clear split in structure – most often leading to a two tier system - are that these organisations have certain societal goals and often are funded with public money. This means that the board has to know the area in which the organisation is active in and has to ensure that the organisation acts as a legitimate entity within these areas. This makes a certain amount of stakeholder representation necessary. A certain amount of board diversity makes public alignment better and makes it easier to keep track of societal developments.

Next to this board structure, an advisory board is seen as relevant by some organisations. A good advisory board leads to critical reflection on corporate policies, makes it easier for stakeholders to freely come with new ideas to the board and strengthens societal representation. Next to their role as 'advisor' these board members can act as advocates of the organisation within the region/sector/profession they come from.

Since the EIF's creation, there have been substantial developments in best practice models of governance for financial institutions– best summarised as transparency, scrutiny, challenge and clarity of role (legitimacy). In a post crisis world, this governance movement is, if anything, even more pertinent in two arenas – financial institutions and EU institutions - and its impact is.

In addition to wider public sentiment demanding more scrutiny, accountability and transparency at financial and EU institutions, there are several other arguments for a more representative board at the EIF:

- EIF is not a traditional company, but a publicly funded organisation that is supporting financial institutions to achieve certain policy/ societal objectives. The board composition should reflect these societal objectives (for example, representative of those who are the policy object such as European SMEs);
- The Board should be more representative, to display the social role of finance and to legitimise public money in private markets;
- Stakeholders can support critical reflection on corporate policies and achievement of societal mission including supporting a 'checks and balance' process to ensure that board members nominated by shareholders act in an ad personam capacity.

Furthermore, an overarching conclusion that can be drawn from the evaluation is that the EIF's board could be more strategic in its orientation, given a number of findings and conclusions on consideration of strategic issues (for example, policy objectives and target setting, RoE, dividend policy, policy impact of EIF, role and added value of EIF in a post-crisis financial world). Board minutes and interview testimonials show that considerable time is spent on project level discussions relative to strategic activity, whereas strategic matters are only discussed in the context of the COP and few other policy documents.

Overall conclusion

There is a case, based on good corporate governance models, to make the EIF's governance structure more representative of wider stakeholder groups. Furthermore, the strategic orientation of the board could be improved.

3.3 Efficiency

3.3.1 Has the EU shareholding in the EIF achieved better policy results than other alternatives like giving Commission mandates to the EIF or other financial institutions, taking into account the financial costs (including opportunity costs) and returns?

Evaluation evidence presented in previous sections (particularly section 3.3.1) demonstrates that:

(a) Own resources and mandates serve slightly different purposes and are not mutually exclusive alternatives; neither are they directly comparable. EU shareholding in EIF is more strategic and long term in nature as compared to mandates which have a finite life and are driven by a narrower and specific set of policy objectives.

(b) The added value of own resources in terms of:

- Supporting enhanced leverage;
- Its flexibility in resource allocation across different policy driven activities and time periods that can be used, in particular at times of crisis and in view of the long budgetary cycles of the Commission;
- Supporting new initiatives and pilot projects helping to provide Europeans SMEs with optimal financing opportunities;
- Acting as a critical component of the Treasury portfolio which remains an important foundation for income generation;
- Underpinning AAA status, essential for own risk and mandated guarantee activity.

(c) Own resources activity and mandate activity is synergetic and mutually supportive.

The orders of magnitude of EU budgetary commitments are also vastly different. The European Commission has invested EUR 223 million in EIF as a shareholder (EUR 180 million taking into account the dividends received) over a 15+ year period with no further capital increase foreseen in the short to medium term and has a potential financial exposure of a further EUR 720 million (although no provisions are made in the budget for callable capital, as the likelihood of this happening is considered extremely low).

In comparison, a mandates such as CIP has a financial envelope of over EUR 1 billion for a seven year period. Repayments of the initial investment plus an eventual participation upside will flow back to the general budget - improving the overall cost-efficiency of the mandates, nevertheless mandates require a significantly higher budgetary commitment than EU shareholding.

3.3.2 How can the efficiency of EIF own resources activity be rated / compared to its peer group?

A meaningful comparison of EIF own resources activity against a peer group cannot be carried out for the reasons stated earlier: (a) the operations of the EIF are not directly comparable to any other financial institution; and, (b) lack of access to data on individual operations of other financial institutions and their effectiveness.

3.3.3 To what extent could measures be taken to improve the efficiency of EIF own resources activity, and what measures would these be?

This issue is addressed in section 4 which sets out the recommendations for improving the effectiveness and efficiency of EU shareholding in the EIF.

3.4 Coherence

3.4.1 To what extent do the EIF internal procedures ensure complementarity and synergy between the various mandates/own resources?

To achieve complementarity and synergy between various mandates/ own resources, EIF has, since 2010, in place a formal mandate development process[75]. The process, inter alia, entails a systematic assessment of a new mandate's positioning vis-à-vis existing mandates through an analysis of market gaps and an assessment of the potential mandate's strategic fit and complementarity with EIF's existing activities.

It is still too early to judge the efficacy of these mandate development procedures as they are relatively recent. However, some potential overlaps between the EIF's various mandates can be noted. For example, between the CIP mandate which targets investments in SMEs that are in seed / start-up stage (GIF 1) and the expansion-stage (GIF 2) and the new RCM which focuses on all stages of private equity as well as technology transfer. Furthermore, anecdotal evidence suggests that the overlap between CIP and JEREMIE portfolio guarantees in some Member States has encouraged 'deal shopping' by financial intermediaries. Finally, interviews with the European Commission imply (and as acknowledged in Board discussions earlier this year) that parallel contacts between the EIF and several European Commission services have led to a fragmentation of EU financial instruments. These examples point to a need to strengthen the EIF's internal procedures for mandate development. In parallel, it is also the European Commission's responsibility to ensure coordination between the different DGs when developing financial instruments. To this end, the creation of an Expert Group within the Commission to coordinate the development of new financial instruments is a step forward. Moreover, as already mentioned, internal Commission coordination has also been strengthened through the consultation procedure prior to each EIF Board meeting and the ex-post report summarising the main discussions and approvals, distributed by the Commission Board members within the European Commission.

Overall conclusion

The EIF and the European Commission have put in place internal procedures to ensure complementarity and synergy between the various mandates/own resources. However, evidence of potential overlaps between some mandates/own resources points to a need to strengthen these procedures, both within the EIF and the European Commission.

3.4.2 To what extent do the EIF deal allocation principles ensure a proper use of the various available resources (mandates) in order to maximise the total added value of EIF activities?

According to the EIF, the Fund takes care not to duplicate activity at the time a new mandate is developed. As explained above, the EIF systematically assesses a new mandate's positioning vis-à-vis existing mandates as part of a formal mandate development process. Additionally, the EIF routinely carries out a mapping exercise to identify any potential conflicting overlaps between its various activities. Where potential conflicts arise (i.e. two mandates have same target markets, similar eligibility criteria and use a similar competing product)[76], these are addressed either through a deal allocation policy or via systematic co-investment between the mandates.

A deal allocation policy was developed by the EIF, on request from the European Commission and following the recommendation of the interim evaluation of CIP, which highlighted a potential overlap between JEREMIE and CIP mandates. The deal allocation policy provides some guidance and transparency on how deals are to be allocated between various mandates/ own resources when there is an overlap.

[75] EIF (2011) EIF Mandate Development Procedures, 14 October 2011.

[76] As long as demand exceeds supply, two mandates covering the same market is not an issue.

According to the latest version of the deal allocation document (Document 11/421 dated 12 December 2011), there are ‘no noteworthy overlaps between equity mandates’. For example, the CIP-GIF mandate and RCM mandate are considered to be ‘largely complementary due to different risk tolerance and intermediary focus’ - although Figure 3.5 extracted from the same document, shows an overlap between the two. Moreover, the differences in risk tolerance and intermediary focus are not sufficiently detailed in the deal allocation document (although it is gleaned that the CIP focuses on first time/ emerging teams and the RCM on established teams and fund-of-funds structures). The deal allocation document also acknowledges possible geographic overlap between JEREMIE and CIP VC operations, but concludes that in practice it is limited and the that there are complementarities in terms of products, intermediaries and targets – which have not been backed by evidence or examples or actual implementation experience. Although the EIF’s resource map and deal allocation document regards CIP and JEREMIE portfolio guarantees as complementary products, anecdotal evidence suggests that the two mandates are competitive and some intermediaries have taken advantage of this by engaging in deal shopping. This is a risk particularly in regions/ countries where the JEREMIE holding fund is not managed by the EIF, although this issue is beyond the EIF’s control.

As far as guarantee operations are concerned, the document acknowledges potential overlaps between CIP micro window and Progress (Figure 3.6), and also between RSI pilot and CIP. To address these overlaps, the document sets out a series of decision rules to inform the allocation of deals between these mandates.

Figure 3.5 EIF Resources Mapping: Equity

Equity - Market Stage Perspective				
	Pre-Seed / TT	VC early stage	VC expansion	Later stage VC/PE

Mandate Resources	Pre-Seed / TT	VC early stage	VC expansion	Later stage VC/PE
EIF own resources			Systematic 10% co-investment with RCM	
RCM (EIB)	As compatible with financial objective			
MFG (EIB)			Priority mandate for mezzanine fund investments	
CIP (EU)		EU value added criterion; focus on emerging teams		
ERP, LfA, UKFTF		Systematic co-investment with other resources		
JEREMIE		Mandates address local policy priorities		

Key:

- (hatched) Leverage of other resources through co-investment rules or other synergies between resources
- (orange) Core focus of mandate
- (yellow) Fits with mandate, but not primary focus

Source: Document 11/421 dated 12 December 2011

Figure 3.6 EIF Resources Mapping: Guarantee Operations

Guarantee Products					
	Guarantees- Credit enhancement & securitisation	**Portfolio Guarantees**	**Funded risk sharing**	**(Quasi-)Equity Guarantees**	**Microfinance guarantees**
Mandate / Resource					
EIF					
CIP					
JEREMIE					
Progress					

Key:

Core focus of mandate

Fits with mandate, but not primary focus

Source: Document 11/421 dated 12 December 2011

Overall conclusions

The EIF examines potential overlaps between its activities as part of a formal mandate development process and routinely carries out a mapping exercise to identify any potential conflicting overlaps between its various activities. Where potential conflicts arise, these are addressed either through a deal allocation policy or via systematic co-investment between the mandates. The deal allocation policy provides a transparent basis for allocating deals between various mandates/ own resources when there is an overlap. However, the deal allocation policy is lacking in detail and does not take full account of potential overlaps.

3.4.3 To what extent is EIF own resources activity coherent with other relevant EU policies and programmes (not managed by the EIF)? Are there any overlaps or contradictions?

In terms of overlaps with other EU policies and programmes not managed by the EIF, the main concern lies with Cohesion policy financial instruments implemented directly by the Member States and the regions. At year-end 2010, an aggregate amount of EUR 8,369 million of ERDF and national contributions (private and public) was committed to 386 funds[77] targeting SMEs, whether through holding funds or directly to specific funds[78]. Of these, the EIF only manages 11 funds.

Cohesion Policy programmes are implemented in a context of shared management between the European Commission and the Member State authorities. Financial instruments are implemented by the Member States/ regions. In such a context, it is practically difficult to ensure coherence between EIF own resources activity and Cohesion policy financial instruments designed and implemented by Member States/ regions.

3.4.4 To what extent are the EIF own resources activities coordinated with initiatives from other financial institutions (national, international, public private)? Are there overlaps or contradictions?

There are some examples of coordination of EIF own resources activity with other financial institutions such as with KfW in the case of SME securitisation activities in Germany and with Barclays where the EIF guaranteed Barclays' contribution to three ERDF funded investment funds in the UK. However, coordination of own resources activity with financial institutions is limited to those who are EIF shareholders and, even within this group, some promotional banks/ development banks expressed the opinion that EIF could be more proactive in coordinating its activities (both mandate and own resources) with these institutions in their respective countries to avoid duplication and overlaps.

[77] 41 holding funds, 60 equity funds, 78 guarantee funds and 116 loan funds

[78] DG Regio (2011) JEREMIE implementation in the EU Member States: State of play

4 Recommendations

A number of Recommendations to support enhanced policy impacts and maximised added value whilst retaining a ‘reasonable rate of return’ can be proposed. These are set out in this section.

Recommendation 1: The re-affirmation and articulation of the general, specific and operational objectives of EU participation in EIF shareholding.

Current EU policy objectives (as the basis of, ultimately, target setting by the EIF Board as reflected in the COPs) remain under-specified given substantial developments over time in the context for and the activities of EIF. A specific objective setting process would be beneficial; potentially, this process could be undertaken through a number of activities and with a choice of stakeholders. Some initial considerations on the objectives of EU shareholding in the EIF are outlined below.

Initial Considerations on the Objectives of EU Shareholding in the EIF

General objective	Specific objectives	Operational objectives
To enhance SME access to finance	To increase the supply of debt finance by taking mezzanine or subordinated positions	To enhance the banking sector’s capacity to lend to SMEs
		To support non-bank channels of debt finance
		To support institution building in less developed markets
		To support institutional diversity in mature markets
	To increase the supply of equity and equity-like debt instruments for SMEs	To invest in early stage venture capital
		To support the development of SME equity markets
		To nurture embryonic markets
		To support mature markets in difficult economic conditions
	To develop and spread innovative financing	To develop and prove new and pioneering financial instruments and structures
		To diffuse successful financial instruments and structures across European financial markets
	To support market best practice and intelligence in innovative financing and to build market know-how	To contribute to the development of best practice, experience and expertise in innovative financing
		To use the EIF’s market proximity as the basis for generating market intelligence and continuous feedback for policy development

EIF should be adequately capitalised to deliver its policy mission and reflecting its product mix. For example, guarantee operations by nature are more capital intensive than equity operations; equity operations can be delivered entirely through mandates whereas guarantee operations require EIF to have its own capital.

Recommendation 2: Maintain the tripartite ownership structure of the Fund

2a The Commission should maintain a substantial shareholding in the EIF (in the order of the current shareholding of 30 per cent)

2b Efforts should be made to prevent a further decline in the share of financial institutions and, ideally, return to a more balanced ownership structure by increasing the shareholding of financial institutions with aligned goals while maintaining the EIB as the main/majority shareholder

EIF was initially conceived as a Public Private Partnership with a shareholder split of 40 per cent EIB, 30 per cent European Commission and 30 per cent financial institutions. The evaluation has illustrated the range of added value of this tripartite structure in supporting EIF as a policy-driven, market orientated institution, notwithstanding the subsequent move to a 60:30:10 shareholding position (EIB, European Commission and financial institutions respectively). A further decline in the share of financial institutions (over time, for example, the share of commercial banks has declined to a mere 2 per cent) would have a detrimental signalling effect (signalling a lack of confidence in the PPP structure) and would diminish the benefits associated with industry knowledge, relationships and presence.

Given the distinctive and demonstrable value of each shareholder group in contributing to the full added value of EIF, efforts should be made to fully maintain the tripartite structure of the Fund –including preventing further decline in the ownership share of financial institutions and, ideally, increasing their share. Arguably, it is more pressing to support renewed joint efforts and operations with financial institutions within the 'post-crisis' financial world.

Nevertheless, the EIB should remain the main/majority shareholder of the EIF to continue boosting cooperation between the two institutions and thereby facilitating the development of joint instruments.

Recommendation 3: A more strategic and representative governance structure

3a Reinforce the strategic orientation of the Board

An overarching conclusion that can be drawn from the evaluation is that strategic and foresight activity could be stronger given a number of findings and conclusions on consideration of strategic issues (for example, policy objectives and target setting, RoE, dividend policy, policy impact of EIF, role and added value of EIF in a post-crisis financial world). Board minutes and interview testimonies indicate that considerable time is spent on discussing individual operations, whereas strategic matters are only discussed in the context of the COP and few other policy documents.

3b EIF shareholders should consider the reputational and strategic benefits that would be brought to EIF through the appointment of stakeholder representatives to the Board of EIF

Since EIF's creation, there have been substantial developments in best practice models of governance for institutions, including incorporating issues of transparency, scrutiny, clarity of role and demonstrating legitimacy. This governance movement is, if anything, even more pertinent currently in two arenas – financial institutions and EU institutions – and its impact is evident in the breadth of stakeholder representation on peer institution boards.

EIF has met many of these developments in the evolution of its governance structure (such as introducing the requirement for Board members to act independently in the interests of the Fund in 2000), but arguments remain for a more representative board, for example:

- EIF is predominantly a publically funded organisation that is supporting financial institutions to achieve certain policy/ societal objectives. The Board composition could legitimately be expected to reflect these societal objectives (for example, representatives of those who are the policy object, such as European SMEs or those with specific expertise in finance);
- To display the social role of finance and to legitimise public money in private markets;
- Stakeholders can support critical reflection on corporate policies and achievement of societal mission including supporting a 'checks and balance' process to ensure that Board members nominated by shareholders act in an ad personam capacity.

Recommendation 4: (given Recommendation 1), **A process of awareness raising of the Commission and EIF partnership and the added value generated through this unique policy instrument**

The process of this evaluation has highlighted a number of perceptions, misconceptions and perspectives across different stakeholder groups as to the role and value of EIF which could be addressed through a process of improved communication, information provision and engagement.

Recommendation 5: An expansion of the current level of internal resources committed by EIF to business processes associated with the delivery of policy objectives

This evaluation has highlighted that the systems and processes in place to support the monitoring, reporting and evaluation of policy impacts – and in contrast to those dedicated to financial objectives -could and should be developed further. Examples exist across the policy cycle: from setting policy objectives to articulation of investment rationales based on market failures to ex-ante and ex-post assessment. Comparison with peer institutions provide pointers on how such expansion might be brought forward, including the creation and / or use of better performance metrics and an independent evaluation function.

Recommendation 6: Seek further assurances and undertaking for destination of investment funds released through securitisation activity

SME securitisation activity constitutes a key mechanism for the delivery of policy impact via own resources activity (by enhancing the lending capacity of originators and making SME financing more profitable for them). Value added assessment of the policy impact of the EIF's SME securitisation operations is primarily undertaken by an ex-ante analysis which is essentially subjective and qualitative in nature. Given the historical and expected future role of SME securitisation operations in overall EIF activity, it is recommended that EIF should put in place practical measures to track and report the recycling of funding or capital relief into new SME lending and, ultimately to support judgements of policy impact.

Recommendation 7: The European Commission should seek a review at Board level of the rationale behind the current setting of the Return on Equity target under the blended returns approach of EIF own resources activity, taking into consideration the prime objective of the EIF to contribute to the achievement of EU policy objectives

Currently, the RoE target setting is not based on a systematic analysis of the risk-reward profile of EIF's operations or business simulations to determine the RoE required for long term sustainability. Shareholder expectations set a threshold level – at least matching long run inflation metrics and self-sufficiency – whilst the current expected RoE of 5 to 6 per cent, according to the EIF, is based on historical performance and what is achievable given the dual statutory objectives.

EIF's historical RoE performance from 1996 to 2011 (excluding 2001) is 3.57 per cent, the short to medium term outlook is of reduced commercial market returns and peer review demonstrates that market credibility can be achieved without an explicit RoE target.

Given the key weighting given to RoE as a Key Performance Indicator for own resources activity, the European Commission should seek a review of the RoE target by the EIF Board as to whether or not it is reasonable and adequate to ensure financial viability of the Fund and given its policy objectives.

Recommendation 8: The European Commission should seek a change in the current dividend distribution policy practised by EIF

A reduction in dividends paid would provide additional investment funds for recycling – for example, into a higher risk capital pot, but still within the agreed blended returns framework. Such a decision must, however, be approved by all shareholders.

Recommendation 9: Automatic co-investment rule under mandates should be reviewed

Substantial levels of own resource investment are required to meet the 'automatic' 10 per cent co-investment rule of the RCM. Whilst 'skin in the game' is good practice, the level set is substantially higher than the industry norm. Mandators should reduce 'automatic' co-investment requirements to industry standards.

Ideally, own resources should only be used for co-investment where it has clear added value, for example: (a) where the mandator is a non-shareholder third party or has a minority shareholding in the EIF and thus, requires additional demonstration of alignment of interest; or, (b) it enhances the leverage capacity of an instrument through risk sharing arrangements by providing capital relief to intermediaries (as in the case of the RSI facility).

Recommendation 10: Continued development of the EIF as a centre of expertise and excellence in the design, implementation, standardisation and diffusion of innovative financial instruments

The added value generated by EU shareholding in the EIF includes the expertise and excellence generated within EIF and available to support the development of European SME finance markets. Indeed, financial institution shareholders strongly value such additional benefits as a balance against reduced commercial returns. The strategic importance of this 'soft' added value to both shareholders and stakeholders alike should be subject to full recognition and strategic development.

Recommendation 11: Strengthening of internal procedures for mandate development and deal allocation policy

The mandate development process and deal allocation policy should be based on a more thorough examination of market gaps, overlaps and risk-reward profiles of potential mandates and existing activity in order to maximise complementarity between mandates and own risk activity.