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EPSC Strategic Notes

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The European Fund for Strategic Investments (EFSI)

Maximising its Potential

Guiding principle of EFSI is to stimulate private, market-based investments, not to replace them

In this sense, EFSI provides risk-sharing through public funds at a time when low investor confidence leads to historically low investment activity. Strict funding criteria ensure additionality, viability and private sector involvement.

EFSI is off to an encouraging start

Within the first eight months after its operational inception, it mobilised over EUR 76 billion in more than 200 projects or financing agreements, or almost a quarter of the total EUR 315 billion foreseen to be triggered during its three-year duration.

Capitalising on EFSI's promise

The success of EFSI suggests that its extension would be a valuable addition to the scope of instruments available to the EU. An extension of EFSI in terms of sectors of investment, size and duration, with the ultimate goal of making EFSI permanent, deserves consideration.

Why a European Fund for Strategic Investments?

The European Fund for Strategic Investments (EFSI) is a key response of the Juncker Commission to the fallout from the global financial crisis, which left many regions in the world with lower economic and investment activity. EFSI addresses the prolonged period of low investment activity by providing risk sharing funds, which then attract private investments. EFSI is a fundamental part of the EU's "Investment Plan", which includes the creation of a stable pipeline of bankable projects, an increase of the technical assistance to public and private investors, and a "third pillar", dealing with the regulatory environment, covering both Member States and EU-level regulatory barriers to investment.

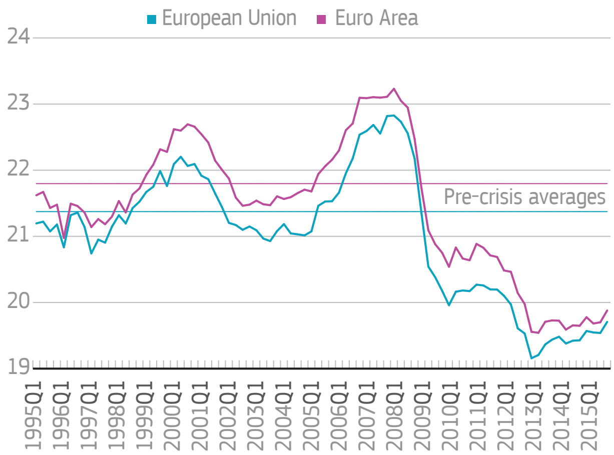
Concretely, investment in the EU is still well below its pre-crisis average (1995Q1 – 2006Q2), suggesting a shortfall of about EUR 61.4 billion in the fourth quarter of 2015. The euro area "investment gap" is about 82% of the total shortfall or about EUR 50.4 billion, a figure larger than the share of the euro area in the EU's output. Measured as a share of GDP, **the investment gap is about 1.7% of GDP for the EU and 1.9% for the EA** (Figure 1).

Broken down by country, these figures vary significantly between Member States – from 3.3 percentage points GDP above pre-crisis average in Sweden and 1 percentage point in Belgium to about 10 percentage points of GDP below pre-crisis average in Greece and Portugal. Some of these gaps are considerable and are a key factor in explaining the current subdued growth environment.

EPSC Strategic Notes are analytical papers on topics chosen by the President of the European Commission. They are produced by the European Political Strategy Centre (EPSC), the European Commission's in-house think tank.

Figure 1: Gross Fixed Capital Formation

Percentage of GDP



Note: Pre-crisis averages include 1995Q1 to 2006Q2.
Source: GDP and Main Components Database, Eurostat.

While the main driver of the "gap" is the fall in GDP growth itself – **a macroeconomic constraint**[1] – there are other important factors at play, largely of **a microeconomic nature**. These impact notably but not only the countries of the so-called euro area "periphery", where structural reform shortfalls, diverging financial market conditions and uncertainty ultimately lead to lower investor confidence.

EFSI Implementation: Where Are We?

The guiding principle behind EFSI is to stimulate private, market-based investments, not to replace them. In this sense, EFSI provides risk-sharing through public funds at a time when low investor confidence is key to understanding the low investment activity. Relying on the know-how and institutional support of the European Investment Bank (EIB), EFSI includes as key pre-conditions –enforced by a robust and independent selection mechanism, namely its "Investment Committee"- the overall **additionality** and **financial viability** of the investment, necessary involvement of **private** capital, and prioritised provision of finance to underbanked sectors (like innovative companies, SMEs). This aims to fill existing "market failures" in the EU's financing ecosystem. Additionally, to increase synergies between EFSI and the EU Budget, the EFSI regulation allows countries to use European Structural and Investment Funds (ESIF) resources to contribute to the financing of projects eligible for EFSI support. EFSI and ESIF joint resources could support the capital structure of a project while covering different and greater total amounts of risks. Importantly, EFSI is generally complementary to all other EU funding instruments.

EFSI has had a promising start since the regulation was approved in mid-July 2015. By mid-March 2016, a mere eight months after its operational inception, it had already mobilised over **EUR 76 billion (using almost EUR 11 billion of the EIB/EIF financing envelope of EUR 61 billion), or almost a quarter of the total EUR 315 billion foreseen over a three-year period** (see Table 1).

Table 1. EFSI State of Play as of March 2016

	Infrastructure and Innovation Window	SME Window	Total
Number of approved projects/financing agreements	54	151	205
Approved financing under EFSI (EUR bn)	7.2	3.4	10.6
Total expected investment triggered (EUR bn)	30.6	45.5	76.1
Total expected investment triggered (%)	40.2%	59.8%	100%

Source: http://ec.europa.eu/priorities/publications/investment-plan-eu-wide-state-play-march-2016_en

The SME Window has proven very successful – with EUR 45.5 billion of triggered investment, it constitutes almost 60% of the total amount of investment mobilised so far in both Windows and around 61% of the investment expected to be triggered within the SME Window in 3 years (see Table 1), with exhausting only around 23% of the **EIF financing allocated** (EUR 3.4 billion out of EUR 15 billion).[2] This implies that the actual leverage in the SME Window is so far higher than that for the Infrastructure and Innovation Window.

The SME Window's goal is to provide new funding opportunities for SMEs and complement EU grants, financing provided under ESIF, national financing programs and other EU-level instruments. The SME Window offers both debt and equity financing, through local financial intermediaries (e.g. national promotional banks, venture capitals or angel investors). It also targets new sectors such as social enterprises, cultural and creative sectors or microfinance borrowers.

There are three products launched within the SME Window since July 2015:

- guarantees supporting loans to SMEs with a higher-risk profile (enhancement of the COSME EFG facility);
- guarantees supporting loans to innovative and research-intensive SMEs and Small Mid-Caps (enhancement of the InnovFin – Horizon 2020 SMEG facility);
- equity investment in venture capital and equity funds (these operate without a EU guarantee under the EIB Risk Capital Recourses Mandate).

Further products are also under development, notably:

- investment in venture capital funds, private equity funds, funds of funds - including social investments, tech-transfer and business angels (Equity Platform);
- products for social enterprises and other target groups (EASI enhancement);
- securitisation of SME loan portfolios;
- lending to innovative companies that lack collateral.

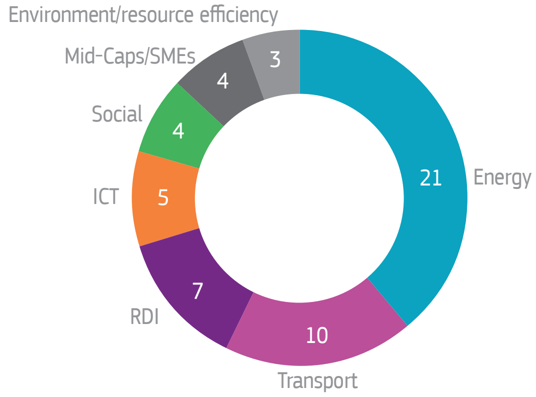
The Infrastructure and Innovation Window has mobilised so far over EUR 30 billion in 7 sectors: energy (21%), transport (10%), research, development, innovation (RDI, 7%), ICT (5%), mid-caps (SMEs), human capital and social sector, as well as environment and resource efficiency (Figure 2).

Within the Infrastructure and Innovation Window, the typical products offered are:

- Long-term debt for higher risk projects;
- Subordinated loans;
- Equity and quasi-equity financing.

Figure 2. Sectorial Distribution of EFSI Infrastructure and Innovation Window

Number of projects



Source: The Investment Plan For Europe State Of Play

To further foster the EFSI implementation, prospective beneficiaries have at their disposal such tools as:

- **European Investment Project Portal (EIPP)** – a web portal facilitating EU-based project promoters to connect with potential investors;[3]
- **European Investment Advisory Hub (EIAH)** – a point of access for investment support.

The EIAH is a joint initiative by the European Commission and the EIB. The Hub offers a single access point to advisory and technical assistance services, i.e. project support throughout the cycle provided by high-level experts. The Advisory Hub also coordinates a network of National Promotional Institutions and Managing Authorities. Through this network the Hub provides project promoters, public authorities and private companies with technical support to help make the project investment-ready and with advice on possible and optimal funding sources.

Investment Platforms are also a key feature of EFSI financing. Their goal is to catalyse investments in a given portfolio by pooling together projects with similar thematic or geographical focus - in a flexible form of a risk-sharing arrangement, special purpose vehicles (SPV), contract-based co-financing or managed accounts. Investment Platforms, by aggregating investments, diminish transaction and information costs and disperse the risk more efficiently between various investors. They could be of different types: national platforms grouping together several investment projects on the territory of a given Member State; multi-country or regional platforms that group together partners from several Member States or thematic platforms that group together investment projects in a given sector. The overarching objective of platforms is to crowd-in private investors by addressing market failures and reducing risks. The EIB can support Investment Platforms via loans, equity investment or a guarantee.

Showing how EFSI is coordinated with other Juncker Commission priorities, work is ongoing in the context of the **Capital Markets Union (CMU)** to revise the Solvency II Directive as well as the Capital Requirements Regulation, with the aim to adapt the regulatory treatment of infrastructure projects for insurers and banks. For the insurance sector, these changes in the prudential regulation have now been agreed. This will facilitate investments in infrastructure by insurers and reinsurers.

EFSI has also reinforced and accelerated a **process of cultural change in the EIB.** From an institution designed to finance a (relatively) small number of large projects with little risk, it became one that **finances a much larger number of relatively small and riskier projects**. EFSI has created a new, much more concrete dimension of **work and cooperation between the EIB and national investment agencies and promotional banks**. Finally, EFSI has enabled a **deepening of the already high level of financial sophistication of the EIB** (via the syndication initiatives, the ongoing development of equity Windows, and the possible syndication of infrastructure projects to enable smaller insurers to participate).

The EFSI success leads to a question of where the programme could be going forward, both in terms of size, areas of activity and types of financial products.

Exploring the Further Potential of EFSI

EFSI, thus far, has surpassed expectations. In the context of the foreseen half-way stocktaking, we have identified three blocks which merit consideration given the private sector's embrace of the project. A closer analysis should identify the private sector component for each of these blocks. These three blocks are: a sectorial extension of EFSI, enlargement of EFSI, and making EFSI a permanent addition to the funding options of the EU. **Importantly, some but not all of these possibilities are likely to imply changes to the EFSI Regulation.**

Possible sectorial developments of EFSI:

- **Venture Capital Window/Platform**: complementing Member States' actions in this area, a dedicated Window could be added to EFSI, providing pooled finance for investment. A small amount of funding would allow testing the model and exploring possible scaling up/expansion. This could be complementary with ongoing CMU initiatives, where venture capital features prominently. The communication on the CMU from September 2015 actually foresees that the EU budget could support the revised "Regulation on European Venture Capital Funds" and the "Regulation on European Social Entrepreneurship Fund" as well as existing proposals for a range of pan-European venture capital funds-of-funds and multi-country funds. Such a Window could reinforce existing tools such as InnovFin of the Horizon 2020 agenda and COSME focused on providing finance to SMEs. Importantly, it would not imply a change in the EFSI regulation. Some work on its possible design is ongoing;
- **Social Innovation:** an envelope has been earmarked to implement social impact instruments, including instruments to be tested and eventually scaled up. The social impact instrument could include different but interdependent financial instruments, an example of which would be the "Payment by Results mechanism", an innovative instrument for financing the delivery of social services for the benefit of vulnerable and socially excluded groups, possibly including refugees and migrants. Social impact instruments would mobilise private resources and channel support to social enterprises catering to such vulnerable groups. The deployment of such resources through EFSI would be complementary to existing EU and EIB instruments (notably with the EIF "Programme for Employment and Social Innovation" -EaSI- Financial Guarantee Instrument and the Funds of Funds managed by EIF – the Social Impact Accelerator). Such a programme would equally not imply a change in the EFSI regulation, and similarly, some preliminary work on it is already ongoing;
- **Human Capital Investment:** also complementing existing Member States' actions in this area, a dedicated instrument could be added to the EFSI, providing pooled finance for additional investment in existing programmes, notably for training, lifelong learning in SMEs, apprenticeships, internships, etc. A small amount of funding could also allow testing the model and exploring possible scaling up/expansion. This could reinforce programmes such as Erasmus+ in education and training and complement the current financial instruments' offer under EaSI (for example, EFSI would allow the frontloading of the implementation of the EaSI Guarantee Instrument, to respond to the very high demand both in the microfinance and in the social entrepreneurship domains);
- **Bank NPL/Capital Relief:** a potential 'bundling' of non-performing loans held by banks – seen as a key constraint is some EU bank systems – with an EU/EIB guarantee, to enable securitisation and the on-selling of those loans, could enable cleaner bank balance sheets and therefore more credit creation;

- **3rd Countries: EFSI could be complemented by an instrument to reinforce EU investments in 3rd countries, building on existing EU and EIB instruments**. Such a plan would be in line with both an overall aim to provide financing for development and stabilising the EU Neighbourhood in the context of the ongoing migration crisis – EFSI can already be used in neighbourhood countries for cross-border projects with EU countries aiming for policy coherence between EU economic and external policies. Also, this could generate direct positive growth and jobs dynamics within the EU, particularly since the investments contribute to a more stable neighbourhood. One added value of a potential 3rd Countries' Window could be the cost effective mobilisation of investments by leveraging an already existing pipeline of projects. It could be implemented speedily, building on the existing EU blending framework with a reinforced partnership with institutions beyond the EIB, like the EBRD, EU MS development banks, aiming also at increasing involvement of private banks and investment funds. As this would be at least partially a revamping/rebranding of EU external actions, **a key question would be the actual degree of integration with the EFSI framework and the level of involvement of the EIB.**

A larger EFSI: As indicated above, the EFSI SME Window is already significantly used. As a redistribution of the resources from the Infrastructure and Innovation Window to replenish the SME one is imminently undesirable, the solution would be **an increase of the EFSI size**. Given a political decision, either a reallocation of resources between different headings and/or usage of any existing "margins" in the Multiannual Financial Framework (MFF) could potentially allow for **several billion euros** to be added to the EFSI – both in terms of its guarantees and possibly also as grants. Of course, the existing constraints and competing priorities in the EU budget (MFF), would need to be carefully considered in this scenario, as would the need to preserve the distinct features of EFSI as a tool.

A "permanent" EFSI: Ways could be explored to turn the EFSI into a more permanent structure, maintaining its market-based approach, possibly within the EIB (thereby capitalising on the changes already brought about by it).

Conclusions

Investments in the EU are picking up and EFSI's approach to stimulate private investments has succeeded, judged by the market's use of the instrument. In this way EFSI has helped address important constraints to investment, and therefore growth in the EU – one of the key priorities of the Juncker Commission.

Taking stock of EFSI half-way could offer a good opportunity to evaluate and ask whether the positive experience to date merits considering an extension or increase of the instrument.

Notes

1. See IMF, "World Economic Outlook", Spring 2015.
2. The EIB financing for EFSI SME Window is provided by the European Investment Fund (EIF), a part of the EIB group.
3. The EIPP has not yet been formally launched. There is also a global dimension to this initiative, namely as part of the G20 discussions on infrastructure investment.