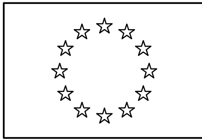

EUROPEAN COMMISSION
DIRECTORATE-GENERAL
REGIONAL POLICY

GUIDANCE NOTE ON FINANCIAL ENGINEERING

DISCLAIMER:

"This is a Working Document prepared by the Commission services. On the basis of the applicable Community Law, it provides technical guidance to the attention of public authorities, practitioners, beneficiaries or potential beneficiaries, and other bodies involved in the monitoring, control or implementation of the Cohesion policy on how to interpret and apply the Community rules in this area. The aim of the working document is to provide Commission's services explanations and interpretations of the said rules in order to facilitate the implementation of operational programmes and to encourage good practice(s). However this guidance is without prejudice to the interpretation of the Court of Justice and the Court of First Instance or evolving Commission decision making practice."

This note has been prepared by the Directorates-General for Regional Policy and for Employment, Social Affairs and Equal Opportunities, in consultation with other Commission services.

The note sets out the reading that the Commission services will give to the issues set out in the note in their dealings with Member States. It should be read together with COCOF note COCOF/07/0018/01 of 16 July 2007. Section A of the note provides guidance on contributions to holding funds, other financial engineering instruments and enterprises, PPPs or other urban projects. Section B provides guidance on other issues related to the implementation of financial engineering that have been raised by Member States.

A. Contributions to holding funds, other financial engineering instruments and enterprises, public private partnerships (PPPs) and projects

1) Level 1: Selection of a holding fund under Article 44 of Regulation (EC) No 1083/2006

1.1. Selection of the EIB/EIF as a holding fund

The mandate which the EIB or EIF may be given by Member States or managing authorities to act as a holder of holding funds under Article 44(b)(i) is not subject to public procurement rules. The reasons for this are set out below.

The relationship between the EIB and its members, i.e. the Member States, is governed by primary law in an exclusive, self-contained and institutional manner. Thus, as a result in the present context, market related public procurement rules do not apply within this privileged relationship. If and when Member States and/or their designated authorities wish to call on the EIB's financing facilities, they may do so without having to observe the procedures set out in Directive 2004/18/EC. Conversely, if and when the EIB wishes to offer its financial facilities to the Member States and/or their designated authorities, it may do so without having to follow procedures launched under Directive 2004/18/EC before being allowed to conclude financing agreements.

Article 159, first subparagraph, EC Treaty empowers the Community to support the achievement of the objectives set out in Article 158 by actions which it takes, inter alia, through the European Investment Bank. The EIB may thus be mandated by the Community to assume special financial tasks in support of economic and social cohesion.

By designating the EIB as a potential holder of holding funds in Article 44(b) of Regulation (EC) No 1083/2006, the legislator has mandated the EIB to assist interested Member States and/or their designated authorities in the implementation of specific financial engineering instruments designed to support economic and social cohesion throughout the 2007-2013 programming period. The detailed rules concerning these financial engineering instruments and the additional provisions applicable to holding funds are set out in Articles 43 to 46 of Commission Regulation (EC) No 1828/2006.

Among the latter rules, Article 44(1) of Regulation (EC) No 1828/2006 requires the interested Member State or managing authority to conclude a funding agreement with the holding fund, which shall, inter alia, set out the "terms and conditions for contributions from the operational programme to the holding fund". It is up to the parties to the funding agreement how the holding fund will be organised and what level of control or supervision the managing authority will retain over the activities of the holding fund. As public procurement rules do not apply to the mandate given to the EIB or EIF in the funding agreement, it will not be

necessary to establish whether the funding agreement is a public procurement contract within the meaning of Article 1 of Directive 2004/18/EC and Article 1 of the Directive 2004/17/EC.

The foregoing also applies, *mutatis mutandis*, to holding funds held by the European Investment Fund (EIF). Indeed, The EIF has its legal basis under primary Community law in Article 30 of the Statute of the European Investment Bank. It was established by the Board of Governors of the EIB through the approval of its Statutes on 14 June 1994, as amended on 19 June 2000[1]. Its tasks are set out in Article 2 of these Statutes and comprise its contribution "to the pursuit of Community objectives". As another "existing Financial Instrument" it is being referred to in Article 159, first subparagraph, EC Treaty, alongside the EIB. Likewise, it is mentioned alongside the EIB in Article 44(b) of Regulation (EC) No 1083/2006

1.2. Selection of a financial institution other than the EIB or EIF as a holding fund

A financial institution other than the EIB or EIF may be chosen as a holding fund either by way of public procurement or by way of a grant, without a call for proposal if this is pursuant to a national law compatible with the Treaty.

A number of factors distinguish a grant from a public procurement. A public procurement contract is defined in Article 1 of Directive 2004/18/EC and Article 1 of the Directive 2004/17/EC.

In general, a public contract will have the following features:

- a product or service is procured, by a contracting authority (or entity) for needs falling within its remit in return for consideration (i.e., price or other consideration);
- the terms of the service or product are set out in detail by the contracting authority in the tender documents;
- the successful tenderer will be contractually bound to comply with the terms of the award;
- the contracting authority or entities will normally bear 100% of the contract consideration;
- the contract is bilateral: it imposes reciprocal obligations on the contracting authority and the product or service provider, with the latter providing the contracting authority or a third party or parties designated by it with the product or service it has ordered. The contracting authority monitors provision of the product or service it has ordered;
- the result of a procurement procedure is a contract.

In general, a grant will have the following features:

- a contribution is made either to an action or project carried out by a grantee which falls primarily within the scope of the grantee's activities or direct to the grantee because its activities contribute to policy aims of the grantor, such action or project of the grantee normally being in the interest of the grantor;
- the application for financing originates with the grantee, who submits a proposal for support for activities it is carrying out or plans to carry out; its proposal sets out the specifications for the action to be performed, which may be within a pre-set legal or other framework laid down in advance by the grantor;

[1] OJ C 225 of 10 August 2001, p. 2.

- ownership will normally remain with the grantee, although it is possible in some cases for the financial contribution to revert to the grantor at the end of an action;
- the grant does not necessarily finance the total cost of the action;
- the financial contribution of the grantor should not be in consideration of any product or service provided by the grantee to the grantor;
- conditions can be attached to the grant awarded, but there is no direct and specific link between individual obligations on either side (grantor and grantee), although the grantor has the right to monitor technical implementation of the action and the use made of the funds granted;
- the grant must not have the purpose or effect of producing a profit for the grantee;
- the outcome of a grant award procedure is a grant agreement or a grant decision.

National authorities will have to ascertain, on a case-by-case basis, whether the structure they are planning to implement is a grant or a public procurement and it is their responsibility to comply with any and all applicable laws.

2) Level 2: Contributions to financial engineering instruments other than holding funds

Managing authorities and holding funds must assess whether their contribution to a financial engineering instrument such as venture capital, loan, guarantee or urban development fund is a public procurement of services governed by EC or national public procurement law and comply with any such applicable law. The conditions for contributions to financial engineering instrument other than holdings funds are set out in Article 43 of Regulation 1828/2006, and they are further explained in point 2(b) of COCOF note COCOF/07/0018/01 of 16 July 2007.

They must also comply with any applicable State aid rules concerning such contributions (see point 3 of the COCOF note COCOF/07/0018/01 of 16 July 2007). Article 43(7) of Regulation (EC) No 1828/2006 requires managing authorities to "*take precautions to minimise distortion of competition in the venture capital or lending markets*", and sets out how returns from equity investments and loans may be used (see point 3 below).

Where a non-repayable contribution is given to a financial engineering instrument, the managing authority should ensure that interest generated and resources returned to the financial engineering instrument will be re-used by the instrument for the benefit of urban development projects or of enterprises.

3) Level 3: Recycling of Contributions to Enterprises, PPPs and Projects

Pursuant to Article 43(1) of Regulation (EC) No 1828/2006, the provisions on financial engineering of that Regulation apply to "*financial engineering instruments in the form of actions which make repayable investments or provide guarantees for repayable investments*" in enterprises, public private partnerships or other urban projects included in integrated plans for sustainable urban development.

To qualify as financial engineering under that Regulation and under Regulation (EC) No 1083/2006, it is therefore necessary that the contribution to the enterprises, public private partnerships or other urban projects is not in the form of a non-repayable contribution, but as a repayable investment or a guarantee for a repayable investment. The intention of the legislator is clear, that resources returned should be re-used for the benefit of urban development projects or of enterprises.

Indeed, Article 78(7) of Regulation (EC) No 1083/2006 expressly provides that "*resources returned to the operation from investments undertaken by funds as defined in Article 44 or left over after all guarantees have been honoured shall be reused by the competent authorities of the Member State concerned for the benefit of urban development projects or of small and medium sized enterprises*". For loan and venture capital funds, the resources returned include interest and loan repayments and capital gains.

Any private contribution to an operation or a financial engineering instrument should be returned to the private entity that contributed it, and not to the competent public authority of the Member State. Indeed, Article 43(7) of Regulation (EC) No 1828/2006 provides that *"returns from equity investments and loans, less a pro rata share of the management costs and performance incentives, may be allocated preferentially to investors operating under the market economy investor principle … and they shall then be allocated proportionally among all co-financed partners or shareholders*."

It is recommended that returned resources be re-used in the region(s) covered by the operational programme and that re-use should be through financial engineering instruments, with a view to ensuring further leverage and recycling of public money.

The funding agreement between the managing authority and the financial engineering instrument must, further to Article 43(6) of Regulation (EC) No 1828/2006, include an exit policy for the contribution from the operational programme out of the venture capital, loan, guarantee or urban development fund. Similarly, further to Article 44(2) of the same Regulation, an exit policy for the holding fund out of the venture capital, loan, guarantee or urban development fund must be included in the funding agreement between the managing authority and the holding fund.

B. Other implementation issues related to financial engineering

1) Possibility to combine interest subsidies and financial engineering instruments

Contributions from operational programmes may co-finance repayable investments such as loans which are combined with interest subsidies in a single financing package. In such cases, interest subsidies may be considered to be a part of the financial engineering instrument and of the repayable investment, in the sense of Article 44 and 78(6) of Regulation (EC) No 1083/2006 and Article 43(1) of Regulation (EC) No 1828/2006.

National authorities must comply with applicable state aid rules.

2) Integrated urban development plans

The Structural Funds regulations for the period 2007-2013 do not include a definition of, or specific requirements for, an "integrated plan for sustainable urban development". Consequently, these should be defined by Member States and managing authorities, taking account of Article 8 of Regulation (EC) No 1080/2006 and the specific urban, administrative and legal context of each region.

Section 2.1 of the Community Strategic Guidelines on Cohesion 2007-13[2] is helpful in this respect. It specifies that "*the preparation of a medium- to long-term development plan for sustainable urban development is generally a precondition for success as it ensures the coherence of investments and of their environmental quality. This will also help to secure the commitment and participation of the private sector in urban renewal. In general, a multi-disciplinary or integrated approach is needed. For area-based actions, for example, to promote social inclusion, this requires that actions seeking to improve the quality of life (including the environment and housing) or the level of services to citizens are combined with actions to promote the development of new activities and job creation in order to secure the long-term future of the areas concerned. The new JESSICA initiative is designed to promote and facilitate the development of financial engineering products to support projects included in integrated urban development plans. In general, integrated support services and programmes should have a focus on those groups which are most in need, such as immigrants, young people and women. All citizens should be encouraged to participate in both the planning and delivery of services.*"

3) Audit trail for contributions from operational programmes to urban development funds investing in projects which include components that are not eligible for the Structural Funds

It is possible that public private partnerships or other urban projects in which urban development funds invest include components that would not be eligible for Structural Funds assistance.

To ensure a clear audit trail allowing expenditure eligible under the Structural Funds to be distinguished from ineligible expenditure, urban development funds must maintain a separate accounting system or use a separate accounting code for co-financed expenditure down to the final level of the project. There should be clear identification of the capital contributed from each operational programme to the urban development fund and the expenditure which is eligible under the Structural Funds, to permit verification that any expenditure declared to the Commission is eligible under the Structural Funds regulations for 2007-2013 and under applicable national eligibility rules. An adequate audit trail is necessary for reporting and audit purposes, in accordance with Article 60 (c), (d) and (f) and Article 90 of Regulation (EC) No 1083/2006 and Article 15 of Regulation (EC) No 1828/2006.

[2] Council Decision of 6 October 2006 on Community strategic guidelines on cohesion (2006/702/EC), OJ L291 of 21.10.2006.

4) Interaction between rules on revenue-generating projects and financial engineering under Article 44 of Regulation (EC) No 1083/2006

4.1. Financial engineering instruments and investments by urban development funds in PPPs

Recital 26 of Regulation (EC) No 1828/2006 acknowledges that contributions to financial engineering instruments from an operational programme or other public sources as well as the investments made by them in individual enterprises are subject to rules on State aid. Where a contribution or investment is subject to State aid rules, it will not be subject to paragraphs 1 to 5 of Article 55 of Regulation 1083/2006, by virtue of Article 55(6) of the same Regulation[3].

The following four paragraphs refer to contributions and investments where State aid is not present.

The financial profitability of the project is vital for the purposes of Article 55 in determining whether any Community contribution should be provided and, if so, the *level* of the contribution to be provided. As recalled in COCOF note on revenue generating projects, "financial profitability", within the meaning of Article 55, is the ability of a project to generate additional resources (i.e., profits), independently of *how* the project is financed. If a project is economically viable or profitable without a contribution from the Funds, application of Article 55 will mean that no contribution from the Funds should be made to it.

By contrast, the very aim of financial engineering operations is to provide financial support through financial engineering instruments to enterprises and public-private partnerships (PPP) and urban development projects, and for such financial support to be repaid, with interest or with a gain, so that resources returned can be re-used for the benefit of enterprises, PPPs or projects. There are even specific rules on how resources returned from financial engineering operations should be re-used (see Article 78(7) of Regulation (EC) No 1083/2006 and 43(7) of Regulation (EC) No 1828/2006).

Thus, instead of applying the rationale in paragraphs 1 to 5 of Article 55 to financial engineering operations, which would have entailed a reduction in the financing given by the amount of any resulting interest or gain, the legislator has set out a specific regime for such operations which instead involves resources returned being re-used to finance other enterprises, PPPs or projects. Indeed, there is a presumption that the target investments to which finance is provided (enterprises, PPPs or projects) will be economically viable overall, and Article 43(2) of Regulation 1828/2006 requires an assessment of the economic viability of the investment activities of the financial engineering instrument[4]. The profitability of financial engineering support is thus relevant to the decision to make the contribution to an enterprise, PPP or project but is not a determining factor when establishing the *level* of that contribution from the Funds, as is the case for projects subject to paragraphs 1 to 5 of Article 55.

Applying paragraphs 1 to 5 of Article 55 to financial engineering operations, whereby finance in the form of equity, loans or guarantees is provided to an enterprise, PPP or project, would

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[3] Article 55(6) excludes from the application of paragraphs 1 to 5 of Article 55 projects which are subject to State aid rules.

[4] Article 45 of the same Regulation goes further in providing that investments shall only be made in activities "*the managers of the financial engineering instruments judge potentially economically viable.*" It further provides that investments shall not be made in firms in difficulty.

thus undermine their very purpose by reducing the financial support available to potentially economically viable enterprises, PPPs and projects.

For these reasons, paragraphs 1 to 5 of Article 55 of Regulation (EC) No 1083/2006 do not apply to financial engineering within the meaning of Article 44 of Regulation 1083/2006 and Section 8 of Regulation (EC) No 1828/2006.

Annex

COMMISSION SERVICES REPLIES TO THE QUESTIONS SUBMITTED BY THE JESSICA EXPERT WORKING GROUP OF MEMBER STATES

Question 1: Combination of ERDF and ESF in the case of financial engineering -Article 34(2) Reg. (EC) 1083/2006

Integrated urban development actions are likely to need interventions which could be financed under both ERDF and ESF, for example actions covering remediation of land; development of business premises; training support for entrepreneurs etc. We presume therefore that both ERDF and ESF can support JESSICA type financial instruments and the 10% modulation facility of Article 34, 2 could also be used at the level of a JESSICA fund.

Reply

Urban development funds may receive contributions from operational programmes co-financed either by the ERDF or by the ESF. In this respect, it should be recalled that contributions from operational programmes to financial engineering instruments are subject to the provisions on the scope of intervention of each Fund, laid down by Regulation (EC) No 1080/2006 for the ERDF and Regulation (EC) No 1081/2006 for the ESF.

The possibility offered by Article 34(2) of Regulation 1083/2006 for both the ERDF and the ESF to finance actions falling within the scope of assistance of the other Fund, in a complementary manner and subject to a limit of 10% of Community funding for each priority axis of an operational programme, can be used in respect of urban development funds. In this regard, it should be recalled that the third paragraph of Article 8 of Regulation (EC) No 1080/2006 permits the 10% to be increased to 15% of the programme or priority axis concerned in the context of ERDF funding of measures under the Regional competitiveness and employment objective in respect of sustainable urban development.

Where an urban development fund receives support from more than one operational programme, keeping separate accounting for contributions from each operational programme to financial engineering instruments-urban development funds is necessary, as indicated in the last paragraph of point 1a) of COCOF note 07/0018.

Question 2: Article 44 Reg. (EC) 1083/2006 and compliance with EU and national public procurement legislation

Question 2.1: Operations financed by the Funds shall comply with the provisions of the Treaty and of acts adopted under it, Article 9, 5 Regulation (EC) 1083/2006 esp. with procurement law and State aid provisions. When operations are organised through holding funds the Managing Authority shall – under certain conditions – implement them through the award of a grant to a financial institution without a call for proposal (Article 44, 2 b ii).

As there is no provision in the regulation for the case that operations are not organised through holding funds the question turns up if in this case the Managing Authority could also award a grant to a financial institution for implementing and running an Urban Development Fund?

Reply

The managing authority is responsible for assessing whether the contribution it intends to give to a financial institution is a public procurement of services governed by EC or national public procurement law and comply with any such applicable law. Where public procurement law is not applicable, and if there is no holding fund, a managing authority can award a grant to a financial institution for implementing and running an urban development fund. In this case, the managing authority must ensure that all applicable laws are complied with, including State aid rules and national legislation on grants.

Question 2.2: As without the existence of an urban development fund a Managing Authority could always award ERDF loans to urban development projects, e. g. by mandating its public bank without a tendering procedure, we presume that is also possible in the framework of an UDF. In this case, the agreement would also – comparable to the conditions mentioned in Article 44 for holding funds - not be a public service contract and the Managing Authority would give a donation to the public bank.

Reply

Article 43(3) of Regulation (EC) No 1828/2006 provides that "financial engineering instruments, including holding funds, shall be set up as independent legal entities governed by agreements between the co-financing partners or shareholders or as a separate block of finance within a financial institution". This provision means that a separate block of finance within a financial institution such as a bank, can be a financial engineering instrument (it is recalled in this respect that urban development funds are also financial engineering instruments, as is made clear by Article 43(1)(b) of Regulation (EC) No 1828/2006).

A contribution from an operational programme to a financial engineering instrument, which may take the form of a loan, with a view to the subsequent financing of repayable investments in enterprises or urban projects, may be considered as an "operation" within the meaning of Article 2(3) of Regulation (EC) No 1083/2006, provided that the provisions of Articles 44 and 78(6) and 78(7) of Regulation (EC) No 1083/2006, and Articles 43-46 of Regulation (EC) No 1828/2006, are respected (see also COCOF note I on financial engineering 2007/0018, point 1a).Concerning the question of the award of a grant by the managing authority to a financial engineering instrument, including banks, please see the reply to the previous question 2.1.

<u>Question 2.3:</u> Is a tendering procedure required for the selection of private partners in publicly created UDF's, without the existence of a Holding Fund?

<u>Reply</u>
The selection of private partners in financial engineering instruments, including urban development funds, created on the initiative of public entities may correspond to the procurement of public services. Member States and managing authorities must assess this, and comply with applicable legislation. **Article 44 of Regulation 1083/2006 should not be read as meaning that where holding funds are not used to organise financial engineering instruments, there is no obligation to comply with applicable public procurement law.**

<u>Question 2.4:</u> Are there further pertinent Community regulations to be observed?

<u>Reply</u>
Applicable Community and national law must be respected. The law applicable will depend on the operations being envisaged.

<u>Question 3: Integrated Urban Development Plan under Article 44 of Reg. (EC) 1083/2006</u>
Article 44 states that projects supported by the new financial instruments shall be included in an integrated plan for sustainable urban development. Are there any requirements on EU level concerning the content and the degree of detail of integrated urban development plans? Could one recur to the term of integrated urban development plans used in the URBAN framework? We expect that, if an UDF is established for a specific Urban Development Plan, its activity could also be limited to a specific area of a city within the Plan.

<u>Reply</u>
The second note to COCOF on Financial Engineering, point **B. 2) Integrated urban development plans**, states that:

"*The Structural Funds regulations for the period 2007-2013 do not include a definition of, or specific requirements for, an "integrated plan for sustainable urban development". Consequently, these should be defined by Member States and managing authorities, taking account of Article 8 of Regulation (EC) No 1080/2006 and the specific urban, administrative and legal context of each region.*
Section 2.1 of the Community Strategic Guidelines on Cohesion 2007-13 is helpful in this respect. It specifies that "the preparation of a medium- to long-term development plan for sustainable urban development is generally a precondition for success as it ensures the coherence of investments and of their environmental quality. This will also help to secure the commitment and participation of the private sector in urban renewal. In general, a multi-disciplinary or integrated approach is needed. For area-based actions, for example, to promote social inclusion, this requires that actions seeking to improve the quality of life (including the environment and housing) or the level of services to citizens are combined with

actions to promote the development of new activities and job creation in order to secure the long-term future of the areas concerned. The new JESSICA initiative is designed to promote and facilitate the development of financial engineering products to support projects included in integrated urban development plans. In general, integrated support services and programmes should have a focus on those groups which are most in need, such as immigrants, young people and women. All citizens should be encouraged to participate in both the planning and delivery of services."
If an urban development fund is established for a specific Urban Development Plan, its activity can be limited to a specific area of a city within the Plan.

Question 4: Article 53(4) of Regulation (EC) 1083/2006 , Co-financing rates for the assistance from the Structural Funds

When creating an UDF the full amount of capital shall in principle first be financed by the MS or private investors and then be included in a statement of expenditure in order to get the structural funds money. Anyhow, Article 53, 4 accepts under certain conditions a 100% ERDF financing. We assume that this provision would also apply in case of JESSICA type financial instruments.

Reply

Article 53(4) of Regulation (EC) No 1083/2006 is applicable to financial engineering under Article 44 of Regulation (EC) No 1083/2006.

Question 5: Financial engineering and Article 55 of Regulation (EC) 1083/2006 about Revenue-generating Projects

Article 55 stipulates that in case of revenue-generating projects the eligible expenditure shall not exceed the current value of the investment cost less the current value of the net revenue from the investment (e.g. a toll bridge). In case of JESSICA type financial instruments an obligation to deduct revenues from the investment would impede the financial sustainability of the fund and be contradictory to the idea of JESSICA. We assume therefore that – as COM recently confirmed to the German Land Brandenburg - Article 55 does not apply to financing of urban development funds.

Reply

Point **B.4) Interaction between rules on revenue-generating projects and financial engineering under Article 44 of Regulation (EC) No 1083/2006** of the second note to COCOF on Financial Engineering states that:
"*4.1Financial engineering instruments and investments by urban development funds in PPPs*
Recital 26 of Regulation (EC) No 1828/2006 acknowledges that contributions to financial engineering instruments from an operational programme or other public sources as well as the investments made by them in individual enterprises are subject to rules on State aid. Where a contribution or investment is subject to State aid rules, it will not be subject to

paragraphs 1 to 5 of Article 55 of Regulation 1083/2006, by virtue of Article 55(6) of the same Regulation[5]*.*
The following four paragraphs refer to contributions and investments where State aid is not present.
The financial profitability of the project is vital for the purposes of Article 55 in determining whether any Community contribution should be provided and, if so, the level of the contribution to be provided. As recalled in COCOF note on revenue generating projects, "financial profitability", within the meaning of Article 55, is the ability of a project to generate additional resources (i.e., profits), independently of how the project is financed. If a project is economically viable or profitable without a contribution from the Funds, application of Article 55 will mean that no contribution from the Funds should be made to it.
By contrast, the very aim of financial engineering operations is to provide financial support through financial engineering instruments to enterprises and public-private partnerships (PPP) and urban development projects, and for such financial support to be repaid, with interest or with a gain, so that resources returned can be re-used for the benefit of enterprises, PPPs or projects. There are even specific rules on how resources returned from financial engineering operations should be re-used (see Article 78(7) of Regulation (EC) No 1083/2006 and 43(7) of Regulation (EC) No 1828/2006).
Thus, instead of applying the rationale in paragraphs 1 to 5 of Article 55 to financial engineering operations, which would have entailed a reduction in the financing given by the amount of any resulting interest or gain, the legislator has set out a specific regime for such operations which instead involves resources returned being re-used to finance other enterprises, PPPs or projects. Indeed, there is a presumption that the target investments to which finance is provided (enterprises, PPPs or projects) will be economically viable overall, and Article 43(2) of Regulation 1828/2006 requires an assessment of the economic viability of the investment activities of the financial engineering instrument[6]*. The profitability of financial engineering support is thus relevant to the decision to make the contribution to an enterprise, PPP or project but is not a determining factor when establishing the level of that contribution from the Funds, as is the case for projects subject to paragraphs 1 to 5 of Article 55.*
Applying paragraphs 1 to 5 of Article 55 to financial engineering operations, whereby finance in the form of equity, loans or guarantees is provided to an enterprise, PPP or project, would thus undermine their very purpose by reducing the financial support available to potentially economically viable enterprises, PPPs and projects.
For these reasons, paragraphs 1 to 5 of Article 55 of Regulation (EC) No 1083/2006 do not apply to financial engineering within the meaning of Article 44 of Regulation 1083/2006 and Section 8 of Regulation (EC) No 1828/2006."

[5] Article 55(6) excludes from the application of paragraphs 1 to 5 of Article 55 projects which are subject to State aid rules.

[6] Article 45 of the same Regulation goes further in providing that investments shall only be made in activities "*the managers of the financial engineering instruments judge potentially economically viable.*" It further provides that investments shall not be made in firms in difficulty.

Question 6: Re-use of resources returned to operations under Article 78 (7) of Regulation (EC) 1083/2006

Question 6.1 Interest generated by payments from OPs to funds as defined in Art 44, shall be used to finance urban development projects. Resources returned to the operation shall be reused by the competent authorities of the Member States concerned for the benefit of urban development projects.
Since it is stated that interest can be used to "finance urban development projects" we take this to also include any form of expenditure necessary to prepare projects for financing, such as feasibility studies, obtaining planning consents, and other such technical assistance expenditures related to the structuring of the project or the financing thereof, and which are defined at national level as eligible expenditure in accordance with Article 56.4 of the same Regulation. Does the COM agree with this interpretation?

Reply
The first subparagraph of Article 78(7) of Regulation (EC) No 1083/2006 lays down that interest generated by payments from operational programmes to urban development funds shall be used to finance urban development projects. The Commission services agree that Article 56(4) of Regulation (EC) No 1083/2006, providing that the rules on the eligibility of expenditure shall be laid down at national level, is applicable in this case too.
We also recall the COCOF note II on financial engineering, point A(3) fifth paragraph of which recommends that:
"It is recommended that returned resources be re-used in the region(s) covered by the operational programme and that re-use should be through financial engineering instruments, with a view to ensuring further leverage and recycling of public money."

Question 6.2: We assume that the "competent authorities" need not be the Managing Authorities.

Reply
The "competent authorities of the Member States" referred to in the second paragraph of Article 78(7) of Regulation (EC) No 1083/2006 need not be managing authorities and can be other national authorities.

Question 6.3: Resources returned to the fund must be re-used for the benefit of urban development projects. Anyhow, as COM confirmed to the German Land Brandenburg, we assume that these resources need not to be reinvested in the geographical area of the OP and need not to conform with ERDF Regulations again.

Reply
Paragraphs 3 and 5 of point **A.3) Level 3: Recycling of Contributions to Enterprises, PPPs and Projects** of the second note to COCOF on Financial Engineering state that:

"...Article 78(7) of Regulation (EC) No 1083/2006 expressly provides that "resources returned to the operation from investments undertaken by funds as defined in Article 44 or left over after all guarantees have been honoured shall be reused by the competent authorities of the Member State concerned for the benefit of urban development projects or of small and medium sized enterprises".
[...]
It is recommended that returned resources be re-used in the region(s) covered by the operational programme and that re-use should be through financial engineering instruments, with a view to ensuring further leverage and recycling of public money."

Question 6.4: Where co-financing is being provided from national private sector or other "external" sources, it would be inappropriate to assume that the amount repaid would be required to be "reused" by the competent authorities. We presume that the reuse provisions outlined above would only apply to the amounts contributed by the Managing Authority to the urban development fund and not to a private co-financing.

Reply
Point **A.3) Level 3: Recycling of Contributions to Enterprises, PPPs and Projects** of the second note to COCOF on Financial Engineering, in particular its paragraph 4, states that:
"*Any private contribution to an operation or a financial engineering instrument should be returned to the private entity that contributed it, and not to the competent public authority of the Member State. Indeed, Article 43(7) of Regulation (EC) No 1828/2006 provides that "[r]eturns from equity investments and loans, less a pro rata share of the management costs and performance incentives, may be allocated preferentially to investors operating under the market economy investor principle … and they shall then be allocated proportionally among all co-financed partners or shareholders*."

Question 6.5: At what point can a contribution from the Structural Funds, which has been invested by the fund in a project, be returned from the fund to the competent authority to be re-used for urban development projects? (After the end of the Structural funds Period in 2013? After a closure of the Fund, irrespective of whether this takes place before or after the end of 2013? At the time and to the extent that a given amount flows back from a project to the fund?)

Reply
Point **A.3) Level 3: Recycling of Contributions to Enterprises, PPPs and Projects** of the second note to COCOF on Financial Engineering, in particular its paragraph 6, states that:
"The funding agreement between the managing authority and the financial engineering instrument must, further to Article 43(6) of Regulation (EC) No 1828/2006, include an exit policy for the contribution from the operational programme out of the venture capital, loan, guarantee or urban development fund. Similarly, further to Article 44(2) of the same Regulation, an exit policy for the holding fund out of the venture capital, loan, guarantee or

urban development fund must be included in the funding agreement between the managing authority and the holding fund."

It is for the parties to the funding agreements to determine the exact time when returns to funds can be returned to the competent authority to be re-used for urban development projects. It would be reasonably expected that this would happen at the closure of the fund. In this way it could be ensured that during the entire period of the life of the fund finance is made available to PPPs and other urban development projects (or to enterprises, in the case of venture capital, loan or guarantee funds).

Question 7: Article 7, 1b of Regulation 1080/2006 – Purchase of Land

According to Article 7, 1b of the Regulation 1080/2006 the purchase of land for an amount exceeding 10% of the total eligible expenditure for the operation concerned shall not be eligible for a ERDF contribution. Does this regulation also apply if urban development funds give loans to enterprises purchasing land or invest in those enterprises?

Reply

Article 7(1)(b) of Regulation (EC) No 1080/2006 is applicable to the investments by means of equity, loans or guarantees made by urban development funds, where the latter use resources contributed by operational programmes to invest in PPPs or other urban projects. In this respect, the definition of an operation in financial engineering is relevant, and reference should be made to point 1a) of COCOF note 07/0018/01 of 16 July 2007.

Question 8: Article 8 of Regulation 1080/2006 and Commercial Projects

The ERDF may, where appropriate, support the development of participative, integrated and sustainable strategies to tackle the high concentration of economic, environmental and social problems affecting urban areas. These strategies shall promote sustainable urban development through activities such as: strengthening economic growth, the rehabilitation of the physical environment, brownfield redevelopment etc. We assume that consequently also commercial projects like shopping malls, offices, hotels etc. would be eligible.

Reply

Investments by urban development funds by means of equity, loans or guarantees in commercial projects, such as shops, offices, entertainment, cultural and sport facilities, may be eligible for contributions from operational programmes co-financed by the ERDF, provided that such commercial projects: a) are part of an integrated urban strategy as described in Article 8 of Regulation (EC) No 1080/2006, b)they comply with the Structural Funds legislation, and c) they comply with national eligibility rules within the meaning of Article 56(4) of Regulation (EC) No 1083/2006.

Question 9: Article 43, 4b of the Regulation 1828/2006 – Management Costs

Is it possible to agree a fixed rate for management costs (e.g. 3% of final investment) without the need for the management to prove the real management costs?

Reply

There is no express provision in the Structural Funds Regulations on the use of a fixed percentage for management costs of financial engineering instruments and holding funds. Reference should be made by the contracting parties to applicable national eligibility rules in this respect.

If the holding fund or financial institution is chosen through a public procurement procedure, it is up to the parties to fix the rate and regard does not need to be had to precise and detailed management costs.

Where, however, the contribution from operational programmes is given as a grant (other than to the EIB or EIF), the presence of a profit may indicate that it is a public procurement and not a grant (see point 1.2 of COCOF II Note on financial engineering).

For example, Commission services have considered the following categories of costs of financial engineering instruments or holding funds as eligible management costs compatible with the principles of sound and efficient management, in the past:

- Staff costs, including travel and subsistence expenses, the cost of offices, equipment, IT systems, consumables and supplies, directly linked to the management and investment of contributions from operational programmes to financial engineering instruments and holding funds; such costs being incurred in carrying out activities such as selection and tendering procedures, controls, monitoring and reporting, consultancy, information and publicity.
- Overheads of the financial institution acting as a financial engineering instrument or holding fund in the management and investment of the contribution from the operational programme(s).

In any case, appropriate evidence should be kept by holding funds or financial engineering instruments, allowing them to demonstrate that management costs paid by operational programmes of the Structural Funds, effectively correspond to sound and efficient management principles.

In any event, the question of what constitutes eligible management costs is dealt with in the first instance by national rules pursuant to Article 56(4) of Regulation (EC) No 1083/2006.

Question 10: Article 43, 6c and Article 44, 2h and i of the Regulation 1828/2006 – Exit Rules and Winding Up provisions

The funding agreement between the Managing Authority and the UDF shall also include an exit policy for the contribution from the operational programme out of the financial engineering instrument. We understand that this would be the correct way to withdraw ERDF funds from the UDF if e.g. for certain reasons the investments to be financed by the fund can no longer be implemented. We assume that these funds would be used as if they had not been placed in the UDF and must be returned to the corresponding M.A.. (Financial assets which have not been spent at all must be returned to Structural Funds; if they have been spent they must be reinvested for urban development).

Reply

The requirement set out by Article 43(6) of Regulation (EC) No 1828/2006 regarding the inclusion of an exit policy in the funding agreement signed between a managing authority or the holding fund and a selected financial engineering instrument, concerns the definition of

the precise conditions for returning to the managing authority, or to another designated competent pubic authority, resources attributable to the public expenditure from an operational programme contributed and invested in financial engineering instruments, including any return earned by it, after one or more full cycles of investment in enterprises or urban projects have been made and completed by the financial engineering instrument.

The precise conditions for withdrawing resources attributable to public expenditure contributed from operational programmes to financial engineering instruments in cases of conflict between the managing authority and the financial engineering instrument or the holding fund, or in case of incapacity of the financial engineering instrument to carry out investments, etc, should also be included in the funding agreement.

Where the managing authority proceeds with a contribution from an operational programme to a holding fund or financial engineering instrument, but does not declare this expenditure to the Commission and hence does not receive a corresponding interim payment from the Structural Funds, the Commission services consider that it would not be irregular for the managing authority to withdraw resources from the holding fund or financial engineering instrument.

However, where the contribution from an operational programme to a holding fund or financial engineering instrument has been declared to the Commission and has been the subject of an interim payment from the Structural Funds, the Commission services would seriously discourage the contribution from the operational programme being withdrawn from the holding fund or financial engineering instrument save in exceptional and justified cases.

This view is taken because there could be serious risks of irregularities in such circumstances. Once the contribution has been paid from an operational programme to a holding fund or financial engineering instrument, and it has been included in a statement of expenditure submitted to the Commission, it will be considered as "expenditure" within the meaning of Article 78 of Regulation (EC) No 1083/2006, and will be reimbursed by the Commission. Where in such cases the contribution from an operational programme is later withdrawn from a holding fund or a financial engineering instrument, the Member State will have received an interim payment by the Commission for expenditure which *in fine* has not been spent in enterprises or urban projects. This may constitute an irregularity, unless the statement of expenditure is subsequently modified to withdraw the 'expenditure' in question.

There is also a question of whether any such withdrawal would comply with the principle of sound financial management. In particular, there is a risk that such a practice would result in an improper circumvention of the provisions of Article 93 of Regulation (EC) No 1083/2006 (n+2/n+3 decommitment rule).

For these reasons, the Commission services recommend that Member States or managing authorities instead proceed prudently, committing money from operational programmes to holding funds and financial engineering instruments in phases, with payment of contributions being dependent on effective investment in enterprises or urban projects.

Question 11: Winding up provisions in the case of holding funds

With respect to Holding Funds, winding up provisions might allow for Holding Funds to be wound up once all contributions from the OP to the Holding Fund have been used to finance Urban Development Funds. In such a case, the Holding Fund would be wound up by transferring their interests in the Urban Development Funds back to the relevant Managing Authority. This would be consistent with the notion that Holding Funds are only optional in the implementation of JESSICA and that Managing Authorities are allowed, themselves, to directly finance Urban Development Funds. Does the COM agree with this interpretation?

Reply

There is nothing in the Regulations to prevent a managing authority organising itself in this way, provided the terms of Regulation (EC) No 1828/2006 are respected.

Question 12: Article 46,1 COM Regulation (EC) No 1828/2006 – Limitation to one single Project

Article 46.1 states that "Where Structural Funds finance urban development funds, those funds shall invest in public private partnerships or other projects included in an integrated plan for sustainable urban development." There does not appear to be anything in the Regulations to say that an urban development fund can only use Structural Fund contributions to initially invest in a single project, or single project company, with the possibility of other projects being added to use the recycled money? Could you also confirm whether, as a result, either the Special Purpose Vehicle created for a project, or another entity that will invest in the Special Purpose Vehicle project company would qualify as an "urban development fund" within the meaning of the Regulations?

Reply

Article 44 of Regulation (EC) No 1083/2006 describes urban development funds as "funds investing in public private partnerships and other projects included in an integrated plan for sustainable urban development". Within the meaning of this provision, urban developments funds would in general be expected to invest in a number of PPPs or other urban projects. It cannot be excluded that an urban development fund invests initially exclusively in one project, and that it invests only at a later stage in other projects.

A Special Purpose Vehicle set out to invest exclusively in a single project may be considered to be an "urban development fund set out to invest in public private partnerships and other urban projects", provided it falls within the definition of an urban development fund in Article 44 of Regulation (EC) No 1083/2006, i.e., that it invests in PPPs or other projects included in an integrated plan for sustainable urban development, and that it does so in accordance with Regulation (EC) No 1828/2006.

Question 13: Mixed use projects

Scenarios can be envisaged where JESSICA funds will invest in mixed use projects, which would include housing development. Would this be ruled out because housing is not an eligible activity for funding under the structural funds outside the EU10? If so, this would

seem to limit the opportunities for investment into truly integrated projects. We therefore assume that the combination would be possible if the eligible parts are clearly separated from the non-eligible part (e.g. separate financial assets, accounts, controls etc.).

Reply

It is possible that public private partnerships or other urban projects in which urban development funds invest include components that would not be eligible for Structural Funds assistance.

To ensure a clear audit trail allowing expenditure eligible under the Structural Funds to be distinguished from ineligible expenditure, urban development funds must maintain a separate accounting system or use a separate accounting code for co-financed expenditure down to the final level of the project. There should be clear identification of the capital contributed from each operational programme to the urban development fund and the expenditure which is eligible under the Structural Funds, to permit verification that any expenditure declared to the Commission is eligible under the Structural Funds legislation and under applicable national eligibility rules. An adequate audit trail is necessary for reporting and audit purposes, in accordance with Article 60 (c), (d) and (f) and Article 90 of Regulation (EC) No 1083/2006 and Article 15 of Regulation (EC) No 1828/2006.

Question 14: In kind contributions paid by beneficiaries under Article 56(2) and financial engineering instruments under Article 44 of Regulation 1083/2006

How is Article 56(2) of Regulation 1083/2006 applicable to financial engineering and financial engineering instruments?

Reply

Article 56(2) of Regulation (EC) No 1083/2006 provides that under certain conditions, as listed in its points (a), (b) and (c) of that Article, in-kind contributions may be treated as expenditure paid by **beneficiaries** in implementing operations.

The note to COCOF nr 2007/00018 on financial engineering clarifies in its point (1b) the definition of "beneficiary" in the case of financial engineering, specifying that the beneficiary is the financial engineering instrument itself, or the holding fund, as the case may be. In the case of financial engineering in the urban context, the financial engineering instrument would be an urban development fund.

The first paragraph of Article 78(6) of Regulation (EC) No 1083/2006 allows for "provisional" eligibility of in-kind contributions by national authorities to urban development funds, while the "final" eligibility of such contributions will only be established at the partial or final closure of programmes, as set out in the second paragraph of Article 78(6) of Regulation (EC) No 1083/2006.

At closure of operational programmes it will, therefore, be necessary to establish whether the in-kind contributions declared to the Commission under the first paragraph of Article 78(6) of Regulation (EC) No 1083/2006 have been subsequently made by the beneficiary and are in compliance with Article 56(2) of Regulation (EC) No 1083/2006, Article 46(2) of Regulation (EC) No 1828/2006 and other relevant regulatory requirements.[7]

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[7] Art 56(2)(b) of Regulation (EC) No 1083/2006 provides that in case of in-kind contributions by beneficiaries, the justification of expenditure should be supported by accounting documents having a probative value equivalent to invoices. Article 56(2)(c) requires that in any case the contribution from the Structural Funds must not exceed the total eligible expenditure **excluding** the value of such in kind contributions by beneficiaries in

Question 15: the meaning of equity investment under Article 46 (2) of Regulation (EC) No 1828/2006

Article 46 (2) of Regulation (EC) No 1828/2006 states that: "urban development funds shall invest [in public private partnerships or other projects] by means of equity, loans or guarantees." It is our understanding that UDFs can be either financial investors or developers undertaking projects themselves. As a result, we interpret the term "equity investment" to mean any form of investment in projects which confers the full risks and rewards of ownership on the investor. An equity investment may therefore be in the form of either a financial investment in shares (or other similar financial instrument), or in the form of undertaking actual project expenditure, such as that incurred by project developers. In the case of the latter, the management cost ceiling of 3% p.a., as prescribed by Article 43 (4), should not include costs directly incurred in respect of implementing individual projects, such as the costs of obtaining planning consent, technical feasibility studies, project management expenses, etc. Please could you confirm that this is also the understanding of the Commission?

Reply

The notion of "equity" in Article 46(2) of Regulation (EC) No 1828/2006, providing that "urban development funds shall invest by means of equity, loans or guarantees", cannot be considered to extend beyond "shareholding". Management costs within the meaning of Article 43(4) of Regulation (EC) No 1828/2006, cannot include costs relating to the direct implementation of individual urban projects, such as the costs of obtaining planning consent, technical feasibility studies, project management expenses, etc.

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implementing operations. Article 46(2) of Regulation 1828/2006 provides that urban development funds shall invest by means of equity, loans or guarantees.