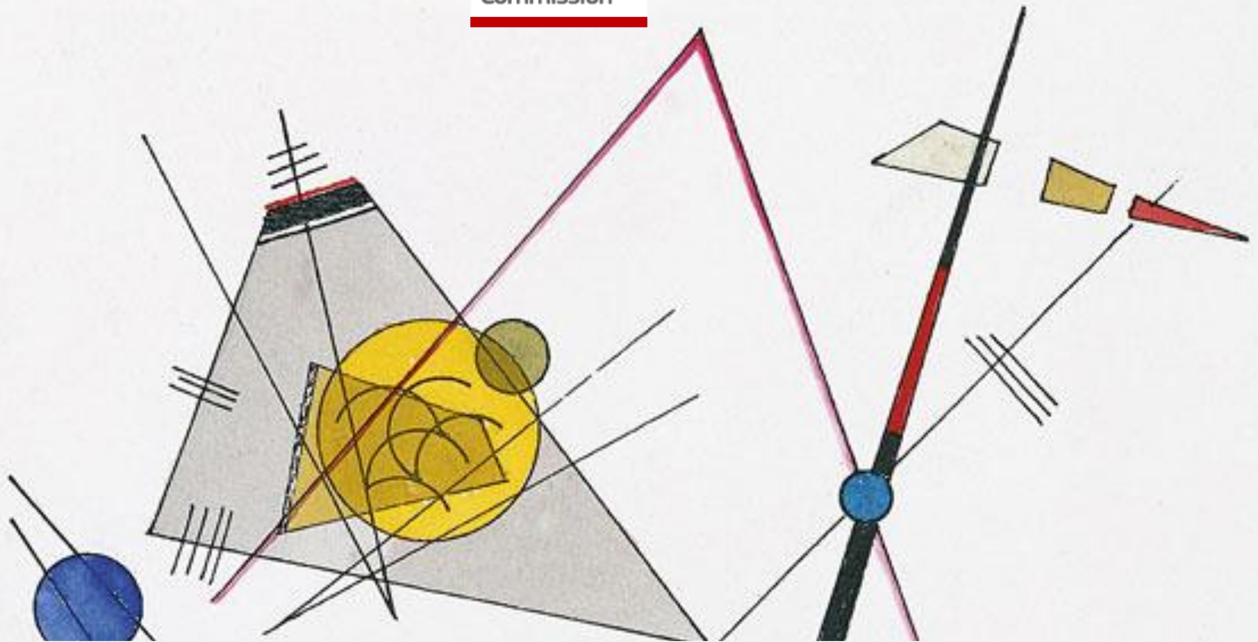


Expert evaluation network 2012

The use of the ERDF to support Financial Engineering Instruments

July 2012

Regional Policy

Expert evaluation network delivering policy analysis on the performance of Cohesion policy 2007-2013

2012

The use of the ERDF to support Financial engineering instruments

Synthesis Report

Terry Ward
Applica sprl

July 2012

A report to the European Commission
Directorate-General for Regional Policy

This report has been prepared by Terry Ward with support from Lydia Greunz and Sara Botti of Applica and Andrea Ciffolilli and Marco Pompili of ISMERI Europa. It is based on the country reports on the same theme produced by members of the Evaluation Network of national experts set up by DG Regional Policy and on the Literature Review of Financial Engineering Instruments produced by Marc Cowling of Exeter University. The author is grateful for comments from Kai Stryczynski and Veronica Gaffey of the Evaluation Unit of DG Regional Policy as well as from participants at the Steering Committee meeting in DG Regional Policy on 19 July. They and other officials in the European Commission, however, are in no way responsible for the views expressed which are entirely those of the author.

Cover: Wassily Kandinsky, "Zarte Spannung (Delicate tension, Tension délicate), 1923 (B. Acq. 638)"
© SABAM Belgium 2012

Contents

1. Introduction 1

2. The scale of ERDF support for FEIs 2

   Amount of funding involved 2

   Changes in ERDF support for FEIs over the 2007-2013 period 5

   The policy areas in which FEIs are used 7

   The use of FEIs in the light of the economic context 7

3. Rationale for using financial engineering instruments 10

   Reasons for not using FEIs 13

   The perceived costs of using FEIs 16

4. The implementation of ERDF-supported FEIs in practice 17

   Differences in the operation of ERDF-supported FEIs from private schemes 18

   Controlling the operation of Financial engineering schemes 20

   Problems in using FEIs 23

5. Evaluations of FEIs 26

   The situation across the EU as regards evaluations of FEIs 26

   The evidence on the effects of ERDF-supported FEIs 27

6. Main findings and future challenges 29

   Main findings 29

   Future challenges and lines of action 30

Annex The Rationale for ERDF support of FEIs - References to market failure in Operational Programmes and from interviews with Managing Authorities 32

Annex Table 34

The use of the ERDF to support Financial engineering instruments in the 2007-2013 programming period: Synthesis report

1. Introduction

The use of Financial engineering instruments (FEIs) as a means of providing support through the Structural Funds has been increasingly encouraged by the European Commission over recent years and is set to be further prioritised in the next programming period. At the same time, the European Court of Auditors has recently produced a report on FEIs which was critical in a number of respects of the way that the ERDF was being employed to assist SMEs through these means[1]. Against this background, the purpose of the exercise which this report summarises was to obtain an informed overview of the use of the ERDF to co-finance FEIs, the rationale for Member States adopting this means of investment support and the way that the schemes set up are operating in practice. The national experts who form the independent evaluation network set up by DG Regional Policy to monitor the implementation and performance of Cohesion policy in the present programming period were, therefore, asked to examine and report on these issues in their own countries on the basis of published information and interviews with Managing Authorities in April-May 2012. This report synthesises the findings of the 27 national reports which were produced as a result. It examines in turn:

- the amount of financial resources from the ERDF for the 2007-2013 period allocated to FEIs, the policy areas concerned, the form which the instruments have taken and the extent to which their use has increased over the period;
- the rationale for using FEIs according to Member States as opposed to other more traditional and non-refundable means of support, and the benefits perceived from doing so;
- the differences in practice in the aims of ERDF-financed instruments and in the way they operate from wholly privately-financed instruments, the influence of national authorities over their operations and how their performance is assessed;
- the problems which have arisen over the deployment of ERDF support to finance FEIs and over the setting up of instruments;
- the extent to which evaluations of FEIs have been carried out and the results of those that have been undertaken.

In doing so, it draws on the Literature Review which was carried out to set the context for the national studies[2]. The Review summarises the existing state of knowledge on the justification for public intervention to fund FEIs to support regional development in the EU, given the differing financial market situation in the different countries and the evidence on the benefits of their use in this regard.

The present report ends by setting out the challenges confronting the use of the ERDF to co-finance FEIs and by suggesting the steps that might be taken to meet these.

[1] *Financial Instruments for SMEs co-financed by the ERDF*, European Court of Auditors, Special Report No.2, 2012.

[2] Financial Engineering Instruments, Literature Review: http://ec.europa.eu/regional_policy/information/evaluations/index_en.cfm#1

For purposes of the study, FEIs are defined in broad terms to include all means of support, mainly to SMEs, other than those which are non-refundable, such as grants or subsidies or the co-financing of infrastructure. As such, they are defined more widely than under Article 44 of the General Regulations governing the operation of the Structural Funds. They are divided into two broad groups:

- those involving the provision of credit, loans or guarantees in various forms, whether associated with subsidised interest rates or not;
- those involving the provision of financing in return for an ownership stake in the company or project, in particular venture capital (VC) funds or equity-based funding.

The distinction between the two groups lies not only in whether or not a share in the ownership is involved but also in the financial burden implied – i.e. in the need to service the debt in the case of loans – and in the claim on assets should the enterprise fail, debt-holders having priority over equity-holders. Equities, therefore, entail a higher risk than loans for funding-providers but offer the chance of a higher return in compensation, while for those needing finance, they give the possibility of avoiding debt servicing costs, which may be important in early stages of company development or when growing rapidly, though in exchange for giving up a share of the ownership. Accordingly, equities tend to be used to finance the investment needs of enterprises with high growth potential, loans and other forms of credit by the large majority of SMEs with more 'normal' prospects of investment returns and for everyday financing requirements.

According to the Literature Review, therefore, '*venture capital is particularly relevant to young innovative firms which are not yet cash generative and whose assets are tacit and thus have limited use as collateral for securing debt*'. Less than 10% of firms in the EU are considered likely to meet VC investor expectations[3].

2. The scale of ERDF support for FEIs

Amount of funding involved

The extent of support from the ERDF going to FEIs in the current programming period on the figures available at the time the country studies of FEIs were carried out (those relating to the situation at the end of 2010) is relatively small in most countries[4]. According to the source of these figures, DG Regional Policy financial database which classifies funding by the category of expenditure and type of support, the amount planned to go to FEIs amounted in total to just over EUR 11.6 billion across the EU as a whole, or 4.4% of the total available for the period (Figure 1). The sum involved in both absolute and proportionate terms, is significantly larger in the EU15 countries than in the EU12, amounting to almost EUR 8.6 billion, or 7.6% of the total available, as opposed to around EUR 3.1 billion, just 2% of the total (Figure 1). It should be noted that these figures are based on data compiled by DG Regional Policy from the information reported by Member States, which in some cases is of questionable accuracy in the sense that expenditure is not always classified as it should

[3] Literature Review, *op. cit*.

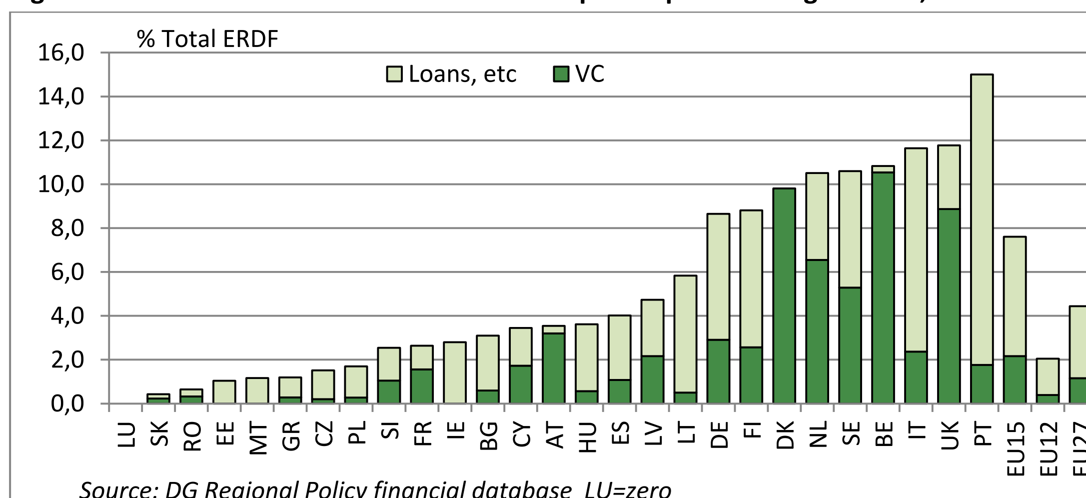
[4] Note that the figures reported here relate to the planned distribution of the ERDF to FEIs in EU Member States rather than to actual payments for which data were not available at the time this report, and the 27 country reports on which it is based, was prepared. See the next section for data on payments.

be[5].At the time the reports were prepared, however, they were the only data available which covered all Member States[6]. While they should be reasonably reliable for most countries for a few (Portugal is a prominent example), they are known to be misleading because of faulty classification (see the following section).

In both the EU15 and EU12, the larger part of the support provided, as would be expected, goes to loans or loan guarantees rather than to VC funds. The former, therefore, account for around EUR 8.6 billion – or almost three-quarters – of the total funding going to FEIs across the EU and a larger share in the EU12 countries (81%) than in the EU15 (72%).

Within both the EU15 and EU12, however, the share of the ERDF going to FEIs varies markedly between countries, as does the division of FEIs between loans and VC funds. The overall share in the EU15, therefore, ranges from over 15% in Portugal (though see the comment above) and just under 12% in the UK and Italy to just over 1% in Greece (which may be understated by the data reported, as indicated in the next section) and nothing at all in Luxembourg. In the EU12, it varies from just under 6% in Lithuania to less than 1% in Romania and Slovakia.

Figure 1 Share of total ERDF for the 2007-2013 period planned to go to FEIs, as at end-2010



In the EU15, all of the ERDF planned to go to FEIs goes to VC funds in Denmark and most of it in Belgium, Austria and the UK. By contrast, the proportion is only around 20% in Italy, 12% in Portugal (though the total figure for FEI support is grossly overstated in the financial database) and zero in Ireland. In the EU12, in the majority of countries, less than 20% of the funding allocated to FEIs goes to VC funds and in all but three countries – Lithuania, Cyprus and Slovenia – support for such funds amounts to less than 1% of the total ERDF available, in most cases much less. Support for VC funds, therefore, tends to be much more important in the more advanced, higher income economies and in most cases – Lithuania being the main exception – is on a very small scale in the less advanced, low income ones.

[5] A particular example are 'repayable grants', which are grants involving an element of repayment if, but only if, financial returns from the investment exceed a certain level. These are used in a few countries (such as Ireland) as measures of business support and may well have been classified as loans, and therefore, FEIs, in the data reported. Another example are guarantees, for which in some countries, Portugal is a prominent example, the expenditure recorded is not the actual cost but the total amount of the loan protected by the guarantee.

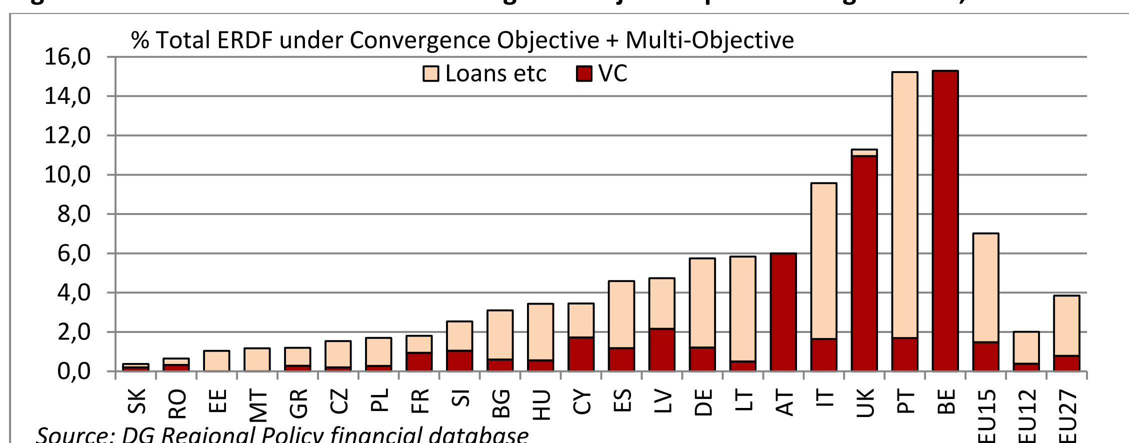
[7] Note that funding provided under 'Multi- Objective', i.e. under the Convergence and Competitiveness Objectives without being split between the two, is included as part of Convergence.

This tendency is equally evident in the deployment of ERDF support under the Competitiveness and Employment Objective as opposed to the Convergence Objective (Figures 2 and 3)[7].

Overall, less than 4% of the overall ERDF support provided under the Convergence Objective for the period was planned to go to FEIs in the EU as a whole as at the end of 2010 as against over 9% under the Competitiveness Objective. This partly reflects the large share of funding under the former going to EU12 countries, though a similar difference is evident if the EU12 and EU15 countries are considered separately. Contrary to the overall tendency, however, in Belgium, Spain, Portugal and Austria, as well as in the Czech Republic (where none of the ERDF is used to support FEIs in Competitiveness regions), support for FEIs accounts for a larger share of the total amount received from the ERDF under the Convergence Objective than under the Competitiveness.

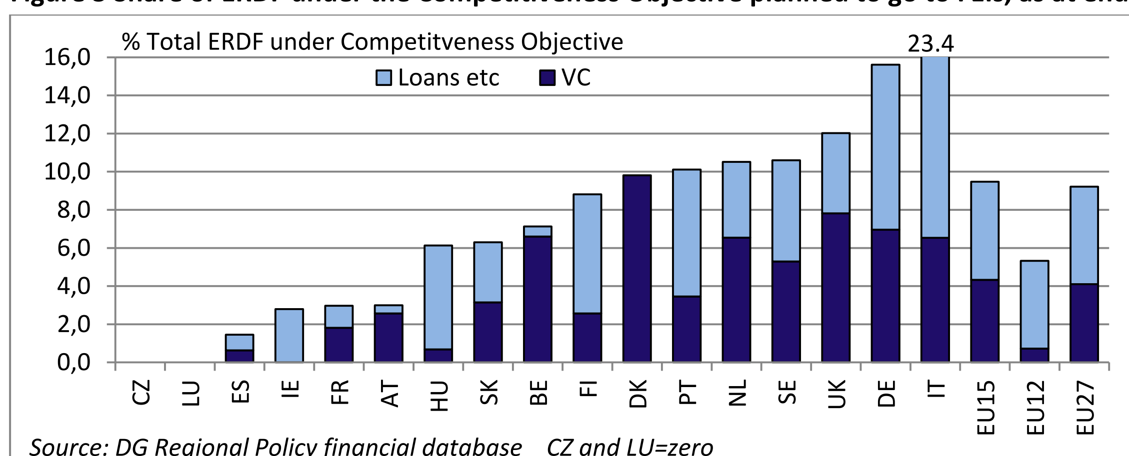
In Belgium, Spain and Austria, moreover, as well as in the UK (and the Czech Republic, though the amount involved is very small), a larger share of the ERDF was planned to go to VC funds under the Convergence Objective than under the Competitiveness, which is the reverse of the average tendency. In Germany and Italy, in particular, the share of support going to both VC funds and FEIs overall is very much larger under the latter Objective than under the former.

Figure 2 Share of ERDF under the Convergence Objective planned to go to FEIs, as at end-2010



Source: DG Regional Policy financial database

Figure 3 Share of ERDF under the Competitiveness Objective planned to go to FEIs, as at end-2010



Source: DG Regional Policy financial database CZ and LU=zero

Structural Fund payments to FEIs

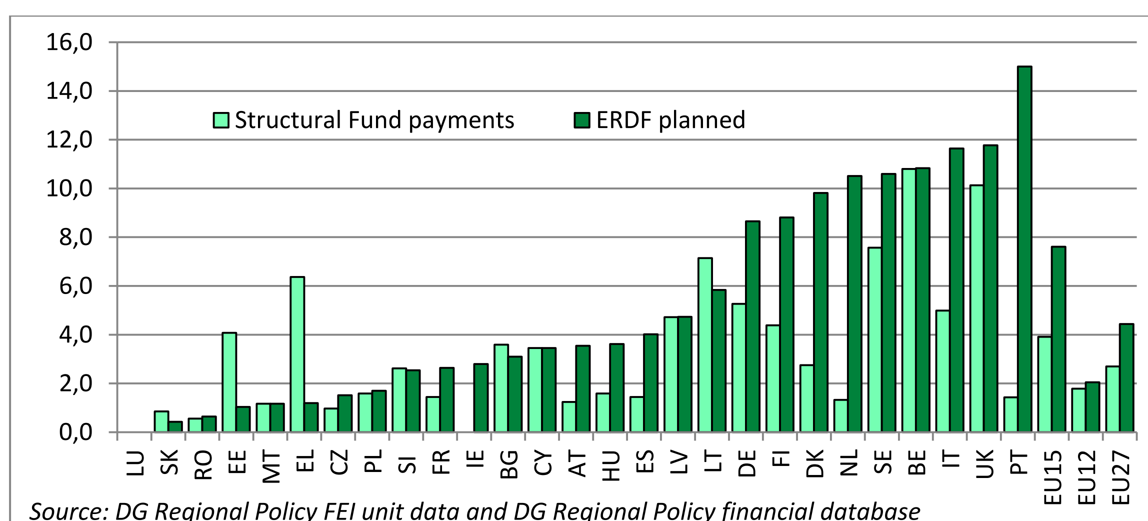
[7] Note that funding provided under 'Multi- Objective', i.e. under the Convergence and Competitiveness Objectives without being split between the two, is included as part of Convergence.

Because of doubts about the validity of the data on ERDF support for FEIs for some countries in the DG Regional Policy financial database, it was decided to compare these figures with an alternative source of data which has recently become available. This relates to the actual payments from the Structural Funds going to FEIs up to the end of 2011, which has been compiled by the Financial Engineering unit in DG Regional Policy, again from details provided by Member States. Since these data relate to payments rather than amounts planned to go to FEIs, they are in many cases smaller than those set out in the previous section. On the other hand, because they relate to the situation up to the end of 2011 rather than 2010, they cover one more year than the data set out in the previous section. Most importantly, because they are based on a specific request to Member States for details on the funding going to the instruments concerned and because they have been carefully checked, they are likely to be more accurate than the figures going into the general financial database which collects information about all types of expenditure.

However, because they cover all of the Structural Funds, and therefore the ESF as well as the ERDF, unlike the figures in the financial database, other things being equal they will tend to be larger than those presented above. But since the ESF in total accounts for only around 3% of the overall Structural Fund payments to FEIs, the amount involved is very small.

The two sets of data can be compared directly by relating the amounts going to FEIs to the total support provided by the ERDF in each of the Member States. (Although the total ERDF support of course excludes the ESF which is included in the payments data, the amount involved is too small for this to be an issue.) In total, the payments data indicate that the funding going to FEIs across the EU amounted to EUR 7.1 billion up to the end of 2011 (EUR 6.9 billion if the ESF is excluded), or 2.7% of the ERDF total support available for the present programming period. This is just under EUR 4.6 billion less than indicated by the data for the planned funding in the financial database, which, as noted above, amounted to 4.4% of the total ERDF at the end of 2010 (Figure 4).

Figure 4 Share of total ERDF for the 2007-2013 period going to FEIs according to different sources



Source: DG Regional Policy FEI unit data and DG Regional Policy financial database

The payments data indicate a significantly lower amount going to FEIs in many Member States than the figures presented in the previous section, most notably in Portugal (where the figures in the financial database are known to overstate the actual amount as noted above), Italy (where payments generally are lagging), the Netherlands, Denmark and Finland. On the other hand, they greatly exceed the planned data in Greece and Estonia, which may result from the additional year

covered by the payments data. It is evident that the big differences between the two sources relate mainly to the EU15 countries and that the differences for the EU12 countries tend to be small (Estonia apart), which in part reflects the small amount of ERDF support going to FEIs in the latter.

Use of the payments data instead of the figures from the financial database does not alter the main conclusion to be drawn from the previous section, which is that the allocation of the ERDF – and the Structural Funds more generally – to FEIs is small in most countries in the present programming period. In particular, the payments data, with only a few exceptions, do not indicate any significant expansion of support after the end of 2010 which the data set out in the previous section relate to. This is not too surprising given that the finance going into financial engineering funds all needs to be spent, in the sense of reaching final beneficiaries, by the end of 2015 and given the time it takes for funds to allocate resources. Moreover, the next section indicates that while there was an average tendency for the planned amount of the ERDF going to FEIs to increase up to the end of 2010 at least, the size of the increase was very small. In other words, no marked tendency is evident for Member States to allocate more of the ERDF to financing FEIs as the programming period has gone on.

Changes in ERDF support for FEIs over the 2007-2013 period

The use of the ERDF to co-finance FEIs has tended to increase over time in most but not all countries. In Belgium, Germany and the UK, funding was allocated to FEIs for the first time in the 1994-1999 programming period and a number of other countries followed suit in the 2000-2006 period, including Spain, the Netherlands and Austria as well as Latvia and Slovenia after 2004 when they entered the EU and became eligible for ERDF support.

In most countries, however, the use of the ERDF to support FEIs was initiated in the present period and in 10 of the 27 Member States, the use has been expanded during the period, though in most cases by a relatively small amount. Overall across the EU, the allocation of funding to FEIs increased by 0.6% of the total ERDF available between the first set of agreed plans for the period and those in force at the end of 2010 (the latest information available at the time the present report was prepared). This increase was entirely a result of more funding being set aside for loans, loan guarantees and other forms of credit rather than for VC funds, which on average remained unchanged (Table 1, which is confined to the countries in which changes occurred between 2007 and the end of 2010).

The increase was particularly marked in Portugal and Lithuania (around 4% of total funding in each case) and, as in the EU as a whole, concentrated on loans and guarantees.

On the other hand, the share of the ERDF going to FEIs was reduced over this period in four countries – slightly in France, Austria and Slovakia and more markedly in Slovenia – while there was also a reduction in Competitiveness regions in Portugal. In all of these countries, apart from France (where the decrease was evenly split) the reduction was concentrated largely on support of VC funds. Indeed, in most of the countries where changes occurred (9 of the 14), there was a reduction in the share of funding going to VC funds and an effective shift away from these towards loans and guarantees.

Table 1 Changes in the share of ERDF support going to FEIs, 2007 to end-2010

% Total funding under each Objective

	Convergence			Competitiveness			Total		
	Loans, etc	VC	Total	Loans, etc	VC	Total	Loans, etc	VC	Total
DE	0.3	-0.1	0.2	0.5	-0.2	0.3	0.3	-0.1	0.2
ES	0.5	0.6	1.1	0.1	0.4	0.6	0.5	0.6	1.0
FR	0.2	0.0	0.2	-0.2	-0.2	-0.4	-0.1	-0.1	-0.2
IT				2.1	-0.6	1.5	0.3	-0.1	0.2
AT				0.0	-0.2	-0.2	0.0	-0.2	-0.2
PT	4.9	-0.3	4.6	-0.8	-2.4	-3.2	4.6	-0.3	4.3
FI				0.0	0.5	0.5	0.0	0.5	0.5
UK				0.1	0.6	0.7	0.1	0.4	0.4
CZ	0.2	-0.1	0.1				0.2	-0.1	0.1
LT	3.6	0.1	3.7				3.6	0.1	3.7
HU	0.5	-0.4	0.1				0.4	-0.3	0.1
PL	0.7	0.0	0.7				0.7	0.0	0.7
SI	-0.2	-0.6	-0.8				-0.2	-0.6	-0.8
SK	-0.1	-0.3	-0.4	3.2	3.2	6.3	-0.1	-0.3	-0.3
EU15	1.0	0.1	1.0	0.2	-0.1	0.2	0.8	0.1	0.8
EU12	0.5	-0.1	0.4	0.1	0.2	0.3	0.5	-0.1	0.4
EU27	0.7	0.0	0.6	0.2	-0.1	0.2	0.6	0.0	0.6

Source: DG Regional Policy financial database

In general, there was more of an increase in the allocation of the ERDF to FEIs in Convergence regions over the period than In Competitiveness ones.

The indications are that in some countries, changes in the amount of ERDF support allocated to FEIs have occurred since the end of 2010 because of the crisis and its effects on company finances. In **Estonia**, therefore, funding has been shifted from the development of renewable energy to enterprise support measures and in **Bulgaria**, it is reported that JEREMIE funds[8] are being expanded to provide more support for enterprises due to the worsening economic situation. On the other hand, in **Lithuania,** where finance for JEREMIE funds has increased since the start of the crisis, there are plans to reduce it by EUR 40 million due to the lack of investment by firms as a result of the depressed state of the economy.

The regional spread of support for FEIs

In a number of countries, the ERDF is used to support FEIs in all, or nearly all, regions:

- In **Germany**, the use of funding to support FEIs is widespread across the country, occurring in 6 of the 7 Convergence regions and 10 of the 11 Competitiveness ones, though the scale is larger, as noted above, in the latter.

[8] JEREMIE stands for Joint European Resources for Micro to Medium Enterprises, which is a joint initiative of the European Commission with the European Investment Fund IF and the European Investment Bank to improve the access of SMEs to finance, specifically to FEIs. It is used here as a generic term to denote the kind of fund concerned. It is not a legal term as such and does not appear in the Structural Fund regulations

- In the **UK,** there were there 5 holding funds and 30 specific funds providing enterprise support at the end of 2010, each with a regional scope, 10 of them providing loans and the others equity participation[9].
- In **Italy**, 39 financial engineering schemes have been set up, with at least one scheme in 18 of the 21 regions[10].
- In **France**, half the regions are using the ERDF to finance loan schemes, 10 regions have set up equity funds and 8 guarantee funds.
- In **Poland,** support is given to FEIs in all 16 regions, though on a small scale (as is evident from Figure 1)[11].
- In **Portugal,** support goes to 28 national funds, which are accessible to enterprises in all regions, and two 2 regional guarantee funds (in Azores and Madeira)[12], as well as to one JESSICA holding fund (supported by 6 Operational Programmes) and three urban development funds[13].
- In **Finland,** funding is allocated to FEIs in all the Operational Programmes, though on a varying scale, larger in the Western and Eastern regions and smaller in the Southern and Northern ones.
- In **Sweden**, 12 regional funds to provide support to existing enterprises and business start-ups were set up in 2009, 10 providing venture capital and two loans.

In other countries, the use is less widespread:

- In **Belgium**, while a significant share of the ERDF goes to FEIs in Hainaut – the one Convergence region in the country – and the rest of the Walloon region, less is used for this purpose in the Brussels region and none at all in the Flemish region.
- In **Spain**, the use of funding to support FEIs is limited to three JEREMIE funds for business development and innovation and two JESSICA funds for urban development.
- In the **Netherlands,** support of FEIs is confined in the present programming period to the West and East regions, though in the previous period it was applied in the other regions too.
- In **Austria**, the use of the ERDF to finance FEIs is limited to two regions, Burgenland – the one Convergence region – and Oberösterreich. Funding was initially earmarked for FEIs in

[9] According to the Summary report on FEIs for 2011, the number had risen to 6 holding funds and 44 specific equity and loan funds by the end of 2011. See Financial Engineering Instruments Implemented by Member States with ERDF Contributions, Situation as at 31 December 2011, European Commission, 2012

[10] According to the Summary report on FEIs for 2011: at the end of 2011, there were 14 holding funds and 66 specific funds (European Commission, *op. cit*.).

[11] According to Summary report for 2011, there were 8 holding funds and 144 specific funds at the end of 2011, mainly providing loans and guarantees (European Commission, *op. cit*.)

[12] According to Summary report for 2011, there were two holding funds and 13 specific funds providing loans, guarantees and other instruments (European Commission, *op. cit*.).

[13] JESSICA stands for Joint European Support for Sustainable Investment in City Areas and like JEREMIE it is an initiative of the European Commission, this time developed in cooperation with the European Investment Bank and the Council of Europe Development Bank with the specific purpose of supporting urban regeneration through FEIs. Like JEREMIE, the term does not appear in the Structural Fund regulations and is used here in a generic sense rather than in any legal sense.

two other regions, Kärnten and Wien, but no schemes have been set up and are unlikely to be so.

The policy areas in which FEIs are used

Most of the ERDF earmarked for FEIs across the EU goes to support enterprises, in many cases in the form of JEREMIE funds. Indeed, in most countries, FEIs are confined to this purpose, though such support takes a number of different forms within the two broad groups identified, including micro-credit for very small firms or one-person ventures and finance for business start-ups. In addition, it can have different areas of focus, such as innovation or 'green' investment.

There are a few countries, however, in which support for FEIs applies to urban development through JESSICA type schemes. As indicated above, this is the case in **Portugal**, where 6 schemes are in place, as well as in **Spain**, where there are two funds in operation. There are also three JESSICA funds in **Italy** and four in the **UK** ((in London, Wales, the North West and the North East), with proposals to set up funds in Yorkshire and Humberside and the West Midlands as well.

In addition, a JESSICA holding fund was set up in **Bulgaria** in 2009, not only for urban development but also for housing renovation, though it has not as yet made any investments, while in **Estonia** and **Lithuania**, funds are in place to support improvements in the energy efficiency of buildings.

The use of FEIs in the light of the economic context

The fact that ERDF financing of FEIs is concentrated on measures for supporting business is only to be expected given that the application of FEIs is contingent on investment yielding a financial return. The scale of funding devoted to support of FEIs, however, and its division between loans, guarantees and other forms of credit, on the one hand, and VC and equity-based schemes, on the other, is worth considering in the light of the underlying circumstances, and the financial market situation in particular, in the different countries. A survey of the national contexts in which FEIs are being implemented in different forms, undertaken as part of the Literature Review for the present study, provides a means of doing this. Although the survey simply obtained the views of the national experts who prepared the country studies on relevant aspects of the situation in their countries, it gives a useful, if very broad, indication of the circumstances which prevail and against which the use of FEIs can be assessed. It should be emphasised that the survey was intended solely to provide a summary overview of the different national situations in which measure to support FEIs were being implemented, and it is not meant in any way to substitute for the detailed ex ante assessment which is required to determine the need for such measures and the scale on which they should be introduced.

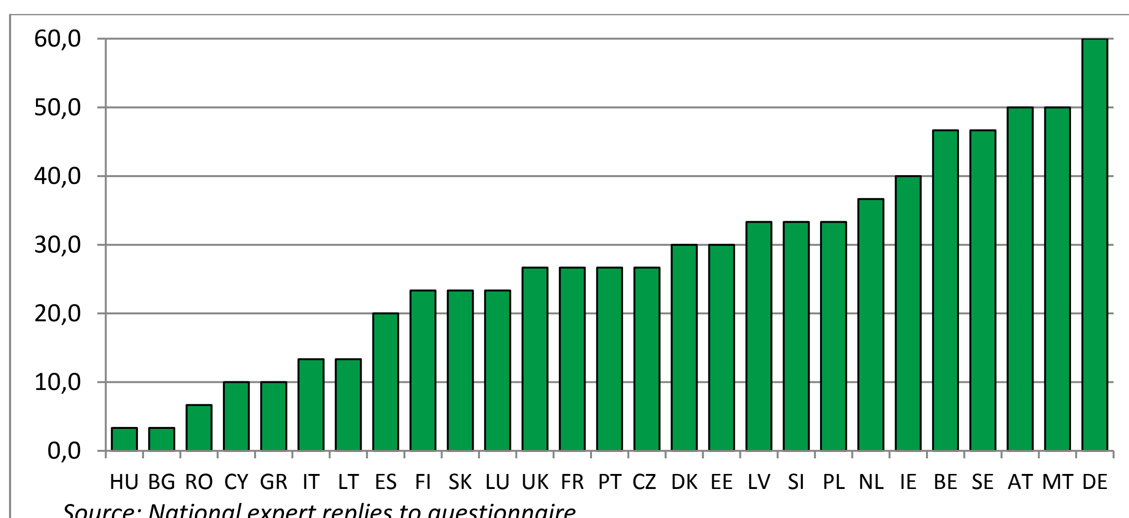
The survey indicates, in particular, that the access of SMEs to bank credit or loans is limited in many countries by the collateral demanded in exchange, the variable expertise in local branches to assess business prospects and the lack of a tradition of banks supporting local enterprises or simply the physical lack of local banks. The importance of these factors varies markedly across countries, with a strong tradition of local banks lending to businesses in some countries - in Germany and Austria – and the virtual complete absence of such a culture in others. An index combining various aspects

which are likely to be important in determining the access of small firms and budding entrepreneurs to bank finance gives an impression of the differences which exist in this respect[14].

The index suggests, therefore, that the support provided by banks to small enterprises and their access to bank loans is relatively good in Germany, Austria and Malta as well as in Sweden and Belgium, if to a lesser extent, and relatively poor in Hungary, Bulgaria and Romania, and to a lesser extent in Cyprus and Greece (Figure 4, in which the scale is intended to indicate the relative situation only –i.e. the higher the index, the more supportive of banks to businesses).

The implication is that the need for public intervention to help small businesses access finance is less in the former group of countries than elsewhere and greater in the latter group, as well as in Italy, Lithuania and Spain. Comparison of the index with the share of the ERDF devoted to support of the provision of loans and guarantees (Figure 1 above) shows a mixed picture. In Hungary and Bulgaria, where the support provided by banks to small enterprises is limited, only a small share of the ERDF received goes to financing loans and guarantees, though in both cases, the share is larger than the EU12 average. In Romania, where the index is only slightly higher than in these countries, the share of funding going to loans is negligible. In Lithuania, on the other hand, where the index is also relatively low, a larger share of the ERDF goes to support loans than in any other EU12 country.

Figure 4 Index of access of small enterprises to local banking support



Source: National expert replies to questionnaire

Among the EU15 countries, the index is lowest in Greece, where less than 1% of the ERDF received is directed to support of loans, and is only slightly higher in Spain, where a larger share of funding goes to such support but still well below the EU15 average. In Italy, by contrast, where the index is even closer to that for Greece, a much larger share of funding than average is allocated to support of loans. This is also the case in Portugal, where the index is around the average.

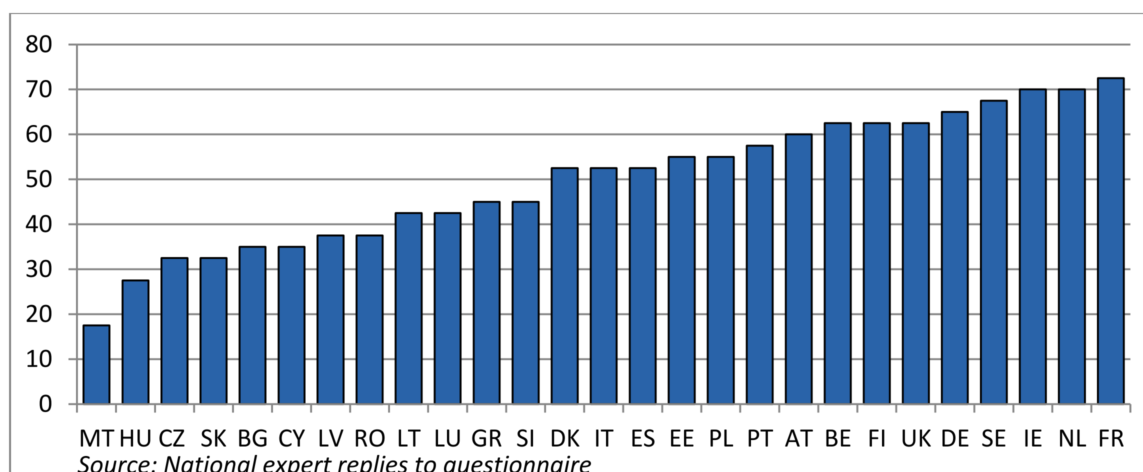
The picture is also mixed for the countries with seemingly the most access to banking support. In both Germany and Sweden, the share of the ERDF going to finance loans and guarantees is around the EU15 average (though in Sweden the absolute amount involved is relatively small - EUR 50 million), whereas in Belgium, it is negligible (less than EUR 3 million).

[14] The aspects included in the index are: the strength of a local banking tradition, the dominance of the financial market of few large banks, the degree of sophistication of the banking system, the presence of public sector banks, the prevalence of local banks, the extent to which borrowing requires collateral, the cost of borrowing, the variability of the quality of banks and the ease of obtaining a loan for a good business prospect. See Literature review (reference).

Overall, therefore, there is no close relationship between the apparent extent of banking support for small enterprises and the share of the ERDF devoted to loans. This does not necessarily mean, of course, that the funding provided to support loans is somehow misplaced in countries like Germany where access to bank loans is relatively favourable, since limitations on access might still be important for particular enterprises. It does, however, raise a question over whether Member States where access to bank loans is limited and where the share of funding going to support loans is small should be devoting more to this.

The survey also gives an indication of the innovative capacity of countries and, therefore, of the potential demand for finance to support investment in innovation, and, accordingly, for venture capital funds or intermediaries willing to take equity stakes in enterprises. As in the case of access to bank finance, the survey responses enable an index to be constructed which combines a number of features of countries which together give an indication of the strength of the capacity to innovate, to develop new products and processes and to commercialise these[15]. This suggests that innovation capacity is relatively strong in France, the Netherlands, Ireland and Sweden, especially, and relatively weak in Malta, Hungary and many of the other EU12 countries (Figure 5).

Figure 5 Index of innovation capacity of Member States



Source: National expert replies to questionnaire

Again the relative level of this index can be compared with the share of the ERDF going to VC funds (Figure 1 above), which shows that the Netherlands and Sweden do indeed devote a relatively large share of the ERDF received to support of such funds, while France and Ireland, on the other hand, allocate relatively little. This may, however, be because most innovative capacity in these two countries is vested in large rather than small firms – in the case of Ireland in multinationals – so that there are not the innovative SMEs to support.

At the other end of the scale, the fact that nearly all of the EU12 countries devote only a very small share of the ERDF to supporting VC funds is consistent with the limited innovative capacity they seem to have. In other words, the *prima facie* evidence, such as it is, does not suggest that, relative to other countries, the share allocated to these funds is excessively small (though as indicated above

[15] The features included in the index are: the presence of world class universities and research institutes, government funding into future technologies, the strength of the science base and the links between research and business, a network of science parks, the presence of many people with experience in investing in new ventures and of opportunities for commercialising new innovations and scientific developments.

a far more detailed analysis would be required to come to any firm conclusion about the scale of funding which should go to support VC funds).

3. Rationale for using financial engineering instruments

As implied by the above, the rationale for government intervention to support FEIs relates is essentially to the difficulties of enterprises obtaining finance for investment from the market relative to their need. In practice, this rationale is put forward by many Member States (either in official documents – Operational Programmes especially - or when Managing Authorities were interviewed) as the justification for devoting funding to FEIs, both loans and VC.

The other frequent argument is that which features prominently in European Commission documents to encourage the use of FEIs, especially in the context of financial constraints on funding. This is that, as compared with other means of supporting enterprises or investment projects more generally, the funding going to FEIs can effectively be re-used once loans are repaid or the stake taken in a company is sold. In this sense, therefore, the funding concerned can be regarded as 'revolving' since a given amount can be used to finance a series of projects over time – assuming, of course, that they are successful and enable the initial sum provided to be repaid.

Countries in which the main reason given to by Member States for the use of the ERDF to support FEIs is to increase the access to funding of firms, and of SMEs in particular, include:

- The **Czech Republic, Portugal** and **Austria,** where reference is made to the need, in the first two, to relieve the credit rationing faced by SMEs and in the last, to make good the deficiencies in the availability of finance for investment;
- **Italy**, where the same general reason is given and where this backed up by reference to the under-developed nature of the Italian financial market and to the fact that the difficulties faced by SMEs in accessing finance have been intensified by the crisis;
- **Germany**, where the same reason is also given, though combined with FEIs helping to reduce the risk of investing and innovating;
- **Spain,** where the need to ease the access of SMEs to credit is combined with the argument that FEIs also serve to increase the sustainability of funding for them as well as for RTDI projects;
- The **UK**, where reference is made to the role of FEIs in easing access to credit in particular for SMEs and business start-ups which are unable to provide the collateral required by banks;
- **Romania** and **Slovakia**, where the emphasis is on the insufficient provision of micro-credit for those wishing to become self-employed or to start up their own businesses as well as on the general lack of finance available for SMEs;
- **Slovenia**, where reference is also made to the need to compensate for a lack of seed capital for business start-ups and venture capital and, more generally, for an under-developed capital market;
- **Hungary**, where FEIs, as well as increasing the supply of credit, are held to contribute to a 'more market friendly' means of supporting SMEs;

- **Latvia**, where similarly emphasis is placed on the role of FEIs in reducing the negative effects of grants on competition and providing a more efficient use of State aid because the same funds can be used repeatedly to provide business support.

The possibility which FEIs open up of funding being used several times over is also referred to by other Member States, though in itself it does not provide a justification for intervention in financial markets, only a reason for using FEIs instead of grants to support businesses. The Member States concerned include:

- **Denmark** and **Poland**, where the main reason given for the use of FEIs is simply their revolving nature and the ability they give for using public money more effectively;
- The **Netherlands**, where the revolving nature of FEIs is regarded as being especially important in times of budget constraint, though where reference is also made to their effect in reducing the risk of investment so encouraging more capital expenditure by firms;
- **Greece**, where it argued that FEIs give an incentive for a more rational and efficient use of finance as well as having a bigger effect on the economy because the funding provided can be recycled to support more firms;
- **Ireland**, where emphasis is similarly placed on the increased incentive given to SMEs, and micro-enterprises especially, to make more efficient use of finance, so enabling the funding provided to be repaid and re-used;
- **Estonia**, where it also argued that the use of FEIs as compared with grants results in the more rational and efficient use of funds and more productive investment;
- **Lithuania**, where in addition to the revolving nature of funding allocated to FEIs, reference is made to the measures having a greater leverage effect on private finance than the use of grants for business support.

In some other Member States, other grounds for the deployment of ERDF support to finance FEIs are referred to. This is the case in:

- **France,** where, according to a survey of Managing Authorities, FEIs are considered to have more of an effect in leveraging private sector finance than grants and to encourage the development of public-private partnerships;
- **Belgium,** where FEIs are regarded too as a way of encouraging public-private partnerships and through this a means of small enterprises being able to access specialised business advice as well as simply finance, a point stressed in a number of European Commission reports;
- **Bulgaria**, where emphasis is placed on the same point, the expertise in this case coming from the European Investment Fund (EIF), and where it is also argued that FEIs enable Managing Authorities to shift some of the administrative burden of managing business support from themselves to the EIF;
- **Sweden**, where the Operational Programme for OP for Smaland and the Islands refers to a statement by the Commission that FEIs are more cost efficient than grants.

In addition, in a few countries, as well as the reasons listed above for the allocation of the ERDF to finance FEIs, Managing Authorities are reported to consider such allocation as a convenient means of accelerating the expenditure of the funding received and of ensuring compliance with the ‘n+2’

rule, so avoiding the possibility of de-commitments (i.e. of losing the funding allocated to them because of not spending it within two years). Once funding is put into a loan scheme, a VC fund or some other FEI, it is, therefore, regarded as having been spent, even though none of it may have reached ultimate beneficiaries (i.e. SMEs looking to finance investment). Although the funding so allocated needs to be passed on to enterprises or other final recipients before the end of the programming period – effectively by 2015 – in order to qualify for ERDF co-financing, this still leaves a much longer time to actually spend the money involved on business support or investment than in the case of other means of funding.

The possibility which FEIs allow of speeding up the spending of funding was reported to be a reason for the use of FEIs, along with others, in **Bulgaria**, **Italy,** a few regions in **France** and **Cyprus**, where reference was also made to the greater effects of FEIs on the economy than other methods of business support.

The reasons listed above for the use of FEIs as a means of supporting businesses, SMEs, in particular, repeat to large extent those set out in Commission statements recommending a shift of funding from non-repayable grants to such measures for this purpose. In essence, they rest on the view, first, that there are serious failures in the way that the financial market functions which limits the access to finance of small firms and those wanting to start up businesses (see Annex for a list of the specific market failure referred to by Member States in official documents and by Managing Authorities when interviewed). Secondly, the view is that support of FEIs is a more efficient and cost effective way of way of tackling these failures than grants because the funding involved can be recycled – i.e. that it can be used to support a number of enterprises over time rather than just one.

The first view is hard to dispute: as indicated above, there is substantial evidence that many small borrowers find it difficult to obtain credit and finance for investment, though the extent of this difficulty and the viability of the investments for which funding cannot be obtained are much less clear, The existence of market failure, however, might justify the need for public intervention but it leaves open the form which this intervention should take. The case for using FEIs rather than grants - given that public funding is used rather than non-financial means, such as cajoling banks to lend more to SMEs – rests on the second view that 'revolving' funds are more efficient than 'one-off' support.-Whether this is valid or not depends both on whether the funds can actually be re-used – i.e. the extent to which loans are repaid and equity stakes sold without a loss – and on whether the overall return from the support provided, including achievement of social and longer-term economic objectives and not simply the financial return, is greater if FEIs are used rather than grants. As indicated below, this too is open to debate in many cases.

A further view expressed in a number of countries is that FEIs are a more efficient use of funding than grants not only because they can be used to support more than one company but also because the investment they finance tends to be more productive. There are three reasons why this might be the case, each of which is open to question.

The first argument is that the enterprises supported have more of an incentive to use the funds received efficiently than if they were in receipt of grants because their own money is at stake. This may be so but it is also the case that those receiving grants are invariably required to co-finance the investment concerned so that the incentive ought not to be very different.

Secondly, it is argued that fund managers are better able to identify productive investments than those managing the allocation of grants. This may also be so, but there is not much concrete evidence to support the contention[16], and it tends to neglect the wider objectives of enterprise support which need to be taken into account too, as indicated above.

The third argument is that because grants involve an element of subsidy, they are more likely to distort the allocation of resources as compared with FEIs and, therefore, cause more of a shift in the allocation away from that resulting from the free operation of market forces, which is assumed to be the most efficient. This, however, neglects the fact that FEIs in many cases involve an element of subsidy themselves. Perhaps more importantly, it also ignores the fact that the purpose of government intervention is precisely to alter the way the market would otherwise allocate resources in order to achieve a more desirable outcome from a social perspective.

Reasons for not using FEIs

Despite the various grounds for using the ERDF to finance FEIs listed above, which are explicitly reported by Member States, it is still the case, as highlighted by the earlier sections of the present report, that the actual amount of funding allocated to them is relatively small in most countries. Major reasons why this is the case and FEIs are not used more seem to lie in their complexity, the time and resources needed to establish schemes and the lack of expertise available in the country or region both to set them up and to manage them. This is particularly the case in the EU12 and, most especially, in relation to VC funds.

It is also the case, however, that in many countries FEIs are regarded as being less appropriate than grants for supporting RTD and innovation, and that grants are preferable to FEIs – and in some cases the only viable option – for supporting cooperative research and research networks. Countries can be divided into a number of groups in terms of the reasons reported for the limited use of FEIs as means of providing support to investment, especially in particular areas.

In a number of countries, most of them in the EU12, the main case for not using FEIs more extensively is the lack of experience of them among both the authorities and the enterprises which are potential recipients and the problems of setting them up:

- in **Bulgaria**, it is pointed out that the EU's JEREMIE and JESSICA initiatives, which are designed to make it easier for Member States to deploy FEIs to support businesses and urban development, are still at an early stage;
- in **Romania**, there is a concern that the procedures for implementing of financial engineering schemes are not well known and could involve revisions to legislation and give rise to regulatory issues to ensure compliance with EU regulations;
- in **Slovakia**, grants are seen as being more accessible and having the advantage of being already in place and known by companies as compared with FEIs, which in any are likely to take too long to set up;

[16] The reflection in the Literature Review is relevant in this regard: '*an immediate question is whether the public policy maker can process and administer grants as efficiently as the 'market' can allocate funds? This is a question of experience and competency in funding appraisal techniques. Here we might initially assume that the private sector financier has greater competency borne from years of experience in making lending decisions. But if the public policy provider acts as a mutual or co-operative financial institution, using local knowledge and softer information in its decision-making process it may be able to make more informed decisions reflecting individual characteristics and local market conditions*.'

- in the **Netherlands**, a lack of knowledge about FEIs is held to have created uncertainty and by the time this was dispelled, little of the limited amount of the ERDF received remained to be allocated;
- in **Malta**, a lack of the expertise and infrastructure needed to set up a VC fund is reported, along with a concern about the significant fixed costs involved and the difficulties of covering these given the relatively small size of the fund.

The same concern is reported in **Luxembourg**, where none of the financial resources received from the ERDF is allocated to FEIs because the amount involved is considered to be too small to justify the costs of setting up the necessary arrangements. This echoes the point made in the Literature Review:

> *'It has to be questioned whether or not the very small size of several hybrid VC funds* (in the sense of those in which there is significant public sector participation) *bears any relevance to the realities of commercial practice in the VC industry. Namely, these funds may well be viewed as too small to have any real chance of successful commercial practice given the imperatives of scale economies in the investment industry'*[17] (Dimov and Murray, 2007).

In other words, VC funds need to be able to spread their risks, given the high degree of uncertainty attached to the investments they finance, which means that they have to be above a minimum size to do so to the extent required to give them a reasonable chance of making a satisfactory return. It also means that the larger the fund the greater the chance of achieving a satisfactory return. Looking at the amount of ERDF support going into financing VC funds in some countries, there has to be a question-mark over the probabilities of them making a reasonable return, unless much larger amounts of private sector finance is also going into them. This applies, in particular, to the EUR 10 million of the ERDF going into VC funds in the capital city region of Hungary, the EUR 8.5 million going into VC funds in Cyprus, the EUR 7.5 million in Burgenland in Austria and, most especially, the EUR 3 million in the Bratislava region in Slovakia (Annex Table A.1).

The question-mark over the size of ERDF-financed VC funds, however, would cover many more VC funds if the view of practitioners cited in the Literature Review is valid, that '*a minimum viable size for an early stage VC fund will be in excess of €120 million*'[18] – such as funds receiving less than EUR 30 million of support under the Convergence Objective in France, Lithuania and Slovakia and under the Competitiveness Objective in Hungary, Austria, Portugal and Finland.

In the **Czech Republic**, the reason put forward for not using FEIs more extensively is also related to the smallness of funding, but in this case in respect of the demand rather than the supply side. There is, therefore, thought to be a lack of demand for early-stage financing of businesses – one of the main areas for the deployment of venture capital – and, accordingly, only a relatively small need to provide funding for this. At the same time, entrepreneurs are considered to find it difficult to prepare a sound business plan, which is essential to be able to access venture capital.

[17] Literature Review reference, p.25, which cites Murray, G.C. and Dimov, D. 2007. 'Through a glass darkly: New perspectives on the equity gap.', In Tom Schamp (ed.), *Entrepreneurship and the Financial Community: Starting Up and Growing New Business* (pp. 161-174). London: Edward Elgar.

[18] See Literature Review, op cit, p.32, where the figure cited is that reported by practitioners to the author. The figure of £120 million – around EUR 150 million – should not be interpreted precisely but very approximately as signifying a relatively large amount.

In other countries, the emphasis is put on FEIs not being suitable or appropriate for supporting particular types of investment, or at least less so than grants. This is especially so in relation to RTD and innovation:

- in **Greece** and **Cyprus**, therefore, this is considered to be the case in respect of projects of this kind where any tangible outcome takes a long time to commercialise and to generate a return;
- in **Denmark**, in respect of projects where no concrete product is being developed;
- in **Spain**, where the enterprises or projects supported entail technological risk or where research networks are involved and where non-repayable grants are regarded are particularly suitable for funding collaborative RTD and research centres in Convergence regions to build up innovative capacity;
- in **Italy**, where, in addition to projects where the results cannot be quickly commercialised, there are important spill-over effects – i.e. those which generate gains for the economy but which are not marketable as such and so do not necessarily produce financial returns for the investor.

Spill-over effects and the difficulties of incorporating wider objectives, such as the development of the regional economy in particular, into financial engineering schemes are also referred to in a number of other countries as reasons for opting for grants rather than FEIs as means of supporting investment. This is the case in:

- the **UK**, where grants are preferred for large business investment projects which are of strategic importance to the economic development of the region;
- **Portugal**, where the use of grants is regarded as making it easier to focus on investment in priority areas such as business innovation, exporting and RTDI and to select the projects and enterprises which are most appropriate to support from this perspective;
- **Estonia**, where grants are considered to be not only much more suitable than FEIs for supporting early stage development but more easily aimed at achieving positive spill-overs in respect of both knowledge and the economy generally;
- **Slovenia,** where grants are also regarded as a more suitable means of taking advantage of the spill-over effects from investment in RTD and innovation and have been used to help to reduce the development gap with the EU15 as well as to mitigate the effects of the crisis;
- **Austria**, where grants are held to be more suitable for supporting a much wider range of enterprises than the small number of high-growth ones targeted by VC funds and where, in addition, Institutional investors are thought to be reluctant to put money into such funds in part because there is not sufficient transparency as regards the expected return on investment.

In practice, in all countries apart from Luxembourg, ERDF financing for enterprise support is divided between FEIs and grants. The difference lies in the way the funding is divided between the two and in the extent of the use of VC funds as compared with loans and guarantees. This difference partly reflects the variation between countries in underlying circumstances – in the innovation capacity and the ease of accessing bank finance –and in the division of support between types of investment, in the extent of support, for example, going to RTD and innovation and the degree of uncertainty and spill-over effects involved. Perhaps more importantly, however, as evident from the above, it

also reflects the differing attitudes to FEIs, and VC funds especially, and the expertise available to implement them.

The perceived costs of using FEIs

A further part of the reason for opting not to use FEIs to support investment lies in the costs involved, or more accurately the costs which are perceived to arise from setting up and managing schemes since there is almost a complete absence of data on the actual costs entailed. These costs also include the time taken to set up schemes which in many cases was significantly under-estimated, reflecting a lack of experience and expertise as well as the complexity and lack of clarity of the EU regulations governing the use of the ERDF to support FEIs.

In most Member States, it is considered that the cost of setting up financial engineering schemes, especially VC funds, is higher than in the case of grants, and the costs of managing them are also thought to be greater. This is the case in:

- **Poland**, where costs are thought likely to be higher because of the newness of FEIs, though no data exist to verify this;
- **Greece**, where the need to publicise and 'market' FEIs is highlighted as an element which adds to the costs of setting up schemes, while the need to meet the reporting requirements of the EIB entail the installation of new IT systems which increase the cost of operating schemes;
- **Ireland**, where reference is made to the costs of carrying out the various checks on enterprises and their prospects – the 'due diligence' –before funding is sanctioned;
- **Spain**, where the greater complexity of management and the more detailed controls over investment projects are held to push up costs;
- **Italy**, where the high management costs and fees of FEIs implemented with EIF and EIB support are referred to;
- **Cyprus**, where reference is also made to the management fees charged by the EIF and other financial intermediaries.

In a few countries, however, FEIs are considered to be no more costly to set up than grant schemes. This s the case in the **Czech Republic** and **Slovenia** as well as **Germany**, where, nevertheless, it is thought that the costs of administering equity funds rather than loans or guarantees might be too high in relation to the benefits achieved.

In the **UK**, it is pointed out that, although the costs of administering FEIs tend to be relatively high, grant schemes can also be similarly high and there is a need for more information before it can be concluded that one involves more costs than the other.

The lack of data is also noted in the **Netherlands**, though the costs of setting up financial engineering schemes, especially equity-based ones, are thought to be relatively high because of the need to establish a fund and a management team to control it. On the other hand, the costs of operating FEIs, once established are held to be lower than for grant schemes for both the Managing Authorities and the enterprises which receive funding because, unlike in the case of grants, there is no certification of expenditure and audit control which need to be carried out. This latter point is also noted in **Portugal**.

At the same time, the ability of Managing Authorities to reduce costs by effectively transferring the management of investment support to a financial intermediary raises a serious question over how far in so doing they are relinquishing control over the way the funds concerned are used and, more specifically, the power to ensure that they are employed to pursue ultimate regional development objectives. This issue is picked up in the following section.

In a number of countries, the high costs of setting up FEIs and the relatively long time required to do so are attributed in part to the EU regulations which need to be complied with. This is the case in:

- **Bulgaria**, where the high cost and time-consuming process of establishing JEREMIE funds are emphasised, along with the complexity of creating JESSICA funds, which proved to be beyond the expertise and administrative capacity available;
- **Lithuania**, where the costs incurred in setting up the institutional, legal, technical and financial infrastructure required by FEIs to comply with EU regulations and the time needed were both much greater than expected;
- **Portugal** and **Sweden,** where the time required to set up FEIs and the necessary regulatory framework to comply with ERDF regulations, which in the latter, are held to be difficult to interpret, was also longer than expected;
- **Denmark**, where the main cost involved in using the ERDF to co-finance FEIs is held to arise from the need to comply with the complex regulations;
- **Austria**, where the establishment of funds which meet EU standards with the necessary private participation is argued to be very complex and time-consuming, and where, in any case, there I a question-mark over the effectiveness of setting up of low-volume funds at regional level – which the question posed above about the small size of the ERDF support allocated to VC funds in Burgenland.

The complexity of the EU regulations and the uncertainty surrounding their interpretation are issues examined further below after considering the way that FEIs supported by the ERDF are implemented in practice.

4. The implementation of ERDF-supported FEIs in practice

As indicated above, there are reasonably clear grounds for government intervention across the EU to increase the availability of funding to SMEs and those seeking to start up businesses because of the failure of financial markets in various respects to ensure sufficient access to finance for investment, irrespective of whether or not these grounds are clearly set out in official documents. This funding, however, can be made available in various ways, through grants as well as FEIs and through direct as well as indirect means. The issue examined here is how far the financial engineering schemes co-financed by the ERDF go beyond merely serving to expand the funding available for investment to controlling – or at least influencing – the way the funding is used, in terms of the enterprises and types of project supported. More specifically, the issue is whether FEIs represent an effective means in practice of pursuing the ultimate objective of the Fund – and of EU Cohesion policy which it is intended to finance – which is to further the development of lagging and problem regions.

The concern, therefore, is to examine how far the operation of ERDF-supported funds – whether providing loans, guarantees or capital – differs from that of purely commercial funds which are

aimed solely at maximising the financial return on the money invested rather at the wider social and economic ends which the ERDF exists to help Member States and regions to pursue.

Differences in the operation of ERDF-supported FEIs from private schemes

In most cases, there appear to be little significant difference in the way that loan and guarantee funds are operated if supported by the ERDF than if financed entirely by private investors. In many cases, they are focused on particular sectors and more often on enterprises located in particular regions, which tends to make them more restrictive than solely privately-financed schemes. VC funds co-financed by the ERDF also tend to be similar to private funds in the way they operate, though in many cases they have explicitly wider objectives than simply generating a return on the capital invested in them, such as stimulating innovation, restructuring the regional economy, improving the environment or furthering gender equality. How far these wider objectives are consciously pursued in practice, however, is in some cases open to question.

The most common differences between ERDF co-financed and other schemes arise from the fact that schemes have to comply with EU state aid regulations governing business support (e.g. EC regulation 800/2008), which in practice typically means that they have to be SMEs (i.e. employ less than 250 people), not to operate in specified sectors and not to be in difficulty. In many cases, they also need to be located in the region in which the fund is set up. In the case of JESSICA funds, they have to be invested in projects which are part of an integrated plan for sustainable urban development[19].

Other requirements stipulated by ERDF-financed schemes for eligibility for support and the objectives set vary between countries. In many, however, the need is to demonstrate that the enterprise is sound and the planned investment viable with a reasonable prospect of success, which is the same as for privately-financed funds. This is the case in:

- **Greece**, the **Czech Republic** and **Cyprus**, where the main, and in most cases the only, criterion for receipt of funding is to have a satisfactory risk profile;
- **Belgium**, where enterprises seeking finance, whether in the form of loans or VC, simply need to demonstrate that the investment planned is technically feasible and likely to be profitable, though they are usually required to 25% or more of eligible costs;
- the **Netherlands**, where recipients of funding do not need to fulfil any specific conditions in addition to those applying to receipt of grants;
- **Sweden**, where firms seeking finance from *Regional co-investment funds*, need to be expanding, have good long-term growth prospects and be able to attract other investors, though the single most important criterion is that firms are led by committed entrepreneurs with the drive to achieve results, which is similar to what privately-financed funds are likely to be looking for.

In some countries, specific conditions are imposed on the type of enterprise which is eligible to apply for funding, as in:

[19] It should be noted that formally the fact of public support of FEIs, or enterprises generally, does not in itself trigger the need to comply with state aid rules but the fact of the schemes or firms supported behaving differently from privately-financed ones.

- **Hungary,** where firms need to have been in business for less than 5 years and have a net annual turnover of HUF 1.5 billion (around EUR 5.4 million) or less or, in the case of the Regional Equity Investment Fund, have been registered for no more than two years and have at least 25 employees over this period;
- **Ireland**, where to receive support from City and County Enterprise Boards, which are co-financed by the ERDF, firms must have no more than 10 people and good prospects for growth, as well as preferably being in manufacturing or the internationally-traded services sector.
- **Denmark**, where in the case of the *CAT Invest Zealand' VC fund*, SMEs need to have a business plans involving a high degree of innovation which is aimed at achieving a significant share of the market with export potential.

In the case of a number of regional funds, wider conditions are imposed in addition to those required to be eligible for ERDF support in order to pursue social and longer-term economic objectives:

- In **Denmark**, to be successful, companies applying to the *Northern Jutland Loan Fund*, must demonstrate that the project will have a positive effect on the development of the region, as well as having to be located in Zealand and to put up at least 50% of the capital required, which is intended to ensure that only firms confident of the investment being profitable apply;
- In **Italy**, in the case of hybrid VC funds (those co-financed by the ERDF), the selection of recipients takes account of wider regional development goals, such as employment creation and gender equality as well as the credit worthiness of the applicant and the prospective profitability of the intended investment.
- In **Slovenia**, the selection of the enterprises to receive funding is also based on wider objectives, in this case on the increase in value added per person employed and the prospective gains in exports as well as job creation, in addition to the credit-worthiness of the firms concerned.
- In **Finland**, the selection of recipients of finance from the *Aloitusrahasto Vera Oy* – the Starting Fund Vera – which is intended for start-ups and firms in the early stages of development, is based on the potential for innovation and growth of the applicants. In disadvantaged regions, like Eastern Finland, however, where the number of start-ups and early-stage innovative firms is limited, the criteria are more lax.
- In **Germany**, the decision to invest in the case of hybrid equity funds is reached through a process of negotiation, in which the detailed conditions to be met are defined on a case by case basis, so potentially enabling wider considerations to be taken into account, along with the share of risk to be taken by each investor and their exit strategy.

As noted above, there are only a few countries in which financial engineering schemes been set up for purposes other than business support as such. The funds created to support urban development and improving the energy efficiency of buildings, however, also tend to stipulate wider conditions than financial ones alone when determining the allocation of finance:

- In **Bulgaria**, recipients of finance from JESSICA funds need to demonstrate significant social effects as well as support from the general public in addition to good prospects for making a profit.
- In **Estonia**, in the case of *Renovation loans for apartment buildings*, energy efficiency needs to be improved by at least 20% in buildings of up to 2,000 square metres and by at least 30% in those over 3,000 square metres as well as the building satisfying an energy audit.
- In **Lithuania**, investment must increase energy efficiency by enough to achieve Class C or D classification and to reduce energy consumption by at least 30% in order to be funded.

Controlling the operation of Financial engineering schemes

As indicated above, many of the funds set up with ERDF support to provide finance for enterprises specify that the investment carried out should be aimed at achieving wider objectives than profits alone in order to quality for funding. This, however, can give rise to a potential conflict with earning the highest financial rate of return possible, since most of the funds have been set up to include substantial private sector participation and, therefore, to involve investors whose motivation tends not to extend much beyond making a profit from the money they put in. Indeed, an important objective of setting up financial engineering schemes is to attract more private sector finance than in the case of grants through the prospect of sharing in the profits generated – through using public funding to 'leverage' finance from private investors (see Box).

The concept of leverage

The term 'leverage' is typically used to denote the amount of private funding raised for a given amount of public or ERDF financing[20]. This definition, however, together with the resulting ratios calculated can be misleading – or at least open to misinterpretation – since it makes no distinction between the attraction of private finance *per se*, i.e. that which would not have been invested otherwise, and the obligation imposed on recipients of public funding by the regulations in force to contribute a minimum amount themselves as a condition for obtaining the funding. It is, therefore, important to take explicit account of co-financing rate requirements when interpreting 'leverage' rates[21].

In addition, allowance also needs to be made for other obligations or conditions imposed on the operation of funds to take wider considerations and objectives into account when allocating finance to enterprises or other beneficiaries. In the case of FEIs especially, the more limited these conditions, the easier it is likely to be to attract private finance since potential investment opportunities can be selected with fewer constraints. At the extreme, with no constraints – other than perhaps on the size of the enterprise – the sole criterion for the allocation of funding becomes the estimated prospective financial rate of return allowing for risk (or the probability of outturns differing from those expected). ERDF support for FEIs, however, implies that the funds concerned will tend to operate under at least some constraints given the Cohesion policy objectives which the ERDF exists to pursue. These may simply relate to the region in which the enterprises receiving funding are located and the sectors in which they operate, which may be more or less narrowly defined. But they may also encompass a wider set of conditions, such as the innovative nature of the firm or the gender or age of the entrepreneur involved.

[20] See, for example, European Court of Auditors, Special Report, *op. cit*. and Communication from the Commission to the European Parliament and the Council, 'A framework for the next generation of innovative financial instruments - the EU equity and debt platforms', Brussels, 2011 (COM(2011) 662 final).

[21] See the European Commission's response to the Court of Auditors' report, published as an annex to the report, *op cit*., which criticises this definition of leverage and the calculation of leverage rates based on it for this reason.

It should be evident that any assessment of the 'leverage' rate of FEIs co-financed by the ERDF-has to take account of the conditions attached to the allocation of funding – to the constraints under which it operates – in order to be meaningful[22]. Equally, the performance of the schemes concerned cannot be satisfactorily assessed without taking account of the wider, non-financial objectives which they are intended to help pursue.

The concern here is to examine how FEIs are operated in practice, to what extent the wider social and longer-term objectives are explicitly taken into account and the degree of control or influence exercised over them by Managing Authorities in this respect. This is based on the studies carried out by the national experts who were asked to investigate the operation of two or three of the main funds co-financed by the ERDF in their countries.

These studies, which are likely to be broadly representative of the way co-financed funds typically operate in the countries concerned, indicate that is some variation in this regard. In most cases, the contracts agreed with the financial intermediaries charged with managing the funds make explicit provision for the pursuit of wider objectives by making them a condition for extending finance to enterprises. What varies, however, is the extent of these conditions, of the tightness of the constraint imposed on the selection of enterprises which to receive funding and the degree to which the conditions are applied in practice.

The extent of control exercised over the operation of funds by Managing Authorities once they have been set up also varies, ranging from close supervision over the allocation of finance in a few cases to very-much arms-length influence, with little or no say over day-to-day operations, in most cases. The same applies to the criteria applied to assessing their performance, which is an important part of controlling their operation. In this case again, there are relatively few instances where the indicators used for this purpose explicitly cover the wider objectives set and in most cases they are limited to basic aspects, such as the number of firms assisted and the extent of private investment attracted.

In practice, the way that the performance of individual funds is monitored and reported seems to be to a large extent much the same as for wholly privately-financed ones, despite the wider objectives they are intended to achieve. For example:

- In **Poland**, in the case of the JEREMIE initiative in the Pomorskie region (or Pomerania in the north of the country where Gdansk is situated), the financial intermediary charged with managing the fund monitors the number, value and average maturity of guarantees provided (broken down by size class), the value of outstanding loans covered by guarantees, the income generated and the cost of management, much as for private funds.

Similar financial indicators tend to be used for loan and VC funds in other parts of the EU, though with the addition of the rate of return on investment in the case of the latter. For instance:

- In the **Czech Republic**, the key indicators of performance of loan and guarantee funds are reported to be the demand for funding and the number of unsuccessful projects in relation to the total number financed, while for VC funds, performance is assessed mainly on the basis of amount invested in enterprises and the profit from the sale of shares in them.

Targets are also set in some cases, though not all, in similar terms, such as in:

[22] The European Court of Auditors' report, *op cit*, estimates leverage rates for a sample of ERDF-financed FEIs providing support to SMEs without making any allowance for such constraints and even compares the rates estimated unfavourably with other EU-funded FEIs which do not operate under these constraints.

- **Latvia**, where for loan and guarantee funds, performance targets are based on the rate of loss from outstanding loans and the relative number of non-performing loans, while for VC funds, there are no specific targets and performance is assessed in the same way as for privately financed funds.

In a number of cases, however, the indicators used to monitor fund performance extend beyond the financial to cover in some degree the wider objectives of policy and the financial intermediaries concerned report on these at regular intervals to Managing Authorities:

- In **Slovakia**, the framework agreement with the EIF defines the indicators to be monitored in the case of the JEREMIE initiative to be the number of new jobs created the private investment in projects and the value-added growth in the SMEs supported as well as the number of SMEs receiving funding.
- In **Denmark**, in the case of the *CAT Invest Zealand* fund, targets are agreed and included in the authorisation letter, covering the effect of loans on the value-added of enterprises as well as the number of loans extended and jobs created or maintained; progress reports on the achievement of targets are submitted twice a year.
- In **Estonia**, in the case of 'subordinated' loans, the targets set relate only to basic indicators, the loans issued and the number of recipients, data are collected and reported on a number of result indicators, including the turnover of the firms assisted, the value-added per person employed and exports as well as the number of employees and private co-investment.
- In **Finland**, the *Finnvera* loan and guarantee fund has targets set which include, as well as the usual ones, the new jobs and new enterprises created for women, though while the targets are reported, the fund has no obligation to report whether they are achieved or not.
- In the **UK**, in the case of the JEREMIE *Finance for Business North East Fund*, in addition to the financial performance of the companies supported, targets are set for a number of strategic Indicators designed to measure the contribution to regional economic development. These include the private sector R&D stimulated and the contribution to the knowledge base as well as the jobs created in the SMEs supported. In the case of the JESSICA *London Green Fund*, the indicators identified by the Managing Authority to monitor pursuit of social objectives include the number of sustainable local jobs created, the diversion of waste from landfill and reductions in CO2 emissions.

The degree of supervision exercised over the operation of funds also varies. In most cases, as noted above, the influence of Managing Authorities is exercised at a distance, if much at all once the funds are set up. There are, however, some exceptions:

- In **Bulgaria**, in the case of the JEREMIE fund, the Managing Authority monitors both the EIF and the enterprises receiving finance in conjunction with the Investment Board and the OP Monitoring Committee on the basis of quarterly reports produced by the EIF, though the degree of detail involved in the monitoring is unclear. Indeed, as noted below, the lack of clear indicators in this regard is held to have reduced the effectiveness of the fund.
- In **Portugal**, financial intermediaries are also required to deliver quarterly reports to Managing Authorities on the operation of funds and the latter regularly verify the performance of a sample of the projects financed. In the case of JEREMIE funds, the EIB delivers annual reports on implementation and regular audits, including basic Indicators such

as the number of guarantees provided and seed capital investment as a share of the total VC extended. In the case of the JESSICA funds, however, only data on expenditure are reported.

So far as Managing Authorities themselves are concerned, as implied by the data typically reported by financial intermediaries, the performance of FEIs – except in the few cases indicated above where the data collected and reported extend to the wider objectives of policy – tends to be assessed on the basis of the usual set of indicators used to monitor enterprise support generally. Indeed, in many cases, FEIs as such are not distinguished from other forms of support when setting targets are assessing outcomes. This is the case in most of the EU15 and EU12 countries and applies to funding provided under both the Convergence and Competitiveness Objectives.

The indicators used, therefore, typically comprise the number of loans extended, the number of firms and business start-ups assisted, the jobs created and the amount of private investment induced. Although in some cases (such as **Spain** and **Slovenia**), they extend to a measure of labour productivity (the value-added per person employed) which bears on the growth potential of the economy, in virtually all cases they relate only tenuously to the ultimate objective of Cohesion policy which to strengthen regional development. Accordingly, a set of result-oriented indicators which bear more directly on this objective, such as business survival rates, the extent of economic restructuring, the growth rates of the companies supported and new products and processes developed, remains to be to put in place.

Problems in using FEIs

The examples of financial engineering schemes examined by the national experts also covered the main problems experienced in using them. These are linked to some extent to the cost issues discussed above and, in particular, to those associated with the need to comply with EU regulations governing the eligibility of measures for ERDF support. Indeed, one of the primary problems referred to was the difficulty experienced in ensuring compliance with the regulations concerned and the lack of clarity surrounding them. This was especially so in the early part of the programming period when plans for the allocation of EU funding were being formulated, though it took until the beginning of 2011 for the Commission to publish a guidance note which covered most of the points requiring clarification[23]. Even then some ambiguities remained, especially in relation to whether working capital is eligible for FEI support or not, an issue which became particularly relevant after the onset of the financial crisis and the increasing difficulties experienced by firms in obtaining bank credit. The clarification given by the Commission in this regard that working capital '*not associated with a plan for the creation or expansion of an enterprise should not be supported through financial instruments*[24] still leaves considerable scope for interpretation.

Other common problems reported are the length of time needed to set up financial engineering funds, which is partly related to the complexity of the regulations and the requirements they impose on Managing Authorities, the cost of training personnel to implement FEIs (especially JESSICA funds) and the difficulties of investing all of the finance allocated to funds by 2015 to comply with the 'n+2' rule.

[23] See the Court of Auditors' Report, *op cit*. on this.

[24] Quoted in Court of Auditors' Report, *op cit*.

Problems relating to the complexity and lack of clarity of the regulations in respect of using the ERDF to co-finance FEIs and, accordingly, the difficulties of ensuring compliance with these were reported in most countries in both the EU15 and EU12. In many cases, especially in the EU12 but also in some of the southern parts of the EU15, they were seen as being compounded by the less developed capital market and the more limited experience of FEIIs of both Managing Authorities and enterprises which are the potential recipients. Problems were also exacerbated in a number of countries by the effect of the crisis in both deterring companies from investing in business expansion and reducing the willingness of private investors to put money into funds. In addition, the EIF was reported as adding to difficulties in some countries (Latvia, Cyprus, Slovakia and Greece) because of its lack of experience, at least initially, the time-consuming negotiations involved in reaching agreements, its extensive reporting requirements and high management fees, all of which increased costs and led to delays in setting up schemes.

A number of more specific problems relating to the establishment of FEIs with ERDF support were reported in some countries. These include:

- In **Germany**, where, as in a number of other countries, the demand for FEIs in some Länder has declined during the crisis so reducing financial absorption and prompting some relaxation of the criteria applied to the companies granted finance. This has led the Court of Auditors to judge the risk assessments carried out as being too generous and leading to too great a loss of capital, so giving rise to a problem of how to absorb the resources allocated to the funds concerned[25].
- In the **Czech Republic**, where the major problem in designing and implementing VC funds has been to set an acceptable level of risk which makes them attractive for private investors. This problem was overcome by establishing a 100% state-owned fund administered by a professional manager, which has led to a dispute with the Commission since the financial intermediary charged with administering the fund was not selected by public tendering procedures.
- In **Greece**, where problems of absorption have been created by the absence of automatic de-commitments in respect of FEIs, in the sense that funding is counted as being spent as soon as it is paid into a scheme, which accordingly means that the 'n+2' rule is satisfied at this point and the risk of de-commitment no longer applies. The funding concerned, however, still needs to reach final beneficiaries by 2015 in order to be eligible for ERDF support, which means that the financial intermediaries concerned have to be relied upon to find suitable companies in which to invest by this time. In addition, problems are also reported to have arisen from the fact that firms experiencing liquidity problems because of the crisis were not eligible for finance under JEREMIE, which was restricted to supporting investment. In April 2012, however, this restriction was lifted (leading to the provision of EUR 18.5 million of funding in a single month, around three times more than in the month before).
- In **Latvia**, where a similar problem to that in Greece is reported, arising from the need for all the funding paid into FEIs to reach the enterprises it is intended for by the end of 2015,

[25] A further issue in Germany is that large amounts of ERDF support are allocated to FEIs which do not comply with Article 44 of the regulation, a fact which has come to light only during the programming period.

which in this case, it is considered, will limit the ability of banks properly to appraise loan requests and equity funds to assess investment options. Accordingly, there is a risk either that the funding will not be allocated or that it will not be used in the most effective way.

- In **Lithuania**, where it is reported that Commission insistence that loans, guarantees and grants cannot be used to finance the same undertaking unduly restricts the use of the ERDF to support FEIs and contradicts earlier Commission advice, on the basis of which contracts with financial intermediaries to implement FEIs were signed in 2009 and 2010. This and other uncertainties over FEI regulations are considered to remain a major problem, which is not resolved by either the 2011 Guidance Note or the new proposed Structural Fund regulations. Accordingly, there is a significant risk that some of the costs incurred will not be considered eligible for funding when programme are closed and that FEIs will be used only very little in the future. It is also reported that the complexity and length of time needed to set up JESSICA initiatives were grossly under-estimated and by the time they were in place, the financial crisis made both banks and residents living in the apartment blocks to be renovated more reluctant to be involved.
- In **Estonia**, where there was a long dispute with the Commission over the specific design of the loan fund for renovating apartment buildings, which was approved only after long negotiation and where it is held that the FEI guidelines issued by the Commission in 2011 should have come much earlier. It is also reported that the length of time needed to set up FEIs meant that the authorities could not respond soon enough to the increased demand for financial support from SMEs as the crisis hit.
- In the **UK**, where the length of time required to establish financial engineering schemes, along with the resources needed, was also regarded as a major problem. The fact that schemes can take up to 2½ years to set up and another 3-4 years or more for the investment targets to be met means that they need to be initiated relatively early in the programming period to satisfy the time constraints imposed by ERDF regulations. Equally, it is emphasised that additional problems tend to arise from the wider objectives set for ERDF-supported funds – from what is sometimes termed the “double bottom line” in that they need not only to meet financial targets but also social objectives, such as CO_2 reductions. As emphasised above, this may not only conflict with earning a sufficient rate of return to attract private capital but also make it difficult to set viable goals and to judge performance.
- In **Malta**, where the resources and time required to set up FEIs were also reported to be a major problem, in part due to the need to train staff and to market the schemes. Concern was expressed, in addition, that EIF scrutiny of the companies receiving funding added to their administrative burden, with particularly adverse effects on very small firms. Moreover, as in the UK, the difficulty of ensuring that funding is allocated in line with ultimate policy objectives was emphasised. While problems of staff training had largely been overcome, there is still a need to ensure that the EIF targeted funding on enterprises in sectors with high value-added potential for the economy.
- In the **Netherlands**, where the limited possibility of controlling the allocation of funding was regarded as an important reason for the government being reluctant to implement FEIs, especially JESSICA schemes.

The various problems in the creation of FEIs and their operations listed above were compounded as, indicated in the case of Hungary, Slovenia and Romania, by the effect of the crisis. This was seen as a particular problem in **Portugal** too because of the resulting reduction in the willingness of financial institutions to participate in schemes and on the diminished demand for funding on the part of businesses.

5. Evaluations of FEIs

Few evaluations of financial engineering schemes have been carried out across the EU and hardly any of the schemes co-financed by the ERDF. This in large part is because of the relatively short time that publically-supported schemes have been in existence in most Member States, especially in the EU12 but also in many of the EU15 countries. There have, however, been some evaluations of FEIs in Spain, Italy, Germany, Austria, Netherlands and the UK as well as in Slovenia and the three Baltic States, though not all of them of schemes co-financed by the ERDF and not in the main of schemes operating in the present programming period apart from *ex ante* assessments. Moreover, a number of evaluations are in the process of being undertaken or are planned, though in some cases, these are part of a wider evaluation of policy rather than being confined to FEIs as such.

The evaluations carried out in the EU15 have for the most part concluded that FEIs have been relatively effective in increasing employment and improving the performance of the firms which have been funded. In Estonia, however, the impact assessment of enterprise support measures concluded that FEIs have had a limited effect on the growth of productivity, turnover and exports in the firms receiving funding.

In addition, the European Court of Auditors' report, referred to above, reviewed a sample of ERDF-financed schemes for SMEs in the 2000-2006 and 2007-2013 periods, but this focussed more on procedures and the way they operated than on their effects on policy objectives. Nevertheless, it did highlight the comparatively small amount of private sector participation in the schemes (though see above on this) and the relatively long time taken for funding actually to reach firms.

The situation across the EU as regards evaluations of FEIs

As indicated above, few evaluations have been undertaken of financial engineering schemes in EU Member States. In many countries, none at all have been carried out. This is the case in **Denmark, Ireland, Greece, France** and **Portugal** in the EU15 and in the **Czech Republic, Cyprus, Malta, Slovakia** and **Bulgaria** in the EU12, largely because the use of public funding to support schemes is relatively recent. Assessments have been made, however, in all cases of the need for FEIs in terms of identifying the gaps which exist in the financial market as regards the access of SMEs to finance and the demand of these for funding, even if the adequacy of the studies carried out has been criticised[26]. In **Romania** too, no evaluations have been undertaken so far, though according to officials an evaluation of JEREMIE is planned to be carried out later in 2012.

In addition, In **Hungary**, the mid-term evaluation of the Economic Development Operational Programme was undertaken in 2010 before the VC scheme started, though it recommended that the use of FEIs should be increased, FEIs should be combined with grants and the existence of VC funds advertised more.

[26] See European Court of Auditors' Report, *op. cit*.

In the other Member States, the situation is mixed. In two countries, evaluations are planned but no evidence exists at present on the effects of FEIs:

- In **Latvia**, evaluations of EDRF-supported schemes are being carried out by the Ministry of Finance, including a mid-term review and selected internal audits, but no reports are as yet publicly available.
- In **Poland**, FEIs are included in the evaluation schedule of regional Operational Programmes, but no attempt has yet been made to examine their real contribution to regional development or to eliminating the funding gap for SMEs.

This leaves 12 of the 26 countries in which the ERDF is being used to support FEIs where some evidence is available on their effects, as summarised below.

The evidence on the effects of ERDF-supported FEIs

Although evaluations as such have not been carried out, some analysis of the effects of FEIs has been undertaken in two countries:

- In **Italy**, Bank of Italy studies of ERDF supported FEIs have found evidence of substitution and crowding out effects, with firms tending to prefer grants to FEIs and financial intermediaries choosing to invest in wholly-privately funded schemes to ERDF-financed ones because of their less restrictive criteria for selecting the enterprises in which to invest, which implies a higher rate of return.
- In **Belgium**, a number of studies have been undertaken to assess the needs of SMEs for financing in order to identify an appropriate public response, while those of VC-backed enterprises have found that they tend to invest more than non-supported ones, with a positive effect on sales and value-added. This has encouraged new investment, which in turn has led to cumulative effects on growth. There is also evidence of a positive effect of micro-credits on employment.

In the other 10 countries, evaluations have been carried out but to a limited extent and not necessarily of ERDF-financed schemes:

- In **Lithuania**, an evaluation of FEIs financed by the Structural Funds, carried out at the end of 2010 for the Ministry of Economy, concluded that they were an effective means of supporting SMEs during economic downturns, though some new ones were considered inadequate because of their relatively long deployment period. The evaluation identified a need for additional support for exports, for VC funds to be developed and micro-credit to be expanded.
- In the **Netherlands**, a number of evaluations on the use of FEIs are either underway or planned, but the only evaluation so far completed is that by the EIB on the JESSICA fund which concluded that since the scheme attracted private capital, it enabled cities to carry out more projects with the same volume of funding.
- In **Sweden**, although the 12 investment funds launched with ERDF support in 2009 have not yet been evaluated, the mid-term report on some of the funds which are subject to an on-going evaluation presented evidence that they had helped to reduce the equity gap. In addition, the evaluation of the pilot FEI projects which preceded the implementation of the

funds country-wide concluded that they had increased the volume of VC available to SMEs in the regions and private investment in them.

- In **Austria**, an evaluation undertaken to assess the impact of VC financing on innovation behaviour and growth found that the firms financed tended to increase employment and sales by more than other firms and though they also tended to more innovative, there was no evidence that this was due to the finance received.
- In **Slovenia**, an evaluation of FEIs published in 2012 found positive effects on the performance of firms in terms of a number of indicators one year after receiving funding, but the effects did not last much longer than this.
- In **Germany**, only two evaluations have been carried out specifically on FEIs, though they have been covered in mid-term and other evaluations of programmes. The studies indicate that FEIs are of minor importance overall, but that they have favourable effects in supporting high-tech start-ups.
- In **Spain**, the three evaluations carried out on the use of FEIs found that assisted firms experienced an improvement in performance and increased employment.
- In **Estonia**, two evaluations have been carried out on the use of FEIs to support investment in the capacity of firms for innovation and growth. One carried out by the National Audit Office concluded that FEIs have had a limited effect on the growth of productivity, turnover and exports of the firms supported. On the other hand, the preliminary results of the impact assessment of enterprise support measures undertaken by the Ministry of Economic Affairs and Communications, which is still on-going, indicates that the SMEs supported by FEIs have grown more rapidly than others.
- In **Finland**, while no evaluations have been carried out specifically on FEIs, a comprehensive evaluation of *Finnvera* which manages loan and guarantee schemes was published in June 2012. This concluded that service provided by *Finnvera* is valued highly valued by SMEs and banks nut that the contribution to regional development is unclear. Moreover, the evaluation pointed to a danger that the support provided postpones necessary structural shifts away from declining industries to new sectors and concluded that, because of changes in the global business environment, supporting SMEs as a means of furthering regional development is no longer efficient.
- In the **UK**, although there is limited evidence on the effect of FEIs in the current programming period, evaluations carried out in the previous period concluded that they produced relatively good results. The most extensive evidence comes from an evaluation of Venture Capital and Loan Funds financed by the ERDF in the 2000-2006 period which concluded that they achieved the expected output and employment aims while adding to the overall amount of finance available. In terms of the unit costs involved, however, they were an expensive means of increasing turnover and jobs. In addition, the evaluation of the Crescent Capital Funds in Northern Ireland found that they helped to narrow the equity gap and meet the demand for finance from manufacturing and tradable service companies.

Overall, therefore, the evidence available from evaluations of FEIs co-financed by the ERDF – or indeed by public funding generally – is extremely limited. Though they seem to add to the funding that SMEs have access to and increase turnover and jobs in the firms supported, very little is known about their effects on ultimate objectives, on strengthening the growth potential of the business

sector and the prospects for regional development. Indeed, in most countries, there is as yet little or no evidence that they are any more effective than grants in this respect nor that, in general, they add significantly to the support available to businesses through recycling funds.

6. Main findings and future challenges

Main findings

The main points to emerge from the above are that:

- In most countries, the use of the ERDF to finance FEIs is relatively recent and limited in size; the share going to FEIs is larger in the EU15 than EU12 and in Competitiveness than Convergence regions and takes the form more of support for loans and guarantees than VC funds.
- There was a very small overall increase across the EU in the share of the ERDF planned to go to FEIs over the programming period combined with a shift from VC funds to loans and guarantees.
- The variation in use is broadly in line with expectations, given that FEIs require expertise to set up and operate and VC funds sufficient innovative high growth firms to be viable.
- There is a strong case for public support of loans and guarantees in many countries given the limited access of SMEs to finance and the large amount of collateral often demanded by banks. This applies particularly to countries where borrowing from banks is most problematic and where the support to businesses they provide is most limited, such as Bulgaria, Hungary and Romania in the EU12 and Greece and Spain in the EU15.
- The case for support of VC funds is weaker and there are only a limited number of areas across the EU which have a sufficient concentration of small high-growth firms to justify public support of them.
- The main reasons for the use of FEIs according to Member States are closely in line with Commission statements, that they fill a gap in the financial market between the demand for funding from SMEs and the available supply in a 'revolving' way which means that more firms can be supported.
- While the use of the ERDF to support FEIs may be justifiable, there is not enough evidence to determine whether the scale of support matches the size of the gaps in the market for loans and equity finance and how far the sums allocated have reduced these gaps.
- It is questionable whether the size of many of the VC funds set up with ERDF support is large enough for them to be viable given the high fixed costs and the high degree of uncertainty attached to investments which makes it important to spread the risk.
- The complexity of FEIs and the time and resources needed to set them up have reduced their use, along with the limited extent of demand for them perceived by Managing Authorities and the preference for grants for many investments where the policy objectives extend beyond making a financial return.
- Very little data exist on the cost of setting up and operating FEIs relative to non-repayable grants but there is a widespread perception that they are higher and the period needed to set them up longer.

- Many of the financial engineering schemes set up with ERDF financing to support businesses operate in much the same way as privately-financed ones, except that they are limited to SMEs, particular sectors and firm located in the region; many, however, also have wider objectives, in line with the aims of Cohesion policy, and impose additional conditions on recipients of funding over and above purely financial ones.
- The main problems of using the ERDF to co-finance FEIs stem from the complexity of the regulations and the uncertainty surrounding their interpretation because of their lack of clarity, which add to costs and time taken to set up schemes; this was especially so in the early part of the period but problems remain even after Commission attempts to clear up ambiguities, which deter the authorities from using FEIs.

Very few evaluations have been carried out on ERDF-financed FEIs or publically-funded schemes generally; those that have been undertaken generally indicate positive effects on the performance of the firms supported, but there is limited evidence on the achievement of wider objectives – on the competitiveness of the business sector and regional development.

Future challenges and lines of action

The findings listed above together with other issues identified in the course of the study imply that there a number of challenges which need to be overcome in order for the use of the ERDF to support FEIs to be more effective in the future. The main one perhaps is to implement FEIs in a way that ensures compatibility between, on the one hand, the financial imperative of earning a reasonable rate of return in order both to attract private capital and to enable funds to be effectively recycled and, on the other, the pursuit of wider policy objectives. The concern is to avoid the danger that these wider objectives, to do with economic and social cohesion which the ERDF was established to help to achieve, are subordinated to purely financial goals[27].

There are a number of steps that can be taken in this regard:

- carrying out the necessary research to identify more clearly the nature and scale of the gaps in the financial market – distinguishing between loans and equities – which limit the availability of finance for SMEs and budding entrepreneurs that public support for FEIs is potentially able to fill; while the EIF undertook a significant amount of analysis to identify the gaps concerned in particular countries before funds were set up in the current period, the economic situation has in many cases changed markedly since then, affecting both the demand and supply side of the market;
- exploring ways of reconciling regional development objectives which are the *raison d'être* of the ERDF with the need to ensure that financial engineering funds are a sufficient size to be viable, especially as regards VC funds, which may involve cooperation between regions;
- undertaking more evaluations into the effects of ERDF-supported FEIs of different kinds on both the performance of the enterprises receiving funding and wider regional development objectives; this is essential to gain more of an understanding of the way that loan funds, guarantee schemes, micro-credit arrangements, VC funds and so on each need to be set up and operated to be effective and the policy areas and circumstances in which they are the most suitable form of intervention;

[27] This essential difference between a financial engineering fund co-financed by the Structural Funds and a privately-financed one is one which is emphasised strongly in the Commission's response to the Court of Auditors' report, *op. cit.*

- establishing relevant indicators and collecting the associated data to be able to monitor and evaluate the performance of FEIs of various kinds in a meaningful way, given the multiple objectives which they are intended to pursue, without imposing an excessive administrative burden on SMEs; these indicators might include, for example, the survival rate of new firms supported, the growth of SMEs receiving funding and the extent of restructuring as reflected in the division of employment or value-added between activities;
- clarifying the regulations governing the use of the ERDF to support FEIs so as to eliminate the uncertainty in Member States over the way they need to be set up and operated which is still prevalent; issues to be resolved – which are raised in the European Court of Auditors' report – include:
    - the eligibility of working capital for funding
    - the required extent of private sector participation
    - the possibility of using FEIs in conjunction with grants to support investment
    - the status of public funding relative to private capital in the event of funds failing
    - the conditions applying to the way recycled funds are used;
- exploring ways of reducing the cost and the time taken to set up FEIs, including through possible cooperation between Managing Authorities in different regions and the sharing of experience and expertise on, for example, the organisation of schemes, creating awareness of them among both potential investors and recipients of funding and appraising the demand for them.

The use of the ERDF to co-finance Financial engineering schemes on any significant scale is relatively new and the growing interest in them means that there is both a need and an opportunity to investigate their operation and effects in some detail. This should enable a better understanding to be gained of the areas in which particular kinds of scheme - loans, guarantees, venture capital funds and so on – are likely to be the most efficient and most effective way of providing investment support given the end-objectives of Cohesion policy and the tight constraints on funding which are likely to remain for some years to come.

Annex The Rationale for ERDF support of FEIs - References to market failure in Operational Programmes and from interviews with Managing Authorities

A number of specific forms of market failure were referred to in Operational Programmes and by Managing Authorities when interviewed to justify the use of ERDF to co-finance FEIs. These include:

- the particular reluctance of banks to lend to small firms and most especially to innovative companies and business start-ups;
- the substantial amount of collateral demanded from borrowers;
- the apparent prejudice of banks against certain borrowers or borrowing for particular purposes;
- the under-developed nature of the equity market which limits the VC available.

Those mentioned in different Member States were:

- In **Belgium**, the increased reluctance of banks to lend to SMEs as the financial crisis has gone on, most notably, after the Basle II prudential rules were imposed, together with the prejudice of banks against the young, unemployed, women and ethnic minorities.
- In **Denmark**, a lack of venture capital which has intensified since the onset of the financial crisis;
- In **Germany**, the overly cautious attitude of banks to assessing risk, and the need for borrowers to provide collateral which they often lack, together with an under-developed equity market;
- In **Spain**, the rationing of credit to SMEs combined with high collateral requirements and/or high interest rates;
- In **France**, a lack of risk capital for the creation of innovative firms and an aversion of banks to risk;
- In **Austria**, a lack of investment finance in the early stages of company development;
- In **Portugal**, a lack of capacity on the part of banks to correctly assess the risk of innovative projects;
- In **Finland**, a lack of risk capital for the creation of innovative enterprises and the need to provide a large amount of collateral, especially in disadvantaged regions;
- In **Sweden**, the problems faced by innovative or newly-created SMEs in obtaining bank loans and the shortage of micro-credit;
- In the **UK**, the limited credit available to SMEs using new environmental technologies, which are regarded as high risk and on which returns from investment tend to accrue only over the long-term;
- In **Bulgaria**, the aversion of banks to risk and the provision of loans to start-ups and innovative SMEs;
- In **Estonia**, the limited availability of credit for SMEs, the high collateral requirements imposed on borrowers and the high price of loans for apartment building renovation;
- In **Lithuania**, the limited availability of credit for SMEs and a lack of finance for investment in the energy efficiency of housing;

- In **Hungary**, the limited supply of finance for newly-created firms and of equity finance generally;
- In **Malta**, the substantial collateral required from potential borrowers;
- In **Poland**, the limited availability of credit for SMEs, especially micro-firms, and a lack of equity finance;
- In **Romania**, a lack of micro-credit and of venture capital;
- In **Slovenia**, a shortage of micro-credit, venture capital and business angels; the high interest rates imposed on small firm borrowing together with significant collateral requirements.

Annex Table Distribution of ERDF available for the 2007-2013 period to FEIs by form of FEI and Objective

EUR million

	Convergence Objective					Competitiveness Objective					Total ERDF				
	Loans, etc	VC	Non-refund	Other	Total	Loans, etc	VC	Non-refund	Other	Total	Loans, etc	VC	Non-refund	Other	Total
BE		68.7	380.5		449.2	2.9	35.7	502.5		541.1	2.9	104.4	883.0		990.3
DK							25.0	229.8		254.8		25.0	229.8		254.8
DE	514.9	137.8	10,708.4		11,361.1	410.5	330.4	3,978.3	27.6	4,746.9	925.4	468.2	14,686.7	27.6	16,108.0
IE						10.5		364.9		375.4	10.5		364.9		375.4
GR	144.5	45.0	15,657.0		15,846.5						144.5	45.0	15,657.0		15,846.5
ES	741.7	255.5	19,186.8	1,556.9	21,740.9	40.0	30.8	4,517.2	271.5	4,859.5	781.7	286.3	23,704.0	1,828.4	26,600.4
FR	20.0	21.8	2,276.7		2,318.5	66.6	104.0	5,320.8	244.9	5,736.2	86.6	125.8	7,597.4	244.9	8,054.7
IT	1,418.7	292.8	13,620.9	2,550.5	17,882.9	530.6	205.4	2,236.6	171.9	3,144.4	1,949.4	498.2	15,857.4	2,722.3	21,027.3
LU								25.2		25.2			25.2		25.2
NL						32.9	54.3	739.4	3.3	830.0	32.9	54.3	739.4	3.3	830.0
AT		7.5	117.5		125.0	2.3	14.3	538.4		555.0	2.3	21.8	656.0		680.1
PT	1,887.2	235.2	11,652.4	166.1	13,940.9	41.7	21.7	558.8	5.0	627.2	1,928.9	256.9	12,211.2	171.1	14,568.2
FI						61.0	25.1	891.3		977.4	61.0	25.1	891.3		977.4
SE						49.6	49.4	835.5		934.5	49.6	49.4	835.5		934.5
UK	6.1	200.4	1,623.8		1,830.3	150.9	280.1	3,154.7		3,585.7	157.0	480.5	4,778.6		5,416.0
BG	137.3	32.7	5,318.2		5,488.2						137.3	32.7	5,318.2		5,488.2
CZ	299.7	45.0	22,165.9		22,510.6			241.2		241.2	299.7	45.0	22,407.1		22,751.9
EE	31.3		2,980.7		3,011.9						31.3		2,980.7		3,011.9
CY	8.5	8.5	475.7		492.7						8.5	8.5	475.7		492.7
LV	101.6	85.3	3,760.5		3,947.3						101.6	85.3	3,760.5		3,947.3
LT	306.4	29.0	4,910.1	501.7	5,747.2						306.4	29.0	4,910.1	501.7	5,747.2
HU	569.4	110.4	19,145.0		19,824.9	80.0	10.0	1,377.2		1,467.2	649.4	120.4	20,522.2		21,292.1
MT	8.5		719.6		728.1						8.5		719.6		728.1
PL	816.9	155.0	56,155.3	51.0	57,178.2						816.9	155.0	56,155.3	51.0	57,178.2
RO	50.0	50.0	15,428.9		15,528.9						50.0	50.0	15,428.9		15,528.9
SI	50.0	35.0	3,260.3		3,345.3						50.0	35.0	3,260.3		3,345.3
SK	16.8	20.0	9,814.7	52.0	9,903.5	3.0	3.0	89.2		95.2	19.8	23.0	9,903.9	52.0	9,998.7
EU15	4,733.1	1,264.7	75,224.1	4,273.5	85,495.3	1,399.7	1,176.1	23,893.4	724.2	27,193.4	6,132.8	2,440.8	99,117.4	4,997.7	112,688.7
EU12	2,396.4	570.9	144,134.8	604.7	147,706.9	83.0	13.0	1,707.6	0.0	1,803.6	2,479.4	583.9	145,842.4	604.7	149,510.5
EU27	7,129.5	1,835.6	219,358.9	4,878.2	233,202.2	1,482.7	1,189.1	25,601.0	724.2	28,997.0	8,612.2	3,024.7	244,959.8	5,602.4	262,199.1

Source: DG Regional Policy financial database