

The use of the ERDF to support Financial engineering instruments

Executive summary

The report synthesises the findings of the 27 country reports produced by the network of independent evaluation experts on the use of financial engineering instruments (FEIs) across the EU and those of the literature review which set the context for the reports. It examines in turn:

- the scale of support from the ERDF in the 2007-2013 period allocated to FEIs and the change over the period;
- the rationale for using FEIs according to Member States and the reasons for not doing so;
- the difference in aims and operation between ERDF-supported FEIS and privately-funded ones;
- the problems in using the ERDF to support FEIs and in setting up schemes;
- the evaluations of FEIs that have been carried out and their findings.

It concludes by making policy suggestions on the basis of the findings.

Scale of ERDF support for FEIs

ERDF support for FEIs, defined to include all means of aid other than non-refundable, is relatively recent in most countries and so is limited in size. It amounts to just over EUR 11.6 billion in the EU in the present period, or 4.4% of total ERDF resources¹. It is larger in the EU15 than in the EU12 and in Competitiveness regions than in Convergence ones. Overall two-thirds goes to loans and guarantees, a third to venture capital (VC) funds. The VC share, along with the FEI total, is larger in the more developed parts of the EU, which accords with expectations given the expertise required to set such funds up.

The share of ERDF going to FEIs has increased slightly over the period with a shift from VC funds to loans and guarantees.

Rationale for the use of the ERDF to support FEIs

All, or almost all, the FEIs co-financed are for the support of SMEs, which can be justified by their limited access to finance and the large collateral often demanded by banks. This is especially so in Bulgaria, Hungary, Romania, Cyprus and Greece where the evidence suggests that support from banks is particularly limited, but the share of the ERDF going to FEIs is equally limited.

The case for support of VC funds is weaker and there are only a few areas across the EU which have a sufficient concentration of innovative high-growth SMES for support to be justifiable. It is open to question whether many of the funds set up are large enough to be viable given the high fixed costs and the uncertainty attached to investments which makes it important to spread the risk.

The main reasons for the use of FEIs according to Member States echo those highlighted by the Commission – that they fill a gap in the market between SME demand for funding and the supply and do so in a ‘revolving’ way so that more firms can be supported. Other reasons referred to include the access to private sector expertise they give and the view that FEIs are more efficient than grants over and above the ‘revolving’ aspect. There is, however, little evidence to support the latter.

¹ It should be noted that these figures are based on data by category of expenditure compiled by DG Regional Policy from the information reported by Member States, which in some cases is of questionable accuracy. It is being reviewed and is set to be updated later in the year.

A further reason is that FEIs are a means of overcoming the 'n+2' rule since funding is deemed to be spent as soon as it is allocated to a fund, though it is still the case that all funding has to reach final beneficiaries by the end of 2015, which could be problematic in some cases.

Reasons for not using FEIs

In many countries FEIs are regarded as being less appropriate than grants for supporting RTD and innovation, especially where cooperative research and research networks are involved. In other areas, their complexity and the time and resources needed to set them up have reduced their use, along with limited demand for them from firms and the preference of authorities for grants where policy aims extend beyond making a financial return. There is also a widespread perception that the cost of setting up and operating FEIs is higher than for grants but there is little data on this.

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

Many of the FEIs set up with ERDF support operate in much the same way as privately-financed ones, except for being restricted to SMEs in particular sectors and located in the regions concerned. But many have wider objectives in line with Cohesion policy aims and apply additional criteria over and above financial ones to receipt of funding. The extent of control exercised by Managing Authorities over their operation once they have been set up, however, is limited in most cases. Moreover, the indicators used to judge their performance rarely relate explicitly to the wider objectives set and tend to be confined to basic aspects, like the number of firms assisted or the amount of private money attracted.

Problems in using FEIs

The main problems reported in using the ERDF to co-finance FEIs relate to the complexity of the regulations and their uncertain interpretation because of lack of clarity. These problems have persisted despite Commission efforts to clear up ambiguities and add to the costs and time of setting up schemes, so deterring their use. The crisis has added further difficulties by both deterring firms from investing in expansion and reducing the willingness of private investors to put money into funds.

Evaluations of FEIs

Largely because of the short time they have been in operation, very few evaluations of ERDF-supported financial engineering schemes have been carried out across the EU and only slightly more of publically-supported 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 suggested policy action

The study points to a number of challenges which need to be overcome in order for the use of ERDF support for FEIs to be more effective in the future. The main one is to ensure compatibility between the imperative of earning a financial rate of return so as to attract private capital and enable funds to be recycled and the pursuit of wider policy objectives. The aim must be to avoid these wider

objectives, to do with economic and social cohesion which the ERDF was established to help achieve, from being subordinated to purely financial goals.

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 gaps in the financial market which limit the availability of both loans and venture capital for SMEs which public support for FEIs is potentially able to fill; this includes updating the analysis undertaken before funds were set up in the current period to take account of the effect of the crisis on both the demand for finance and the supply;
- exploring ways of reconciling regional development objectives which are the *raison d'être* of the ERDF with the need to ensure that schemes, especially VC funds, are of a sufficient size to be viable, including possible cooperation between regions;
- undertaking more evaluations into the effects of ERDF-supported FEIs of different kinds on both the performance of firms receiving funding and wider regional objectives so as to gain more of an understanding of the best way of setting up and operating them and to identify the policy areas where they are the most suitable form of intervention;
- establishing relevant indicators and collecting the related data to enable the performance of FEIs to be assessed in a meaningful way, given their multiple objectives, without imposing an excessive administrative burden on SMEs; examples of indicators include: the survival rate of new firms supported, the growth of SMEs receiving funding and the extent of restructuring, as reflected in changes in the division of employment or value-added between activities;
- clarifying the regulations governing the use of ERDF support for FEIs so as to eliminate uncertainty over the way they need to be set up and operated; issues to be resolved 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 expertise and experience on, e.g., the organisation of schemes, creating awareness of them and appraising the demand for the funding they provide.

Given that ERDF support for FEIs is relatively new and interest in them is growing and given also the tight constraints on funding which are likely to persist, there is both a need and an opportunity to investigate their operation and effects in detail and gain a better understanding of where and how they can best be deployed.