



**Expert evaluation network
delivering policy analysis on the
performance of Cohesion policy 2007-2013
Year 2 – 2012**

Task 1: Financial engineering

The Netherlands

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

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List of abbreviations

- AA Audit Authority
- CA Certificate Authority
- EC European Commission
- EEN Expert Evaluation Network
- ERDF European Regional Development Fund
- FEI Financial Engineering Instrument
- MA Management Authority
- OP Operational Programme
- VC Venture Capital

Executive summary

1. The Operational Programmes (OPs) West and East make use of Financial Engineering Instruments (FEIs) in the present programme period in order to stimulate innovation and entrepreneurship (other regions are uncertain about these unknown instruments) in particular of SMEs, because there is no market to finance innovative projects.
2. The use of FEIs rather than grants is perceived as being beneficial by the programme managers because:
 - a. The revolving character of some FEIs (e.g. JESSICA) in times of budget deficits (economic crisis). Revolving funds are more valuable in regional economic terms.
 - b. Participation of the government stimulates involvement of the private market which results in a leverage effect.
 - c. A 'better' governmental intervention to realise balanced public-private partnerships aimed at sustainable economic development.
 - d. It anticipates on market failure. In particular for starting SMEs without a track record there are no possibilities at the capital market.
 - e. The use of FEIs ensures long term continuity (partnership) for funds and projects (also) aimed at societal revenues.
3. There are no extra demands concerning the projects based on FEIs (compared with grants). There are no extra preconditions for final beneficiaries. The criteria applied to assess the performance of FEIs are equal to criteria for projects which received a grant.
4. The main problems perceived by programme managers with regards to FEIs are: The uncertainty about the possibilities to set up FEIs under the ERDF 1828/2006 regulations and the late response (2011) from the European Commission, the opposition of the Dutch national government (in particular the Dutch Ministry of Finance) regarding FEIs and the low execution costs that are permitted for Programme management in the Netherlands make it difficult to implement FEIs, which have relatively higher costs.
5. In the beginning of the programme period in 2007 the FEIs were unknown, which increased uncertainty. That is why FEIs have not been widely implemented. There is in particular a need for specific and better indicators and definitions which are focused on FEIs instead of grants. At the moment no distinction is made between subsidies and FEIs.
6. Due to the economic crisis and the budget deficits the need for financial instruments and in particular revolving funds will increase. This extends the need for more and better service, regarding the implementation of FEIs. A future challenge besides is to raise interest of fund management and participation.

1. Use of financial engineering instruments

In the Netherlands we distinguish four ERDF funded OPs (North, South, East & West). In the present programme period, FEIs are not used extensively. The only programmes using FEIs are West and East (See Table 1 and 2 below).

Table 1: OP – West (Kansen voor West)

Title	Doorstart Technofonds Flevoland	Garantiefonden Microkredieten Amsterdam	Startersfonds Den Haag	JESSICA Urban Development Fund SOFIE	JESSICA Fonds Ruimte en Economie Den Haag (FRED)	JESSICA Energiefonds Den Haag (ED)
Objective	Economic development	Economic development	Economic development	Economic development	Sustainable & economic development	Sustainable & economic development
Theme	Innovation & entrepreneurship	Entrepreneurship	Entrepreneurship	Urban development	Sustainable spatial development	Sustainable development / energy
Form	Risk capital	Guarantee fund	Risk capital	Loans, Guarantee, equity	Loans	Loans
Budget (EUR million)	5.50	1.20	2.40	6.50	4.10	4.00
ERDF (EUR million)	1.25	0.40	1.20	2.46	2.0	1.7
Share of ERDF	22.7%	33.3%	50.0%	37.85%	48.8%	42.2%

In the West region the use of different types of FEIs is extensive. In particular these aimed at supporting entrepreneurship, innovation and in broader sense economic development. The form of these FEIs is amongst others: risk fund, guarantee-fund, loans, additional equity. The expectation is that FEIs will become more important in the programming period 2014 – 2020. In order to gain more experience, practical knowledge and insight OP West increased the use of FEIs during the realisation of the programme (even more than initially planned).

Table 2: OP – East (Go-Oost)

Title	Innovatiefonds Oost – Nederland	Gelderland voor innovaties
Objective	Improving of innovation and competitiveness of SMEs	Stimulation of investments in innovation and growth of SMEs
Theme	Innovation in the field of food, health, technology	Innovation
Form	Risk capital	Loan
Budget (EUR million)	13.6	4.2
ERDF (EUR million)	6.1	2.1
Share of ERDF	45.1%	50.0%

In the East region there are two FEIs (Innovation funds) which is more than initially planned. The OP did not mention the set up of regional funds or financial engineering instruments.

In the Northern and Southern Regions FEIs have been used in the programme period 2000–2006. Although the results were positive and more insight and knowledge in revolving funds had been developed, specific measures to include FEIs in the period 2007–2013 have not been taken. Nevertheless FEIs are not excluded in the present period.

The OP South did not mention FEIs. There are, however, particular regulations aimed at SMEs, but these are subsidies means and not FEIs. The use of FEIs decreased even compared with the initial plan. The Programme foresaw the use of Venture Capital (VC) but eventually this option was not chosen.

The use of ERDF co-financed FEIs has been intensified over the period in the OPs West and East while the opposite was the case in the OPs South and North, due to a very fast budget exhaustion.

2. Rationale for using financial engineering instruments

FEIs or grants?

Reasons given by the relevant authorities for the use of FEIs rather than grants are amongst others:

1. The revolving character of some FEIs (e.g. JESSICA) in times of budget deficits (economic crisis) results in more financing possibilities which stimulate investments. Besides, the regions mention that FEIs can be applied more efficiently.
2. The use of revolving funds is in regional economic terms valuable if the means can be revolved (leverage in case of revenue generating projects).
3. Increase the number of public – private partnerships aimed at regional and local (urban) economic development is easier to realise if the public authorities act more like market investor by anticipating more on market developments.
4. In particular for starting SMEs without a track record there are no possibilities on the capital market. Because SMEs are very important for the realisation of innovations the

expert committee advised to increase the financing possibilities for SMEs with among others FEIs such as hybrid investments (participations, loans) ¹

Within the various OPs, no distinction is made between the objectives of FEIs and grants. The objectives are at OP level, which is the stimulation of regional economic development. More in general, grants and financial engineering instruments are used for different objectives. Therefore both are applied differently in order to be most efficient.

Market failure

With regards to market failure the East region is very clear. In particular market failure on the capital market is mentioned as a reason for the use of FEIs rather than grants. On the capital market, innovative, but critical investments are hardly being accepted. If accepted, the interest percentages are enormous. Because there is a need from starting SMEs for financial instruments, the East region decided to start with two regional funds². In case a market exists or will develop the FEI becomes revolving, which results in a leverage effect. Another reason to use financial engineering as an instrument is to make sure that companies get used to market forces.

Reasons for not using FEIs

Main reasons given by the authorities for not using FEIs to provide policy support in particular policy areas but using instead non-refundable grants are:

1. FEIs were certainly in the beginning of the programme period relatively unknown. This resulted in a lot of uncertainty. At the time the FEI became clearer the majority of the budget had already been allocated via grants.
2. Lack of stimulation from the central government (Ministry of Finance).
3. Because of the (perceived) exacting control procedures (very strict and demanding).

The East region mentions the JESSICA pilot in Rotterdam (OP West) which is being realised at this moment. The results of this pilot determine what the possibilities are for the set up of a JESSICA fund in East Netherlands.

In South (in the end of 2011) research has been done to determine whether a JESSICA fund could be realised in priority 3 (attractive cities). However, taking into consideration the short time left in the programming period, the limited budgets left, the supposed complexity of this instrument and the relatively high administrative costs the result was a no-go.

The Northern region did not mention particular reasons why non-refundable grants are being used rather than FEIs.

With regards to particular policy areas, there are no reasons indicated.

¹ Expert committee installed by the State Secretary of Economic Affairs (April 2007)

² Ministry of Economic Affairs, ability to undertake, the Dutch finance gap (April, 2007)

Perceived benefits

The use of FEIs rather than grants is perceived as being beneficial (by programme managers) because of:

1. Revolving character and increase of the leverage effect (in particular in times of economic crisis).
2. It facilitates sustainable economic development in the middle - and long term. It improves therefore long term continuity (partnership) for funds and projects (also) aimed at societal revenues.
3. Participation of the government decreases the investment risk for private parties and the involvement of the private market results in a leverage effect.
4. Depending on the chosen investment strategy, interest percentages and preconditions can be competing. By using this instrument market-oriented confrontation with state aid regulations can be avoided.
5. FEIs are more suitable for income generating projects. The chosen methodology of FEI is easier to apply than article 55 on revenue generating projects (due to technical aspects not to be discussed in this policy paper).

Relative costs

Concerning the relative costs involved in using FEIs, there is a lack of data. The East region mentioned however that the relative costs during the management of the fund (the Management Authority (MA), Certificate Authority (CA) and the Audit Authority (AA)) are low. This is caused by the control procedure. Control by the authorities mentioned above is aimed at fund-level (in this case the FEI). The basic rule is that control does not take place at the level of the final beneficiary. On the other hand the fund manager does have to pay a lot of efforts that are comparable to the efforts of the MA.

Because there is no control from CA and AA at final beneficiary level the relative costs are lower than ERDF projects funded by grants.

However the cost for the application (set up) of FEIs is relatively high. Reasons for this are amongst others caused by: development of an entity (creation of a fund), the procurement of fund management and the notification for State Aid at DG Competition for every single fund.

3. The effectiveness of financial engineering instruments: selected examples

Public and private FEIs

The FEIs used as part of Cohesion policy in the Netherlands and which are implemented at the moment are aimed at stimulating investments in innovation, entrepreneurship and economic development. Moreover, these instruments are aimed at starting SMEs. The status of FEIs in other areas, such as JESSICA, is that they are being prepared at the moment. We therefore focus on FEIs aimed at the stimulation of innovation of SMEs.

Various studies state the bottleneck of market failure on the capital market in particular for young innovative enterprises with a high risk in The Netherlands and Europe³. Although the need for financial engineering instruments increased, the market lagged behind. Investors, such

³ Ministry of Economic Affairs, ability to undertake, the Dutch finance gap (April, 2007)

as merchant banks, are not interested in investing in innovative projects of young SMEs because of the inevitably high risks. During the last years, in various ERDF OPs the regions tried to solve this problem via intervention into the market through subsidies and grants. The use of financial means such as subsidies and grants did not result in best practice. One of the reasons behind that is that subsidies have different objectives/targets than FEIs and therefore should be used differently. No distinction is made regarding the objectives of FEIs and grants within the OPs. These instruments (both FEIs and grants) are means to realise the OP objectives.

In brief, private FEIs especially in the field of SMEs are not available because of market failure. A comparison between ERDF supported FEIs and private ones is therefore difficult to make.

Control

In general the control of the MA is limited to the allocation of means from the FEIs. A subsidy contract and a finance contract are set up when a regular subsidy is provided. For this, agreements are made between MA and fund manager. This defines the fund. The fund manager is obliged to respect the contract and the MA controls this.

Although some regions developed a special working manual (handbook) for non-JESSICA projects, there are in general no extra demands concerning the funds compared with projects which received a grant.

Only one extra demand has been written down in the East region with regard to the progress report specifying that FEIs also need to report on all organisations they have invested in, including a progress update about the developments within these organisations. Via these progress reports MAs have more control over the firms or organisations which receive support via FEIs.

Preconditions

In the West and East regions, final beneficiaries do not need to fulfil extra preconditions in order to receive support from the FEIs in comparison with subsidy supported projects. Specific eligibility criteria which are listed for companies are amongst others the following: SME status, technological character (ICT, life sciences), starter, et cetera. Solvability has not been mentioned.

Assessment of performance

In order to assess the performance of funds the same indicators have been used as for regular ERDF projects. Below is an overview of indicators and targets set for the various instruments in the different OPs. The funds report on the progress made (both content and financially) every 6 months.

In the East region FEIs also need to report on all organisations they have invested in, including a progress update about the developments within these organisations. There is no progress report available for the FEI in the West region.

Table 3: Financial Engineering Instruments in The Netherlands

Title	Urban Development Fund SOFIE		JESSICA Energyfund Den Haag (ED)		Innovation fund East - Netherlands	
	<i>Target</i>	<i>Realisation</i>	<i>Target</i>	<i>Realisation</i>	<i>Target</i>	<i>Realisation</i>
Number of supported R&D projects	1				1	
Private contribution to research facilities (EUR million);	1.75				0	
Private investments after realization (EUR million)			1.0		6.5	
Number of collaborations between knowledge, research or educational institutions.	1				0	
Number of supported SMEs					35	
Number of supported starting businesses (<5 years)					0	
Impact indicators	<i>Budget</i>	<i>Realisation</i>	<i>Budget</i>	<i>Realisation</i>	<i>Budget</i>	<i>Realisation</i>
Gross created jobs	65		7		147	
Budget (EUR million)	6.5		4.		13.6	
ERDF (EUR million)	2.45		1.7		6.1	

As the schedule above indicates, the FEI JESSICA, SOFIE and ED are in preparation so that there is nothing to report regarding their progress. Moreover because there is not much practical experience with ERDF co-financed FEIs it difficult to comment on the targets. These are set for FEI as a whole and not for individual projects within the FEI.

Appropriate indicators

From the MA perspective, funds are controlled in the same way as other projects. Therefore the same output – and impact indicators are used. Although this is logical, we suggest to add to the existing ones the following SMART result indicator:

Leverage effect: in order to determine the added value and leverage from public funding.

The indicators are appropriate because it emphasizes the progress in economic development as a whole and not the various projects supported.

4. Main problems in using financial engineering instruments

Main problems

In general there was uncertainty regarding the implementation of FEIs within the context of the ERDF regulations. Only in December 2008, the European Commission (EC) created (limited) clarity regarding the interpretation of the Structural Fund regulations 1828/2006 EG. Finally in 2011 the EC developed a relevant interpretation note on FEI with a clear distinction between various FEIs. Moreover, it is difficult for regions to comply with the European state aid rules.

The East region does not mention any practical problem. The authorities appreciate the possibilities offered by the ERDF regulation to set up FEIs in the field of innovation and urban development. Moreover The European Investment Bank facilitated the possibility to set up funds, thanks to the set up of financial instruments such as JEREMIE, JESSICA, JASPERS, JASMINE and ELENA.

Also the West region did not perceive “multi interpretability” of the ERDF regulations as a bottleneck regarding the implementation of FEIs. The only region which is actually involved in the preparation of a fund supported by JESSICA, indicates problems but these relate more to the political commitment of the national government, more precisely the Ministry of Finance:

1. The Ministry of Finance is an opponent of FEIs because of a fear of lacking control possibilities. It should be mentioned that the FEI supported projects are not subject of control but there is control of the FEI itself;
2. In the Netherlands, due to small budgets available, the permitted execution costs are very low. Because the expectation is that FEI have higher costs it is perceived difficult to implement them;
3. In relation to the relatively small amount allocated to FEIs the percentage of allowed management costs is too low. It is therefore difficult to attract fund managers.

Problems to overcome

In general there is still no clarity about: the eligibility criteria of working capital, leverage effect, revolving character of the funds and unjustified preferential treatment. Moreover:

1. It is still a problem to comply with the state aid rules because the state aid rules have not changed.
2. There is still uncertainty regarding the implementation of FEIs within the legal framework of ERDF.
3. Unsuitability of the supervision, reporting and control processes of FEIs within ERDF. The Dutch ERDF control mechanism is expenditure driven and based on the principles of real cost. This principle is not in line with the principle of investment nor the revolving character of funding.
4. The position of the Dutch Ministry of Finance has not been changed.

5. Evaluations of financial engineering instruments

Evaluations

The following evaluations have been carried out:

- The European Investment Bank evaluated the FEIs (JESSICA) in the Netherlands in 2010⁴. Objective of the study was to map the possibilities to start a JESSICA fund in the Netherlands. The conclusion is that JESSICA is of added value for the Netherlands:
 - National level: long term regional investment potential is maintained and the leverage effect will render the use of ERDF resources more efficient;
 - Local level: a city is able to develop more spatial projects with the same amount of funds;
 - Private sector: public supported venture capital and streamline public actions.
- Regional development policy has been evaluated in the Netherlands in 2011. The mid-term review does not mention FEIs⁵.

Regarding the use of FEIs in West, the JESSICA funds, which are being prepared at the moment, will be evaluated in 2014. The other funds will be evaluated later. Relevant main findings regarding evaluations of FEIs in progress can not be mentioned.

6. Concluding remarks

General remarks

1. The overall picture that emerges is that in general, after a slow start FEIs are becoming more popular in the West and East regions. The present programming period is being used to prepare for the next multiannual framework where FEIs are expected to become more important. The focus of the FEIs is to support innovation in particular in SMEs. For these, the capital market fails to provide the finance they need because of high risks.
2. Although the South and North regions are familiar with the advantages of FEIs, there is not perceived as urgent to set up FEIs. Reasons behind this are amongst others: uncertainty, risk avoidance, lack of stimulation from central government and lack of financial means regarding the execution costs of the programme management.
3. The present regulations offer enough possibilities regarding FEIs.

Particular needs?

1. A need for indicators and definitions specific to FEIs and which are different from those applied for subsidies (result indicators such as leverage effects). At the moment, there is no distinction in indicators between subsidies and FEIs.
2. More political commitment for FEIs is needed. There is in particular a need for more and better information and practical service in order to set up FEIs.
3. The regions also mention the need for more political support in this regard.
4. At the beginning of the programming period in 2007 FEIs were unknown. There was much uncertainty at the time FEIs started to be implemented. Only in 2011, after the European

⁴ JESSICA, Joint European support for sustainable investment in city areas, Evaluation study, Rotterdam, 2010.

⁵ Mid-term review ERDF – Objective 2, 2007 - 2013, Berenschot, 2011

Commission published a report about the possibilities of FEI within the ERDF more clarity was gained.

Future challenges?

4. Due to the economic crisis and the budget deficits there is a bigger need for financial instruments and in particular revolving funds. This increases the need for more and better information about the instruments and their promotion. The need for financial support (investments) increases in particular in the private sector, while in the public sector the need to use FEIs is growing more than grants because of the leverage effect.
5. The relation between the size of the fund on the one hand and the available budget on the other. The question raised is how to combine multi funds and programmes.
6. How to raise interest in fund management and participation in the current economic context (stricter risk management in the financial sector)?
7. Multi-level approach (national and regional government) and other stakeholders such as the financial sector, European Commission in order to realise a higher multiplier effect.

References

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Interviews

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Ruud van Raak, Gemeente Rotterdam (Kansen voor West), MA West;

Pieter Liebrechts, Province of North-Brabant (Stimulus), MA South;

Roelof Jansma, SNN, MA North;

Martijn Panjer, Province of Gelderland, MA East.