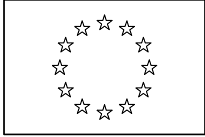

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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

A framework for the next generation of innovative financial instruments - the EU equity and debt platforms

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1. INTRODUCTION

Innovative financial instruments should play an increasingly important role in the EU budget spending of the 2014-2020 Multiannual Financial Framework (MFF). This Communication presents the Commission's view on the design and management of innovative financial instruments. The Commission's aim is to develop innovative financial instruments that pursue the Europe 2020 Strategy's objectives of smart, sustainable and inclusive growth in a highly efficient and effective manner, based on the solid experience already gained through the management of instruments which are operational in the current MFF.

Some of the effects of the economic and financial crisis are likely to spill over into the first years of the next MFF and impact the functioning of financial markets in the years to come. Fiscal consolidation measures will continue to reduce the capacity for national public investments, at the same time as structural changes in the regulation of financial institutions lead to changes in the appetite of such institutions for certain asset classes and types of risk. Macroeconomic market developments will continue to impact the availability of venture capital for high growth and innovative activity supporting the Europe 2020 objectives. There will be a need to mitigate the prevailing risk aversion to ensure access to capital for growth generating activity such as infrastructure, SMEs and innovation throughout the MFF period, and innovative financial instruments can play an important role in this respect.

Innovative financial instruments combined with appropriate regulatory measures can also contribute to the development and consolidation of financial (capital and equity) markets as well as higher EU financial market integration, opening up alternative sources of finance for the growth generating sectors. The Single Market Act[1] underlines the key role financial markets development will play in paving the way towards new forms of growth. The reforms undertaken in the area of financial services regulation will provide a crucial contribution to the promotion of sustainable and inclusive growth based on a strengthened confidence in Europe's financial markets and actors.

Moreover, by catalysing investment related to improving energy efficiency, to renewable energy sources and related infrastrucure, such instruments can contribute to promoting the transition to a low-carbon and climate-resilient economy and society.

Innovative financial instruments are firmly anchored in the strategic documents which aim to shape the future EU funding. In the Commission's Communication on the next MFF[2] and the Budget Review[3] it is noted that innovative financial instruments could provide an important new financing stream for strategic investments, supporting long-term, sustainable investment at a time of fiscal constraint. In order to demonstrate EU value added, the instruments should be focused on addressing identifiable market failures/imperfections that can be adequately addressed at EU level, taking into account the state of national financial markets, the legal and regulatory environment and the needs of final beneficiaries.

The Europe 2020 Strategy[4] envisages an increased mobilisation of innovative financial instruments as part of a consistent funding strategy pulling together EU and national public

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1 COM(2011) 206.

2 COM(2011) 500 "A Budget for Europe 2020".

3 COM(2010) 700 "The EU Budget Review".

4 COM(2010) 2020 "EUROPE 2020 - A strategy for smart, sustainable and inclusive growth".

and private funding to pursue the Strategy's objectives of smart, sustainable and inclusive growth. It aims to exploit the opportunity of the on-going revision of the Financial Regulation (FR) to develop the potential of innovative financial instruments, whilst ensuring sound financial management. In its proposal for amendment of the FR in the context of the triennial review, the Commission included a new Title dedicated to the budgetary management of financial instruments[5].

Moreover, the Europe 2020 Strategy also aimed to address the present fragmentation of EU funding instruments. In this respect, a cross-policy grouping of instruments (e.g. instruments that are mutually reinforcing and/or complementary) rather than a "one instrument per policy" approach would promote the achievement of the objectives under the Europe 2020 flagship initiatives, not the least because the geographical and sectorial diversification resulting from a multi-policy approach will help attract investors to Europe 2020 priority areas by reducing the overall risk. Finally, the Europe 2020 Strategy emphasised the role of public-private partnerships (PPPs) in innovative financing. As underlined in the PPP Communication[6], PPPs can provide more effective ways to deliver sustainable infrastructure and strategic public goods and services.

The present Communication takes stock of the analysis work on a new framework for innovative financial instruments which has been carried out by the Commission's services – in collaboration with its financing partners and other stakeholders and building on formal evaluations and assessments – throughout the phase of preparation of the next MFF. It looks at the design and management of innovative financial instruments across policy sectors and sets out the next steps in achieving the Commission's ambition of a more streamlined, comprehensive and highly efficient and effective toolbox of innovative financial instruments to support the Europe 2020 Strategy objectives.

2. INNOVATIVE FINANCIAL INSTRUMENTS IN EU BUDGET SPENDING

2.1. Scope and sectors

EU budget expenditure through innovative financial instruments is not a new feature, as the first use of EU budget in such instruments dates back more than ten years. The term "innovative financial instrument" is used in this Communication for interventions other than pure grant funding. Innovative financial instruments in this sense cover a broad range of cases where financial support from the budget is provided in other forms than pure grants, including cases where EU grants are blended with loans from financial institutions. The intention behind an increased use of innovative financial instruments is however not to replace grant funding with financial instruments, as grants will still be necessary in a range of areas, but to complement the grant funding by supporting projects pursuing EU policy objectives through other forms of intervention.

The innovative financial instruments dealt with in this Communication include instruments which provide equity/risk capital, or debt instruments (such as loans or guarantees to

[5] COM(2010) 260. The proposal builds on the premise that the FR should contain the fundamental principles and the basic rules of budgetary and financial management, leaving the details to be specified in the Implementing Rules (or rather, following the new Treaty, the delegated act replacing the current Implementing rules, for which a proposal has not yet been made) and soft law such as internal guidelines.

[6] COM(2009) 615 "Mobilising private and public investment for recovery and long term structural change: developing Public Private Partnerships".

intermediaries that provide financing to a large number of final recipients who have difficulties in accessing finance, or risk sharing with financial institutions in order to increase the volume of finance and hence the impact resulting from the EU budget intervention). Where appropriate, such EU support can be provided indirectly via dedicated investment vehicles, in particular if participation of private investors alongside public investors is sought. A short description of main current instruments is provided in the Annex.

Financial instruments are particularly suited to addressing sub-optimal investment situations in a broad range of policy areas, e.g. for business activities or infrastructures that are capable of being financially viable (in terms, for example, of revenue generating capacity), but do not (yet) attract sufficient funding from market sources. They are in particular relevant:

– to foster the capacity of the private sector to deliver growth, job creation, social inclusion and/or innovation, notably through support to start-ups, SMEs, micro-enterprises, social enterprises, investment in human capital, research institutions, business/science parks, knowledge/technology transfer, or investment in intellectual property rights.

– to build infrastructures with an earmarked revenue stream, making use of adequate funding structures such as PPPs, to reinforce EU competitiveness and sustainability in areas such as transport, environment, energy and digital infrastructures.

– to support mechanisms that mobilise private investments to deliver public goods such as climate and environment protection.

These objectives should be attained without creating market distortions, ineffective market structures or preserving inefficient firms, in line with state aid rules as clarified by the Commission's decision-making practice regarding the currently operational innovative financial instruments.

2.2. Management of risks for the EU budget

It is important to stress that budget spending through financial instruments does not imply more financial risk than grants, as it is ensured through the design and contractual set-up of the financial instrument that the risk for the EU budget is in all cases limited to the budgetary contribution. Contrary to grants, where financial instruments involve investment of the committed EU funds, the budget contribution can even create proceeds such as interest or return on capital.

A recent study carried out for the European Parliament[7] with regard to instruments co-financed with the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) confirmed that there “are in fact few, if any, concerns in a formal sense in terms of budgetary liability. All of the co-financed instruments involve allocations to programmes which are capped in size and so none of these instruments pose a risk to the budget beyond that which is initially committed. Even in those cases in which the financial instrument involves a form of guarantee there remains no liability beyond that which was originally committed during the design of the instruments”.

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[7] Study commissioned by the European Parliament's Committee on Budgets: “The implications of EIB and EBRD co-financing for the EU budget”, May 2011.

As set out in the Budget Review, the norm for projects with long-term commercial potential should be that EU funds are used in partnership with the financial and banking sector, particularly the EIB Group or Member States' financial institutions with a public policy mission, but also with other international financial institutions (IFIs) and the private financial sector. This ensures a unique blending of expertise and knowledge of these institutions and Commission services in the design and implementation of schemes in pursuit of EU objectives. Moreover, a well thought-out design of financial instruments, in particular ensuring an adequate incentive and interest alignment framework (through the remuneration scheme and appropriate risk sharing arrangements) with the financial institutions partnering with the Commission, reduces implementation risks and promotes the achievement of the policy objectives targeted by the instruments.

2.3. The rationale for innovative financial instruments

2.3.1. Pursuit of EU policy objectives

Innovative financial instruments pursue specific EU policy objectives by ensuring necessary finance for areas of EU interest, be it for innovation, sustainable growth, job creation, etc. They aim to correct market failures/imperfections that give rise to an insufficient funding of such areas from market sources, for instance because the field is perceived as too risky by the private sector. Innovative financial instruments can thus complement and go beyond the regulatory interventions aiming to provide the conditions under which the desired activity can flourish, by providing concrete financial support in a proactive way even before the potential is recognized by the business community.

In addition to the financial impact, financial instruments implemented at EU level can have important non-financial effects such as demonstration effects in the targeted markets, triggering wider application to other sectors. The consistent application and promotion of best practices through the EU instruments may foster a qualitative development of certain markets, such as for instance the venture capital markets, and increase intermediary sophistication over time, while contributing to a less fragmented EU market.

The expertise of the EU and the financial institutions responsible for the implementation of EU-level innovative financial instruments can be transferred to national, regional or local authorities. Transferring skills and knowledge across frontiers could play a significant role in aligning national policies to growth and innovation-oriented measures, reducing the gap between European economies and enhancing competitiveness. The full impact of such non-financial effects can only be reached if the instruments are designed and managed in a consistent way.

2.3.2. Increasing efficiency and effectiveness of public resources

By pooling resources from various sources, financial instruments can catalyze investments for identified market gaps, achieve economies of scale and/or minimize the risk of failure in areas where it would be difficult for individual Member States to achieve the required critical mass.

The EU intervention must adhere to the subsidiarity principle; as pointed out by the Court of Auditors, expenditure from the EU budget must offer clear and visible benefits for the EU and for its citizens which could not be achieved by spending only at national, regional or local

levels[8]. The EU added value of an EU level instrument is demonstrated if its results (in terms of efficiency or scale) go beyond what could have been achieved by funding under national schemes.

Assuming the EU value added of an EU level instrument can be demonstrated, the cost-benefit ratio of such an instrument is likely to be more advantageous than for a series of financial instruments at national, regional or local level, due to higher volumes under management, cost efficiencies through harmonised implementation standards and terms and lower implementation costs, e.g. management fees charged by the financial intermediaries.

2.3.3. Promoting enhanced performance and financial discipline

Well-designed innovative financial instruments can promote enhanced performance by setting appropriate success indicators suited to the achievement of public policy objectives. Financial discipline is promoted by harmonising to the extent possible the implementation frameworks and management principles in accordance with best practices.

National and local institutions can benefit from the EU institutions' knowledge in the design of financial products which otherwise would not have been available to them. An example is the European guarantee schemes implemented under the Competitiveness and Innovation Framework Programme (CIP): In many Member States, guarantee societies do not exist and a European counter-guarantee scheme is important also for newer guarantee institutions still building up their portfolios. The presence of a European guarantee and/or counter-guarantee either provides the possibility for new guarantee institutions to boost their volumes in the early stage, or facilitate the creation of such schemes, thus making a considerable contribution to "institution building".

2.3.4. Multiplier effect of the EU budget

Innovative financial instruments create a multiplier effect for the EU budget by facilitating and attracting other public and private financing for projects of EU interest throughout the various levels of the implementation chain (intermediaries and final beneficiaries). Through risk coverage or risk participations, the EU intervention may induce investors to invest or invest more in cases where they would have not invested at all or invested less without the support from the EU budget. Such financial "leverage" or multiplier effect can be achieved through co-financing by international financial institutions or through the additional debt volumes banks and guarantee institutions are requested to provide to final beneficiaries. By way of example, under the Risk Sharing Finance Facility (RSFF) projects worth more than EUR 6 bn had been supported at the end of 2010, where the total EU budgetary commitments amounted to around EUR 0,5 bn.

Furthermore, an additional multiplier effect is achieved during the lifetime of the innovative financial instrument, if repayments of capital or interest and proceeds of an investment can be reused for the instrument. Such "revolving" character can considerably increase the reach of instruments. After this period, repayments of the initial investment plus an eventual participation upside will flow back to the general budget, which also positively impacts the overall cost-efficiency of the intervention.

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[8] "*Response by the European Court of Auditors to the Commission's communication "Reforming the budget, Changing Europe*", *Opinion 1/2010*: Improving the financial management of the European Union budget: Risks and challenges", and *Audit of the SME Guarantee Facility*.

3. ASSESSMENT OF THE IMPLEMENTATION OF INNOVATIVE FINANCIAL INSTRUMENTS IN THE 2007-2013 FINANCIAL FRAMEWORK

3.1. Lessons learned from existing instruments

3.1.1. Experience to build on

For some of the currently existing innovative financial instruments (mainly those under the CIP), assessments in the form of audits, interim and ex post evaluations and studies have been carried out[9]. Other instruments are still in a too early stage of implementation to have been evaluated. Moreover, significant practical experience has been gained by the Commission's services in the management of such instruments, including the budgetary management. A key conclusion at this juncture is that due to the individual manner in which the existing innovative financial instruments have been developed, some instruments overlap in terms of areas and beneficiaries targeted and their design and management models vary, which could create confusion among stakeholders and beneficiaries.

In the design of the new generation of financial instruments for the 2014-2020 MFF, if instruments are to be rolled out at larger scale, focus should be on exploiting the experience with the existing financial instruments in order to establish appropriate rules, guidance and standardisation for the design and management of innovative financial instruments in accordance with market requirements and best practices, to avoid overlaps and simplify implementation modalities. This – together with an appropriate cross-policy grouping of the innovative financial instruments proposed at EU level and enhanced consistency with such instruments implemented at national, regional, transnational or cross border level under structural funds programmes – will ensure an optimisation of their impact and EU value added in the next MFF.

3.1.2. Innovative financial instruments provide needed access to finance, promote product development and best practices

The audits and evaluations carried out of existing innovative financial instruments are in particular positive regarding their output. Existing instruments have provided funding in cases where beneficiaries did not have any other option for obtaining the funds needed, or could only have obtained less than needed. In addition, instruments have helped encourage financial intermediaries to develop and offer new financial products at local level. The international financial institutions to which the implementation of EU programmes has been delegated have enabled the EU to offer instruments across a wide range of countries by providing expert skills on how to run such instruments and promote best practice in a direct way.

Findings are however mixed as regards the EU value added of instruments. The evaluation of RSFF found that this instrument remained one of the few financial instruments available to

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9 *Audit of the SME Guarantee Facility*, European Court of Auditors Special Report No. 4/2011, *Final Evaluation of the Entrepreneurship and Innovation Programme* (April 2011), Centre for Strategy & Evaluation Services and EIM Business and Policy Research; *Combined ex-ante evaluation and impact assessment of the successor to the Entrepreneurship and Innovation Programme under the Competitiveness and Innovation Framework Programme 2007-2013* (May 2011), Economisti Associati in collaboration with EIM Business & Policy Research, The Evaluation Partnership, Centre for Strategy and Evaluation Services, and Centre for European Policy Studies; *Public consultation on the future EU support to competitiveness and innovation* (2011); *Mid-Term Evaluation of the Risk-Sharing Financial Facility* (RSFF), Report of the Group of Independent Experts (July 2010); as well as the *COBU study* mentioned in footnote 6.

innovative firms and organisations at a time when banks and other financial institutions were reducing access to finance for high risk investments in R&D and innovation areas . As regards the SME Guarantee Facility under CIP, the Court of Auditors found the EU value added of SMEG not demonstrated, as the results from SMEG "*might also have been achieved by funding under national schemes*". By contrast, the final evaluation of the EIP found that the "*SMEG loan and micro credit windows [...] fulfil a demand for finance which otherwise would not have been met".* The Commission, while stressing that there was a strong presumption of EU value, as observed by the independent evaluation, accepted the recommendation to consider how EU value added could be maximised in any successor to the instrument. This is being taken into account with an increased focus on ensuring EU added value in the planning for the next generation of financial instruments in the 2014-2020 MFF.

3.1.3. Increased coherence and consistency between instruments

The RSFF evaluation mentions that the very broad range of activities supported by EU funds – "from frontier research under FP7, to regional research capacity building under the Structural Funds and access to innovative financing mechanisms under the CIP" – all contribute to the general development of the research and innovation capacity of the EU. The RSFF was found to be "complementing rather than competing" with other funding instruments. However, due to the ad-hoc manner in which some instruments have been set up in the current financial framework, there are cases of incoherence and inconsistency and even undesirable duplication of instruments supported by the EU budget. There is also currently a fragmentation of financial support schemes and panoply of delivery mechanisms in use. By way of example, the EIP final evaluation pointed out that overlaps exist between the financial instruments under CIP and the structural funds, or between CIP and the Progress Microfinance Facility (see description in Annex)[10]. It is an important aim of the new framework to avoid incoherence and optimise the overall efficiency of the innovative financial instruments.

3.1.4. Governance and control issues for EU level instruments

While the implementation of innovative financial instruments has been entrusted to financial institutions offering the necessary assurances in terms of sound financial management and adequate procedures, the Commission has maintained control and influence on the policy objectives and strategic directions of centrally managed EU level instruments by participating in appropriate governance structures, e.g. in steering committees or supervisory bodies. This does not imply involvement in the day-to-day management of the innovative financial instruments, as this falls under the expertise and responsibility of duly appointed managers/management committees.

Much can be achieved by ensuring an intelligent and well-suited design of the innovative financial instruments from the outset, building on the expertise gained from the existing instruments in assessing and managing risks. In addition, checks and balances are built into the system in the case of EU level instruments, enabling the Commission and the competent budgetary authority to exert adequate budgetary control in compliance with applicable rules,

[10] In the field of micro-finance, first steps in establishing a more coherent approach has been taken by agreeing allocation guidelines for deals signed between the EIF and microfinance providers. In the next MFF, EU level micro-finance support for EU-based micro-enterprises would be concentrated and include institution and capacity building in one instrument under the new Union Programme for Social Change and Innovation.

including in the form of results-oriented monitoring and reporting by the financial intermediaries, tailored to the objectives and identified key risks of the individual instrument.

It is necessary that the EU intervention is conditioned upon acceptance, by the financial intermediaries and final recipients of the right of the European Anti-Fraud Office (OLAF) to carry out on-the-spot checks and inspections in order to to protext the EU's financial interests. The intermediaries shall be obliged to cooperate with OLAF and communicate to the Commission any suspicion pointing at fraud or irregularities affecting the EU's financial interests.

3.1.5. More can be done to raise visibility and transparency of instruments

Findings point to low stakeholder and final recipient awareness of the EU contribution to financial instruments. As also pointed out, this is hardly surprising, as financial instruments are typically delivered through a chain of intermediaries, including local intermediaries, who are ultimately responsible for disbursing the funds to final recipients, making the EU’s role somewhat opaque. This underlines the importance of e.g. visibility clauses in contractual arrangements with intermediaries, to ensure appreciation of EU added value for example in the form of job creation or capacity building and other indicators. However, awareness remains low despite the fact that such clauses are applied to a large extent in existing contractual arrangements, and visibility should be further pursued.

Importantly, findings also show that multiplication of schemes covering the same financing needs may actually serve to reduce political and market visibility. This is a point where the proposed new framework aspires to promote rationalisation of innovative financial instruments, which should serve to enhance their visibility. Evaluations and studies of existing instruments also refer to more general issues such as the need to ensure more transparent information and better communication to intermediaries. This is necessary to increase market understanding of the suitability and availability of EU financial instruments delivering debt and equity financing.

3.1.6. New risk-sharing arrangements could achieve higher finance volumes

In line with the general principle of proportionality of public support, private (co-)investment is sought to demonstrate private commitment, promote sharing of investment risks and avoid risks of crowding out. Depending on the structure of the markets and of the presence of private investors, private and public investment in line with the market economy investor principle may be treated equally, or incentives may be needed to stimulate private investment in important policy areas, e.g. through asymmetrical risk/return structures as described below, but must not go beyond the minimum necessary to ensure commercial viability of investment projects based on realistic business plans.

Current risk-sharing instruments are based on a project-by-project risk assessment or on a "pari passu" financial risk sharing between the EU budget and the financial institutions, such as the EIB Group or other financial institutions including national public banks which are willing to share the risk with the Commission. As the Mid-Term Evaluation of the RSFF carried out by a group of independent experts has shown, the current approach limits the capacity to take into account the market needs for a higher volume of risk based financing. The experts recommended that the Commission should consider a different approach to risk-sharing regarding the use of its capital contribution to meet expected and unexpected losses on loans. In particular, there is a need to develop a *portfolio approach* to risk sharing, i.e. that losses are covered for a portfolio of loans provided to specific target groups to allow for a

distribution of risk and thus increase the volume of finance which can be generated with a certain amount of budgetary funds set aside to cover provisions and capital allocations.

One variant or further development of this approach in the area of debt finance could be that the EU contribution would be used to cover potential first losses up to a defined percentage *("first-loss" cushion)* as a way to attract sufficient private involvement in financing higher risk (and high EU value added) operations. A first-loss approach where the EU takes a subordinated position would further increase the multiplier effect of the EU funds, without going beyond the limits of a fixed EU budget contribution. It could be considered for future risk-sharing instruments to be set up with EU budget funds, but needs in any event to be accompanied by appropriate rules and guidance, such as limits for the first-loss piece and requirements regarding the part of the unexpected and/or expected loss risk which should be retained by the Commission's financing partners.

In the area of equity finance, the EU contribution could be used to provide adequate incentives to private investors, notably in the form of preferential returns or priority returns not exceeding a fair rate of return ensuring commercial viability of their investments. Beyond that fair rate of return, profits shall be shared proportionately between public and private investors in order to avoid overcompensation.

Such specific requirements and minimum standards on risk and return would be developed in the context of the equity and debt platforms as explained in section 5.2.2. In all circumstances, alignment of interest between the Commission and our financial partners needs to be ensured.

4. INNOVATIVE FINANCIAL INSTRUMENTS FOR THE 2014-2020 FINANCIAL FRAMEWORK

Part II of the MFF Communication outlines a number of the Commission's sector-specific proposals for innovative financial instruments in the next MFF.

To support investments in research and innovation (RDI) under Horizon 2020, two financial instruments are planned: 1) a debt instrument providing loans to single beneficiaries for investment in RDI, guarantees to financial intermediaries making loans to beneficiaries, combinations of loans and guarantees and guarantees and/or counter-guarantees for national or regional debt-financing schemes, and 2) an equity instrument that would (i) invest in technology transfer and intellectual property vehicles and in venture capital funds providing equity finance to early stage RDI-intensive SMEs, and (ii) support investments in RDI sectors by targeting thematically focused, multi-country funds-of-funds with a broad investor base, including private institutional and strategic investors.

Likewise, to support competitiveness and SMEs, two financial instruments are proposed:

(1) An equity facility for growth-phase investment, which will provide commercially oriented reimbursable equity financing primarily in the form of venture capital (VC) through financial intermediaries to SMEs. Two measures are envisaged:

– Direct investments in VC funds which operate across borders within the EU and are focused on investing in growth-oriented enterprises not primarily based on innovation or research.

– “Funds-of-funds” investing across borders in VC funds which subsequently invest in enterprises, in particular in their international expansion phase.

(2) A loan facility, providing direct or other risk sharing arrangements with financial intermediaries to cover loans for SMEs and provide cross-border lending or multi-country lending with a high leverage effect.

Furthermore, to promote self-employment, micro-enterprises and social enterprises, the European Union Programme for Social Change and Innovation proposed by the Commission[11] includes a Microfinance and Social Entrepreneurship axis which builds upon and continues the existing Progress Microfinance Facility[12]. It extends its coverage through supporting the building-up of the institutional capacity of microcredit providers, and complements it by a financial instrument with an EU contribution to provide equity, debt, and risk sharing instruments to social investment funds and other financial intermediaries for financing social enterprises.

Financial instruments under the Connecting Europe Facility for infrastructure are likely to include 1) a risk-sharing instrument covering loans and bonds (incl. the Europe 2020 Project Bond Initiative) to respond to the requirements of multiple financing models applied across the EU, the size and sector of projects and the stage of development of project finance and capital markets in general, and 2) an equity instrument to complement the toolbox of infrastructure instruments with the objective of further developing EU-wide risk capital markets.

In the area of education and culture, guarantee facilities are developed to contribute to the EU2020 objectives: a student loan guarantee facility to enable master level students to undertake studies in another country, contributing to the objective that 20% of higher education students participate in cross-border learning mobility, and a guarantee facility (possibly to be combined with another SME financing instrument) to incentivise financial intermediaries to extend loans to SMEs in the cultural and creative sectors (CCS), which include producers, music companies, video game developers, publishers and distributors whose assets are mostly intangible (such as intellectual property rights), often resulting in financial intermediaries percieving the CCS as too risky to finance.

An increasing share of support under the structural funds will be delivered by means of financial instruments, in particular support to enterprises and other projects or investment activities that generate revenues, notably in the areas of climate change, environment, innovation, ICT and infrastructure. Member States and regions will also be encouraged to support financial instruments under the European Social Fund (e.g. for students, job creation, mobility of workers, social inclusion and social entrepreneurship).

5. A NEW FRAMEWORK FOR INNOVATIVE FINANCIAL INSTRUMENTS

5.1. Common rules for streamlining and rationalising instruments

5.1.1. EU instruments

The envisaged new framework for streamlining and rationalising the design and management of the new generation of financial instruments is based on what has been dubbed the EU equity and debt platforms. The platforms are a set of *common rules and guidance for equity and debt instruments* (including guarantees and risk sharing) for internal policies, ensuring a

[11] COM(2011) 609

[12] See section 3.1. of the Annex for details.

consistent approach to such instruments where they are supported by the EU budget. The common rules and guidance also aim to streamline relations with financing partners, in particular the international financial institutions and provide transparency vis-à-vis the markets on how the EU intervenes by means of equity and debt instruments, ensuring higher visibility of the EU's intervention.

The EU equity and debt platforms would form part of a coherent body of horizontally applicable principles, rules and guidance; the Financial Regulation (FR) and the delegated act replacing the Implementing Rules would set out the overall principles for innovative financial instruments in terms of budgetary/sound financial management, while more detailed specific operational requirements would be developed in full accordance with these overall principles, and would contain the specific financial parameters reflecting best practice in the design of new financial instruments in the internal market (see 5.2.2. below).

In the FR, intervention through financial instruments should be made conditional on the existence of a market failure/imperfection, the demonstration of the added value of the EU intervention, the mobilisation of additional public and private finance through the EU contribution ("multiplier effect"), the non-distortion of competition in the internal market and the implementation of measures ensuring alignment of interest between the Commission and the financial institution entrusted with the implementation of the financial instrument. The delegated act replacing the Implementing Rules and the specific operational requirements to be set out in Commission guidance would reflect these principles.

5.1.2. Structural funds instruments

Although the shared management principle means that EU level instruments and the instruments implemented by Member States under structural funds programmes are governed by different sets of rules, the highest possible consistency should be achieved between the instruments in shared and direct management and overlaps be avoided, in order to prevent that several instruments target the same beneficiary groups at EU and national/regional level while offering different terms. It should be made attractive to Member States to contribute to EU level instruments with their structural funds, or to use "off-the-shelf solutions" mirroring the EU instruments, coupled with strong incentives.

A 3-options approach has been proposed within the framework of the Structural Funds Regulations:

(3) Member States continue creating tailor-made instruments under shared management principles, aligned with some common rules inspired by the EU equity and debt platforms under development for the EU instruments;

(4) Creation of "off-the-shelf instruments" under shared management principles which would facilitate the set-up of instruments for Member States as well as ensure compatibility with the EU-level instruments;

(5) Member States would be encouraged to invest part of their structural funds in compartments of EU level instruments "ring-fenced" for investments in regions and policy areas covered by operational programmes from which structural funds resources are contributed ("joint instruments").

5.1.3. *External dimension of internal policy instruments*

To promote coherence during the planning and implementation of the instruments, closer market integration as well as optimal use of the instruments once operational, it should be considered – when setting up new financial instruments – to which extent internal policy instruments which include an external dimension can be extended to allow neighbouring countries to participate, while avoiding multiplication of schemes covering the same financing needs.

5.1.4. *External policy instruments*

The MFF Communication proposed further use of innovative financing in all external policy instruments (where appropriate through regional investment facilities) so as to mobilise additional funding – including from the private sector – in support of EU priorities and cover the investment needs of partner countries. This will be facilitated by the entry into force of the proposed new provisions in the FR on financial instruments, and with the establishment of common principles for such instruments to the degree appropriate to the environment of external actions.

The use of innovative financial instruments in external policies should be supported under the EU platform for external cooperation and development combining the respective strengths of the Commission, Member States and European bilateral and multilateral financial institutions (notably the EIB) active in the external development and cooperation field. The platform will contribute to fostering EU coherence, effectiveness, efficiency and visibility in external financing, while taking account of the specificities of the EU's external partners.

5.2. The content of the EU equity and debt platforms

5.2.1. *The scope of the platforms*

The platforms will cover distinct financial and technical parameters (such as maximum ceilings for risk-sharing arrangements or minimum levels of equity participations and other key parameters) for the design and implementation of innovative financial instruments, with a view to their streamlining and rationalisation. Such parameters have been defined on the basis of the experience gained with the design and implementation of current financial instruments, taking due account of relevant industry practices. They will cover standard issues which are not policy-specific, while issues such as political objectives, target population and specific eligibility criteria could be addressed in the sector-specific proposals.

5.2.2. *Specific operational requirements*

The common set of specific operational requirements and guidance to complement the principles of the FR and delegated act replacing the Implementing Rules will treat issues such as:

- Where appropriate and not covered by the general rules, specific requirements for the ex-ante evaluation/impact assessment of financial instruments. These could be matched with similar requirements for the interim and ex-post evaluations;
- Minimum standards or ranges with regard to multiplier effect, risk/return profile and risk diversification, aiming to protect the EU budget resources during the life of the instrument and ensure a fair balance of risk taking with the various financial intermediaries involved in the process, while allowing the terms of individual

instruments to be modulated, within the specified and reasonable ranges, taking into account the nature and scale of market imperfections or failures that give rise to an insufficient funding from market sources;

– Requirements in relation to managers of investment vehicles such as for instance equity funds, covering inter alia the incentive framework to ensure alignment of interest, remuneration schemes and criteria for removal;

– An integrated monitoring and governance system to provide reasonable assurance that EU funds are used for the purposes intended, making use of (minimum) performance/results oriented indicators, tracking mechanisms (e.g. for climate related expenditure[13]), and standardised reporting formats aiming to facilitate comparative analysis of the success of instruments.

– The establishment, implementation and evaluation of risk-tailored fraud prevention measures ensuring a high level of protection for the EU's interests.

Some parameters will be common for equity and debt instruments, while others will be specific to either type of instruments. In the case of instruments combining equity and debt, the rules and guidance will apply to the distinct parts of the "hybrid" instrument.

5.2.3. Delivery of financial instruments

Financial instruments are typically delivered through a cascade of actors, starting with the Commission and involving the EIB Group or other financial institutions and financial market participants (such as equity funds or banks).

Financial instruments can be implemented directly by the Commission or indirectly through financial institutions with the necessary technical and financial capacity to implement such financial instruments. There are basically two main forms of delivery of financial instruments: through financial institutions (e.g. the EIB Group, the EBRD, other IFIs, national public financial institutions) or through dedicated investment vehicles (DIVs). Minimum rules for EU participation in DIVs will be included in the platforms.

Agreements with the implementing bodies incorporating the rules and principles of the platforms should be standardised as far as possible and, in the context of financial institutions preferably be preceded by framework agreements covering issues such as implementation, management, trust accounts, accounting, tracking reporting, monitoring and evaluation, appropriate anti-fraud clauses, etc. This would facilitate and speed up the start of new financial instruments, while allowing for harmonisation of general conditions of cooperation.

6. CONCLUSION AND NEXT STEPS

Important ground work on the innovative financial instruments has been undertaken by the Commission and its financing partners since the launch of the Europe 2020 Strategy and the preparations for the next Multiannual Financial Framework, including in the context of discussions on the future of specific financial instruments (such as the CIP or RSFF). Discussion has also begun with Council and Parliament in the context of the revision of the

[13] The Commission intends to increase the proportion to at least 20% with contribution from different policies, subject to impact assessment evidence. The framework for innovative financial instruments should contribute to a low-carbon and climate-resilient Europe and to the tracking of the climate relevance of EU budget expenditure through these instruments as specified in COM (2011)500.

Financial Regulation. Strong focus has been put on the importance and relevance of financial instruments for the attainment of EU policy objectives.

In addition, there is broad agreement on the necessity of streamlining and harmonising existing instruments and having fewer and more focused EU level instruments, as well as increased coherence with the structural funds instruments. In the latter respect, the proposal to establish joint instruments is deemed a particularly promising avenue.

It is in this spirit that the framework for the financial instruments for the next Multiannual Financial Framework will be developed. And it is in this spirit that the Commission is looking forward to discussing further with Council and Parliament in the coming months, both on the general framework to be created by the Financial Regulation and the Delegated Act replacing its Implementing Rules, and on the specific legislative proposals for the next MFF which will be successively adopted by the Commission in 4th Quarter 2011. The equity and debt platforms will help ensuring that this spirit of streamlining and cooperation is translated into effective and efficient instruments designed and managed in accordance with the applicable rules.

ANNEX

DESCRIPTION OF INNOVATIVE FINANCIAL INSTRUMENTS IN THE 2007-2013 FINANCIAL FRAMEWORK

1. EU level risk capital/equity instruments: CIP/GIF, Marguerite

1.1. CIP – High Growth and Innovative SME Facility (GIF)

Innovative financial instruments form part of the Entrepreneurship and Innovation Programme (EIP), one of the three specific programmes under the CIP. Their overall objective is the improvement of access to finance for start-up and growth of SMEs in order to support the investments of such companies in innovation activities, including eco-innovation.

The High Growth and Innovative SME Facility (GIF), with a budget of over EUR 600 million of which a part is specifically earmarked for eco-innovation, aims to increase the supply of risk capital/equity for innovative SMEs in their early stages (GIF1) and in the expansion phase (GIF2). It is operated by the European Investment Fund (EIF) on behalf of the Commission (representing the EU). The EIF enters into investment agreements with venture capital (VC) funds which support such SMEs. GIF is a long-term facility under which investments in VC funds with a lifetime of up to 12 years may be made. The majority of the capital invested in any VC fund is to be provided by market-oriented investors and all investments are made pari passu (Like Risk, Like Reward) with private investors.

1.2. The Marguerite Fund

The 2020 European Fund for Energy, Climate Change and Infrastructure (the Marguerite Fund) is a pan-European equity fund for infrastructure investments in the transport, energy and renewables sectors. The EU has invested EUR 80 million from TEN-T budget in Marguerite out of a total committed fund size of EUR 710 million (target size: EUR 1,5 billion). The other investors are public banks, but the fund is open to participation of private investors. Investments are made pari passu. The fund has endeavoured to invest a total sum equivalent to 3.5 times the EU contribution into TEN-T projects.

The Fund was established as a regulated, specialised investment vehicle under Luxembourg law. The Commission, representing the EU, has a seat on the Supervisory Board responsible for setting the overall strategy of the Fund, but is not involved in the day-to-day management of the Fund or in individual investment decisions, as this is the responsibility of the Management Board and Investment Committee of the Fund. All decisions must be taken in compliance with the investment policy of the Fund, which was established together with the Commission.

2. EU level debt instruments (guarantees/risk sharing): CIP-SMEG, RSFF, LGTT

2.1. Risk Sharing Finance Facility (RSFF)

The Risk Sharing Finance Facility aims to support the financing of risky projects in the field of Research, Development and Innovation (RDI) by private and public sector promoters which do not have easy access to the capital markets. The instrument was developed jointly by the Commission and the EIB to share the risk on the Bank's direct loans or guarantees for loans supporting RDI investments in thematic priority areas of the Seventh Framework Programme for Research and Technological Development (FP7).

The pooling of the EU contribution of EUR 1 billion from the FP7 budget and the EIB contribution of EUR 1 billion from its own resources provides a capital cushion to cover potential losses incurred for the financing of estimated EUR 10 billion of loans over the period 2007-2013. Based on its own financial evaluation and in accordance with its credit risk policy guidelines, the EIB assesses – on a project-by-project basis – the level of financial risks for which it is required to set aside provisioning and capital allocation (for expected and unexpected loss), in accordance with normal banking rules, and requests a contribution from the EU to cover the provisioning and capital allocation. The Commission is represented in the RSFF Steering Committee which oversees the implementation of the instrument in accordance with the policy objectives of the instrument.

2.2. CIP – SME Guarantee Facility (SMEG)

The SME Guarantee Facility (SMEG), with a budget of EUR 500 million, provides counter-guarantees to national guarantee schemes as well as direct guarantees to financial intermediaries in order to increase and enhance the supply of debt finance to SMEs. SMEG is operated by the European Investment Fund (EIF) on behalf of the Commission (representing the EU).

The financial intermediaries supported by the EU guarantee in turn provide debt finance to SMEs while passing on the advantage of the guarantee to the final beneficiaries, e.g. by accepting a higher risk profile or less collateral, or by charging lower interest rates or providing similar advantages compared to their ordinary financing activities. Under SMEG a portion of each individual transaction is guaranteed, typically 50% (guarantee rate). The overall exposure for the EU budget is however limited by a contractually agreed maximum cap on portfolio losses (cap rate).

2.3. Loan Guarantee Instrument for TEN-T projects (LGTT)

The Loan Guarantee Instrument for TEN-T projects (LGTT) aims at facilitating larger participation of the private sector in the financing of Trans-European Transport Network infrastructure (TEN-T). Attracting private sector funding in core European transport projects can be challenging due to the relatively high levels of revenue volatility in the projects' early operating stages. The LGTT partially covers this revenue risk and consequently improves the financial viability of such TEN-T projects.

LGTT is financed with a capital contribution of up to EUR 500 million from the EU budget. Technically, the LGTT Guarantee is issued in favour of commercial banks which provide a stand-by liquidity facility (SBF) to the project. Such SBF can be drawn upon by the project company in case of unexpected reduction of traffic/usage related income of the project during the initial operating period in order to insure the service of the senior debt facilities.

In terms of governance, the Commission is represented in the Steering Committee of the instrument. The role of the Steering Committee is to review the progress and achievement of the strategic objectives of LGTT and make recommendations in order to achieve these.

3. Instruments combining equity and debt support

3.1. European Progress Microfinance Facility (EPMF)

In the most recent EU level innovative financial instruments, structures have been set up to combine equity and debt support. The European Progress Microfinance Facility (EPMF), set up in 2010, consists of two parts: 1) a guarantee instrument to providers of micro-credit (i.e.

loans of up to EUR 25,000, in particular to vulnerable groups in risk of social exclusion, for the purpose of setting small commercial operations) and 2) a structured investment vehicle set up under Luxembourg law, the European Progress Microfinance Fund, which offers senior loans, subordinated loans (financing subordinated to senior creditors), risk-sharing loans (senior loans combined with risk participation in the micro-credit portfolio) and equity participation to micro-credit providers. The EU has invested EUR 100 million in the Facility.

A budget of EUR 25 million is allocated for the guarantee instrument. The maximum guarantee rate is 75% of the underlying microcredit or guarantee portfolio, while a cap is agreed for each guaranteed portfolio, based on the expected cumulative losses of the portfolio. The maximum liability for the EPMF is set at 20% of each guaranteed portfolio.

The European Progress Microfinance Fund has the EU (represented by the Commission) and the EIB as investors while the EIF act as Management Company. The EU holds the junior shares, which means that it bears the first net losses affecting the fund's assets, within the agreed cap, while the EIB is protected as holder of the senior shares against the losses borne by the junior shares.

3.2. European Energy Efficiency Fund (EEEF)

The European Energy Efficiency Fund (EEEF) was set up this year using unspent funds from the European Energy Programme for Recovery. The fund is a structured finance vehicle set up under Luxembourg law to invest either directly in smaller scale energy efficiency and renewable energy projects of local authorities or invest in such projects indirectly via financial institutions. The Fund will notably support the development of energy service companies (ESCOs),

The EU, represented by the European Commission, is investing EUR 125 million in the junior tranche of the fund, while the EIB and the Italian Cassa Depositi e Prestiti (CDP) are investing EUR 75 million and 60 million, respectively, in the mezzanine and senior tranches. Deutsche Bank will act as Investment Manager of the fund and has invested EUR 5 million in the mezzanine tranche. The target size of the fund is EUR 500-600 million.

4. Structural Funds

Member States and Managing Authorities have the option of using part of the resources made available to them through the European Regional Development Fund (ERDF) and the European Social Fund (ESF) to support financial engineering instruments. The ERDF resources are primarily used for support to enterprises (mainly SMEs), urban development and regeneration, energy efficiency and use of renewable energy in buildings, while ESF is used for support to self-employment, business start-ups and micro-enterprises. Nearly all Member States today implement a range of equity and/or debt (loan and guarantee) instruments in at least one of these areas, either directly by contributing resources from an operational programme to a venture capital fund, loan or guarantee fund, or through holding funds set up to invest in several funds. Instruments are implemented through a variety of governance models and legal structures specific to each Member State or region.

In many cases, instruments are implemented through investment into holding funds. Under the JESSICA initiative (Joint European Support for Sustainable Investment in City Areas), holding funds are implemented through the EIB. Under the JEREMIE initiative (Joint European Resources for Micro to Medium Enterprises), holding funds are generally implemented through the EIF or a range of national or regional institutions. In general,

depending on the areas of intervention, the EIB or the EIF can receive a mandate to carry out holding fund tasks through a direct award of a contract by Member States or Managing Authorities. Other financial institutions can also be selected to implement operations organised through a holding fund, either by way of public procurement or by way of a grant.

5. External policy instruments in the pre-accession area

The Western Balkans Investment Framework (WBIF) was introduced in 2009 as a joint initiative of the European Commission together with the CEB, the European Bank for Reconstruction and Development (EBRD) and the EIB, pooling grant resources in order to leverage loans for the financing of priority infrastructure in the Western Balkans, as well as SME financing and energy-efficiency. The WBIF provides grant resources to projects likely to be supported by loans from the partner banks, for project preparation, accelerating existing loans or enabling projects by bridging a funding gap.

An example of the use of innovative financial instruments in the pre-accession area is the European Fund for Southeast Europe (EFSE) which offers long-term funding to qualified local financial institutions in the South-eastern European and Southern Caucasus countries. The funds are used to provide security and leverage private investors' capital at large scale for development purposes (business loans to micro and small enterprises, rural business loans and housing loans to low-income private households with limited access to financial services via local financial institutions). EFSE is based on a public-private partnership model initiated by the German KfW Entwicklungsbank. The investors of the fund are the Commission (representing the EU) who has invested EUR 120 million, other public donors and international finance institutions, including the EIB and the EBRD.