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FINANCIAL INSTRUMENTS FOR SMEs CO-FINANCED BY THE EUROPEAN REGIONAL DEVELOPMENT FUND

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(pursuant to Article 287(4), second subparagraph, TFEU)

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GLOSSARY

Business transfer: Transfer of an undertaking, business or part of an undertaking or business by its owner to another person.

CEB: Council of Europe Development Bank

CIP: competitiveness and innovation framework programme (see EIP below)

Critical mass: Amount determined in function of the relationship between the size of a fund and its return. With larger investments, a more favourable rate of return may be provided and the transaction costs are generally reduced.

Default: In the context of this audit, failure of an SME to repay its credit under the contractual conditions. In the case of guarantees, default is the moment when a guarantee is executed and the guarantee fund, the counter-guarantee fund, or both, take on the duty to pay the outstanding amount.

DG: directorate-general

EBRD: European Bank for Reconstruction and Development

EIB: European Investment Bank

EIF: European Investment Fund (EIB Group's specialist fund providing equity and guarantee instruments to SMEs)

EIP: entrepreneurship and innovation programme — an SME programme of the Enterprise and Industry DG, part of the CIP, managed by the EIF under the supervision of the Economic and Financial Affairs DG. On the basis of Decision No 1639/2006/EC, this SME aid scheme includes five facilities, of which three aim at improving access to finance for SMEs: High Growth and Innovation Facility I and II (GIF I and GIF II) and the SME Guarantee Facility (SMEG). They succeed to the MAP facilities (see below).

Equity: Risk capital invested or held in a firm in the form of equity instruments or instruments of equivalent ranking (e.g. convertible and subordinated loans).

ERDF: European Regional Development Fund

ERP: European Recovery Programme — in the context of this audit, the German Marshall funds and their legacy funds. The ERP has not been fixed by any programme period term and has not been implemented regionally. As an evergreen national fund for the benefit of Germany's enterprises, it is revolving; legacy funding cannot be transformed back into grants. KfW is the ERP funds' trustee and regional managing authorities are not involved in their management. More information on the ERP and the Marshall funds in Germany is available on KfW's website.

ETF-Start-up: European Technology Facility Start-up (see MAP)

Evergreen: A financial instrument or fund without a fixed maturity or term.

Financial engineering instruments (or financial instruments): Term used by the Commision to designate various repayable instruments offered by the Structural Funds in order to improve SME access to finance, urban development and energy efficiency. In the context of this audit, these instruments are equity, loan and guarantee instruments for SMEs.

Financial institution: Firms whose financial activities are central to their business, such as taking deposits, investing funds or dealing. All financial institutions are financial intermediaries.

Financial intermediary: Entity acting as an intermediary between sources of capital supply and demand (e.g. bank, holding fund, fund).

Financing gap: Mismatch between the demand and the supply of financial resources. In the context of this audit, the financing gap only concerns the gap in the different types of financial instruments for SMEs in a given area of the EU.

Fund: A segregated portfolio of financial engineering instruments managed by one or several fund managers following defined investment policies and targets. A fund can be legally constituted or constituted as a separate block of finance within a financial institution. The fund has segregated accounts and operations. In this report, the term 'fund' applies to the co-financed operations, whereas 'Fund' is the term reserved for the Structural Funds.

Fund manager: The general partner or entity responsible for implementing a fund's investment strategy and managing its portfolio of financial instruments, as set out contractually.

GIF: High Growth and Innovation Facility (see EIP)

Grant: Non-reimbursable budgetary contribution from the EU or any Member State public institution. Also referred to as 'public subsidy'.

Guarantee: In the context of this audit, an undertaking by a party (the guarantee fund) to bear at a predefined guarantee rate principal and interest due in case of default of a loan extended by a financial intermediary (a bank) to an SME. A guarantee always leaves some of the risk with the lender and the SME remains liable for the loan. Guarantees can take effect on first demand or not.

Holding fund: Legally constituted fund that has a controlling interest in several subsidiary equity funds, guarantee funds or loan funds.

ISME: innovative SME active in high-technology activities

Jeremie: Joint European Resources for Micro to Medium Enterprises (a Commission/EIB Group initiative for SME financing strictly using the Structural Funds).

KfW: Kreditanstalt für Wiederaufbau is Germany's federal development bank experienced in SME financing. Notably acting as a subcontractor of the Council of Europe Bank, it is active as an international financial institution on the central and east European SME finance market.

Leakage effect: Any effect reducing the amount of money available to grant financial instruments to SMEs.

Legacy funding: The prospective surplus of a fund attributable to the public sector contribution, which can, once available, be used to assist SMEs.

Leverage effect: In the context of this performance audit, leverage has been expressed in terms of how many euro of funding (public and private) have been raised and paid for SME finance for each euro of public (EU and Member State) funding paid. ***Annex II*** gives a schematic overview of how leverage works for each main category of financial instruments and, in the context of the ERDF, how the concept of leverage is to be understood.

Loan: The lending of money at interest to a borrower who must repay the amount lent.

Management costs: In the context of this audit, management costs are all costs borne by the financial intermediary or the SME in relation to the cost of managing financial instruments. A non-exhaustive list of such costs includes arrangement fees, guarantee fees, handling fees, membership fees, monitoring fees, performance fees, processing fees, as well as fund manager overheads. Interest payments and dividends are not considered as management costs.

Managing authority: The public authority of the Member State managing the Structural Funds (including the ERDF) on behalf of the Member State.

MAP: multiannual programme for enterprise and entrepreneurship — an SME programme of the Enterprise and Industry DG, managed by the EIF under the supervision of the Economic and Financial Affairs DG. Following Decision 2000/819/EC and amended by Decision No 1776/2005/EC, this programme has been implemented via two SME facilities managed by the EIF: the ETF-Start-up Facility (venture capital instruments, 'ETF-Start-up') and the SME Guarantee Facility (guarantee instruments, 'SMEG'). The successor programme of MAP is the CIP/EIP (see above).

Mezzanine: Type of high-yielding debt finance often seen in leveraged buy-out transactions and often featuring an option or right to acquire shares in a firm at a preferential rate. Mezzanine finance often takes the form of subordinated convertible loans.

Microcredit: In the context of this audit, small loans (usually up to 25 000 euro) granted to micro-enterprises (as defined by the EU). Usually, these micro-enterprises obtain free business advisory and mentoring as well.

Moital: Ministry of Industry, Trade and Labour of the State of Israel

MoU: memorandum of understanding

NUTS: *nomenclature des unités territoriales statistiques* — a standard term defined by Eurostat. In the context of the ERDF, the Commission uses the so-called NUTS 2 regions.

***Pari passu* treatment**: Legal term used to describe the fact that two or more financial instruments have the same class in terms of repayment rights. The opposite of *pari passu* treatment is preferential investor/private sector treatment.

Preferential investor treatment: Term used in the context of this audit to describe situations when the public sector is not treated *pari passu* because the private sector (e.g. commercial banks, private investors) is treated preferentially. That means that public sector funds are in a lower class in terms of repayment rights.

Public funding: In the context of this audit and in conformity with the Structural Funds regulations, any public contribution to the financing of financial engineering operations whose origin is the budget of the EU, the Member State, regional and local authorities and any similar expenditure.

Revolving: The concept that contributions to financial instruments, after a first utilisation (or cycle), get revolved (or reutilised, recycled).

SBIC: Small Business Investment Companies Program — one of the financial assistance programmes available through the US Small Business Administration (SBA). It was created by the US Congress in 1958 to bridge the gap between entrepreneurs' need for capital and traditional financing sources. The structure of the programme is unique in that SBICs are privately owned and managed investment funds, licensed and regulated by the SBA, that use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses. It is a government-sponsored fund of funds which invests long-term capital in privately owned and managed investment firms (licensees). The SBA does not invest directly into small business through the SBIC program. The SBA provides support without any regional differentiation.

SME: small and medium-sized enterprise (as defined by the Commission) — in the 2007–13 programming period, this could also be any small business

SMEFF: SME Finance Facility — a facility under the Enlargement DG's Phare programme ('Poland and Hungary: Assistance for Restructuring their Economies').

VC: venture capital — a specialist form of equity finance provided to new, small or risky unquoted firms

Winding up: liquidation — a process that entails selling all the (holding) fund's assets, paying off creditors, distributing any remaining assets to the owners and dissolving the fund

Working capital: an enterprise's current assets (short-term inventory + receivables + cash equivalents + cash) minus its current liabilities (short-term liabilities + prepayments)

EXECUTIVE SUMMARY

I.
Small and medium-sized enterprises (SMEs) are the backbone of the EU's economy, generating employment, innovation and wealth. However, SMEs may suffer from financing gaps, in that they cannot obtain access to the type and the amount of finance they need at a given time.

II.
To support entrepreneurship, the European Union (EU) mainly uses its enterprise policy and its cohesion policy.

III.
Cohesion policy mainly uses grants and increasingly, in the European Regional Development Fund (ERDF) framework, financial instruments.

IV.
Financial instruments are repayable and revolving instruments that ensure that successive waves of SMEs can benefit.

V.
The Court's audit focused on the financial engineering measures co-financed by the ERDF during the 2000–06 and the 2007–13 programming periods. The audit findings are based on a direct review of a sample of projects and on an examination of the Commission and Member States' management, monitoring and information systems.

VI.
The main objective of the audit was to assess whether ERDF spending on financial engineering measures for SMEs had been effective and efficient.

EXECUTIVE SUMMARY

VII.

The Court found that the effectiveness and efficiency of measures were hampered by important shortcomings, mainly due to the inappropriateness of the current regulatory framework of the Structural Funds:

(a) The SME financing gap assessments, if available, suffered from significant shortcomings.

(b) The Structural Funds regulations, originally designed for grants, contain four important weaknesses, as they do not address the specificities of financial instruments (see paragraph 119).

(c) Before funds reach SMEs, delays were significant and, compared with other EU programmes for SMEs, the ERDF's ability to leverage private investments was poor.

VIII.

The Court recommends that:

(a) When proposing financial engineering measures, the managing authorities should make sure that their proposal is duly justified by an SME gap assessment of sufficient quality, including a quantified analysis of the financing gap.

(b) When approving operational programmes including financial engineering measures, the Commission should verify their consistency with the SME gap assessment and make sure of the quality of the latter.

(c) When designing proposals for the Structural Funds regulations, the legislator and the Commission should address the different specific weaknesses mentioned in the report (see paragraphs 48 to 77). More generally, the legislator and the Commission should provide a more adequate regulatory framework so that the design and the implementation of financial engineering measures do not suffer from the deficiencies of the Structural Funds' regulatory framework, geographical constraints and scattering effects.

(d) The Commission should provide a reliable and technically robust monitoring and evaluation system specific to financial instruments. As a result, financial instruments should be segregated from pure grants in the Commission's monitoring, reporting and auditing processes and the amount of money actually paid to the SMEs should be transparent. In particular, the Commission and the Member States should agree on a small number of measurable, relevant, specific and uniform result indicators for financial instruments.

(e) The Commission should explore the possibility of supplying to the Member States off-the-shelf financial engineering structures and instruments for SMEs (e.g. grants with royalties, dedicated investment vehicles) in order to speed up implementation and reduce management costs.

(f) Member States, with the support of the Commission, should aim at the inclusion of all ERDF co-financed financial instruments for SMEs into a single operational programme per Member State. This would rationalise the planning process and remove one of the key delaying factors found.

(g) Apart from defining the concepts and definitions of leverage and recycling in the Structural Funds regulations, the Commission should, depending on the type of holding fund or fund, require contractually binding minimum leverage ratios, minimum revolving periods and data for the calculation of leverage indicators.

(h) If the above recommendations cannot be implemented under the cohesion policy framework, the Court invites the legislator and the Commission to consider alternative ways of pursuing SME support through financial engineering instruments. In such a case, such instruments should either be supported by progammes centrally managed by the Commission, dedicated investment vehicles in cooperation with the Commission and the Member States or by the Member States directly.

INTRODUCTION

1. Small and medium-sized enterprises (SMEs)[1] are the backbone of the EU economy, representing 99 % of all enterprises[2]. However, the financial markets are wary of investing in SMEs because they are perceived as riskier than large companies, especially if the SMEs are in innovative markets (ISMEs).

2. According to the Observatory of European SMEs[3], limited access to finance is a problem for SMEs in Europe. Recent financial crises, which have hit some Member States particularly hard, have worsened the situation.

3. As the public sector has an important role to play in supporting SMEs, in particular the provision of suitable financing, the Commission has provided access to finance in various ways.

EU COHESION POLICY

4. The EU cohesion policy aims at strengthening economic, social and territorial cohesion within the EU by reducing disparities between the EU regions. In the framework of cohesion policy, the ERDF explicitly provides for the possibility to contribute to SME access to finance by using overwhelmingly one-off grants that are, by their very nature, not reimbursable by the recipient.

5. In the 2000–06 ERDF programming period and, to a greater extent, in the 2007–13 ERDF programming period, financial engineering instruments (repayable instruments) have been used by the Commission and most Member States in the context of the EU cohesion policy. It is the development of these ERDF financial instruments which is the subject of this performance audit.

[1] SMEs are defined in this report as per Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (OJ L 124, 20.5.2003, p. 36). An SME is an enterprise which employs fewer than 250 employees and which has an annual turnover not exceeding 50 million euro and/or an annual balance sheet total not exceeding 43 million euro. It must also satisfy the criterion of being an autonomous enterprise.

[2] 'Giving SMEs the credit they need', *Enterprise & Industry online magazine*, European Commission, 12.2.2009 and COM(2005) 551 final of 10 November 2005.

[3] Observatory of European SMEs, Analytical Report, November 2006–January 2007, *Flash Eurobarometer*.

EU FINANCIAL ENGINEERING SUPPORT TO SMEs OTHER THAN COHESION POLICY

6. As securing and improving access to finance for SMEs is so important, the EU has supported SME access to finance by two major means:

(a) The development of specific programmes, the multiannual programme for enterprise and entrepreneurship (MAP), which was succeeded by the entrepreneurship and innovation programme (EIP). The MAP and EIP combined represented 1,6 billion euro, from 2001 to 2013. They are implemented by the European Investment Fund (EIF). The SME Guarantee Facility (SMEG), which is a part of the MAP and the EIP, has recently been the subject of an audit by the Court[4].

(b) The European Investment Bank (EIB) has implemented loan programmes amounting to approximately 70 billion euro (2001–10) aiming at improving access to finance for SMEs. These programmes are mainly funded by the EIB's resources and without any funding from the EU budget[5].

ERDF FINANCIAL ENGINEERING SUPPORT TO SMEs

7. Over the last two programming periods, in the context of the cohesion policy, the Commission has encouraged repayable forms of assistance through financial engineering instruments. According to the Commission, this represents about 12 billion euro of the EU budget committed in favour of financial engineering measures across the EU Member States[6]: 1,6 billion euro (2000–06) and 10,4 billion euro (2007–13), out of which, respectively, 1,5 billion euro and 7,9 billion euro in payments to holding funds or funds contributing to financial engineering instruments.

[4] The objective of that Court's 'Audit of the SME Guarantee Facility' (SR 4/2011) was to assess the effectiveness of the SMEG (see ***Glossary***), notably the design and planning, the management of its operations and the achievement of its objectives. The Court considered that the framework for the management of daily operations is appropriate. The full report can be found on the Court's website (http://eca.europa.eu).

[5] Estimated number consolidated on the basis of the following EIB documents: SME Consultation 2007/2008 of May 2008, Annual Report 2006 of June 2007 and Annual Report 2010 of May 2011.

[6] Amounts drawn from SFC database, European Commission, 8 June 2011.

8. Figures are indicative and should be treated with care[7], in particular for the 2007–13 programming period[8]. This is mainly the result of the Commission not having detailed information on the funding of financial engineering instruments[9]. In addition, it remains unknown to what extent SMEs actually benefited from the amounts granted to holding funds and funds.

9. A brief summary of the total amounts involved per programming period is available in ***Annex I***.

10. Currently, the regulation[10] specifies that financial engineering instruments can be used for three purposes: funds for the support of enterprises, primarily SMEs, urban development funds and funds for the promotion of energy efficiency.

11. The same regulation foresees that Member States may involve the EIF in the implementation of financial engineering instruments in three different ways:

- preparing evaluations, i.e. the SME financing gap assessments;
- acting as a holding fund; this is currently the case for eight Member States and three regions[11];
- acting as an adviser to national or regional authorities.

FINANCIAL INSTRUMENT MECHANISMS

12. The implementation of access to finance programmes requires the active involvement of financial intermediaries, which transform public funds into financial instruments for SMEs. Additional funds provided by the private sector may be added to the public funding, increasing the total amount available for investments in SMEs; this is how the Court defines the leverage effect. The leverage effect is schematically explained per category of financial instrument in ***Annex II***.

[7] As stated by the Commission services, Member States have misinterpreted the classification rules of allocations and may have included other forms of finance than financial engineering instruments.

[8] For that period, financial instruments include instruments for enterprises that do not fit the EU's SME definition, as well as urban development projects and energy efficiency projects.

[9] See paragraph 4.32 of the Court's 2010 Annual Report.

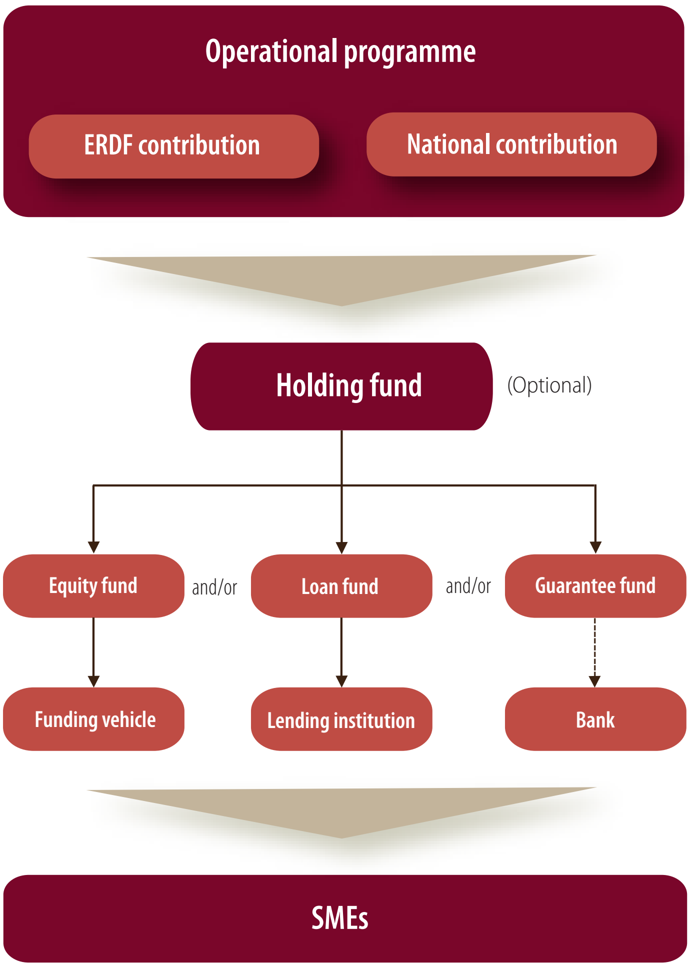
[10] Council Regulation (EC) No 1083/2006 of 11 July 2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999 (OJ L 210, 31.7.2006. p. 25).

[11] The EIF is currently the holding fund manager in Bulgaria, Cyprus, Greece, Latvia, Lithuania, Malta, Romania and Slovakia, as well as for the French region of Languedoc-Roussillon and the Italian regions of Campania and Sicily.

13. The majority of funds contributed by the operational programmes go to a selected holding fund (managed by the EIF, national institutions or others) then to selected intermediaries (see the ***Figure***). Alternatively they may be transferred directly to selected financial intermediaries. In the context of financial engineering instruments, beneficiaries are financial intermediaries and SMEs are final recipients.

FIGURE

FLOW OF FUNDS FROM AN OPERATIONAL PROGRAMME DOWN TO THE SME (SIMPLIFIED ILLUSTRATION)



14. Three main types of financial instruments are to be distinguished: equity, loan and guarantee instruments. They are all eligible instruments for ERDF co-financing, but must comply with EU and national eligibility rules (e.g. business transfer, working capital, state aid).

15. In the case of equity and loans, proceeds generated by, respectively, selling equity or servicing debt are supposed to be reused to finance additional financial instruments for other SMEs; this is the revolving effect.

16. In the case of guarantees, only in case of default is money actually being spent. If there is no default, the amounts contributed can be released when the underlying contractual conditions have been met.

17. According to recent strategic papers published by the Commission, it is very likely that financial engineering instruments will be developed further in the next programming period[12]. Indeed, the responsible department at the Commission, the Regional Policy DG, considers the leverage and revolving effects as the main advantages of financial instruments as opposed to grants. Other advantages of financial instruments often put forward are that they can:

(a) supply sustainable SME funding on market-friendly terms;

(b) increase the financial expertise and know-how of public authorities and SMEs;

(c) provide greater upfront financing for SME investment projects as compared to grants.

[12] COM(2010) 700 final of 19 October 2010, 'The EU budget review, pp. 4 and 20; 'Management Plan 2010 (final version)', Regional Policy DG, 10 May 2010, pp. 6–7; 'Fifth report on economic, social and territorial cohesion,' November 2010 (preliminary version), pp. xv–xvi and 213–218.

AUDIT SCOPE AND APPROACH

18. The main objective of the audit was to assess whether ERDF spending on financial engineering instruments[13] for SMEs has been effective and efficient.

[13] In the context of this audit, these instruments are equity, loan and guarantee instruments for SMEs (see the ***Glossary***).

19. The Court addressed the following key issues of effectiveness and efficiency:

(a) the quality of the assessment of the SME financing gap;

(b) the suitability of the ERDF framework to implement financial instruments;

(c) the effectiveness and the efficiency of the financial instruments in achieving results.

20. The audit was carried out at the Commission and in five Member States (Germany, Hungary, Portugal, Slovakia and the United Kingdom). Based on figures provided by the Commission, these five Member States represent approximately 46 % and 30 % of the ERDF **allocations** to financial engineering instruments, respectively during the 2000–06 and the 2007–13 programming periods. In selecting these Member States, attention has been paid to ensure sufficient diversity of financial instruments, funding structures and geographical balance.

21. A sample of 34 operations co-financed by the ERDF was assessed, 24 from the 2000–06 programming period and 10 from the 2007–13 programming period. ***Annex I*** gives an overview of the total amounts committed and paid covered by this report, including their proportion out of the total of the ERDF.

22. Audit work included documentation review and meetings with representatives of various public authorities and financial intermediaries responsible for the design, implementation and management of the financial engineering measures and instruments for SMEs.

23. Evidence has also been gathered from financial audits undertaken by the Commission or European Court of Auditors ('the Court') during the two programming periods, desk research and audit meetings at the Commission and the EIF[14].

24. The audit work at the EIF concerned two of the three kinds of services it delivered in the context of ERDF financial engineering measures for SMEs: preparing SME financing gap assessments and acting as a holding fund.

25. In the context of its benchmarking exercise, the Court has considered as good practice certain internationally reputable programmes[15], as well as certain comparators found among centrally managed EU programmes[16]. Indeed, all these programmes follow a similar intervention logic as SME access to finance programmes under the cohesion policy (except for the broad territorial cohesion objective). Indeed, they all have in common the pursuit of economic growth and job creation objectives by the development of enterprises through financial instruments.

[14] As a result, a number of additional observations were made concerning Germany, Estonia, Greece, Spain, France, Italy, Poland and the United Kingdom.

[15] ERP in Germany, Moital's programmes in Israel, the SBIC in the United States of America. See also ***Annex III***.

[16] The ETF-Start-up and GIF programmes for equity instruments, the SMEFF for loan instruments and the SME Guarantee Facility for guarantee instruments.

OBSERVATIONS

QUALITY OF THE ASSESSMENT OF THE SME FINANCING GAP

26. The mismatch between the demand and the supply of the different types of financial instruments for SMEs, called the financing gap, constitutes the rationale for public intervention in the market. To be effective in meeting the real needs in terms of SME finance, ERDF operations should be based on a sound assessment of the financing gap[17].

27. The Court examined the quality of the gap assessments and, in particular, whether the gap assessments:

(a) identified and quantified a need for public sector action in favour of financial engineering measures for SMEs;

(b) were linked with the related operational programmes;

(c) were made available sufficiently in advance to all stakeholders concerned.

28. Although all EIF gap assessments followed a standard methodology (i.e. a common template), they markedly showed uneven levels of quality. However, the Court identified the EIF's gap assessment for Sweden as good practice and used it as a benchmark (see ***Box 1***).

[17] See Article 44(1) of Commission Regulation (EC) No 1828/2006 of 8 December 2006 setting out rules for the implementation of Council Regulation (EC) No 1083/2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund (OJ L 371, 27.12.2006, p. 1) and Commission/EIF memorandum of understanding (MoU) of May 2006.

BOX 1

THE EIF'S GAP ASSESSMENT FOR SWEDEN, A CASE OF GOOD PRACTICE

The EIF's gap assessment finalised in January 2007 included:

- a full analysis of nationwide demand and supply of SME finance by type of financial instrument and, where applicable, taking regional specificities into account;
- areas where the existence of financing gaps could or could not reasonably have been established;
- references to previous ERDF support or other EU access to finance schemes, including on the role of the EIB Group;
- information on the intended structuring of the co-financed funding of SME finance (fund allocation), including a link with the operational programme submitted to the Commission for approval;
- information on which potential financial intermediaries could be capable of implementing the funding.

2000–06: GENERALLY NO GAP ASSESSMENTS

29. During the 2000–06 programming period, the Commission and the Member States generally did not assess the SME financing gap. Although 1,60 billion euro had been spent on SME financial engineering measures, gap assessments were neither mandatory, nor recommended by the Commission.

30. *Ex ante* evaluations, as foreseen by the Structural Funds regulations[18], did not include a proper SME financing gap assessment. For instance, in Portugal, SME schemes were funded without any preceding gap assessment, whilst in Germany (regions of Berlin and North Rhine-Westphalia), the assessments made were not specific and their actual use by the relevant bodies is uncertain.

2007–13: SIGNIFICANT SHORTCOMINGS

31. For the 2007–13 programming period, there are no specific legal requirements for the existence and the use of SME financing gap assessments at operational programme level. However, the Commission, aware of their usefulness, decided in partnership with the EIF to co-finance gap assessments carried out at the request of Member States and free of charge[19]. These would be used for the preparation of operational programmes in order to set out objectives and resources to improve SME access to finance.

32. Between 2006 and 2009, the EIF prepared 55 gap assessments at the optional request of 20 Member States, out of which 18 were reviewed during the audit. Apart from the gap assessments concerning audited Member States, additional gap assessments made for Spain, France and Poland were reviewed, as these three Member States represented the bulk of the gap assessments.

[18] Council Regulation (EC) No 1260/1999 of 21 June 1999 laying down general provisions on the Structural Fund (OJ L 161, 26.6.1999, p. 1).

[19] Commission/EIF memorandum of understanding of May 2006, point 4, second paragraph, p. 2. For the legal basis, see Article 45 (Technical assistance at the initiative of the Commission) of Council Regulation (EC) No 1083/2006.

THE EIF IDENTIFIED AND QUANTIFIED A NEED FOR PUBLIC SECTOR ACTION

33. For all gap assessments reviewed, the EIF quantified the financing gap and concluded that there was a need for public sector actions in favour of financial engineering for SMEs.

34. However, the EIF only made scarce reference to previous EU SME access to finance support within or without the context of the ERDF. If and when the EIF referred to such support, it did not attempt drawing lessons.

NO CLEAR LINK WITH THE OPERATIONAL PROGRAMMES

35. In none of the cases reviewed did the EIF gap assessments establish a link with the ERDF operational programmes they were pertaining to. The gap assessments prepared by the EIF were conducted independently from the operational programme process, often subject to delays and leading to a sub-optimal fund allocation from operational programme measures to financial instruments.

36. As a result, when subsequent framework agreements (between Member States and holding fund managers) had to be negotiated, considerable operational programme constraints (e.g. allocation between different types of instruments, territorial constraints, monitoring and reporting requirements), not addressed in the gap assessments, resurfaced.

37. For instance, the Polish regional authorities were not satisfied with the level of quality of five regional gap assessments[20]. In other cases, the gap assessments were largely ignored in the context of the implementation of the operational programmes (e.g. Andalusia, Hungary).

38. The Commission did not require an independent evaluation or quality review of the gap assessments it ordered from the EIF. However, the EIB conducted an evaluation, which rated the gap assessments to be 'partly unsatisfactory', mainly criticising the delayed gap assessment process and a 'variety of external problems', including regulatory problems[21].

[20] Jeremie conference in Poznan, 8 April 2008, Regional Policy DG note to the file dated 23 May 2008 and internal Regional Policy DG note 'Contribution from GU to the Jeremie Steering Committee' dated 24 June 2008. Mission report, Warsaw, 17 July 2008, Regional Policy DG note to the file of 28 July 2008.

[21] 'Operations evaluation', EIB Synthesis Report (Lessons learnt, p. iv) with Commission comments (released in September 2011).

GAP ASSESSMENTS WERE NOT SYSTEMATICALLY MADE PUBLIC

39. In order to optimise the size and the quality of the supply of SME finance, it is necessary to raise as much as possible the stakeholders' awareness of the specific SME financing needs. This means providing financial intermediaries as well as various SME interest groups and networks with the full gap assessments at the same time as the managing authorities.

40. Against the provisions of the memorandum of understanding[22], in the majority of cases, the full reports were not published, but the Commission only published executive summaries.

THE SUITABILITY OF THE ERDF FRAMEWORK FOR IMPLEMENTING FINANCIAL INSTRUMENTS

41. An adequate regulatory and administrative framework is a critical success factor in delivering SME access to finance effectively and efficiently for the Member States and the numerous regions and financial institutions involved.

42. The Court examined whether:

(a) the legal and management frameworks took sufficient account of the specific nature of the different financial instruments;

(b) the use of the ERDF as a mechanism for the delivery of financial instruments was conducive to sound financial management;

(c) Commission monitoring and information systems were fit for purpose.

[22] Commission/EIF memorandum of understanding, Results of evaluations, p. 2, 30 May 2006.

THE SPECIFIC NATURE OF THE DIFFERENT FINANCIAL INSTRUMENTS IS NOT SUFFICIENTLY CONSIDERED

43. The current Structural Funds regulations[23] state that financial instruments include venture capital (a form of equity finance), loan and guarantee funds. They do not include any additional specific provisions on equity, loan and guarantee funds, which are fundamentally different, both from non-repayable instruments (grants) and between each other. The Financial Regulation[24] is not specific to financial instruments either.

44. As a result, the Commission manages repayable assistance to SMEs under the same legal framework as non-repayable grants.

45. The Commission has recognised that this causes problems. For instance, a 2010 internal audit report[25] found that the design of the regulatory and strategic framework was not best suited to achieving objectives, and that the inadequate system design might have a strong adverse impact on performance and the reputation of the Commission.

46. With the aim of helping Member States understand how the Structural Funds regulations should apply to support financial instruments, the Commission first issued two interpretative notes, limited in scope, in July 2007 and December 2008. Not until February 2011, four years after the start of the current programming period, did the Commission issue a comprehensive and relevant interpretative note on financial engineering instruments, which distinguishes the main types of financial instruments.

47. However, the Commission's February 2011 interpretative note is not legally binding and four major deficiencies in the Structural Funds regulations remain:

- insufficient leverage and fund revolving provisions;
- the possibility to commit unjustified allocations to financial instruments;
- the possibility for unjustified recourse to preferential treatment of the private sector;
- unclear eligibility conditions for working capital.

[23] For the 2007–13, programming period, Council Regulation (EC) No 1083/2006, implemented by Commission Regulation (EC) No 1828/2006 and subsequent amendments. For the 2000–06 programming period, Council Regulation (EC) No 1260/1999, implemented by Commission Regulation (EC) No 1685/2000 and subsequent amendments.

[24] Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities (OJ L 248, 16.9.2002, p. 1), as amended on 14 April 2007.

[25] Advice from the Regional Policy DG IAA (final report), 4 March 2010, points taken from pp. 6–10.

INSUFFICIENT LEVERAGE AND FUND REVOLVING PROVISIONS

48. A first deficiency is the absence in the Structural Funds regulations of clear reference to leveraging funds and revolving legacy funds in general and, in particular, as to how and until when these concepts are applicable[26]. As reiterated by the Commission on many occasions, these are key features of financial engineering instruments and even of the Structural Funds in the current programming period[27].

49. The Structural Funds regulations do not stipulate a specific duration (10, 20, 30 years) or recycling factor (at least once, twice, three times) for the reuse of legacy funding where the latter has not been exhausted. In addition to that, the way in which equity, loan and guarantee funds leverage funding is fundamentally different, which has not been reflected in the regulations.

50. Whilst the February 2011 note acknowledges differences in the type of financial instruments, it makes little reference to their leverage effect, referring to the benefits of leverage, without defining it and setting any leverage requirements (leverage ratios, frequency and reutilisation of legacy funds)[28].

51. Regarding the revolving nature of the funds, the interpretative note provides guidance by encouraging the 'reallocation for the same type of action in the same region covered by the operational programme' of public resources returned after a first investment cycle[29]. Nevertheless, managing authorities could always apply considerable discretion in the reutilisation of legacy funds, if any, as these could always be transformed back into non-reimbursable grants[30], reducing the potential benefits of financial engineering instruments.

[26] Paragraphs 106 to 113 explain the poor leverage ratios achieved for equity and loan instruments.

[27] Non-exhaustive examples include: Commission/EIF MoU of 30 May 2006 signed by the Commissioner for Regional Policy and the EIF's CEO, p. 4; Fourth Report on Economic and Social Cohesion of 30 May 2007, pp. 3–4, interpretative note COCOF/07/0018/01 addressed to the Member States on 16 July 2007, p. 4.

[28] 'Selecting more than one financial engineering instrument may produce the best possible leverage effects for public resources contributed by the operational programme to involve as much as possible available resources and expertise from the private sector and to maximise opportunities to achieve the investment and development objectives of the operational programme. […]', interpretative note COCOF/10/0014/00, point 2.2.2.

[29] Interpretative note COCOF/10/0014/00, point 9.2.3.

[30] See Commission Regulation (EC) No 1685/2000 of 28 July 2000 laying down detailed rules for the implementation of Council Regulation (EC) No 1260/1999 as regards eligibility of expenditure of operations co-financed by the Structural Fund (OJ L 193, 29.7.2000, p. 39) (Annex, Rule 8, Condition 2.6) and Article 43 of Regulation (EC) No 1828/2006.

52. In Andalusia, for instance, the winding-up provision just mentioned that the remaining liquidated funds should be transferred to the regional treasury and then freely be used by the regional government. This meant that the legacy funding could be used to cover regular expenditure of the regional government or in the form of grants to other economic operators than small enterprises[31].

53. Additionally, as explained later in paragraphs 78 to 83, the monitoring and information systems in place do not allow verification of whether an investment strategy, an exit policy and the winding-up provisions[32] effectively set out the terms and conditions under which legacy funding could be revolving. As a result the Commission does not receive sufficient information to monitor the revolving nature of the funds.

POSSIBILITY TO COMMIT UNJUSTIFIED ALLOCATIONS TO FINANCIAL INSTRUMENTS

54. A second deficiency is that under the current Structural Funds regulation[33], Member States that have implemented holding funds are not subject to automatic decommitments during the life of the operational programme when holding fund disbursements have not taken place.

55. As mentioned in paragraph 32, Member States were not obliged to undertake SME gap assessments. Hence, the legislator offered the possibility to make over-sized allocations to financial instruments.

56. It is only at the closure of the programme, more than two years after the end of the seven-year programme period, that the Commission will be in a position to regularise the situation.

57. One telling example of such an over-sized fund allocation is a guarantee fund in Italy (see ***Box 2***).

[31] The Court's Annual Report 2010, paragraph 4.33, example 4.4 (c).

[32] Provisions as defined by the Commission under Article 43 of Regulation (EC) No 1828/2006 and as subsequently amended.

[33] Article 44 of Regulation (EC) No 1083/2006.

POSSIBILITY OF UNJUSTIFIED RECOURSE TO PREFERENTIAL TREATMENT OF THE PRIVATE SECTOR

58. A third deficiency is that Structural Funds regulations[34] allow, without further specification, the recourse to preferential private sector treatment over the public sector, in this case, the Structural Funds. This preferential treatment effectively occurs when contracts do not grant the ERDF the same repayment rights as the private co-funders (i.e. *non-pari passu*).

[34] Regulations (EC) No 1685/2000 and (EC) No 1828/2006 as subsequently amended.

59. Preferential treatment may be justified to attract private investors or lenders by increasing their chances of getting reimbursed and receiving a better risk/return reward. However, its use must be carefully justified as it restricts the capacity to raise sufficient legacy funding for the next wave of SMEs.

BOX 2

CASE OF OVER-SIZED FUND ALLOCATIONS: ERDF GUARANTEES IN ITALY (SARDINIA)

The managing authority of Sardinia did not request any gap assessment. Considering the target financial leverage of 10 combined with an average guarantee rate of 65 % laid down in the managing authority's business plan[35], the 233 million euro endowment of the fund would result in new guarantees to be issued of at least 3 585 million euro, i.e. 51 % higher than the maximum expected amount of new guarantees as per the business plan.

This represents approximately 38 % of the outstanding loan stock of all Sardinian enterprises (currently at 11 803 million euro), which is unrealistic. By mid-2011, 1,5 million euro out of a total endowment of 233 million euro had been pledged against this fund. This excessive endowment is not subject to automatic decommitments.

[35] The managing authority's business plan, in line with Article 43(2) of Regulation (EC) No 1828/2006, should be understood as the equivalent of the 'investment strategy and planning' further to the amendment required by Commission Regulation (EC) No 846/2009 of 1 September 2009 amending Regulation (EC) No 1828/2006 setting out rules for the implementation of Council Regulation (EC) No 1083/2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and of Regulation (EC) No 1080/2006 of the European Parliament and of the Council on the European Regional Development Fund (OJ L 250, 23.9.2009, p. 1).

60. For this reason, managing authorities should assess whether preferential treatment exists and whether it is justified[36]. However, the current Structural Funds regulations do not specify this further, nor do the Commission's interpretative notes.

61. Three cases of unjustified recourse to preferential treatment have been found in the English regions of, respectively, London, Merseyside, and Yorkshire and the Humber. If only one of the lower-tier funds of the holding funds had defaulted, the holding fund would have had to first repay the bank at the expense of the non-defaulting funds.

62. A fourth case was found in Hungary, where equity investors secured their return using a yield restriction clause at the expense of the public contributor and limited their risk by using a loss mitigation clause. As a result, the public contributor bears the full risk, but not the upside in the reward.

UNCLEAR ELIGIBILITY CONDITIONS FOR WORKING CAPITAL

63. A fourth deficiency is the eligibility conditions for working capital, which has not been addressed in the Structural Funds regulations. In the interpretative note of February 2011, the Commission considers that the financing of working capital that is not associated with a plan for the creation or expansion of an enterprise should not be supported through financial instruments[37].

64. The use of the ambiguous term 'expansion capital' and the many exceptions to the use of working capital caused confusion among the financial institutions in the Member States. Indeed, the Commission took the view that working capital eligibility 'must be examined and implemented on a case-by-case basis, taking properly into account and respecting applicable state aid legislation and rules'[38].

65. The consequence of this legal uncertainty could, for instance, be felt in Hungary, where the managing authority stated that the Commission's conditions were difficult to interpret, could not be monitored and increased the risk to financial intermediaries to such an extent that they have lost interest in granting working capital under the ERDF.

[36] During the previous programming period, the Commission recognised that precautions should be taken to minimise distortion of competition in the venture capital and lending markets (see Condition 2.6 of Regulation (EC) No 1685/2000, as subsequently amended.

[37] Interpretative note COCOF/10/0014/00, points 3.2.6 and 3.2.7.

[38] Commission reply of 12 February 2009 to the EIF's letter of 11 December 2008.

CURRENT CHARACTERISTICS OF THE ERDF HAMPERED THE SOUND FINANCIAL MANAGEMENT OF FINANCIAL INSTRUMENTS

66. The characteristics of the ERDF that hampered the sound financial management of financial instruments are mainly its territoriality and its insufficient critical mass (scattering effect). These characteristics affected the ERDF throughout the different programming periods.

ERDF: TERRITORIALITY WITH FAR-REACHING CONSEQUENCES FOR SME FUNDS

67. The first inherent characteristic of ERDF is its territorial approach. For its implementation, the 27 Member States have been divided into 271 statistically defined regions, i.e. usually at the level of NUTS 2[39].

68. This approach is in contradiction with a Commission statement that the competition, which European firms face, is increasingly global and innovation is seen as a global phenomenon that is not successful and sustainable in a closed environment[40]. Indeed, unlike ERDF co-financed repayable assistance, other SME financial instruments (ETF-Start-up, GIF, SME Finance Facility (SMEFF), SMEG, etc.) managed by the Commission are not subject to such territorial restrictions within the EU.

69. In addition to that, several cases of good practice without regional restrictions were identified by the Court in the EU (Germany) and outside the EU (United States of America and Israel), some of which have been further explained in ***Box 3***.

70. This regional split-up prevents the use of typical indicators pertaining to financial instruments such as the percentage of foreign equity in SME balance sheets, banking intermediation rates, default rates, loan rejection rates or equity-to-debt ratios. Indeed, such statistics, in many instances, do not exist at regional level or, at least, at the level of the regional split-up underpinning ERDF support.

[39] Article 13 of Regulation (EC) No 1260/1999 and Article 35 of Regulation (EC) No 1083/2006. Interpretation confirmed to the Court's auditors by the Regional Policy DG during the audit meeting of 1 December 2010.

[40] SEC(2005) 433 final of 6 April 2005, COM(2005) 121 final of 6 April 2005.

ERDF DOES NOT PREVENT THE CREATION OF FUNDS BELOW CRITICAL MASS (SCATTERING EFFECT)

71. During the operational programme fund allocation process, public authorities typically not acquainted with SME finance allocate public contributions to funds in such a fashion that their size often reaches below critical mass. This is not only the result of the territorial approach as mentioned earlier on, but also of possibly different thematic operational programmes with multiple economic, environmental, social and territorial objectives.

72. Providing access to finance with fund sizes below critical mass is very likely to be unsustainable. This is because the overhead costs and the risks associated with investments or loans cannot be spread over a sufficient number of SMEs[41].

[41] 'Comparative Study of Venture Capital and Loan Funds Supported by the Structural Funds', Final Report commissioned by the Regional Policy DG (Centre for Strategy and Evaluation Services, 2007).

BOX 3

GOOD PRACTICE FOUND IN OTHER SME PROGRAMMES

In Germany, the European Recovery Programme (ERP) has not been fixed by any programme period term and has not been implemented regionally. As an evergreen national fund for the benefit of Germany's enterprises, it is truly revolving, as legacy funding cannot be transformed back into grants.

The Small Business Investment Companies Program (SBIC) in the United States of America and the Ministry of Industry, Trade and Labour of the State of Israel (Moital)[42] R & D Fund, Yozma and Technological Incubators programmes in Israel provide access to finance to small businesses without applying regional differentiation. For the SBIC, the focus is the accreditation and control of financial intermediaries, whereas for Moital, it is the strict focus on high-technology SMEs.

All these programmes emphasise other main factors, although important regional differences exist in Germany, the United States and Israel.

[42] See ***Annex III***.

73. In the United Kingdom and Germany, respectively, 433 million and 204 million euro were scattered during the 2000–06 programming period across 31 regions in the United Kingdom (c. 14 million euro per region on average) and 21 regions in Germany (c. 10 million euro per region on average). In particular, 14 regional funding structures had less than 10 million euro to finance SMEs in the developed and populated regions of Berlin, London, North Rhine-Westphalia and the West Midlands through several financial instruments. Moreover, in the case of Berlin, the funds had to distinguish SMEs according to their business location in five different territorial units[43].

74. ***Table 1*** shows fund sizes, including the private contribution, where applicable, in four different EU regions.

[43] In application of Articles 3, 4 and 6 of Regulation (EC) No 1083/2006: Objective 1 (core or transitional areas), Objective 2 (core or transitional areas) and non-eligible areas.

TABLE **1**

FUND SIZES IN THE ERDF REGIONS OF BERLIN, NORTH RHINE-WESTPHALIA, LONDON AND WEST MIDLANDS (FUND NAMES HAVE BEEN ANONYMISED)

COUNTRY	REGION	FUND NAME	FUND SIZE (in million euro)
GERMANY	Berlin	Loan Fund A (Objective 1 compartment)	4,52
		Loan Fund A (Objective 2 compartment)	7,22
		Equity Fund A (Objective 1 compartment)	1,26
		Equity Fund A (Objective 2 compartment)	4,14
	North Rhine-Westphalia	Equity Fund D	0,41
UNITED KINGDOM	London	Equity Fund O (Objective 2)	7,98
		Equity Fund N (Objective 2)	5,95
		Loan Fund H (loans operation)	3,62
		Loan Fund G	1,88
		Loan Fund H (mezzanine operation)	0,82
	West Midlands	Equity Fund P	13,12
		Equity Fund L	13,08
		Loan Fund J	7,08
		Equity Fund Q	6,23
		Equity Fund M	3,46
		Loan Fund I	1,00

Note: ECB pound sterling/euro rate as of 31.12.2008 (payment closure date): 1,0499.

75. In the case of three funds, respectively covering the regions of London, North Rhine-Westphalia and the West Midlands, the combined risk profile and the small fund size actually put the entire fund portfolio at risk, because of an insufficient diversification of the risk taken by the fund.

76. The risk that ERDF managing authorities may scatter SME finance is relevant to the 2007–13 programming period as well. At the time of the audit, there was no evidence that the regions concerned would have fund sizes endowed with sufficient critical mass. A telling example has been highlighted in ***Box 4*** (Slovakia).

77. Conversely, the setting-up of holding funds and funds with sufficient critical mass is facilitated when, according to its national laws, a Member State can consider its territory as a single region (Lithuania) or earmark financial engineering measures for one specific operational programme at multi-regional level (Portugal). At the same time, this facilitates implementation, since only one managing authority has to be involved.

BOX 4

SUB-CRITICAL MASS IN SLOVAKIA

In Slovakia, for instance, sub-critical fund sizes had originally been sourced from up to five different national operational programmes against the explicit advice of the EIF, the holding fund manager.

The sub-critical mass size problem has been worsened by the application of the Commission concepts of 'assisted' and 'non-assisted' areas, which are used in the context of compliance with EU state aid rules and are unrelated to the concept of the SME financing gap.

In order to secure a national exemption from state aid rules, the Slovak authorities defined Bratislava as a 'non-assisted region'. A third of all Slovak SMEs and half of Slovakia's potential in research and development are based in the capital region. As a result, numerous SMEs have been excluded from the benefit of guarantee instruments and were allocated a very small amount in equity instruments.

COMMISSION AND MEMBER STATE MONITORING AND INFORMATION SYSTEMS DO NOT ADDRESS THE SPECIFICITIES OF FINANCIAL INSTRUMENTS

78. The combined complexity of financial instruments, shared management and the state aid and Structural Funds rules called for specific information, communication and monitoring systems between the Commission, the managing authorities and the beneficiaries (the financial intermediaries). In addition to that, given the new provisions of the 2007–13 regulatory framework, Member States and other stakeholders particularly sought the Commission's guidance and advice.

79. Under both the 2000–06 and 2007–13 programming periods, Member States and managing authorities have to correspond with the Regional Policy DG's so-called 'geographical desks'. Based on the Regional Policy DG's internal audit findings, these desks were affected by a poor flow of information and limited transparency[44].

80. During the 2007–13 programming period, the Commission set up a unit with responsibility, inter alia, for SME financial instruments supported by the ERDF. However, most staff were assigned to other unit activities.

81. In practice, only three full-time equivalent staff were assigned to SME financial engineering instruments. With internal calls for sharing knowledge and expertise with other directorates-general not having been followed[45] and no specific information technology application accessible to Member States and stakeholders, the Commission may not have the means to provide appropriate guidance and advice.

44 Advice by the Regional Policy DG IAA (final report), 4 March 2010.

45 Advice by the Regional Policy DG IAA (final report), 4 March 2010.

82. The standard cohesion policy monitoring instruments put in place for the ERDF[46] are inadequate or not adapted for the purpose of financial instruments.

(a) **Annual implementation reports**, with the exception of the United Kingdom, do not report specifically on the performance of financial engineering instruments.

(b) The legal remit of **monitoring committees** is to monitor at operational programme level[47]. Consequently, they are generally not in the position to address the specificities of the different types of financial engineering instruments.

(c) **Operational programme indicators** do not make the distinction between financial instruments (repayable instruments) and grants (non-repayable instruments)[48]. As a result, most of the indicators used — output-oriented 'macro-indicators of development'[49] — are not helpful for assessing the progress of financial engineering instruments.

83. Aware of this weakness, in its interpretative note of February 2011 the Commission recommended to the 27 Member States that they report on over 100 suggested indicators[50].

EFFECTIVENESS AND EFFICIENCY OF THE FINANCIAL INSTRUMENTS IN ACHIEVING RESULTS

84. When assessing the effectiveness and efficiency of the ERDF in delivering financial instruments, the Court examined whether and to what extent:

(a) SME finance was subject to delays;

(b) unjustified management costs reduced funds actually available for SME financing (leakage effects)[51];

(c) the public funds leveraged private funding.

WIDESPREAD DELAYS

85. The timeliness of delivering SME access to finance could be assessed as compared with the start of the respective operational programmes, respectively, in 1999/2000 and 2007.

[46] Articles 34 to 37 of Regulation (EC) No 1260/1999 and Articles 63 to 68 of Regulation (EC) No 1083/2006.

[47] Article 35 of Regulation (EC) No 1260/1999 and Article 65 of Regulation (EC) No 1083/2006. Two exceptions, specific to the United Kingdom, have been found in London and the West Midlands, where monitoring committees met specifically to address the programming of financial engineering measures and instruments.

[48] During the 2000–06 programming period, in the regions audited in England and Germany, amounts labelled by the Commission under the 'Financial engineering' indicator have been found to comprise a majority of grants to SMEs or organisations supporting SMEs. For the 2007–13 programming period, the Commission's 'Financial engineering' indicator disappeared altogether.

[49] E.g. 'jobs maintained, created', 'actions in favour of local initiatives', 'enterprises having improved quality.'

[50] Interpretative note COCOF/10/0014/00, Annex II Template Monitoring Report (Commission, February 2011).

[51] In the context of this performance audit, only leakage effects in the form of unjustified management costs have been considered.

86. Apart from the reputational risk that delays to access to finance programmes may cause, the likely knock-on effects of delays would affect the capacity of the Commission to recycle funds in the 2007–13 programming period and in the following programming periods.

87. Whenever delays in delivering SME access to finance occur, funds cannot spend the money SMEs could be entitled to in the form of financial instruments. From the point of view of the managing authority, this entails that the alternative, using grants for SMEs, becomes more attractive.

88. The main causes of delays in both programming periods have been summarised in ***Table 2***. Delays have been widespread across Member States. Some causes of delay have re-occurred in the current programming period and, apart from 'obtaining private sector contribution', delays are less related to volatile financial circumstances than to administrative, legal, organisational or strategic reasons.

TABLE 2

MAIN CAUSES OF DELAY IN IMPLEMENTING ERDF FINANCIAL INSTRUMENTS

CAUSES FOR DELAYS	MEMBER STATES OR REGIONS
2000–06	
Time-consuming structuring and negotiations	Berlin, London, North Rhine-Westphalia, Portugal, West Midlands
State aid issues in Objective 2 regions	London, North Rhine-Westphalia, West Midlands
Commission guidance on fund structures	Berlin, London
Obtaining private sector contribution	London
2007–13	
Time-consuming structuring and negotiations	Greece, London, Hungary, Poland, Slovakia
Obtaining private sector contribution	London, West Midlands, Hungary
Administrative reasons	Andalusia, Greece, Poland, Sardinia
Management cost negotiations	Poland, Slovakia
Governance arrangements	Greece, Slovakia
Uncertainty of working capital eligibility	Hungary
Negotiating entity not a managing authority	Slovakia

Note: Delays may not concern all types of financial instruments to be supplied; delays of less than two years from operational programme approval date have been ignored; categories have been simplified by the auditors; all categories based on evidence.

89. A few telling examples have been set out in the following paragraphs, one taken from the previous and three from the current programming period.

90. In **Germany**, funds started very late in the 2000–06 programming period, causing at least three funds in Berlin and North Rhine-Westphalia to be unable to spend the foreseen amounts of SME financing of, respectively, 24,4 million euro, 13,6 million euro and 2,6 million euro. This represented underutilised funds ranging from 18 % to 87 % of the amount originally planned.

91. In **Greece**, the holding fund agreement was signed in June 2007 and well before that Member State's sovereign debt crisis unfolded. As of 30 June 2011, only 0,21 % of the 250 million euro holding fund has effectively been paid out to SMEs. It is only since April 2011 that Greek SMEs started receiving ERDF support. As the Hellenic Republic and the EIF signed the holding fund agreement early, calls for tenders could have been issued directly by the holding fund manager if only the Member State had not delayed the holding fund's governance arrangements, notably by making these dependent on appointments within managing authorities involved and in the fund's investment board.

92. In **Slovakia**, as of June 2011 and five years after the EIF and the Slovak Republic signed a memorandum of understanding, SMEs have been left without ERDF funding. The fund allocation from the different operational programmes and the terms and conditions with respect to the establishment of the holding fund were only finalised in January 2011. The financial intermediaries have not been procured and management costs have already been incurred since October 2009.

93. In **Poland**, from 2008 until June 2011, SMEs have not been funded by the ERDF. After deciding not to appoint the EIF as holding fund manager, the Republic of Poland appointed its development bank, Bank Gospodarstwa Krajowego, which has yet to agree with five regional authorities on a uniform system of management costs. The Polish Ministry of Regional Development referred to the legal and organisational difficulties of the Joint European Resources for Micro to Medium Enterprises (Jeremie) initiative and, in particular, to the need to widely interpret the Structural Funds regulations in view of their complexity[52].

[52] Letter addressed to Poland's Supreme Audit Institution dated 3 January 2011, the contents of which have been verified with Regional Policy DG internal files.

LEAKAGE EFFECTS

94. It is normal market practice that SMEs can be charged management costs by financial intermediaries. However, in the context of the ERDF, such costs are generally paid directly from the operational programme to the financial intermediaries as reimbursement or compensation for managing the funds[53].

ADDITIONAL CHARGES TO THE SMEs …

95. Commission guidance (including two interpretative notes of 2007 and 2011) does not set the terms and conditions, which would prevent SMEs being charged costs that are not based on actual SME risk taken or service provided by the financial intermediaries.

96. In Saxony-Anhalt (Germany) and Estonia, the financial intermediaries appointed by the respective managing authorities charged individual SMEs for the refinancing and processing costs, a practice found following Court audits in 2009. Refinancing and processing costs are items of ordinary operating expenditures for financial intermediaries.

97. In England as well, SMEs were charged arrangement, handling, monitoring and other types of fees on top of the usual market charges. The status of handling and monitoring fees in terms of impact on eligible expenditure declarations at closure is currently being investigated by the Commission as part of audit inspections conducted in the English regions.

... NOT ALWAYS VERY TRANSPARENT

98. Because the Commission does not legally consider the SME to be the beneficiary and because Member States do not always report management costs correctly, there have been instances where management costs borne by the SMEs are unknown.

[53] Drawn from Interpretative note COCOF 10/0014/04, point 2.6.

99. Out of the 16 equity funds audited, the management costs of four of them could not be estimated due to a lack of available data at the time of the audit.

100. For instance, in North Rhine-Westphalia, neither the managing authority, nor the appointed fund manager, could provide information about the management costs actually incurred by the region. Indeed, documentation on the calculation of the interest rate charged, including the margin for financing management costs, could not be provided. Additional costs for supporting SMEs (including costs of external consultants) were financed through the funds in the case of one early stage equity fund, but an overview of these costs could not be provided either.

101. The absence of robust management cost information is not confined to equity funds, but is a more widespread problem. In 11 out of the 34 operations audited, management cost rates could not be established, because information on management costs was not available or was not reliable.

POOR RECORD OF THE ERDF IN ATTRACTING PRIVATE MONEY

102. The Commission and other international players in the field of SME finance (see paragraph 25) consider that attracting private sector funding is one of the main advantages of supporting SMEs through financial instruments[54]. As a result, the Court defines leverage as the extent to which private funding has been attracted, as set out in ***Box 5***.

103. When public funding is limited to the EU contribution (like in EU centrally managed programmes) both calculations give the same result. However, the situation is generally different in the context of cohesion policy. Member States' co-financing of operational programmes generally constitutes public funding. This may be national funding, regional funding or could take other forms of public aid[55].

[54] According to the Commission communication COM(2011) 662 on the 'EU debt and equity platforms' (p.7), leverage can be achieved through co-financing by international financial institutions or through the additional debt volumes banks and guarantee institutions are requested to provide final beneficiaries (in the Communication SMEs are here referred to as 'final beneficiaries').

[55] In some very rare cases, Member States' co-financing takes the form of private commercial loans.

104. Whereas the Commission includes Member State co-financing to an operational programme as a contribution in the multiplier effect, the Court's ratio does not consider this as a contribution to the leverage effect. Indeed, Member State co-financing is not specific to financial instruments. Such Member State co-financing exists for any cohesion policy action, including also traditional non-reimbursable grants.

105. At the level of the holding funds, the audit did not come across significant leverage from the private sector. This was true for both programming periods. Indeed, there are typically no explicit leverage requirements in the funding agreements between the managing authorities and the financial intermediaries, except for certain equity funds in the United Kingdom, which had binding leverage requirements for private co-investors.

BOX 5

LEVERAGE

The Court calculated leverage as follows:

$$\frac{\textbf{Finance to final recipients}}{\textbf{Public contributions}}$$ [56]

Using the Court's calculation method, ***Annex II*** gives a schematic overview of how leverage works for each main category of financial instrument and, in the context of the ERDF, how the concept of leverage is to be understood. For instance, a leverage ratio of 1,00 means that no private funding was raised at all.

In August 2011 the Commission formalised the concept of 'multiplier effect', which corresponds to:

$$\frac{\textbf{Finance to final recipients}}{\textbf{EU contribution}}$$

The numerator of both the Court's leverage ratio and the Commission's multiplier ratio are identical. Regarding the denominator, while the Court sums up all public funding, the Commission solely takes into account the EU contribution.

[56] This includes both the ERDF contribution and, as is normal for the ERDF, co-financing provided by the Member State. In the exceptional case of the United Kingdom, the private sector provided the Member State's funding in accordance with the regulations' co-financing rules; this funding was taken into account as private funding and not as public funding, applying the principle of substance over form.

106. For equity and loan instruments, the Court found that the leverage achieved has not been significant and lower than comparator benchmarks. For guarantee instruments, in contrast, leverage was very high.

LEVERAGE OF ERDF EQUITY INSTRUMENTS

107. For this type of financial instrument, the Court audited:

(a) five VC funds focusing on high-technology SMEs (ISMEs);

(b) 12 risk capital funds with less or no focus on high technology.

108. ***Table 3*** shows that the leverage ratios achieved ranged from around 1 (no leverage of private funding) to 2,75.

109. As a benchmark, the Court has used the ETF-Start-up Facility, which is funded centrally by the Commission and is accessible to all eligible financial intermediaries in the EU under the fiduciary management of one fund manager, the EIF. The facility is designed for VC and focuses on relatively risky SMEs.

110. The ETF-Start-up Facility has achieved an average aggregate leverage ratio of 4,6 (1998–2008) and 6,50 (2001–08) and also succeeded in generating revenues for the Commission[57]. More specifically, in Germany, Portugal and the United Kingdom, where the ERDF was equally active, leverage ratios achieved by the ETF-Start-up Facility were, respectively, 4,88, 5,93 and 5,03[58]. On the other hand, from April 2000 until June 2010, leverage ratios achieved by the ERDF for the audited funds (in ***Table 3***) ranged from 1,09 to 2,75.

[57] External evaluation of the EIP for the Enterprise and Industry DG, pp. xi, 63 and 67, 30 April 2009. Evaluator figures deemed plausible on the basis of a preceding and independent evaluation of MAP (2001–05) for the Enterprise and Industry DG, which mentioned already in 2004 that ET-Start-up reached a leverage of 4,00. Furthermore, based on the June 2009 figures of the EIF quarterly report (issued after the 2009 evaluation), the figures for the programmes were 4,91 and 6,52, respectively, for equity instruments that started under the 1998 and the 2001 programmes.

[58] Weighted figures for Germany, Portugal and the United Kingdom based on Tables 3a and 3b, Annual Report ETF-Start-up, 21 October 2009, data as at 30 June 2009.

TABLE 3

LEVERAGE OF EQUITY INSTRUMENTS AUDITED (FUND NAMES HAVE BEEN ANONYMISED)

Member States	Fund name	Product description	Leverage ratio
High-technology funds			
Germany	Equity Fund B	VC (high-tech)	2,26
United Kingdom	Equity Fund L	VC equity (high-tech)	2,01
United Kingdom	Equity Fund M	VC equity (early stage high-tech)	1,95
United Kingdom	Equity Fund N	VC equity (early stage high-tech)	1,89
Germany	Equity Fund D	VC (early stage high-tech)	1,33
Other funds			
Germany	Equity Fund A	Risk capital (multi-sector)	2,75
Portugal	Equity Fund G	VC equity fund-of-funds	2,22
Portugal	Equity Fund H	VC equity (multi-sector)	2,12
United Kingdom	Equity Fund O	VC equity (early stage creative)	1,89
Germany	Equity Fund C	Risk capital (multi-sector)	1,88
United Kingdom	Equity Fund P	Film fund	1,78
Hungary	Equity Fund E	VC equity (multi-sector)	1,72
Hungary	Equity Fund F	VC equity (multi-sector)	1,43
Portugal	Equity Fund I	VC equity (tourism sector)	1,33
United Kingdom	Equity Fund Q	VC equity (early stage creative)	1,09
Slovakia	Equity Fund J	VC equity outside Bratislava region	-
Slovakia	Equity Fund K	VC equity in Bratislava region	-

Notes:
— Equity Funds E and F were in the investment start-up phase at the time of the audit visit.
— Leverage ratios calculated on the basis of figures transmitted during the audit by the fund manager or the managing authority.

LEVERAGE OF ERDF LOAN INSTRUMENTS

111. Irrespective of any benchmark, ***Table 4*** shows that 5 out of the 10 loan funds did not leverage any private funding at all, whereas the other loan funds showed very limited leverage.

112. As a benchmark, the Court has used the SME Finance Facility (SMEFF), which was used in central and east European countries that joined the EU in 2004 and 2007 before they achieved that status. The SMEFF provided grants (mainly performance fees, but also so-called 'technical assistance') to networks of local financial intermediaries through international financial institutions[59]. These grants were conditional to the effective set-up and the revolving of SME debt portfolios of a pre-defined size.

113. The EU's SMEFF leveraged private funding achieving leverage ratios usually exceeding 5 and reaching up to 12,5 and 19,2[60]. From 1998 until June 2009 and depending on the implementing financial intermediary, SMEFF achieved leverage ratios ranging from 2 to 12,5 in Hungary and from 4 to 10 in Slovakia.

LEVERAGE OF ERDF GUARANTEE INSTRUMENTS

114. Fewer guarantee funds were subject to the audit (six, see ***Table 5***), as the United Kingdom and the regions audited in Germany generally do not use ERDF guarantees.

115. The leverage ratios achieved varied greatly, with the highest being 171. Even the lowest ratio (4,16) of a guarantee fund in Hungary and which started operating in November 2008 is a higher leverage ratio than achieved by any of the equity and loan funds. These levels of leverage compare well with the SME Guarantee Facility (SMEG, see paragraph 6(a)) that cumulatively leveraged 67 times each euro of public money spent from 2001 until 2006[61].

59 The Commission worked with three international financial institutions: CEB/KfW, EBRD and EIB.

60 SMEFF — EIB's Semi-Annual Report 2009, p.1. EU/EBRD SME Finance Facility Semi-annual Operational Report, p. 70, June 2009.

61 End Report on the MAP (SMEG), 31 December 2006, p. 7.

TABLE 4

LEVERAGE OF LOAN INSTRUMENTS AUDITED (FUND NAMES HAVE BEEN ANONYMISED)

Member States	Fund name	Product description	Leverage ratio
Other funds			
United Kingdom	Loan Fund G	Long-term senior loans to social enterprises	1,67
United Kingdom	Loan Fund H (2 operations)	Senior loans (multi-sector)	1,67
United Kingdom	Loan Fund I	Senior loans (multi-sector)	1,41
Hungary	Loan Fund B	Microcredits, small loans	1,33
Hungary	Loan Fund C	Microloans (multi-sector)	1,10
Germany	Loan Fund A	Microloans, loans	1,00
Hungary	Loan Fund D	SME loans	1,00
Hungary	Loan Fund E	Working capital loans	1,00
Hungary	Loan Fund F	Working capital loans	1,00
United Kingdom	Loan Fund J	Microloans (multi-sector)	1,00

Note: Leverage ratios calculated on the basis of figures transmitted during the audit by the fund manager or the managing authority.

TABLE 5

LEVERAGE OF GUARANTEE INSTRUMENTS AUDITED (FUND NAMES HAVE BEEN ANONYMISED)

Member States	Fund name	Product description	Leverage ratio
Portugal	Guarantee Fund B	Guarantees	171,00
Portugal	Guarantee Fund C	Guarantees	114,00
Portugal	Guarantee Fund D	Guarantees	80,00
Portugal	Guarantee Fund E	Counter-guarantees	11,00
Hungary	Guarantee Fund A	Guarantees	4,16
Slovakia	Guarantee Fund F	First loss portfolio guarantees	-

Note: Leverage ratios calculated on the basis of figures transmitted during the audit by the fund manager or the managing authority.

CONCLUSIONS AND RECOMMENDATIONS

QUALITY OF THE ASSESSMENT OF THE SME FINANCING GAP

116. Generally, during the 2000–06 programming period, gap assessments did not exist at all.

117. During the 2007–13 programming period, where they existed, all SME gap assessments concluded that there was a need for public sector intervention in various forms and they quantified the SME financing gap. However, in the 2007–13 programming period, there are significant shortcomings in the quality of the gap assessments. In particular, the critical link between the different programme allocations and the financing gap identified was not established.

118. An independent review of the quality of the gap assessments and of their underlying process did not take place.

RECOMMENDATION 1

(a) When proposing financial engineering measures, the managing authorities should make sure that their proposal is duly justified by an SME gap assessment of sufficient quality, including a quantified analysis of the financing gap.

(b) When approving operational programmes including financial engineering measures, the Commission should verify their consistency with the SME gap assessment and make sure of the quality of the latter.

SUITABILITY OF THE ERDF FRAMEWORK TO IMPLEMENT FINANCIAL INSTRUMENTS

119. The Structural Funds regulations, which were originally designed for grants, contain four important weaknesses, as they do not address the specificities of financial instruments. These weaknesses regard the insufficient provisions for leverage and revolving funds, the justification of allocations to financial engineering, the conditions to justify the recourse to preferential private sector treatment and the eligibility conditions for working capital. Not until February 2011, four years after the start of the current programming period, did the Commission issue a comprehensive and relevant interpretative note on financial instruments (see paragraphs 46 and 47).

120. Delegating the implementation of co-financed financial instruments to a large number of public authorities means that the same amount of ERDF funding that could theoretically be available for all SMEs in a Member State under a single framework has to be scattered across a large number of EU regions, thus affecting the critical mass of the funds.

121. Where they existed, suitable monitoring and information systems were ill-equipped to inform on and monitor the sound financial management of the funds. Despite the experience of the 2000–06 programming period, this prevented the Commission from reporting relevant information that was useful to decision-makers and stakeholders operating in the context of the cohesion policy.

RECOMMENDATION 2

(a) When designing proposals for the Structural Funds regulations, the legislator and the Commission should address the different specific weaknesses mentioned in the report (see paragraphs 48 to 77). More generally, the legislator and the Commission should provide a more adequate regulatory framework so that the design and the implementation of financial engineering measures do not suffer from the deficiencies of the Structural Funds' regulatory framework, geographical constraints and scattering effects.

(b) The Commission should provide a reliable and technically robust monitoring and evaluation system specific to financial instruments. As a result, financial instruments should be segregated from pure grants in the Commission's monitoring, reporting and auditing processes and the amount of money actually paid to the SMEs should be transparent (see paragraph 8). In particular, the Commission and the Member States should agree on a small number of measurable, relevant, specific and uniform result indicators for financial instruments.

EFFECTIVENESS AND EFFICIENCY OF THE FINANCIAL INSTRUMENTS IN ACHIEVING RESULTS

122. The implementation of financial instruments for SMEs through the ERDF has been affected by widespread delays. Some of the reasons for delays during the 2000–06 programming period have recurred in the 2007–13 programming period.

123. ERDF co-financed financial instruments have also been subject to leakage effects in terms of management costs. In particular, some SMEs have been charged additional costs not based on the SME risk taken and the reporting of management costs has not always been transparent

124. Except for guarantees, leverage ratios for ERDF co-financed funds implementing financial instruments (as defined by the Court) were poor.

RECOMMENDATION 3

(a) The Commission should explore the possibility of supplying to the Member States off-the-shelf financial engineering structures and instruments for SMEs (e.g. grants with royalties, dedicated investment vehicles) in order to speed up implementation and reduce management costs. Examples of such structures have been described in ***Annex III***.

(b) Member States, with the support of the Commission, should aim at the inclusion of all ERDF co-financed financial instruments for SMEs into a single operational programme per Member State. This would rationalise the planning process and remove one of the key delaying factors found.

(c) Apart from defining the concepts and definitions of leverage and recycling in the Structural Funds regulations, the Commission should, depending on the type of holding fund or fund, require contractually binding minimum leverage ratios, minimum revolving periods and data for the calculation of leverage indicators.

GENERAL RECOMMENDATION

If the above recommendations cannot be implemented under the cohesion policy framework, the Court invites the legislator and the Commission to consider alternative ways of pursuing SME support through financial engineering instruments. In such a case, such instruments should either be supported by programmes centrally managed by the Commission, dedicated investment vehicles in cooperation with the Commission and the Member States or by the Member States directly.

This report was adopted by Chamber II, headed by Mr Harald NOACK, Member of the Court of Auditors, in Luxembourg at its meeting of 11 January 2012.

For the Court of Auditors

Vítor Manuel da SILVA CALDEIRA
President

ANNEX I

COMMITMENTS AND PAYMENTS TO FINANCIAL ENGINEERING INSTRUMENTS

2000–06

Audited Member States	Commitments (in million euro)	%	Payments (in million euro)	%
Germany	204	13	170	11
Hungary	-	-	-	0
Portugal	106	7	88	6
Slovakia	-	-	-	0
United Kingdom	433	27	410	27
Total	**742**	**46**	**668**	**45**
EU TOTAL	**1 596**	**100**	**1 497**	**100**

2007–13

Audited Member States	Allocations (in million euro)	%	Payments (in million euro)	%
Germany	1 370	13	710	9
Hungary	770	7	669	8
Portugal	292	3	233	3
Slovakia	30	0	27	0
United Kingdom	614	6	230	3
Total	**3 075**	**30**	**1 868**	**24**
EU TOTAL	**10 393**	**100**	**7 879**	**100**

Source: European Commission (Regional Policy DG).

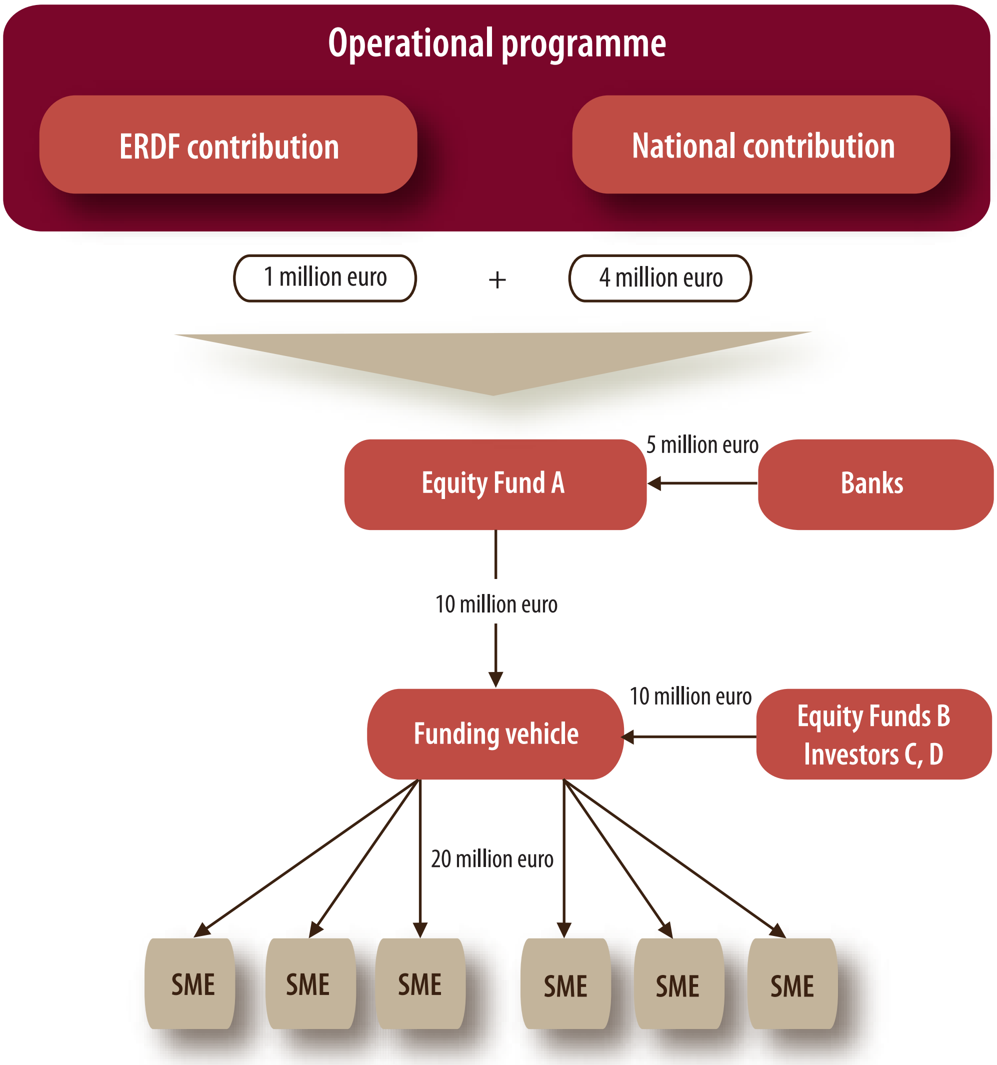
Remarks:

- Sums of percentages may differ due to rounding before the decimal.
- For the 2000–06 programming period, final recipients were exclusively SMEs.
- For the 2007–13 programming period, financial instruments include instruments for enterprises that do not fit the EU's SME definition, as well as urban development projects and energy efficiency projects.
- At least for the 2007–13 programming period, the accuracy of figures is subject to caution, as Member States have misinterpreted the classification rules of allocations and may have included other forms of finance than financial engineering instruments.

ANNEX II

SCHEMATIC OVERVIEW OF THE LEVERAGE CONCEPT AS APPLIED TO EQUITY, LOAN AND GUARANTEE INSTRUMENTS

EQUITY



Leverage ratio:

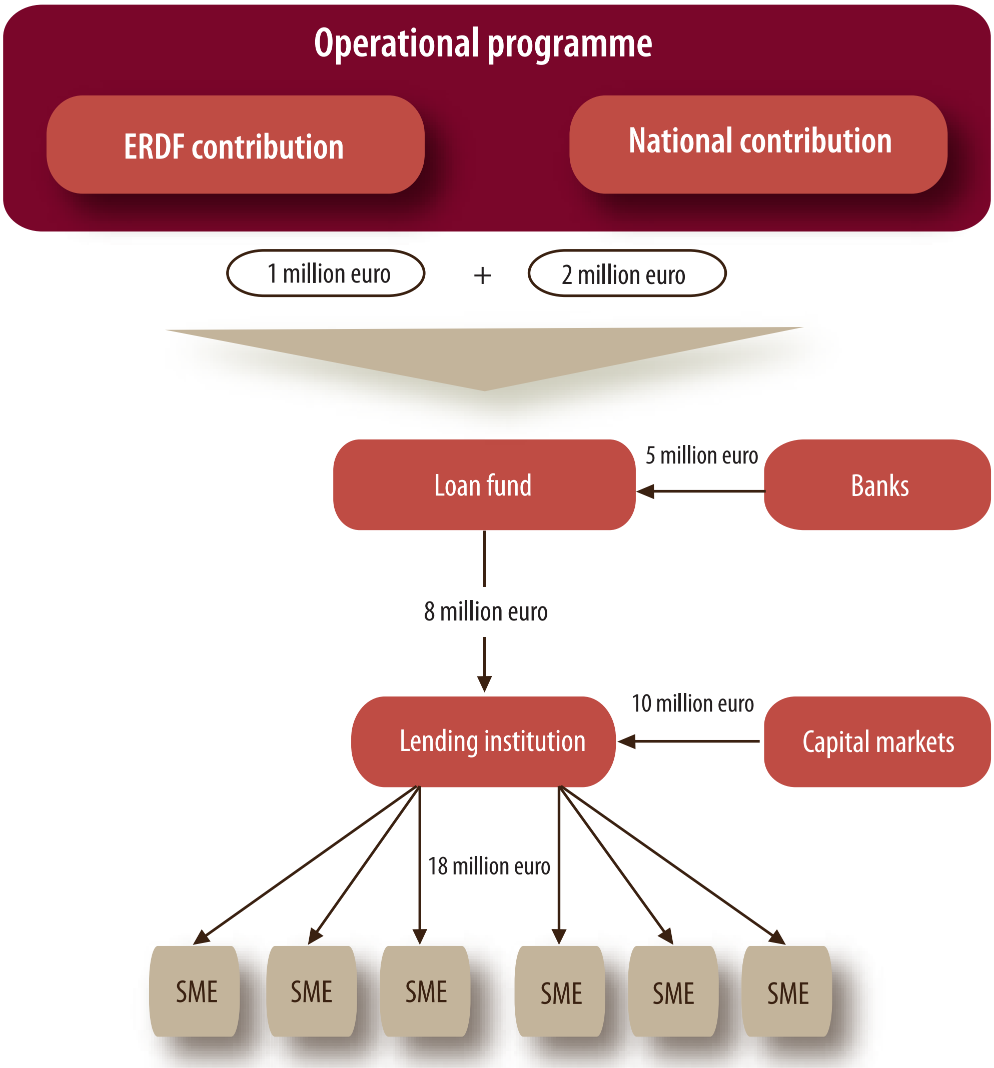
$$\frac{\text{Funding available to SMEs: 20 million euro}}{\text{Operational programme funding: 5 million euro}}$$

Leverage ratio = 4

Remarks:

- This schematic overview is purely given for illustration purposes.
- The public contribution corresponds to the operational programme funding.

LOANS



Leverage ratio:

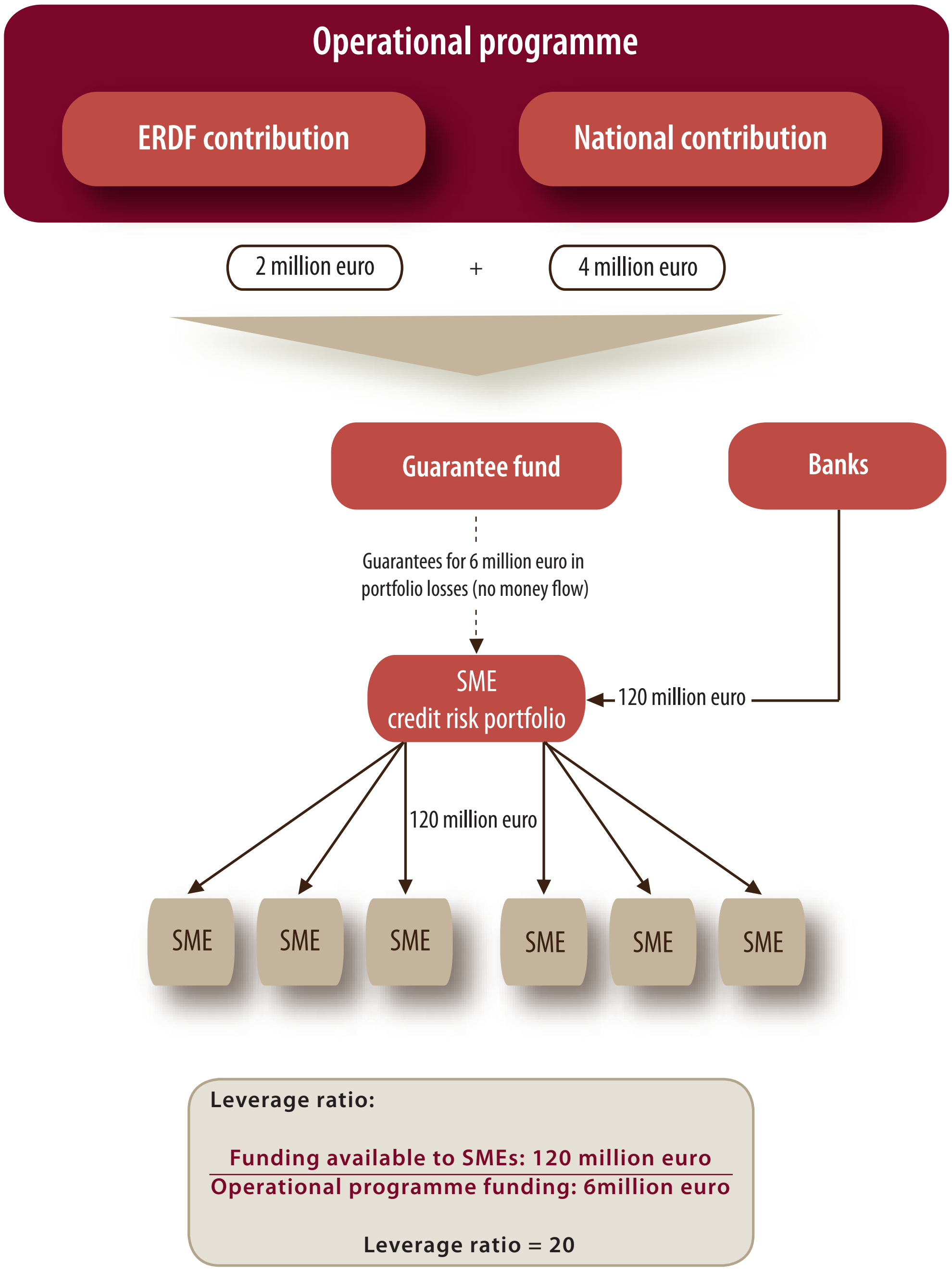
$$\frac{\text{Funding available to SMEs: 18 million euro}}{\text{Operational programme funding: 3 million euro}}$$

Leverage ratio = 6

Remarks:

- This schematic overview is purely given for illustration purposes.
- The public contribution corresponds to the operational programme funding.

GUARANTEES



Remarks:

- This schematic overview is purely given for illustration purposes.
- The public contribution corresponds to the operational programme funding.

ANNEX III

EXAMPLES OF OFF-THE-SHELF INSTRUMENTS AND VEHICLES

GRANTS ASSORTED WITH ROYALTY PAYMENTS: THE EXAMPLE OF MOITAL, ISRAEL

In Israel, most aid schemes for SMEs (R & D Fund, Technological Incubators, Heznek, …), even though they use non-reimbursable grants, condition the payment of the grant to the commitment of the beneficiary SME to pay royalties in case of success. Royalties are calculated on the basis of sales or profit. The benefit of grants assorted with royalty payments is that they are less complex than financial engineering instruments, whilst focusing on SMEs with potential in research and development. For more information, see http://www.moital.gov.il/.

DEDICATED INVESTMENT VEHICLES

- **European Recovery Programme**: ERP is an evergreen national fund managed by KfW for the benefit of Germany's enterprises with, as one of its main characteristics, its revolving nature. For more information, see http://www.bundesfinanzministerium.de/

- **Israel's Yozma Fund**: When it was still a state-owned fund, its principle was the co-investment of public funds and private investor funds under a minimum leverage ratio requirement of 2,5. It invested in Israeli start-up companies in high-technology sectors. A key feature of this programme was that it provided both the Israeli government and private investors to share the profit *pari passu*. As the private sector partners were given an option to buy the government's share during the first five years at a cost of LIBOR+1 plus royalties until the end of the funding period, the government could subsequently reinvest these proceeds in new funds or SMEs. For the Israeli government, Yozma yielded 40 million US dollars in profit. For more information, see http://www.yozma.com/overview/

- **The European Progress Microfinance Facility**: The Commission's European Progress Microfinance Facility does not directly provide financing to SMEs, but enables microfinance institutions in the EU countries to increase lending to them. This is done by issuing guarantees to microfinance institutions thereby sharing their risk and by increasing their microcredit volume through funded instruments (i.e. loans and equity). For more information, see http://ec.europa.eu/social/

- **The European Fund for Southeast Europe (EFSE)**: EFSE's main investment activity is the refinancing of selected partner lending institutions in the region of south-east Europe and the European eastern neighbourhood region with senior or subordinated credit lines, whereby the borrower obliges himself to on-lend the funds to the final target groups, including micro and small enterprises and low-income private households. A large sponsorship characterises this fund, which includes international financial institutions (EBRD, EIB, KfW, etc.), the Commission, as well as public and private financial institutions. For more information, see http://www.efse.lu

REPLY OF THE COMMISSION

EXECUTIVE SUMMARY

IV.

The revolving character of financial instruments may not be present in financial instruments implemented under other policy areas, for which the resources returned to the financial instruments at the end of the investment period or at winding up must be returned to the EU budget. This specific feature embedded in the Structural Funds regulations[1] will be continued in the future[2].

VII. (a)

The Commission agrees on the importance to provide funding to financial instruments corresponding to the needs as identified in a gap analysis.

The relevant observations by the Court are partly covered by the proposal for CSF regulation COM(2011) 662 final.

VII. (b)

The regulatory framework for the period 2007–13 may have been insufficiently detailed to provide the necessary environment for a significant increase of the cohesion policy assistance delivered through financial engineering instruments.

The Commission proposals for the next programming period take into account the experience gained in the previous periods, providing a detailed implementation framework.

VII. (c)

Those delays were in most cases explained by the novelty of the instruments in cohesion policy and by the state aid-related issues. Financial instruments financed from the ERDF are implemented in a shared management manner. There is a certain trade-off between the application of the subsidiarity principle (implementation by Member States and their managing authorities at regional level as close as possible to the final recipients and in accordance with the diversity of their needs) and the slower implementation.

1 In paragraph 2.6 of Rule 8 under Commission Regulation (EC) No 1685/2000, Article 78(7) of Council Regulation (EC) No 1083/2006.

2 As proposed by the Commission in Articles 38 and 39 of the Commission's proposal on the common provisions for the funds under shared management for the period 2014–20 (COM(2011) 615 of 6 October 2011).

REPLY OF THE COMMISSION

VIII. (a)
The Commission welcomes this recommendation which is covered by the Commission's proposal for the new the cohesion policy framework[3].

This requirement will be further detailed in the implementing legislation.

VIII. (b)
For the future programming period the emphasis will be placed in ensuring that each financial instrument is 'based on an *ex ante* assessment which has identified market failures or suboptimal investment situations, and investment needs'. When approving the operational programmes emphasis will be placed on ensuring alignment with EU2020 strategic priorities, identification/fulfilment of *ex ante* conditionalities and evaluation of the rationale for the form of support proposed.

VIII. (c)
Given the expected increase in the importance of financial instruments in the future, the Commission's proposals for the future CSF regulations include more detailed and clear rules regarding the use of financial instruments. These rules build upon the experience accumulated in the current programming period and will be further detailed in the implementing legislation.

VIII. (d)
The Commission welcomes this recommendation which is already covered in the Commission's proposals for the new cohesion policy framework. These proposals also include specific provisions regarding monitoring and reporting of financial instruments. Furthermore, the Commission notes that already in the current programming period it managed to gather important monitoring information on existing financial instruments, and this without the legal obligation of the Member States to provide such information.

VIII. (e)
The Commission welcomes the Court's recommendation regarding off-the-shelf instruments which is covered in the proposal for the new programming period.

[3] Article 32 of the Commission proposal COM(2011) 615 requiring that financial instruments should be 'based on an *ex ante* assessment which has identified market failures or suboptimal investment situations, and investment needs'.

VIII. (f)
The Commission can concur with the aims of this recommendation. In the proposals for the new cohesion policy framework, the Commission has opened the possibility of Member States contributing to EU-level instruments. Furthermore they include incentives where the whole priority axis is delivered through financial instrument[4].

However, the implementation of cohesion policy programmes and the underlying actions (including financial instruments) under shared management and by national or regional authorities are fundamental elements of cohesion policy.

VIII. (g)
In the 2014–20 period, the concepts and definitions of leverage and revolving will be developed in the secondary legislation, which will also be aligned as much as possible with the concepts used for all instruments implemented with EU budget funding, as foreseen in the Commission communication COM(2011) 662 on the 'EU debt and equity platforms' and which will also be regulated in the delegated act regarding Title VIII of the amended Financial Regulation. However, achieving high leverage ratios must be balanced with public policy objectives of cohesion policy.

VIII. (h)
The Commission welcomes the Court's recommendations for the improvement of the legal framework for implementing financial instruments as part of the cohesion policy. With the experience gained in the current and previous programming periods and the improvement of the regulatory framework in line with the Court's recommendations the Commission considers that financial instruments should continue to be used as important instruments for the implementation of the cohesion policy, including their possible extension to new thematic areas, as a more sustainable and efficient way of delivering EU resources to support cohesion policy objectives.

[4] Article 110(5) of the Commission proposal COM(2011) 615.

REPLY OF THE COMMISSION

INTRODUCTION

8.
In July 2011, Member States did provide the Commission with data on their implementation of financial engineering instruments on voluntary basis.

The proposed amendment of the current Structural Funds regulations and the next generation of these regulations (2014–20) will require Member States to provide this kind of information on a regular basis.

12.
The Commission has a different concept, measuring the multiplier effect of the EU contribution. See paragraph 102 and reply[5].

AUDIT SCOPE AND APPROACH

25.
The 'internationally reputable programmes' identified by the report have limitations to be used as benchmarks for EU cohesion policy instruments since the cohesion policy objectives and the regulatory framework have specificities not present in other programmes.

OBSERVATIONS

31.
The Commission agrees that there was no such legal requirement at the level of programming. However, at the level of each financial engineering instrument there is a legal requirement of gap assessment. The result of this assessment should be reflected in the funding agreement.

The Commission's proposals for 2014–20 include the requirement that the *ex ante* evaluation should cover inter alia 'the rationale for the form of support proposed'.

34.
At the time of preparing gap assessments, most of the 2000–06 programmes were still ongoing.

[5] Such a concept has been expressed in the 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' (COM(2011) 662 of 19 October 2011), Section 2.3.4.

38.
The gap assessments were carried out by the EIF, the body of the EU with special expertise and responsibility in implementing EU budget support to enterprises, thus an independent assessment was not deemed necessary.

40.
The Commission and the EIF made available the full reports to the relevant authorities of the Member States concerned. National authorities were entirely free to publish the full reports and some of them did so[6].

43.–44. Common reply
The Commission acknowledges that current Structural Funds regulations as well as the Financial Regulation do not contain specific provisions on venture capital, loans and guarantee funds.

However, the proposed Structural Funds regulations for the 2014–20 programming period as well as the proposal for the revision of the Financial Regulation contain detailed provisions in that area.

In addition, the Commission made sure that both set of proposals are coherent with each other.

46.
The Commission made significant efforts to improve the guidance framework for the implementation of financial engineering instruments in cohesion policy. The Commission guidance notes issued in 2007 and 2008 addressed the issues which were identified at the time as needing specific clarification. The Commission guidance note issued in February 2011 is more comprehensive and covers a much wider range of issues which were raised by the national authorities and partners concerned as part of the process of the rolling out of financial engineering instruments throughout the vast majority of Member States and regions.

[6] http://ec.europa.eu/regional_policy/archive/funds/2007/jjj/doc/pdf/jeremie_sme_access.pdf

REPLY OF THE COMMISSION

47.
Although the Commission guidance notes are not legally binding, they provide technical guidance to the attention of public authorities, practitioners, beneficiaries or potential beneficiaries, and other bodies on how to interpret and apply the EU rules in this area, on the basis of the applicable EU Law.

47. first indent
The Commission refers to its replies to relevant paragraphs below.

47. second indent
The Commission refers to its replies to relevant paragraphs below.

47. third indent
The Commission refers to its replies to relevant paragraphs below.

47. fourth indent
The Commission refers to its replies to relevant paragraphs below.

48.
For the 2014–20 period, the Commission intends to introduce provisions regarding leverage in the implementation framework, while ensuring sufficient flexibility to accommodate the characteristics of each product, each market gap to be addressed, beneficiaries targeted and financial intermediaries involved.

Regarding the 'funding revolving provisions', they were amply developed in the Commission guidance note of 2011[7]. There are references to the revolving nature in the cohesion policy legal framework[8].

The details on how and when this concept is applicable vary between the type of the financial instrument and between the regions (the gap assessment will show needs and features of the specific financial instrument). These details should be therefore reflected in the funding agreements.

49.–50. Common reply
The Structural Funds regulations for the periods 2000–06 and 2007–13 allowed the reuse of resources for an indefinite period until exhaustion. However, for the period 2014–20 the Commission's proposals foresee a minimum period of 10 years.

51.
The Commission agrees with the Court's observation. For the current period the regulations require that resources returned to the operation from investments undertaken shall be reused by the competent authorities of the Member Sate concerned for the benefit of SMEs. For the 2014–20 period the Commission proposes that Member States should have provisions in place to ensure the revolving nature of financial instruments for at least 10 years.

52.
The point raised during a DAS audit by the Court has been followed up. The relevant winding-up provisions have subsequently been amended to be consistent with Article 78(7) of Regulation (EC) No 1083/2006.

53.
Under shared management and in line with the subsidiarity principle, the Commission does not monitor in detail the implementation of individual operations, It is the responsibility of national authorities to ensure that individual operations are implemented in accordance with the applicable legal provisions. In 2011, the Commission developed an audit framework shared with Member State audit authorities to verify the correct implementation of financial instruments until closure of the programmes.

[7] Sections 5.2 and 9.2 as they correspond to legal obligations under Article 78(7) of Regulation (EC) No 1083/2006 and Article 43(3)(d) and Article 44(2)(i) of Regulation (EC) No 1828/2006.

[8] Second paragraph of Article 78(7) of Regulation (EC) No 1083/2006 on the use of resources returned to the operation from investments undertaken and Article 43(3)(d) and Article 44(2)(i) of Regulation (EC) No 1828/2006 concerning the provisions in the funding agreement on the reutilisation of resources returned.

REPLY OF THE COMMISSION

54.
The holding fund needs to have certain liquidity to ensure smooth investments in enterprises. The investment strategy and/or business plan required by the regulations must give proper estimation of funds needed.

The Commission guidance notes of 2008 and 2011 recommended Member States or managing authorities to exercise restraint regarding payment of contributions into funds, namely by making such payments in phases in line with the underlying investment strategy and/or business plan.

The Commission's proposals for the 2014–20 regulation provide for more strict discipline, imposing that amounts disbursed to FEIs be effectively invested in final recipient.

55.
The Commission refers to its reply to paragraph 31.

56.
The Commission refers to its reply to paragraph 54.

58.
Preferential treatment of the private sector as foreseen in the regulations is an important factor to attract private investors to co-invest with public funds in areas of high risk/low return, pursuing public policy objectives.

The overall purpose is to address market gap failures when implementing financial engineering through Structural Funds, which can require *non-pari passu* aspects. All *non-pari passu* instruments must comply with state aid rules enforced by the Commission.

59.
Preferential treatment concerns only the gains and other earnings generated by investments, as foreseen in the regulations[9].

[9] Article 43(5) of Regulation (EC) No 1828/2006 and paragraph 2.6 of Rule 8 of Regulation (EC) No 1685/2000.

60.
The Commission guidance note[10] considers that, on the basis of state aid legislation, investment shall be effected *pari passu*. However, different arrangements, subject to the approval of a specific state aid scheme, are also possible.

Each managing authority must take a deliberate policy decision, as part of the investment strategy and business plan, as to the degree of private sector involvement in addressing public policy objectives and the level of legacy funds expected to be created.

61.
The cases mentioned by the Court cannot be considered as cases of unjustified preferential treatment of private investors. The first priority for the allocation of resources returned to the funds was the discharge of existing debt, with a view to reduce the funds' liabilities (including interest on debt) and free liquid resources for onward investments.

62.
Yield restriction clauses are in line with the regulations. Preferential treatment is an important factor to attract private investors to co-invest with public funds in areas of high risk/low return, pursuing public policy objectives.

63.
Structural Funds should not be used just to finance a normal business activity for enterprises which do not correspond to the eligibility requirements of the regulation[11]. The possibility of financing working capital as part of the expansion of a business activity was already foreseen in the Commission guidance note of 16 July 2007 and was further developed in the Commission guidance note of 21 February 2011 to make clearer that financing of working capital in early stages, or as part of the seed capital for new enterprises is acceptable.

[10] COCOF 10-0014004, paragraphs 8.1.7 and 8.1.8.

[11] Article 45 of Regulation (EC) No 1828/2006 provided for support to enterprises only at their establishment, in the early stages, including seed capital, or an expansion.

REPLY OF THE COMMISSION

64.
The term 'expansion' referred to in Structural Funds regulations is in line with the approach and the terminology of state aid legislation[12].

65.
The Commission guidance was further developed in 2011 to make clear that financing of working capital in early stages, or as part of the seed capital for new enterprises can be financed. In this respect, the Commission does not share the observation of the Hungarian managing authority that conditions were difficult to interpret.

The Commission considers it is good practice in line with cohesion policy that a Member State did not finance working capital under the ERDF.

66.
Territoriality and insufficient critical mass have impact on the attractiveness of the financial instrument and certain financial conditions (relatively high management cost). These elements are known a priori (in a business plan/strategy) and should be then assessed by the managing authority.

68.
The Commission's staff working document quoted by the Court refers to a financial instrument which implements enterprise policy. It should therefore not be compared with regional policy which has different objectives[13].

69.
The Commission considers that the examples mentioned by the Court cannot be used as a comparator for financial engineering instruments implemented under cohesion policy. These cases do not share cohesion policy objectives, as expressed in the Treaty[14].

[12] Section 4.3.2 of the Community guidance on state aid to promote risk capital investments in SMEs (2006).

[13] The objective of cohesion policy is to create new opportunities and reduce gaps in income levels between regions, while the objective of SMEFF is to enhance the competitiveness at European level.

[14] Regarding economic, social and territorial cohesion and the aim to reduce 'disparities between the levels of development of the various regions and the backwardness of the least favoured regions'.

71.
The operational programme allocations were agreed in 2007. At that time in certain regions/countries the gap assessments and strategies did not exist. For many Member States this is the first attempt to develop financial instruments. This is why certain critical mass was not reserved in the relevant programmes.

72.
The Commission shares the view that it is necessary for a holding fund to have a critical mass but it considers that in some circumstances it is justified to have funds with smaller sizes to achieve cohesion policy objectives.

75.–76. Common reply
The managing authorities and fund managers decided and accepted to implement such funds on the basis of their potential viability.

78.
Under the policy and legal framework applicable to Structural Funds the approval, monitoring and control of individual operations fall within the responsibility of managing authorities. For its part the Commission must satisfy itself that the Member States set up adequate management and control systems.

The Member States sought and the Commission provided guidance on 2007–13 provisions not only on financial engineering, but also on other important elements of implementation.

79.
The follow-up made by the same internal audit in 2011 considered that the advice given by the report mentioned by the Court had been addressed and therefore this matter was considered closed.

80.
The 'financial engineering' unit set up within the Regional Policy DG has a broader mission.

81.
Following the internal audit report the situation described has been overcome. Namely, comprehensive guidance has been provided to Member States, and working arrangements with other DGs have been intensified as well as internal information sharing and training.

REPLY OF THE COMMISSION

82.
Please refer to the Commission's reply to paragraph 78.

88.
Setting up financial engineering instruments under Structural Funds implied a whole new concept for some Member States, which required a learning process. In the future programming period either the already established funds will continue or new funds based on models proposed by the Commission can be established, an element which is expected to avoid delays.

90.
Resources not used through financial engineering instruments can be reprogrammed for other forms of assistance.

91.
The signature of the Jeremie holding fund agreement between the EIF and Greece for the initial amount of 100 million euro took place in June 2007, while the related cost letter was signed in October 2008. In June 2009, Greece transferred the amount of 100 million euro from EU ERDF funds to the Jeremie fund, to be transformed into financial engineering to enhance access to finance to SMEs in Greece.

On 5 October 2010, Greece and the EIF entered into a funding agreement whose purpose was, inter alia, to restate and replace the initial funding agreement and cost letter, and increase the relevant amount from 100 million euro to 250 million euro. The additional funds of 150 million euro transferred to the holding fund in early November 2010 are earmarked to support the ICT sector and ICT-related projects, an area of significant strategic importance for Greece to foster innovation and improve its competitiveness.

92.
The funding agreement marking the start of the fund was signed in October 2009, after which the first payments to the holding fund took place.

93.
The delay in Poland was also related to issues of national regulatory framework, i.e. the requirement for all beneficiaries (including holding funds) to provide collateral in the amount of ERDF financing received to guarantee good performance of the contract. Since only BGK, the state-owned bank, was formally exempt from that regulation, the Ministry of Regional Development needed to amend this legislation. This process, in consultation with the Ministry of Finance, took a considerable amount of time.

However and in parallel to this process, the EIF worked with the regions on the implementation proposals and negotiated contractual arrangements.

95.–98. Common reply
The Commission's guidance note of 21 February 2011, did provide elements regarding possible conflict between costs and fees charged to final recipients and management costs and fees declared to the Commission as eligible expenditure. Whenever the Commission detected additional charges to SMEs, these were corrected. The Commission issued additional guidance to prevent the occurrence of this situation.

101.
The 2007 CSES 'Comparative study of venture capital and loan funds supported by the Structural Funds' includes very useful information regarding management costs. The study is available at http://ec.europa.eu/regional_policy/sources/docgener/studies/pdf/2007_venture.pdf.

102.-103. and Box 5 Common reply
The Commission has a different concept, measuring the multiplier effect of the EU contribution.

Box 5
Section 2.3.4 of the Commission communication COM(2011) 662 final emphasises the importance of leverage effect.

The Commission refers to its reply to paragraph 104.

The Commission formalised the concept of 'multiplier effect' with a view to harmonising various concepts and calculation methods to measure leverage for financial instruments supported by the EU budget.

104.
In accordance with the applicable regulations, cohesion policy co-financing obligation is set at programme level. Individual operations (e.g. funds) may have national co-financing or not at all. Therefore the Commission does not agree with the approach used by the Court to calculate leverage for the ERDF.

REPLY OF THE COMMISSION

CONCLUSIONS AND RECOMMENDATIONS

106.
See the reply to paragraph 25. The key objectives of the cohesion policy as expressed in the Treaty are economic, social and territorial cohesion and the aim to reduce 'disparities between the levels of development of the various regions and the backwardness of the least favoured regions'. The Commission notes that the comparators used by the Court do not primarily reflect these objectives.

108.
Since ERDF financed equity instruments were mainly implemented in assisted areas and aimed to address sectors of market failure, the Commission considers that the achieved leverage ratio as measured by the Court is significantly positive[15].

109.
Applying the Commission's methodology for calculating the multiplier effect to both the Structural Funds and the ETF would bring the ratios closer. However, the Commission considers that the ETF has limitations to be used as a comparator for risk capital investments supported through the Structural Funds.

110.
Please refer to the reply to paragraph 102.

111.
See the reply to paragraph 102.

112.-113. Common reply
It is not appropriate to compare SMEFF with financial engineering instruments implemented under cohesion policy.

The SMEFF is a facility providing banks with financial incentives to promote bank lending to SMEs. The SMEFF did not co-finance loans, as did the ERDF funds covered by the report, therefore they are not comparable products.

Moreover, loans funded by the ERDF target directly SMEs and are focused on regional funding, where private sector investment remains more difficult.

[15] The 'Community guidelines on state aid to promote risk capital investments in small and medium sized enterprises' clearly define the case for public support to risk capital investments in areas of market failure. One of the conditions for compatibility of public support with state aid rules is that 'at least 50 % of the funding of the investments made under the risk capital measure must be provided by private investors, or for at least 30 % in the case of measures targeting SMEs located in assisted areas'.

116.
The Commission considers that the requirement on the *ex ante* evaluation of the operational programme[16] serves as gap assessment for financial engineering instruments as a specific type of assistance.

117.
The Commission agrees on the importance to provide funding to financial instruments corresponding to the needs as identified in a gap analysis.

The relevant observations by the Court are partly covered by the proposal for CSF regulation (COM(2011) 662 final). More exhaustive provisions will be included in the secondary legislation.

The gap assessments should obviously have an adequate level of quality.

118.
Each gap assessment was provided to the managing authority concerned and to the respective services of the Commission to be taken account in programming of cohesion policy resources and in the identification and selection of operations to be funded. The gap assessments were carried out by the EIF, the EU body with special expertise and responsibility in implementing EU budget support to enterprises through financial instruments.

Recommendation 1 (a)
The Commission welcomes this recommendation which is covered by the Commission's proposal for the new cohesion policy framework[17].

This requirement will be further detailed in the implementing legislation.

[16] Article 41 of Regulation (EC) No 1260/1999 requires that *ex ante* evaluation covers inter alia: analysis of strengths, weaknesses and potential of the Member State, region or sector concerned; assessment of the consistency between the strategy and targets. It should take into account the situation in small and medium enterprises.

[17] Article 32 of the Commission proposal COM(2011) 615 requiring that financial instruments should be 'based on an *ex ante* assessment which has identified market failures or suboptimal investment situations, and investment needs'.

REPLY OF THE COMMISSION

Recommendation 1 (b)
For the future programming period the emphasis will be placed on ensuring that each financial instrument is 'based on an *ex ante* assessment which has identified market failures or suboptimal investment situations, and investment needs'. When approving the operational programmes, emphasis will be placed on ensuring alignment with EU2020 strategic priorities, identification/fulfilment of *ex ante* conditionalities and evaluation of the rationale for the form of support proposed.

119.
The regulatory framework for the period 2007–13 may have been insufficiently detailed to provide the necessary environment for a significant increase of the cohesion policy assistance delivered through financial engineering instruments.

The Commission guidance notes provided in 2007 and 2008 tried to solve the possible areas of perceived lack of clarity that were identified at that time. The Commission note of February 2011 provided more comprehensive and relevant guidance, based on the accumulated experience in the implementation of funds during the previous years.

The Commission proposals for the next programming period take into account the experience gained in the previous periods, providing a detailed implementation framework.

120.
Cohesion policy programmes are implemented under shared management by national or regional authorities. This is a fundamental element, fully consistent with the principles of subsidiarity and proportionality. Even if for the future the Commission proposals for the CSF regulations open the possibility of national and regional authorities contributing to EU-level instruments with cohesion policy resources, which would be ring-fenced for investments in line with the objectives of specific cohesion policy programmes, national and regional authorities must always have the option of implementing instruments at national or regional level, designed to meet their specific needs.

121.
The policy and legal framework applicable to Structural Funds is such that the approval, monitoring and control of individual operations fall under the responsibility of managing authorities[18]. For its part the Commission must satisfy itself that the Member States set up adequate management and control systems.

The Commission underlines that, despite the lack of a legal basis, in the course of 2011, it carried out an extensive mapping of the financial engineering instruments in place, based on information provided by Member States and managing authorities on a voluntary basis.

Recommendation 2 (a)
Given the expected increase in the importance of financial instruments in the future, the Commission's proposals for the future CSF regulations include more detailed and clear rules regarding the use of financial instruments. These rules build upon the experience accumulated in the current programming period and will be further expanded in the secondary legislation.

Recommendation 2 (b)
The Commission welcomes this recommendation which is already covered in the Commission's proposals for the new cohesion policy framework. These proposals also include specific provisions regarding monitoring and reporting of financial instruments. Furthermore, the Commission notes that already in the current programming period it managed to gather important monitoring information on existing financial instruments, and this without any legal basis to do so.

[18] Consistently with the principles of subsidiarity and proportionality, Articles 60 and 72 of Regulation (EC) No 1083/2006 clearly spell out the division of responsibilities between the managing authorities and the Commission. Furthermore, Articles 2 to 10 and 12 to 26 of Regulation (EC) No 1828/2006 clearly spell out the information measures and management and control systems which the managing authorities must have in place.

REPLY OF THE COMMISSION

122.
Those delays were in most cases explained by the novelty of the instruments in cohesion policy and state aid-related issues. As demonstrated, however, by the mapping exercise carried out in 2011, on average the rate of progress in the implementation of financial engineering instruments is not lower than the rate of implementation of other actions financed through cohesion policy.

It is expected that in the next programming period, the development of off-the-shelf instruments will contribute to limiting significantly delays.

123.
The Commission guidance note of February 2011 did provide elements regarding possible conflict between costs and fees charged to final recipients and management costs and fees declared to the Commission as eligible expenditure. Whenever the Commission detected additional charges to SMEs, these were corrected. The Commission issued additional guidance to prevent the occurrence of this situation.

124.
Please refer to the reply to paragraph 102. The Commission considers that the comparators established by the Court do not reflect the different levels of intervention for different types of the funds, implemented under different market conditions and with different target beneficiaries and objectives than those implemented under cohesion policy.

Recommendation 3 (a)
The Commission welcomes the Court's recommendation regarding off-the-shelf instruments, which is covered in the proposal for the new programming period.

Recommendation 3 (b)
The Commission can concur with the aims of this recommendation. In the proposals for the new cohesion policy framework, the Commission has opened the possibility of Member States contributing to EU-level instruments. Furthermore, they include incentives where the whole priority axis is delivered through financial instruments[19].

However the implementation of cohesion policy programmes and the underlying actions (including financial instruments) under shared management and by national or regional authorities are fundamental elements of cohesion policy.

Recommendation 3 (c)
In the 2014–20 period, the concepts and definitions of leverage and revolving will be developed in the secondary legislation, which will also be aligned as much as possible with the concepts used for all instruments implemented with EU budget funding, as foreseen in Commission communication COM(2011) 662 on the 'EU debt and equity platforms' and which will also be regulated in the delegated act regarding Title VIII of the amended Financial Regulation. However, achieving high leverage ratios must be balanced with public policy objectives of cohesion policy.

General recommendation
The Commission welcomes the Court's recommendations for the improvement of the legal framework for implementing financial instruments as part of the cohesion policy. With the experience in the current and previous programming periods and the improvement of the regulatory framework in line with the Court's recommendations the Commission considers that financial instruments should continue to be used as important instruments for the implementation of cohesion policy, including their possible extension to new thematic areas, as a more sustainable and efficient way of delivering EU resources to support cohesion policy objectives.

[19] Article 110(5) of the Commission proposal COM(2011) 615.

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SMALL AND MEDIUM-SIZED ENTERPRISES ARE THE BACKBONE OF THE EU'S ECONOMY, GENERATING EMPLOYMENT, INNOVATION AND WEALTH. THE COURT AUDITED THE PERFORMANCE OF THE COHESION POLICY'S FINANCIAL INSTRUMENTS FACILITATING THEIR ACCESS TO FINANCE. THE COURT FOUND THAT THE EFFECTIVENESS AND EFFICIENCY OF THESE INSTRUMENTS WERE HAMPERED BY IMPORTANT SHORTCOMINGS, MAINLY DUE TO THE INAPPROPRIATENESS OF THE CURRENT STRUCTURAL FUNDS REGULATIONS, INSUFFICIENT QUALITY OF NEEDS ASSESSMENTS AND WIDESPREAD DELAYS IN THEIR IMPLEMENTATION. FINALLY, THE ABILITY TO LEVERAGE IN PRIVATE INVESTMENTS WAS POOR AS COMPARED WITH OTHER EU PROGRAMMES FOR SMEs.

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