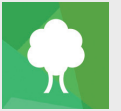


Special Report

**Are financial instruments  
a successful and  
promising tool in the rural  
development area?**



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Luxembourg: Publications Office of the European Union, 2015

Print	ISBN 978-92-872-2302-9	ISSN 1831-0834	doi:10.2865/01725	QJ-AB-15-004-EN-C
PDF	ISBN 978-92-872-2268-8	ISSN 1977-5679	doi:10.2865/359246	QJ-AB-15-004-EN-N
EPUB	ISBN 978-92-872-2247-3	ISSN 1977-5679	doi:10.2865/14273	QJ-AB-15-004-EN-E

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*Printed in Luxembourg*

**Special Report****Are financial instruments  
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development area?**

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

# Audit team

The ECA's special reports set out the results of its performance and compliance audits of specific budgetary areas or management topics. The ECA selects and designs these audit tasks to be of maximum impact by considering the risks to performance or compliance, the level of income or spending involved, forthcoming developments and political and public interest.

This performance audit was produced by Audit Chamber I — headed by ECA Member Rasa Budbergytė — which specialises in preservation and management of natural resources spending areas. The audit was led by ECA Member Kersti Kaljulaid, supported by Peeter Lätti, head of private office; Helder Faria Viegas, head of unit; Bertrand Tanguy, team leader; Jan Huth, deputy team leader; Christine Kleinsasser, auditor; Ioannis Papadakis, auditor; Roberto Resegotti, auditor and Jolanta Zemalaite, auditor.



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## **Reply of the Commission**

## Abbreviations

**EAFRD:** European Agricultural Fund for Rural Development

**ESI funds/ESIF:** European structural and investment funds

**FEI/FI:** Financial engineering instrument. Renamed Financial Instrument for the 2014–20 period.

**RDP:** Rural development programme

## Technical terms

**Axis (plural axes):** A coherent group of measures with specific goals resulting directly from their implementation and contributing to one or more of the objectives of the rural development policy. For instance, axis 1 measures contribute towards improving the competitiveness of the agricultural and forestry sector, whereas axis 3 measures aim to contribute towards the quality of life in rural areas and the diversification of the rural economy.

**Disbursement rate:** For loan funds, the share of the capital invested in the fund which is paid out to final recipients. For guarantee funds, the share of the capital invested in the fund which is used to guarantee loans to final recipients.

**Final recipient:** Individual or body that receives support from a financial instrument.

**Funding agreement:** Agreement between a Member State (or a managing authority) and a fund manager laying down the terms and conditions for funding.

**Fund manager:** A body responsible for implementing an investment strategy and managing a portfolio of investments related to a financial instrument.

**Guarantee:** A commitment by a third party (guarantor) to pay the debts of a borrower. When borrowers cannot repay them themselves, the guarantor is liable.

**Guarantee funds:** Guarantee funds provide financial guarantees for credit sought by rural businesses or organisations, thus making it easier for them to obtain funding from banks. These funds are said to 'revolve' because, as individual projects pay back their loans, the guarantees are released and new guarantees can be issued. Guarantee funds revolve through a multiplier of the fund capital.

**Leverage:** Calculated here in terms of how many euros in (public and/or private) funding have been guaranteed or paid out for rural activities for each euro of public (EU and Member State) funding.

**Loan funds:** Funds that provide money for loans for small business development projects. They are said to 'revolve' because money becomes available for new loans as individual projects pay back the previous ones.

**Managing authority:** A national or regional body designated by a Member State to manage a rural development programme.

**Measure:** An aid scheme for implementing a policy. **Investment measures** are measures that provide financial support for investments in machinery and equipment, building and/or other works.

**Outputs and results:** Outputs are activities directly realised by the financial instruments. For example, the 'number of guarantees issued' would be an output for a guarantee fund. Results are the direct effects or changes that result from the implementation of a project. For example, obtaining a loan from a bank is a 'result' for the final recipients.

**Overcapitalisation:** This situation occurs when the amount paid into the capital of an FEI is too large in relation to the amount provided to final recipients in the form of loans or guarantees issued.

**Paying agency:** A national or regional body responsible for assessing, calculating and paying out agricultural subsidies.

**Programming period:** The period covered by the rural development programmes.

**Revolving fund:** The system whereby money raised for financial instruments is reused, or 'revolved', after it has been used once.

**Risk exposure ratio:** The upper default limit that is considered acceptable in the management of a given guarantee fund. For instance, the risk exposure ratio would be 1/5 if it were anticipated that a maximum of 20 % of the guarantees could be in default.

**Shared management:** One of the ways that the EU budget is implemented. Management is said to be 'shared' where EU-funded projects are managed by national or regional bodies (here, the 'managing authorities'). The Commission has supervisory duties.

**Venture capital funds:** Profit-making private funds that provide capital, usually in new, high potential, high risk businesses.

**Winding up:** In the context of the closure of the RDPs at the end of the programming period, the procedure applied to the fund in order to determine the eligible amount for EAFRD co-financing.



## I

Financial instruments (known, until 2014, as ‘financial engineering instruments’) were first applied to agriculture in the 2000–06 programming period and were extended to 2007–13 with a view to helping farmers and small rural businesses obtain private funding for rural investment projects. These instruments, via loan funds and guarantee funds, are meant both to attract additional public and/or private capital (leverage effect) and allow the initial allocations of funds to be reutilised (revolving factor). At the end of 2013, the EU and the Member States had contributed around 700 million euro in financial instruments in the area of rural development.

## II

The financial instrument framework has also been extended for the 2014–20 period, when the Commission intends to maximise the impact of EU funds. It also expects their use to increase in the forthcoming years and wants the Member States to commit themselves to increasing their use, at least twofold, in key investment areas.

## III

In this audit, the Court addressed the question of whether financial instruments had been successful in the area of rural development and whether they were likely to be so in the future. In order to do so, it sought to establish whether they had been well designed and managed in the 2007–13 programming period and to what extent the changes introduced for 2014–20 were likely to have a significant impact on the key shortcomings identified.

## IV

Overall, the Court concluded that financial instruments had been unsuccessful in the field of rural development and although the 2014–20 period is potentially promising, it will be a considerable challenge to achieve the desired impact. The Court found that no clear case had been made for setting up financial instruments in the 2007–13 programming period and that they were overcapitalised. In particular, the legal framework did not take into account the specific characteristics of rural development policy and there had been no assessment of real needs.

## V

The Court also concluded that there was no reliable quantifiable information to justify the type of financial instruments established, determine demand for financial instruments in the field of agriculture and show that the amount of capital earmarked for the fund was appropriate. The Court estimated that guarantee funds were overcapitalised by 370 million euro at the end of 2013.

## VI

The Court further concluded that the financial instruments had not worked as expected and, consequently, had not provided their full potential benefits in terms of the revolving and leverage effects. This had partly been due to delays in implementation (including the fact that they had been set up late or not at the most appropriate time). Moreover, the legal framework had not included adequate provision to encourage the achievement of the expected benefits. Finally, neither the Commission nor the Member States had introduced appropriate monitoring systems to provide reliable data to show whether the instruments had achieved their objectives effectively.

### VII

The Court's analysis included an examination of winding up and exit policies. The Court concludes that precise conditions to establish the balance of the financial instruments to be paid at the end of the programming period and exit policy conditions were not in place in the 2007–13 period, mainly because of an absence of clear rules and guidance from the Commission on these issues.

### VIII

The Court found that the 2014–20 framework has the potential to provide the necessary improvements. However, certain obstacles to a more extensive use of financial instruments remained and although the new legal framework contained new specific provisions to limit the recurrent problem of overcapitalisation, the risk may persist. Also, it placed insufficient focus on long-term effects, and financial instruments risked remaining too dependent on grants. Finally, the key performance issues of leverage and revolving effects were not adequately addressed.

### IX

The Court recommends that:

(a) the Commission should:

- increase incentives for Member States to set up financial instruments for rural development by identifying the challenges, specific characteristics and obstacles faced in this field and actively encourage Member States to use such instruments where appropriate;
- provide guidance and actively promote the quality of the mandatory Member States' *ex ante* assessments, which are intended to serve as key tools to avoid overcapitalisation;

- set appropriate standards and targets for leverage and revolving effects;
  - provide precise operational implementing rules, in due time, before the closure of the rural development programming period 2007–13 (including an appropriate exit policy).
- (b) the Commission and Member States should decide clear transitional rules between programming periods.
- (c) the Member States should:
- consider setting aside a certain share of the available EAFRD budget for financial instruments and make these instruments more attractive than grants in clearly defined circumstances;
  - validate the risk exposure ratio with the help of appropriate technical expertise, in order to avoid overcapitalisation;
  - implement the new legal provisions in such a way as to ensure the greatest level of flexibility, for instance by establishing a single financial instrument (providing both loans and guarantees) capable of tackling the needs;
  - pay particular attention to potential risks of deadweight or displacement effects when assessing applications for funding by applying appropriate indicators. Where such risks apply, financial instruments could become the preferred option;
  - examine how grants and financial instruments can be combined to provide the best value for money, by optimising leverage/revolving effects.

## 01

Financial instruments (known until 2014 as ‘financial engineering instruments’) are EU budget tools used to enable beneficiaries to obtain funding in the form, for example, of loans, guarantees or equity investments. They differ from grants mainly because they are repayable as illustrated in **Figure 1**.

## 02

Financial instruments have been used in almost all major areas of the EU budget (for internal policies managed by the Commission centrally or jointly with financial institutions, for cohesion and rural development policies where the management of funds is shared between the Commission and Member States and for external policies<sup>1</sup>).

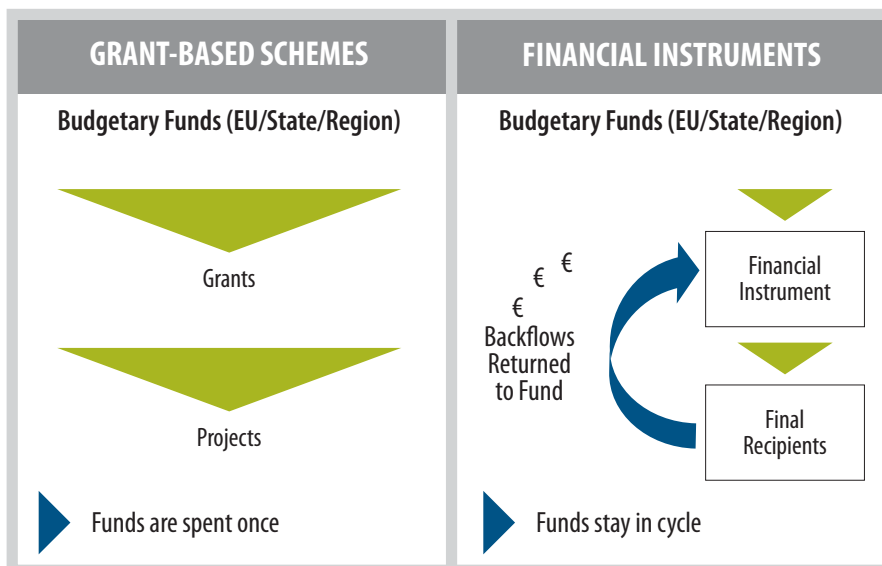
## 03

Within shared management areas financial instruments have mainly been used in the area of cohesion policy. There were over 941 financial instruments in this policy area and support from the EU budget and national contributions amounted to 14.3 billion euro at the end of 2013<sup>2</sup>.

- 1 Under the 2007–13 multiannual financial framework a little over 1 % of the EU budget (13,6 billion euro) was allocated to financial instruments for internal and cohesion policies.
- 2 Commission report on the progress made in financing and implementing financial engineering instruments reported by the managing authorities in accordance with Article 67(2)(j) of 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), programming period 2007–13, situation as at 31 December 2013. Document dated 19 September 2014 and referenced EGESIF\_14-0033-00.

Figure 1

### Grant-based schemes in comparison to financial instruments



Source: Interact, *Financial Instruments in European Territorial Cooperation Programmes*, 2013.

## Previous Court audits

### 04

So far, the Court has audited financial instruments predominantly in the cohesion policy area<sup>3</sup>. The European Parliament requested the Court of Auditors to audit them over all policy areas<sup>4</sup>. This report responds to this request with regard to rural development. In this area, Member States had contributed around 700 million euro in financial instruments by the end of 2013.

## The rationale for the financial instruments

### 05

At a time of fiscal constraint on public budgets, achieving more investments with less public money is of key importance. Financial instruments have a potential to improve the use of scarce public resources by providing funding for more investments with the same budget. The funds are expected to reutilise the initial allocation of money used to set them up (revolving factor) and stimulate the achievement of the policy objectives further by attracting additional public or private capital (leverage effect). The rationale for the financial instruments is outlined in **Box 1**.

- 3 See e.g. Special Report No 2/2012 'Financial instruments for SMEs co-financed by the European Regional Development Fund'. The main conclusion is 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' (<http://eca.europa.eu>).
- 4 Resolution of the European Parliament of 10 May 2012 with observations forming an integral part of its Decision on discharge in respect of the implementation of the general budget of the European Union for the financial year 2010, Section III — Commission and executive agencies (paragraph 20).

## Box 1

### The rationale for the financial instruments

'Pursuit of EU policy objectives: Innovative financial instruments pursue specific EU policy objectives by ensuring necessary finance for areas of EU interest [...]. They aim to correct market failures/imperfections that give rise to an insufficient funding of such areas from market sources, for instance because the field is perceived as too risky by the private sector.'<sup>5</sup>

'Leveraging investment: By working with the private sector on innovative financial instruments it is possible to magnify the impact of the EU budget, enabling a greater number of strategic investments to be made, thus enhancing the EU's growth potential.'<sup>6</sup>

'Multiplier effect of the EU budget: An additional multiplier effect is achieved during the lifetime of the innovative financial instrument, if repayments of capital or interest and proceeds of an investment can be reused for the instrument. Such 'revolving' character can considerably increase the reach of instruments'<sup>7</sup>.

5 COM(2011) 662 final of 19 October 2011 'A framework for the next generation of innovative financial instruments — the EU equity and debt platforms'.

6 COM(2011) 500 final of 29 June 2011 'A Budget for Europe 2020'.

7 COM(2011) 662.

## Introduction

### 06

The Council<sup>8</sup> and the Commission expected that the use of financial instruments would increase under the multiannual financial framework for 2014–20 as compared with 2007–13.

### 07

In its discharge resolution for the year 2010<sup>9</sup>, the European Parliament stated that the Commission had promoted an increased use of financial instruments for the next multiannual financial framework<sup>10</sup>.

## Recent developments

### 08

In its recent communication 'An Investment Plan for Europe'<sup>11</sup> the Commission states that it intends to maximise the impact from EU funds. It therefore invites Member States to increase significantly their use of financial instruments in key investment areas under the ESI Funds<sup>12</sup> for the programming period from 2014 to 2020 in order to achieve at least an overall doubling of expenditure. In this regard it also recommends target percentages for their use.<sup>13</sup>

## Financial instruments in rural development

### 09

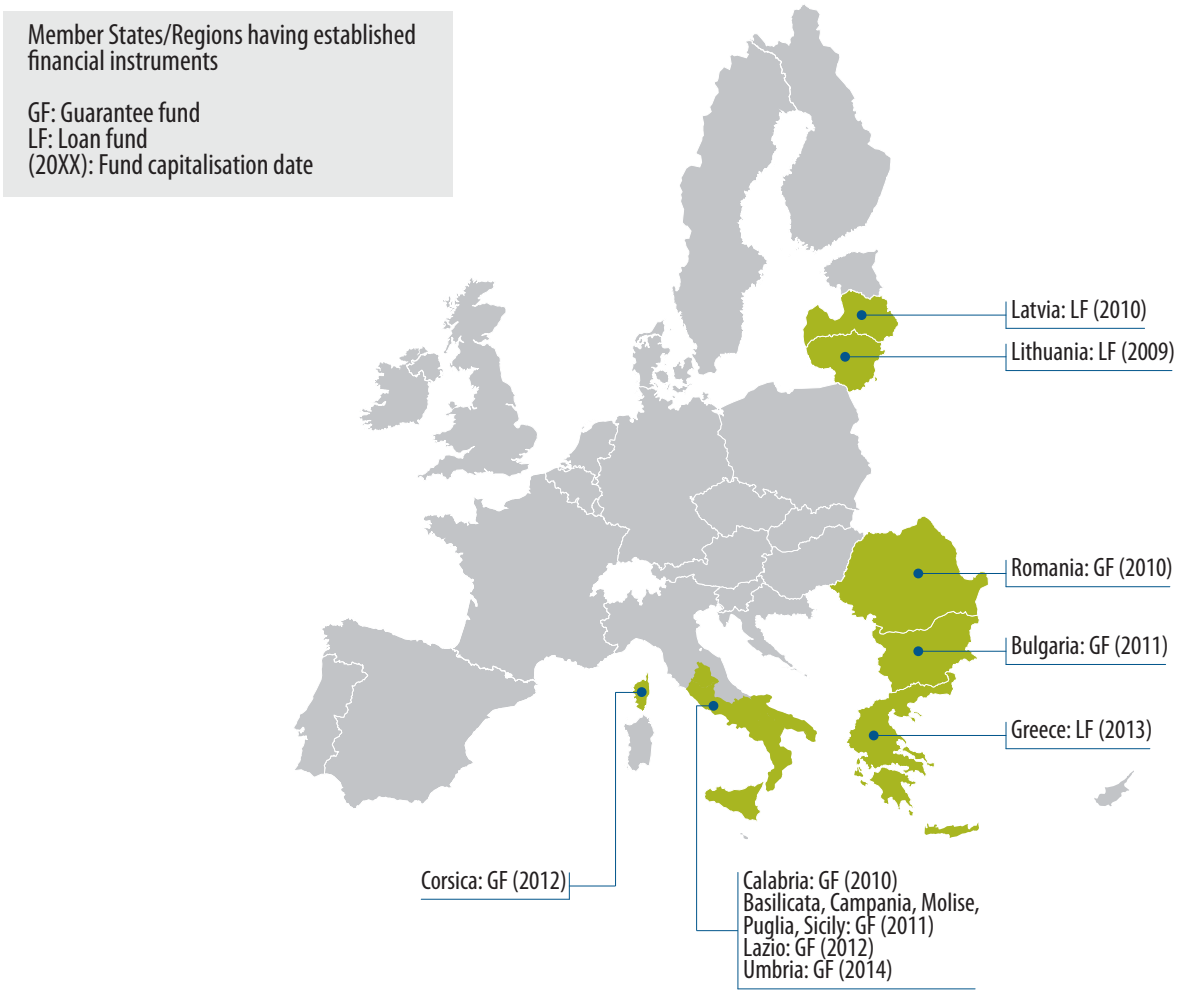
The EU's rural development policy is implemented through rural development programmes (RDPs). Each of these programmes covers a period of 7 years. Financial instruments have been part of rural development policy since 2000.

### 10

For this field, the main legislation for the 2007–13 programming period is Commission Regulation (EC) No 1974/2006<sup>14</sup>, which envisaged three types of financial instrument: venture capital funds, guarantee funds and loan funds. In reality, the Member States established 11 guarantee funds (in Bulgaria, France (Corsica), eight different Italian regions and Romania) and three loan funds (in Greece, Latvia and Lithuania) between 2009 and 2014 but no venture capital fund (see **Figure 2**).

- 8 See e.g. paragraph 26 of the conclusions of the European Council (24/25 October 2013) (EUCO 169/13) which states: 'the programming negotiations of the European Structural and Investment Funds (ESIF) should be used to significantly increase the overall EU support from these funds to leverage based financial instruments for SMEs in 2014–20, while at least doubling support in countries where conditions remain tight.'
- 9 European Parliament decision of 10 May 2012 on discharge in respect of the implementation of the general budget of the European Union for the financial year 2010, Section III — Commission (COM(2011) 473 final — C7-0256/2011 — 2011/2201(DEC)) P7\_TA(2012)0153.
- 10 COM(2011) 662 final, *ibid*.
- 11 COM(2014) 903 final of 26 November 2014.
- 12 The European Regional Development Fund, European Social Fund, Cohesion Fund, European Agricultural Fund for Rural Development and European Maritime and Fisheries Fund.
- 13 Member States are recommended to deliver, through financial instruments, a specific percentage of the allocations made in their partnership agreements to each of the key investment areas as follows: 50 % in the field of SME support, 20 % in the field of CO<sub>2</sub> reduction measures, 10 % in the field of information and communication technology, 10 % in the field of sustainable transport, 5 % in the field of support for research development and innovation and 5 % in the field of environmental and resource efficiency.
- 14 Commission Regulation (EC) No 1974/2006 of 15 December 2006 laying down detailed rules for the application of Council Regulation (EC) No 1698/2005 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD) (OJ L 368, 23.12.2006, p. 15).

**Figure 2** Financial instruments in the rural development area in the 2007–13 programming period



Source: Data from the relevant funding agreements.

## Introduction

## 11

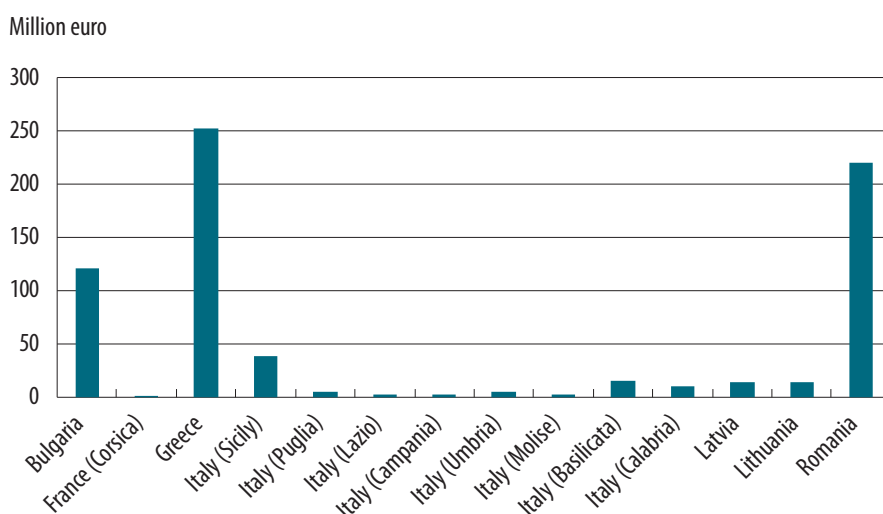
Member States are using financial instruments to target activities under axes 1 and 3 of the RDP for measures such as the modernisation of agricultural holdings, adding value to agricultural and forestry products, or business creation and development. Guarantee funds provide financial guarantees for credit sought by businesses or organisations, thus aiming to make it easier for them to obtain funding from banks. As individual project owners pay back their loans, the guarantees are released and new guarantees can be issued. Loan funds provide money for loans for business development projects. Money becomes available for new loans as individual projects pay back the previous ones.

## 12

From the total amount of 700 million euro<sup>15</sup> contributed to financial instruments (see paragraph 4), public money represented 564 million euro and the EU share of this amounted to approximately 440 million euro. **Figure 3** shows the allocations broken down by Member State.

<sup>15</sup> This amount included an amount of 138 million euro of private money paid into the loan fund in Greece in addition to 115 million euro of public money.

**Figure 3** Funding of financial instruments at the end of 2013



Source: Data from the business plans, the relevant 2013 annual progress reports and ECA calculations.

## Management of the financial instruments in rural development

### 13

The Commission and Member States share the management of the financial instruments. The Commission appraises and approves RDPs prepared and submitted by the Member States, which adopt all the legislative, statutory and administrative provisions required to ensure that the financial instruments work correctly. The four main players in the Member States are the managing authority (generally the Ministry of Agriculture), the fund manager, the financial institutions (e.g. banks and credit institutions) and the final recipients (e.g. agricultural holdings or food processing companies).

### 14

The managing authorities design and supervise the financial instruments. The fund managers are required to

implement the investment strategy and verify whether the investments actually achieve their intended objectives. The financial institutions assess the economic viability of the projects presented and analyse the creditworthiness of the final recipients. The latter enter into (loan or guarantee) contracts with the fund managers and/or financial institutions. The final recipients are also responsible for actually executing the investments and reimbursing the financial institutions in accordance with the provisions of their contracts.

### 15

The specific responsibilities and tasks of the various players also depend on the type of financial instrument applied, as loan funds function in a different way from guarantee funds. For instance, flows of money go out of loan funds, which is not the case for guarantee funds, unless the recipient defaults.

## Financial instruments in brief

- Repayable instruments: money can be reused in the programme area. The revolving effect is important at a time when public budgets are constrained.
- Another key expected effect is to attract additional private capital for the pursuit of EU policy objectives: this is called leverage.
- Little experience and low materiality for rural development, as the main field for financial instruments so far has been cohesion.
- Guarantee funds are used predominantly but some loan funds have also been established.
- Management responsibilities are shared between the Commission and the Member States.
- The Commission promotes the use of financial instruments but implementation difficulties and risks exist.



# Audit scope and approach

## 16

The purpose of this audit was to determine whether financial instruments implemented under the rural development policy had been well designed and managed in the 2007–13 programming period. Also, the main EU regulations for the 2014–20 rural development programming period have recently been approved. This allowed the Court to consider the extent to which the changes introduced by the new legal framework were likely to have a significant impact on the key shortcomings identified through the audit.

## 17

The overall audit question was:

### **Are financial instruments a successful and promising tool in the area of rural development?**

More specifically, the audit aimed to answer the following questions:

- Were financial instruments set up and capitalised properly in the 2007–13 programming period?
- Did financial instruments perform well in the 2007–13 period?
- Were adequate winding up and exit policy conditions in place in the 2007–13 period?
- Does the 2014–20 framework have the potential to provide the necessary improvements for financial instruments?

## 18

The Court established audit criteria concerning the design, implementation and monitoring/evaluation of financial instruments. These criteria were developed from previous Court audits, legislation, Commission documents and other publications. The Court also consulted experts from the OECD<sup>16</sup> on the validity and feasibility of these audit criteria and carried out a review of existing OECD literature.

## 19

Audit visits were carried out in France, Greece, Lithuania, Romania and Italy, ensuring the inclusion of both guarantee funds<sup>17</sup> and loan funds<sup>18</sup>. In each Member State, audit evidence was collected and examined against the audit criteria by means of interviews and the analysis of documents and data. Through desk reviews, the auditors also collected and analysed additional information on financial instruments implemented by Member States or regions that were not visited (particularly Bulgaria and Latvia). They also held interviews with Commission officials and analysed relevant documents.

## 20

The Court surveyed a sample of 37 managing authorities, 32 of which had not implemented any financial instruments under rural development policy in the 2007–13 period. At the end of 2013, these managing authorities had absorbed about 90 % of the EAFRD payments for core investment measures under which financial instruments were used<sup>19</sup>. The purpose of the survey was mainly to identify the reasons which had contributed specifically, in the planning and design phase, towards preventing them from setting up one or more financial instruments.

- 16 Organisation for Economic Cooperation and Development.
- 17 France (Corsica), Italy (Puglia and Sicily) and Romania.
- 18 Greece and Lithuania.
- 19 Namely measure 121 (Modernisation of agricultural holdings) and measure 123 (Adding value to agricultural and forestry products).

## Were financial instruments set up and capitalised properly in the 2007–13 programming period?

### 21

Careful preparation of the 2007–13 programming period was necessary in order to provide a solid basis for the financial instruments. In particular, the legal framework for the financial instruments needed to take into account the specific characteristics of rural development policy and there had to be an assessment of real needs, based on reliable quantifiable information that justified the type of FEI required, determined the market demand for FEI support and demonstrated that the amount of capital earmarked for the fund was appropriate. The Court examined these main features of the design of financial instruments during the 2007–13 programming period.

## The programming framework was not satisfactorily prepared

### 22

This section assesses whether the legal framework for financial instruments took into account the specific characteristics of rural development policy and a solid assessment of needs. It also provides information from the survey sent to the Member States on the low utilisation of financial instruments in the 2007–13 period.

## The 2007–13 legal framework for financial instruments was not specifically designed for rural development purposes

### 23

The Court found that the 2007–13 legal framework for financial instruments in rural development was predominantly influenced by cohesion policy. The Commission was not able to show that it had evaluated and addressed the specific characteristics of rural development when designing this framework. In rural development, unlike cohesion, for example, most potential beneficiaries were small farms, which were accustomed to non-reimbursable grants and the projects were also very small. Furthermore, the Member State managing authorities had not had sufficient experience with types of funding other than grants.

### 24

The Commission had not had sufficient past experience of financial instruments in rural development upon which to base the 2007–13 programming period. While a separate financial engineering measure had actually been available in the 2000–06 programming period, in practice, only Portugal and four Italian regions<sup>20</sup> had set up financial instruments. Financial engineering was the least implemented measure.

20 Basilicata, Calabria and Puglia (under EAGGF-Guidance) and Marche (under EAGGF-Guarantee).

**25**

Only three types of instrument were included in the 2007–13 legal framework (see paragraph 10), without any explanation. Furthermore, in the literature produced by the OECD and the FAO<sup>21</sup>, and through exchanges held with OECD experts and national authorities during the Member State visits, the Court found that other types of instrument were actually used in the farming sector, such as warehouse receipt financing<sup>22</sup>.

**Objectives were general and there was no clear assessment of real needs**

**26**

The Member States that used the instruments did not establish specific and measurable objectives. The objectives they did provide were rather vague and were therefore not considered useful for assessing whether the credit gap had been reduced. Examples of how the objectives were defined are included in **Box 2**.

- 21 Food and Agriculture Organisation of the United Nations.
- 22 Receipts are issued as evidence that specified commodities of stated quantity and quality have been deposited at particular locations by named depositors. The latter can use them as collateral to obtain financing.

**Box 2**

**Examples of objectives used for financial instruments**

In Greece, the intended objectives for setting up the loan fund were mentioned in general terms in the revised RDP; they included enhancing liquidity for final recipients/borrowers and allocating loans from banks on favourable conditions so as to support entrepreneurship, and speeding up the absorption of the EAFRD funds.

In Lithuania, the objective for the loan fund included in the RDP was to provide access to credit for investments that pursue the objectives listed in the measures.

In Italy (Puglia and Sicily), the objective assigned to the financial instrument was to increase access to credit for agricultural holdings. The RDPs did not develop any further objectives.

In the Romanian RDP, the objectives of the guarantee schemes were the following: improved access to credit for rural development and increased interest and confidence of the financial institutions in the rural economy.

**27**

The assessment of real needs was not based on reliable quantifiable information and formal gap assessments were not available for any of the Member States that implemented financial instruments. Although the legislation did not actually require a gap assessment, there was also no other type of analysis with a similar probative value, such as quantified information

on the nature of the needs and the most appropriate type of financial instrument. All programmes merely reported a lack of liquidity and general difficulties for the agricultural sector in obtaining access to credit. This weakness in the initial assessment of needs resulted in a large number of over-capitalised financial instruments (see paragraph 43).

**Financial instruments were not considered useful by most Member States**

**28**

The Court survey confirmed that most Member States did not consider the financial instrument tool to be useful<sup>23</sup>. The suitability of financial instruments in relation to the characteristics of most EAFRD beneficiaries was a key problem for the managing authorities. The main reason mentioned was that there was a lack of demand for the financial instruments as potential beneficiaries were unfamiliar with them and were used to funding projects with grants.

**29**

The table below confirms the limited interest in financial instruments in the 2007–13 programming period as around 1.5 % of the EAFRD amounts spent for the relevant rural development axes 1 and 3 was paid out via financial instruments (**Table 1**).<sup>1</sup> *Source:* DG Agriculture and Rural Development — Annex to information note on rural development programmes — Rural Development Committee — 19 November 2014.

**However spending rules are advantageous for Member States**

**30**

The Court found that financial instruments were attractive for some Member States because they allowed faster spending, thus helping to ease the application of certain provisions in relation to absorption of EU money. They could also generate revenue (interest).

23 The main reasons were as follows: the specific characteristics of rural development are not (or not properly) addressed by the governing legal framework, the population of beneficiaries, notably farmers, are accustomed to receiving grants, sufficient advantages of using financial instruments compared to other support measures were not identified, support via financial instruments would not match the standard characteristics of common EAFRD beneficiaries and no need or no demand for financial instruments in the area of rural development was identified.

**Table 1 EAFRD amounts paid into financial instruments in the total of EAFRD spending**

	Amount (in million euro)	Percentage compared to EAFRD payments for axes 1 and 3 until 15 October 2014 (including advances)
Cumulative EAFRD declared expenditure for axes 1 and 3 (Q4 2006 to Q3 2014) <sup>1</sup>	32 767	100.00 %
Financial instruments (available maximum EAFRD share of the fund capital until the 3rd Q2014 declaration) <sup>2</sup>	530	1.62 %

1 *Source:* DG Agriculture and Rural Development — Annex to information note on rural development programmes — Rural Development Committee — 19 November 2014.

2 ECA calculation based on the quarterly declarations of expenditure.

### Contributions to financial instruments are treated as incurred expenditure

#### 31

Council Regulation (EC) No 1290/2005 states that the Commission must make intermediate payments in order to reimburse the expenditure incurred in implementing the programmes<sup>24</sup>. Commission Regulation (EC) No 1974/2006 states that expenditure declared to the Commission as incurred must include the total expenditure paid in establishing or contributing towards financial instruments<sup>25</sup>. This provision allowed the Member States to declare higher spending levels than occurred in reality.

### Interest earned accrues to Member States

#### 32

The legislation also allows the full amount of fund capital to be claimed and paid from the outset to financial instruments. There was an incentive for Member States to do so as they could then earn interest by investing the fund capital. The case that illustrates this best was found in Romania where the full amount of fund capital was paid in a single contribution and held in national accounts. The type of financial instrument established (guarantee fund) and the low default rate<sup>26</sup> (below 1 %) meant that the Member State did not actually have to spend the bulk of the capital, enabling it to generate a significant amount of interest. Up to the end of 2013, Romania earned a total of about 50 million euro in this way.

### Released guarantees at the end of the programming period were eligible for EU co-financing

#### 33

Any loans issued to final recipients and then paid back to the fund, or guarantees which were issued to cover loans and then released, were deemed eligible at the end of the programming period for EAFRD co-financing. This led to a situation where money could be kept by the Member State concerned, even if, in the end, it was no longer at risk (loan paid back) or no real cost or money flow ever occurred (guarantees released). Although this is backed by an implementing regulation<sup>27</sup>, the Court stresses that the principles of sound financial management are not respected when released guarantees are considered as eligible expenditure as they were never actually spent in monetary terms (see also paragraphs 75 to 77).

24 Article 26 of Council Regulation (EC) No 1290/2005 of 21 June 2005 on the financing of the common agricultural policy (OJ L 209, 11.8.2005, p. 1).

25 Article 52(1) of Commission Regulation (EC) No 1974/2006.

26 This is defined as the amounts of guarantees in default compared to the amounts of guarantees issued.

27 Commission Regulation (EC) No 1974/2006.

**Financial instruments set up so that public money (loans/guarantees) helps spend public money (grants)**

**34**

Financial instruments were used mainly to help release EAFRD spending in the 2007–13 period but their impact on grant consumption was not always corroborated by available data. Structural factors also hampered this impact (see **Box 3**).

**35**

Financial instruments were set up so that public money (loans/guarantees) could help spend other public money (grants), rather than providing an alternative to grants. For all the financial instruments implemented in 2007–13 by the Member States visited, the Court found that only grant applicants could access them (indirect access).

**Box 3**

**Structural difficulties in obtaining access to credit in Romania**

The paying agency estimated that, ultimately, approved projects totalling 700 million euro, under all investment measures, could not be executed as the potential beneficiaries had not been able to obtain credit or lacked collateral. Approximately 69 % of project cancellations up to June 2014, were due to the absence of a co-financing share. Because of structural factors (little interest in agriculture on the part of the banks, no credit history, no other adequate security, projects that the banks thought economically unviable), even with a financial instrument, the Romanian credit gap remained and the absorption of grants related to guarantees was still low. Available data until 31 March 2014 show that around 15 % of all grant spending was backed by a guarantee from the EU co-financed guarantee fund on borrowings required to fund the projects.

**36**

The Court found specific cases in Italy (Puglia and Sicily), Lithuania and Romania where the total amount of the grant and financial instrument together was either close to the amount of the eligible cost of the project, equal to it or even higher. Therefore, at the end of the 2007–13 programming period, there was a risk of projects actually being financed up to 100 % with public money.

**37**

In the policy area of cohesion, this situation is explicitly prevented, as financial instruments and grants operate separately. Financial instruments are not allowed to cover costs of a project which are already supported by a grant.

### In certain cases, financial instruments contributed towards helping to alleviate the application of the de-commitment rule

#### 38

Council Regulation (EC) No 1290/2005 includes a mechanism for stimulating the financial execution of programmes. It contains a rule that requires the Commission to 'de-commit' (cancel) any portion of an annual budget which has not been used within a period of 2 years (known as the 'N+2' rule<sup>28</sup>). The purpose of this rule is 'to speed up execution of programmes and contribute to sound financial management<sup>29</sup>'. The Court has already pointed out, on several occasions, that there is a risk that financial instruments might contribute towards circumventing this rule<sup>30</sup>.

#### 39

The Commission also acknowledges this risk in relation to some Member States<sup>31</sup>. The Court found that such risk existed in Bulgaria, Greece (**Box 4**) and Italy (Sicily) at the time when their funds were established.

28 Article 29 of Council Regulation (EC) No 1290/2005.

29 DG Agriculture and Rural Development 2013 Annual Activity Report, annex 10, p. 158.

30 Court annual reports concerning the financial years 2010 (paragraph 4.33) (OJ C 326, 10.11.2011) and 2012 (paragraph 4.7) (OJ C 331, 14.11.2013); Court's Opinion No 7/2011 on the proposal for a Regulation of the European Parliament and of the Council laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund covered by the Common Strategic Framework and laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1083/2006 (paragraph 49) (OJ C 47, 17.2.2012), Special Report No 2/2012 (paragraph 54); Court document (2014), 'Agriculture and cohesion: overview of EU spending 2007–13' (paragraph 21) (<http://eca.europa.eu>).

#### Box 4

### Situation as regards the 'N+2' rule in Greece

In Greece, a payment of 115 million euro in public money was made to a loan fund in December 2013. The Court found that there was a high risk that the establishment of the fund also served the purpose of limiting the application of the 'N+2' rule. This was because:

- the amount allocated represented a significant share of the funds available<sup>32</sup>;
- insignificant amounts were disbursed to final recipients (see **Box 5**);
- the risk of de-commitment was significant in 2013.

32 Between 10 % and 30 % of the budget available for the measures concerned.

40

Therefore, in three out of the seven Member States that set up financial instruments in the 2007–13 programming period, financial instruments were established and were also used to withhold and retain EU payments rather than address the officially communicated needs and objectives. By accepting such practices the Commission did not ensure that the principles of sound financial management had been adhered to<sup>33</sup>.

Significant overcapitalisation of financial instruments

41

A situation of overcapitalisation occurs when the amount paid into the capital of the financial instruments is too large in relation to the amount provided to final recipients in the form of loans or guarantees issued.

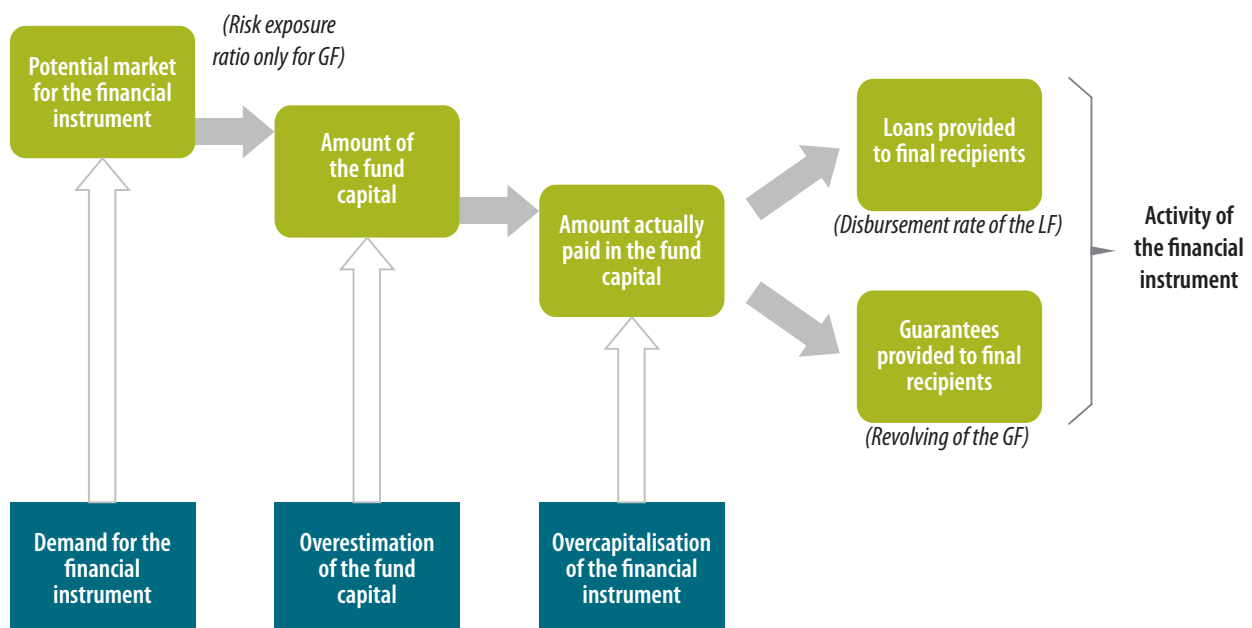
42

Figure 4 shows that the process starts with the determination of the potential market for the financial instrument. This information serves to estimate the fund capital. A wrong estimate might lead to an overcapitalisation of the financial instrument:

31 In its reply to the Court's annual report concerning the financial year 2012, the Commission recognises that it 'itself has observed that some Member States make extensive use (...) of financial engineering instruments which can have the effect of reducing or avoiding a loss of funds under the N+2 rules.'

33 Article 9(2) of Council Regulation (EC) No 1290/2005 and Article 73 of Council Regulation (EC) No 1698/2005 of 20 September 2005 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD) (OJ L 277, 21.10.2005, p. 1).

Figure 4 Factors contributing to overcapitalisation





### Amount of fund capital generally overcapitalised

#### 43

The Commission supervised the process of determining the amount of fund capital provided for financial instruments. Despite this supervision, the Court observed significant overcapitalisation in Bulgaria, Greece, Italy (Basilicata and Sicily), Lithuania and Romania. The Commission only took concrete action in the case of Bulgaria, leading to a reduction in the fund capital. Examples of overcapitalisation are provided in **Box 5**.

### One reason for overcapitalisation is the absence of a sound analysis of the demand for financial instruments in the Member States

#### 44

The Court found that attempts had been made by Member States, in operational documents such as business plans, to estimate the demand for established financial instruments, but they were based on rough estimates of grant consumption. Similar weaknesses were found for all the financial instruments audited in the Member States (see paragraph 19), with the exception of France (Corsica). Information collected for review shows that similar weaknesses also existed in Bulgaria. Some examples are described in **Box 6**.

#### Box 5

### Examples of the overcapitalisation of financial instruments

In Greece, the loan fund benefitted from public funding amounting to 115 million euro, to be spent in the 2014–15 period. In reality, only 0.5 million euro has been paid to final recipients until November 2014.

In Lithuania, a fund size of over 130 million euro was initially planned, but in practice the maximum fund allocation was only 52 million euro. At the end of 2013, the fund capital was reduced to 13.8 million euro.

In Italy (Sicily), the amount paid into the guarantee fund was around 38 million euro. This amount was largely overestimated considering that the uptake was around 5 million euro. (see paragraph 55).

## Box 6

**Examples of the failure to analyse the demand for financial instruments**

In Italy (Puglia and Sicily), the principle applied was to estimate the potential demand for guarantee funds. This corresponded to around 75 % (Puglia) and 50 % (Sicily) respectively of the expected loans to be provided by the banking sector for financing the private part of projects linked to the investment measures concerned. This resulted in an estimated demand (312 million euro in Puglia and 120 million euro in Sicily) that significantly exceeded the real demand. The estimated demand for guarantee funds for only two regions (Puglia and Sicily) was 8 % higher than the total guarantees provided by the fund manager for the whole country<sup>34</sup> as at July 2014.

In Bulgaria, the authorities considered that the guarantee fund would cover 75 % of total potential investments. The potential demand for the guarantee fund was then established at around 600 million euro for the 2012–15 period. This was 12 times higher than the real market at the end of April 2014. The Commission reviewed the process without challenging the fact that the 75 % hypothesis, upon which the calculations were based, was not substantiated.

In Romania, no evidence of an *ex ante* analysis was provided to back the estimates. They were stated to have been based on prior experience and the SAPARD programme, without quantifying the volumes of guarantees in the period beforehand.

<sup>34</sup> The fund manager (ISMEA) is a public body that provides information and financial services to the farming sector in Italy. It manages a national guarantee fund and is also the fund manager for six regional guarantee funds supported by the EAFRD.

**45**

The Court found that the attractiveness of the financial instruments for potential final recipients depended mainly on the cost of the credit, which, in turn, depended on market interest rates. This can be illustrated by the case of Lithuania. The periods when the contracts with final recipients were actually concluded largely coincided with the periods when the loan fund was attractive in terms of interest rates<sup>35</sup>. This illustrates the fact that demand for financial instruments needs to be assessed thoroughly, and over the long term, as it depends on a combination of intrinsic circumstances and situations as well as external trends.

**Another reason for the overcapitalisation of guarantee funds: Risk exposure ratios poorly determined****46**

For guarantee funds, the risk exposure ratio gives the upper default limit that is considered acceptable in the management of the fund. If the amount of capital multiplied by the risk exposure ratio is too high in relation to the guarantees issued to final recipients, a situation of overcapitalisation occurs.

<sup>35</sup> Interest rates offered by the loan fund compared with interest rates proposed by the market.

## Observations

### 47

The value of the risk exposure ratio heavily influences the amount of capital to be paid into guarantee funds. There is a need to adapt the value used for the risk exposure ratio according to the value of the default rate actually observed. For instance, in Romania, the level of default (below 1 %, see paragraph 32) observed at the end of 2013 was much lower than the upper limit of 20 %, which was the basis used for capitalising the guarantee fund.

### Estimate of overcapitalisation of the guarantee funds

### 48

The Court estimated the amount of overcapitalisation of the guarantee funds at 31 December 2013 on the basis of the exposure ratios used by the national authorities. The calculations in **Annex I** show that the total amount for the guarantees issued at the end of 2013 for all financial instruments implemented in 2007–13 could have been provided with total capital of around 50 million euro paid into the funds. In reality, around 420 million euro had been invested. This shows a massive overcapitalisation at the end of the year 2013, as the amounts invested were eight times higher than realistically required.

### Examples of cautious approaches in capitalising the funds were also observed

### 49

Despite the overestimation of a potential demand, the Italian region of Puglia applied a prudent step-by-step approach and limited payments into the fund to 20 % of the estimated fund capital to avoid overcapitalisation. This decision proved to be relatively in line with the guarantees issued (see paragraph 55). Such an approach also existed in other Italian regions (Campania and Molise).

### 50

A similar approach was observed in France (Corsica). Only half of the initially planned fund capital was actually paid into the fund, in correspondence with the guarantees issued. Nonetheless, taking the risk exposure ratio into account the financial instruments in Italy (Puglia) and France (Corsica) would also have been fully operational with a much lower capital endowment.

### Did financial instruments perform well in the 2007–13 period?

#### 51

For financial instruments to perform well, certain conditions should hold. Only when sufficient financial instrument resources reach the final recipients in due time, the instruments work as expected and, consequently, provide their full potential benefits (revolving and leverage effects). The EU legal framework would be expected to include adequate provision to stimulate the achievement of these benefits. Setting up of the financial instruments in good time during the programming period should also help these expected advantages to be achieved. There should also be monitoring systems that produce reliable data to make it possible to judge whether the instruments achieve their results.

#### 52

The Court assessed whether these key conditions for performance were in place when the financial instruments were implemented in the 2007–13 programming period. Overall, it found that this was not the case.

### Financial instruments performed poorly in revolving money

#### 53

The Court's annual report concerning the 2013 financial year highlights the low level of assistance to final recipients provided by the financial instruments in the policy area of cohesion<sup>36</sup>. It stated that the disbursement rates were 'still too low to expect that all funds available [would] be used at least once'. This audit confirmed that this situation also existed for rural development. As at 31 December 2013, only 45 % of the 700 million euro financial instrument fund capital (of both the loan and guarantee funds) had actually been guaranteed or paid out to the final recipients of both the loan and guarantee funds.

#### 54

One of the main effects that can be expected from financial instruments consists in obtaining a revolving effect. However, there is no legal requirement for any degree of revolving and insufficient disbursement rates can delay revolving effects from developing. The audit also confirms this situation for rural development.

36 See paragraphs 5.33 to 5.36: According to the latest Commission figures, only 37 % of the 8,4 billion euro that had been paid into financial instruments from 2007 to the end of 2012 had actually been paid out or guaranteed to the final recipients.

## Observations

### For guarantee funds, revolving effects were insufficient to date

#### 55

The potential of a guarantee fund is to go far beyond the capital available through a multiplier effect. It is then possible to provide more guarantees than the capital available. However, the multiplier or revolving effect achieved in the Member States was insufficient. According to the Court's data, the revolving effect for the 11 existing guarantee funds was 0.53 at the end of 2013, as illustrated in **Table 2**.

#### 55

The revolving effect for some Italian guarantee funds (Basilicata, Calabria, Sicily, and Umbria) was particularly low. Only in three of the guarantee funds shown in **Table 2** (in Italy (Campania, Molise and Puglia)) were more guarantees provided than fund capital, generating only a slight revolving effect.

**Table 2** Revolving effect of the guarantee funds

Member States/ Region(s)	Maximum amount paid into the fund until 31.12.2013 (in million euro) A	Total of amounts guaran- teed to final recipients as at 31.12.2013 (in million euro) B	Revolving effect (multiplier — 31.12.2013) B/A	Targeted maximum multiplier
Bulgaria	171.29	50.00 <sup>1</sup>	0.29	5
France (Corsica)	0.60	0.40	0.67	3
Italy (Sicily)	37.63	5.48	0.15	3 <sup>2</sup>
Italy (Puglia)	5.00	6.58	1.32	12.5 <sup>2</sup>
Italy (Lazio)	2.50	0.92	0.37	12.5
Italy (Campania)	2.25	3.26	1.45	12.5
Italy (Umbria)	4.80	0.00	0.00	3
Italy (Molise)	2.45	2.45	1.00	3
Italy (Basilicata)	14.86	1.70	0.11	3
Italy (Calabria)	10.00	1.68	0.17	2
Romania	220.00	177.17	0.81	5
<b>TOTAL</b>	<b>473.80</b>	<b>249.64</b>	<b>0.53</b>	-

1 Guarantees issued up to 30 April 2014.

2 The maximal value for the multiplier was set at 12,5 both in Puglia and Sicily. However, in Puglia, the amount of the fund capital was determined on the basis of this value while in Sicily the value of 3 was used.

Source: Data from the business plans, the relevant annual progress reports 2013 and ECA calculation.

## Observations

### 57

Bulgaria reduced the fund capital, respectively by more than a quarter in 2013 (from 171.29 to 121 million euro) and Romania reduced it by nearly a half (from 220 to 115 million euro) in 2014. Corresponding EAFRD money was transferred back from the guarantee fund to the grants part of the applicable investment measures. These reductions in fund capital had the effect of increasing the multiplier/revolving effect.

### 58

By taking these reductions into account and estimating the guarantees provided in the first three quarters of 2014, no multiplier effect had been achieved as at 30 September 2014 for all 11 existing guarantee funds. This was still far below the multiplier targeted by the Member States themselves (see **Table 2**, last column) and the situation presented in **Annex I**. This means that the capital paid into the guarantee funds still exceeded the amount for the guarantees issued to final recipients, weakening the potential of the instrument.

### For loan funds, the revolving effect is equally low

### 59

According to the Court's data, the average disbursement rate for the two operational loan funds at the end of 2013 was 0.75, as illustrated in **Table 3**.

### 60

In Greece, no loans were actually provided until mid-2014. For Lithuania and Latvia, the figures mask a situation where the funds worked in a discontinuous manner. In Lithuania, not one single contract had been signed since the first quarter of 2012 (see paragraph 45). No effort was made to adapt the fund conditions to market needs. In Latvia, the situation was similar: no new loans had been provided since June 2012. The solution found in Lithuania and Latvia was to gradually reduce the fund capital, by around three quarters and two thirds respectively until the end of 2013. This reduction practice continued in 2014.

Table 3

### Disbursement rate of the loan funds

Member States/ Region(s)	Maximum amount paid into the fund until 31.12.2013 (in million euro)	Total of amounts paid out to final recipients as at 31.12.2013 (in million euro)	Disbursement rate with maxi- mum amount paid into the fund until 31.12.2013
Latvia <sup>1</sup>	37.60 <sup>2</sup>	28.25	0.75
Lithuania	52.45	39.05	0.74
<b>TOTAL</b>	<b>90.05</b>	<b>67.30</b>	<b>0.75</b>

1 In accordance with the exchange rate of the Bank of Latvia 1 EUR = 0.702804 LVL.

2 ECA estimation following the Latvian quarterly declarations, including the 4th quarter 2013.

Source: Data from the relevant annual progress reports 2013 and ECA calculation.

## Observations

### 61

For the loan funds, the revolving effect can only kick in once a loan has been repaid by the final recipient. For those funds, the Court found that no revolving effect was actually occurring at the end of the year 2013.

#### Leverage effect rarely occurs and some of the funds were set up too late

### 62

In its reply to the Court's annual report concerning the financial year 2013 (paragraph 5.36), the Commission emphasised the limits of a single indicator like the disbursement rate as a tool for assessing the performance of financial instruments and considered that 'the assessment of performance should also focus on the achievement of results by the co-funded financial instruments, including the revolving and leveraging effects'.

#### Leverage effect rarely occurs

### 63

Financial instruments are meant to leverage public aid by incentivising the involvement of the private sector. If, for example, every euro provided by public sources is matched by one euro from private funding, the total amount that benefits final recipients is doubled. However, there is no legal requirement to achieve a given degree of private participation (leverage).

### 64

Article 223 of the implementing regulation to the Financial Regulation<sup>37</sup> states that financial instruments shall '(...) aim at achieving a leverage effect of the Union contribution by mobilising a global investment exceeding the size of the Union contribution' and that the 'leverage effect of Union funds shall be equal to the amount of finance to eligible final recipients divided by the amount of the Union contribution'.<sup>38</sup> However, in the context of the EAFRD, this concept considers normal public co-financing provided by the Member States as part of the leverage even where no private funding was raised at all.

### 65

The Common Provisions Regulation<sup>39</sup> defines the 'expected leverage effect' as 'an estimate of additional public and private resources to be potentially raised by the financial instrument down to the level of the final recipient (...)'. In line with this concept, in the context of this performance audit, the Court considers leverage in terms of how many euros of funding (public and private) have been guaranteed or paid out for financing rural development projects for each euro of public (EU and Member State) funding. Therefore, the Court calculated the leverage effect<sup>40</sup> as follows:

Finance to final recipients

---

Public contributions

37 Regulation (EU, Euratom) No 966/2012 of the European Parliament and of the Council of 25 October 2012 on the financial rules applicable to the general budget of the Union and repealing Council Regulation (EC, Euratom) No 1605/2002 (OJ L 298, 26.10.2012, p. 1).

38 See Commission Delegated Regulation (EU) No 1268/2012 of 29 October 2012 on the rules of application of Regulation (EU, Euratom) No 966/2012 of the European Parliament and of the Council on the financial rules applicable to the general budget of the Union (OJ L 362, 31.12.2012, p. 1).

39 See Article 37(2) of Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

40 See Special Report No 2/2012, paragraph 102.

## Observations

### 66

The Member States did little to achieve a leverage effect. The Court's audit visits showed that no leverage was achieved, for example, in Latvia, Lithuania and Italy (Sicily), as the implementation of the financial instruments did not attract any additional private capital to rural development projects. A certain degree of leverage was observed in France (Corsica), Italy (Puglia) and Romania, for the non-guaranteed part of the loans<sup>41</sup> provided to final recipients.

### 67

Greece and Italy (Umbria)<sup>42</sup> were the only Member States where the funds had been explicitly designed to achieve leverage. In Greece, it was expected that a certain level of leverage would be attained as, in addition to the public contribution a private bank acted as part-financing partner<sup>43</sup>. However, as at mid-2014 no leverage had actually been achieved as no loan had been issued.

41 Example: the guarantee in France (Corsica) covers 65 % of the loan, while in Romania this can go up to 80 %.

42 In Italy (Umbria), for a guarantee fund which was not audited on the spot, the business plan states that at least 20 % of the resources for the fund must come from the private sector.

43 The full capital invested in the loan fund was 253.025 million euro, out of which 115 million euro was the public part and 138.025 million euro was the private part invested by the Piraeus Bank.

### Box 7

#### Leverage achieved by the six financial instruments audited on the spot

From the sample of Member States/regions visited on the spot in the course of the audit, leverage was as follows:

	Corsica (GF)	Greece (LF)	Lithuania (LF)	Puglia (GF)	Romania (GF)	Sicily (GF)
<b>Leverage</b> (Amount of the credit distributed/Capital paid into the FEI)	1.47	Not yet	n/a	2.24	1.41 <sup>1</sup>	0.28

1 The calculation in this table uses the maximum fund capital of 220 million euro.

#### Some financial instruments were set up too late

### 68

Several financial instruments were established late, thus reducing their performance within the 2007–13 programming period. This was the case in France (Corsica) (June 2012) and Bulgaria (February 2012), but more particularly in Greece and Italy (Calabria) (see **Box 8**).



## Box 8

**In Greece and Italy (Calabria), timing reduced the performance of the funds**

The Greek managing authority proposed the establishment of a loan fund in January 2011 and the European Commission approved it in May 2011. It was expected to enhance liquidity for investors and entrepreneurs in the rural sector. In reality, the loan fund only started in January 2014. In the specific context of an acute economic crisis, which, according to the national authorities, explained the delays, the loan fund was implemented only 2 years before the end of the programming period at the end of 2015. This reduced its performance over the whole 2007–13 period.

The Court found that an important gap existed between the time when in Italy (Calabria) a fund was set up administratively and the fund capital paid in, on the one hand, and the time when first guarantees were issued, on the other. The guarantee fund was set up in 2010, but the first guarantees were only provided in 2013.

**The monitoring of financial instruments in 2007–13 did not provide enough relevant information on performance achieved****69**

The Court's view is that the following main indicators measure financial instrument performance:

- leverage effect,
- revolving effect<sup>44</sup>,
- default rates.

**70**

This set of indicators provides information on performance. The Court noted that the rural development framework did not include any specific targets or indicators to enable the effectiveness and impact of financial instruments to be measured and observed that the Member States predominantly

monitored disbursement rates. Member States had exhaustive lists of the final recipients concerned<sup>45</sup>, but they did not establish any performance or result indicators to monitor performance against the three criteria (revolving and leverage effects and default rate).

**71**

The Court also found cases where the figures included in the annual progress reports to the Commission were not always complete or reliable (see **Box 9**).

44 These two performance indicators (leverage effect and revolving effect) are also considered to be relevant by the Commission (see paragraph 62).

45 These lists mentioned also the measures concerned, the amount of the loans, the amount of the guarantees (if applicable), the currencies, the state of play of the loans (repayment stage), etc.

Box 9

**Reporting not complete and reliable**

Romania included the amounts for ineligible guarantees, and reported guarantees that had been cancelled without any loans being provided. Romania also reported guarantees that were not active because the guarantee commission had not been paid by the final recipients.

Lithuania included loans which had never become active because the contracts were cancelled and France (Corsica) reported on data which did not match the certified information included in the fund manager's database.

**Were adequate winding up and exit policy conditions in place in the 2007–13 period?**

**72**

The management of financial instruments does not follow the usual system for managing grants either at the level of the Member State administrations or at that of the final recipients. Financial instruments needed a completely new architecture in the Member States, especially to comply with Articles 50 to 52 of Regulation (EC) No 1974/2006. Key features of this specific financial instrument architecture are winding up and exit policies.

**73**

Furthermore, rural development legislation requires winding up and exit policy issues to be included in key documents (business plans and funding agreements). Therefore, clear rules should exist for winding up the financial instruments at the end of the programming period (31 December 2015), and conditions should be

set to prevent remaining funds being used for any purpose other than the original rural development objective of the RDP measure. They should also only be used for the benefit of individual undertakings. Finally, the Commission should provide the Member States with guidance to reduce their administrative burden, and an appropriate risk management system should be introduced to tackle specific risks linked to financial instruments (like the protection of public money).

**74**

The Court assessed the approaches followed by Member States and the Commission to match these requirements and found that both clear rules and Commission guidance were lacking.

## Observations

### Closure had not yet been well prepared and provisions were interpreted differently by the Member States and the Commission

#### 75

The programmes will be closed at the end of the rural development programming period 2007–13. In this connection, it will be determined what FEI expenditure is eligible and the corresponding amounts that can be kept by the Member States (paying the balance of the financial instruments) (see paragraph 33). It will also be decided what exit and winding up provisions will enter into force. The Court found out that this crucial event had not been soundly prepared by either the Member States or the Commission.

#### 76

During the 2007–13 programming period, the Commission and the Member States have interpreted the applicable FEI rules differently, especially in the case of guarantee funds. The legislation considers two categories of guarantee as eligible: released and ongoing guarantees. The Commission stated that all released guarantees are eligible at closure. According to the Commission ongoing guarantees are not eligible in total but a 'risk exposure ratio' has to be applied for them at closure, reducing the amounts which can be kept by Member States.

#### 77

The Court observed that DG Agriculture and Rural Development's approach here was in line with the interpretation provided by DG Regional and Urban Policy in its guidance note, but this is not backed up by the text of the legislation. The Member States visited during the audit had divergent interpretations of these rules. Italy understood that it had to apply this ratio to all guarantees (released and ongoing), while France (Corsica) and Romania did not want to apply a ratio at all.

### Lack of clarity regarding exit policy provisions

#### 78

There are currently no precise exit and winding up provisions for Member States. The EU rural development rules only require that resources returned to the operation after the final eligibility date of the rural development programme should be used by the Member States concerned, for the benefit of individual undertakings. The Member States visited during the audit all considered that the future of all the audited funds was still open: it was not clear if the funds would continue, for how long and for what purpose.

## Observations

### 79

According to the Commission's interpretation<sup>46</sup>, individuals outside rural development and the farming sector can receive support, but no clear definition of these individual undertakings was available. The Court considers that there is a risk of resources initially dedicated to rural development, for potential beneficiaries of agricultural policy, being transferred to sectors other than those concerned by rural development.

### 80

Finally, the Court found that the Commission did not intend to monitor this provision in the period after closure, in order to ensure that the funding capital and returning resources are, in the mid- and long term, not used by the Member States for purposes other than for the benefit of individual undertakings.

### Does the 2014–20 framework have the potential to provide the necessary improvements for financial instruments?

### 81

A new legislative framework for the 2014–20 policies in the areas of social affairs, fisheries, cohesion and rural development was adopted at the end of 2013. In compliance with the Financial Regulation<sup>47</sup>, for cases of shared management, the common provisions regulation for the 2014–20 period sets out principles to be respected for financial instruments for all areas. The Court assessed to what extent these legal changes could increase the performance of the financial instruments in rural development.

### There are some notable improvements in the new legal framework ...

### 82

The Court noted that the legal framework on financial instruments provides certain improvements, in particular:

- compulsory *ex ante* assessments for all instruments which should result among other things in a better estimate of the fund capital required;
- phased-in payments linked to the level of actual disbursements to final recipients for loan funds, or actual uptake for guarantee funds which should reduce the risk of overcapitalisation;
- the option of setting up different types of financial instrument at different levels (national, regional, transnational or cross-border) e.g. via fund of funds (holding funds<sup>48</sup>), specific tailor-made or off-the-shelf instruments (both to be set up by the Member States) or via contributions to EU level instruments; and
- compulsory reporting from the outset, including on a range of indicators linked to the Financial Regulation<sup>49</sup>.

46 Opinion of the legal service of DG Agriculture and Rural Development in a note to the auditors dated 8 October 2014.

47 Article 139(5) of Regulation (EU, Euratom) No 966/2012.

48 Funds set up to invest financial resources in venture capital funds, guarantee funds, loan funds, or funds or other incentive schemes providing loans, guarantees for repayable investments or equivalent instruments.

49 E.g. managing authorities will need to provide specific reporting on operations comprising financial instruments as an annex to the annual progress report. This will include a number of elements (leverage, performance) to bring the reporting in line with the Financial Regulation. For the EAFRD this reporting is a novelty.

## Observations

### ... but certain obstacles remain

#### 83

The Court identified that the risk of overcapitalising financial instruments remained and that the conditions required to guarantee their long-term effects were still not in place. The Court also found that performance issues were still not adequately addressed in the EU legal framework for 2014–20 and that financial instruments risked remaining too dependent on grant schemes.

### Overestimating the capital needed and then overcapitalising the funds are risks which remain

#### 84

The new provision on phased-in payments (Article 41 of the common provisions regulation) provides that payments from the EAFRD budget to fund capital depend on the spending activity of financial instruments. This provision may limit overcapitalisation, but there is still a risk that it will not

be enough to remedy the problem of 'parking funds'<sup>50</sup> with a view to circumventing the application of the de-commitment rule.

#### 85

One of the main purposes of the new mandatory *ex ante* assessment is to quantify how much should be committed for funding financial instruments. The quality of this assessment is therefore of key importance as it has direct financial effects. The legislation in force does not require the Commission to check such quality.

#### 86

Based on the 2007–13 experience, there is a risk that the new provision on phased-in payments may be insufficient to ensure that funds are not too large, particularly if the *ex ante* assessments are inadequate. The amount of the first 25 % instalment<sup>51</sup> depends on the amount committed for the financial instrument under the relevant funding agreement (see **Table 4**).

50 In Italy (Sicily), for instance, guarantees were provided in a continuous manner, but, overall, only a small share of the capital was actually used. The guarantee fund therefore acted as a 'parking fund'.

51 The common provisions regulation states that each amount paid from the programme to the financial instrument shall not exceed 25 % of the total amount of programme contributions committed to the financial instrument.

Table 4

### Potential impact of phased-in payments (in million euro)

	Amount planned to be committed to the financial instrument under the relevant funding agreement	Interim payment subject to a maximum ceiling of 25 %	Multiplier	Maximum amount to be provided in guarantees	Latest amounts issued as guarantees	In % of the maximum amount
Bulgaria	121.00	30.25	5	151.25	50	33.0 %
Italy (Puglia)	25.00	6.25	12.5	78.125	6.6	8.5 %
Italy (Sicily)	39.50	9.875	12.5	123.44	5.5	4.4 %

## Observations

### The risk remains that financial instruments may be set up too late

#### 87

Implementing a financial instrument in good time and at an early stage of the programming period is a key condition for enhancing its performance throughout the programming period. The Court considers that the way the current financial instruments are cleared in December 2015 will impact the decision and the process for setting up financial instruments under the new framework. Overall, as no RDPs had been approved at 1 December 2014 and no *ex ante* assessments had been finalised for the new financial instruments, there was a high risk that implementation would only start from 2016 onwards, thus reducing the time during which they could be operational.

### Risk of insufficient focus on the long-term effects

#### 88

The Court found that some Member States, such as Lithuania and Latvia, implemented financial instruments to respond to individual difficulties caused by the economic and financial crisis. However, the funds had stopped running once the situation on these countries' financial markets had improved (see paragraphs 45 and 60). However, for repayable instruments of this type to be able to deliver significant effects, they need to work on a long-term basis. In Corsica, even if the credit lasted over a longer period, the guarantees were limited to 60 months. In its recent communication (see paragraph 8) the Commission also underlined the need to consider long-term growth adequately and support long-term investment projects.

#### 89

The Court considers that one condition for ensuring that the financial instruments work in the long term is to have clear transitional rules between programming periods to avoid discontinuities linked to the management of programming cycles. There is no such provision in the new legal framework.

### Leverage and revolving effects: performance issues not adequately addressed

#### 90

The Court found that performance was not monitored in 2007–13 (see paragraphs 69 and 70). There was, therefore, no useful information to feed a 'lessons learnt' process for the next programming period.

#### 91

Mandatory private participation (leverage) is still not required in the new legal framework and the new legislation does not set any appropriate targets or provide any data for calculating leverage indicators. The Court considers that the concept of leverage, as proposed in paragraph 64, is not suited to financial instruments in the area of rural development for the 2014–20 programming period<sup>52</sup>.

52 Article 59(2) of Regulation (EU) No 1305/2013 of the European Parliament and of the Council of 17 December 2013 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD) and repealing Council Regulation (EC) No 1698/2005 (OJ L 347, 20.12.2013, p. 487) states that 'The EAFRD contribution shall be calculated on the basis of the amount of eligible public expenditure.'

## Observations

### 92

Furthermore, the new framework does not include any minimum contractually binding revolving periods. According to Article 45 of the common provisions regulation, resources paid back to financial instruments during a minimum period of 8 years must be used in accordance with the aims of the programme(s). Whilst the definition of such a minimum period is welcomed, the provision allows for the reduction of the fund capital and the reuse of such financial instrument resources as grants, thus limiting the advantage provided by the revolving system.

**There is a risk that the dependence of financial instruments on grants remains in the 2014–20 period**

### 93

Previous audits by the Court on rural development<sup>53</sup> found problems in the way grants had been managed for investment measures. There were often deadweight, displacement effects and selection weaknesses. The measure which supports investment in the processing of agricultural products was found to be the most prone to error<sup>54</sup>. As financial instruments benefit from additional expertise in assessing the viability of projects (see paragraph 14) they have the potential to mitigate the risks identified in relation to the use of grants.

### 94

Any final recipient that fulfils the eligibility and selection criteria for accessing a financial instrument can apply directly without the need to submit an application for the grant schemes. This represents a direct access to a financial instrument. Contrary to the situation found in the 2007–13 programming period (see paragraphs 34 and 35) direct access increases the scope of the intervention by the financial instruments, and therefore their potential impact.

### 95

A Commission guidance paper<sup>55</sup> for the 2014–20 programming period identified the possibility of direct access to financial instruments as one of the main changes between the two programming periods. However, the Court considers that the move from indirect to direct access cannot be attributed to the new legal framework, as indirect access was not required by the legislation applicable to the 2007–13 period<sup>56</sup>. The approach used for cohesion involves direct access, and rules have been determined by DG Regional and Urban Policy on how to combine financial instruments and grants. Nothing similar was done by DG Agriculture and Rural Development in 2007–13 (see paragraph 37).

- 53 See e.g. Special Report No 8/2012 'Targeting of aid for the modernisation of agricultural holdings'; Special Report No 1/2013 'Has the EU support to the food-processing industry been effective and efficient in adding value to agricultural products?' and Special Report No 6/2013 'Have the Member States and the Commission achieved value for money with the measures for diversifying the rural economy?' (<http://eca.europa.eu>)
- 54 Special Report 23/2014 'Errors in rural development spending: what are the causes, and how are they being addressed?' (<http://eca.europa.eu>)
- 55 European Commission; Financial instruments in ESIF programmes 2014–20, a short reference guide for Managing Authorities, 2.7.2014.
- 56 Council Regulation (EC) No 1698/2005 and Commission Regulation (EC) No 1974/2006.



## 96

Overall, the Court concluded that financial instruments had been unsuccessful in the field of rural development<sup>57</sup> and although the 2014–20 period is potentially promising, it will be a considerable challenge to achieve the desired impact. No clear case had been made for taking into account the specific characteristics of rural development policy and there had been no assessment of real needs. The Court therefore found that the potential benefits of moving ‘away from grant dependency culture’<sup>58</sup> had not been demonstrated by the actual implementation of financial instruments in 2007–13.

## 97

The Court found that the 2014–20 framework has the potential to provide the necessary improvements. However, certain obstacles to a more extensive use of financial instruments remain. Although new specific provisions were introduced to limit the recurrent problem of overcapitalisation, the risk still persists. Finally, the key performance issues of leverage and revolving effects have not yet been adequately addressed (paragraphs 81 to 95).

## 98

The Court found that no clear case had been made for setting up financial instruments in the 2007–13 programming period and that they were overcapitalised (paragraphs 21 to 50). The demand for financial instruments in 2007–13 was particularly low and there will therefore be a need to provide specific incentives to use them in the

coming years. In 2007–13, there had no longer been a separate ‘financial engineering’ measure, like the one in the 2000–06 period, and financial instruments could only be embedded in a selection of investment measures. Having the possibility to set up the financial instruments, either as part of an investment measure or as a separate measure, leads to more flexibility in managing the money invested, while weakening the link with grants. The 2014–20 framework does not envisage this possibility either.

## Recommendation 1

In order to increase incentives for Member States to set up financial instruments for rural development, the Commission should identify the challenges, specific characteristics and obstacles faced in this field and actively encourage Member States to use such instruments where appropriate. In order to stimulate demand, an option for Member States could be to set a certain share of the available EAFRD budget aside for financial instruments and make those instruments more attractive than grants in clearly defined circumstances.

## 99

The problem of the overcapitalisation of financial instruments was recurrent in the 2007–13 period, leading to an excess amount of 370 million euro (see paragraph 48). Though specific provisions (mandatory *ex ante* assessments, phased-in payments) were introduced into the 2014–20 legal framework to limit this problem, the risk may persist.

57 See also **Annex II** of this report.

58 European Commission; Financial instruments in ESIF programmes 2014–20, a short reference guide for Managing Authorities, 2.7.2014.



## Conclusions and recommendations

### Recommendation 2

In the field of rural development, the Commission should provide guidance and actively promote the quality of the mandatory *ex ante* assessments for financial instruments, which are intended to serve as key tools to avoid overcapitalisation. In addition, the risk exposure ratio used should be validated by Member States by appropriate technical expertise.

### 100

Financial instruments performed insufficiently in the 2007–13 programming period (paragraphs 70 and 71). They performed poorly in revolving money and leveraging additional private resources to the benefit of rural development policy. The reporting procedure was not designed to illustrate the financial instruments' activities in a comprehensive manner and provide relevant information on the performance achieved. Therefore, the Commission did not perform its shared management supervisory duties adequately. Nevertheless, the improvements introduced in the 2014–20 legal framework do have the potential to remedy main reporting weaknesses found (see paragraph 82).

### Recommendation 3

In the field of rural development and in order to increase the effectiveness of the financial instruments for the programming period 2014–20, the Commission should set appropriate standards and targets for leverage and revolving effects.

### 101

Financial instruments need to work over the long term to provide their full effects. The Court found that insufficient focus had been put on this aspect. For instance, loan funds answered a short term problem of lack of liquidity in the context of the recent economic crisis. They therefore only ran over a limited period of time despite the significant administrative effort which had been invested in setting them up.

### Recommendation 4

In order to promote the long-term effects of financial instruments, the Commission and the Member States should decide on clear transitional rules between programming periods. The Member States should implement the new legal provisions in such a way as to ensure the greatest level of flexibility. In this context, the Commission could encourage Member States to establish a single financial instrument which is able to provide both loans and guarantees, thus increasing its activity and critical mass.

### 102

Previous audits by the Court on rural development found problems (dead-weight, displacement effects and selection weaknesses) in grants' management for investment measures (see paragraph 93). Financial instruments have the potential to mitigate the risks identified related to the use of grants.

### Recommendation 5

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Member States should pay particular attention to potential deadweight or displacement effects when assessing applications for funding. In order to do so, they should apply appropriate indicators, such as return on investment and projected cash flow statements. For eligible activities, where the risk of deadweight/displacement effects is particularly high, financial instruments could become the preferred option. Member States should examine how grants and financial instruments can be combined to provide the best value for money, by optimising leverage/revolving effects.

### 103

Finally, the Court concludes that precise conditions to establish the balance of the financial instruments to be paid at the end of the programming period and exit policy conditions were not in place in the 2007–13 period, mainly because of an absence of clear rules from the Commission on these issues (paragraphs 72 to 80).

### Recommendation 6

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The Commission should provide in due time in 2015 precise operational implementing rules before the closure of the 2007–13 programming period, including the exit policy.

This Report was adopted by Chamber I, headed by Mrs Rasa BUDBERGYTĖ, Member of the Court of Auditors, in Luxembourg at its meeting of 25 March 2015.

*For the Court of Auditors*



Vítor Manuel da SILVA CALDEIRA  
*President*

### Estimate of the overcapitalisation of the guarantee funds at 31 December 2013 according to the risk exposure ratio

	Amount paid into the Fund as at 31.12.2013 (in euro)	Amount of guarantees issued to final recipients at 31.12.2013 (in euro)	Maximum level of default expected	Risk exposure ratio used to determine the amount paid into the fund (1 to X)	Estimate of over-capitalisation of the Fund (in euro)
Bulgaria	121 000 000.00	50 006 000.00	20.0 %	5.0	110 998 800.00
France (Corsica)	600 000.00	403 795.00	33.3 %	3.0	465 401.67
Italy (Sicily)	37 628 950.00	5 485 210.23	33.3 %	3.0	35 800 546.59
Italy (Puglia)	5 000 000.00	6 585 275.50	8.0 %	12.5	4 473 177.96
Italy (Lazio)	2 500 000.00	920 105.60	8.0 %	12.5	2 426 391.55
Italy (Campania)	2 250 000.00	3 262 536.52	8.0 %	12.5	1 988 997.08
Italy (Umbria)	4 800 000.00	0.00	33.3 %	3.0	4 800 000.00
Italy (Molise)	2 450 000.00	2 451 400.00	33.3 %	3.0	1 632 866.67
Italy (Basilicata)	14 860 000.00	1 699 990.00	33.3 %	3.0	14 293 336.67
Italy (Calabria)	10 000 000.00	1 678 400.00	50.0 %	2.0	9 160 800.00
Romania	220 000 000.00	177 173 471.00	20.0 %	5.0	184 565 305.80
<b>Total</b>	<b>421 088 950.00</b>	<b>249 666 183.85</b>			<b>370 605 623.98</b>

Capital needed (in euro)	50 483 326.02
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Overcapitalisation (expressed as a factor)	8.34
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Source: ECA audit findings.

## Annex II Overview of the main weaknesses reducing the performance of the financial instruments audited

	France (Corsica)	Italy		Romania	Greece	Lithuania
		Puglia	Sicily			
Type	GF	GF	GF	GF	LF	LF
Late setting up	W				W	
Over-estimation of the demand	W	W	W	W	W	W
Risk exposure ratio too low (for GF)	W		W		NA	NA
Excessive capital endowments			W	W	W	W
Low disbursement rate			W		W	W
Insufficient level of revolving	W	W	W	W	W	W
Insufficient level of leverage	W	W	W	W	W	W
No reporting on performance	W	W	W	W	W	W

GF: guarantee fund; LF: loan fund; NA: Not applicable

W Weakness identified.

Source: ECA audit findings.

## Executive summary

**I** While the attraction of private capital is one of the value-added associated with financial instruments, the EU legislation<sup>1</sup> in the field of rural development in 2007–13 does not explicitly link financial engineering instruments to private funding.

**III** The Commission notes that the programming period 2014–20 has just started and most of the ESIF programmes, including RDPs, have not yet been adopted. Moreover, financial instruments may be set up by MS at any time of the programming period.

**IV** The Commission notes that financial instruments were implemented in seven Member States in 2007–13 which is a significant improvement compared to the 2000–06 period where only two Member States used them.

The EU legal framework for the 2007–13 programming period provides for large flexibility in the implementation of the rural development measures. The Commission is of the opinion that the 2007–13 legal framework takes into account the specificities of rural development and this is reflected in the financial instruments supported by the EAFRD. Council Regulation No 1698/2005 and Commission Regulation (EC) No 1974/2006 define the scope and area of intervention of the EAFRD, including specific support measures<sup>2</sup>. Each rural development measure contains various eligibility rules and provisions, which must be respected by financial instruments created under the measure and should form part of the funding agreement.

<sup>1</sup> Council Regulation (EC) No 1698/2005 and Commission Regulation (EC) No 1974/2006.

<sup>2</sup> For instance support for investments in modernisation of agricultural holdings, adding value to agricultural and forestry products, creation and development of micro-enterprises in rural areas, diversification into non-agricultural activities, village renewal, etc.

The requirement of carrying out an appropriate *ex ante* assessment of expected losses was introduced in 2011 as regards EAFRD co-financing of operations comprising guarantee funds<sup>3</sup>. As regards the 2014–20 programming period, the undertaking of an *ex ante* assessment is obligatory for any operation comprising financial instruments co-financed by the EAFRD<sup>4</sup>. The legislation provides incentives to MS to use financial instruments and gives them the possibility to immediately launch them based on ready-to-implement models such as the off-the-shelf models. The Commission also provides the necessary guidance to MS and stakeholders and will continue doing this throughout the rest of the period 2014–20.

**V** Guarantee funds need to have certain liquidity to ensure smooth investments in enterprises.

After an updated assessment of needs by the Member States and preparation for closure of guarantee funds, the figure was reduced to 362.69 million euro by the end of 2014.

**VI** The financial instruments supported by the EAFRD were set up within the legally allowed period, in line with the EU legislation.

The Commission would like to remind that rural development is implemented under shared management, with the Member States being fully responsible for monitoring of operations.

The Commission notes that as regards the period 2007–13, it gathered important reporting information on existing financial instruments. Moreover, a comprehensive reporting on financial instruments is designed for the 2014–20 programming period.<sup>5</sup>

<sup>3</sup> Commission Regulation (EU) No 679/2011 from 14 July 2011.

<sup>4</sup> Article 37(2) of Regulation (EU) No 1303/2013.

<sup>5</sup> Article 46 of Regulation (EC) No 1303/2013.

The Commission is of the opinion that the assessment of the benefits of the financial instruments should be made also in the context of the financial crisis affecting the access to finance in some Member States.

### VII

The Commission notes that it is the responsibility of national authorities to ensure that individual operations are implemented in accordance with the applicable legal provisions. The Commission evaluates the issues related to financial instruments during its audit missions.

According to the applicable EU legislation for 2007–13, the winding up and exit arrangements are to be defined by the managing authority in the funding agreement with the fund manager, ensuring that the relevant provisions are adequately taken on board.

Under shared management and in line with the subsidiarity principle, the Commission must satisfy itself that the Member States set up adequate management and control systems.

For the period 2007–13, the Commission gave guidance to any MS which has requested it. The guidelines on closure of the 2007–13 rural development programmes were adopted in 2015<sup>6</sup>. The respect of the legal rules and guidance will be verified during the clearance of accounts.

The Commission will provide more consolidated and improved guidance for the period 2014–20.

### VIII

The Commission considers that the new legal framework for the programming period 2014–20 addresses the concerns raised by the Court sufficiently well.

<sup>6</sup> C(2015) 1399 final from 5.3.2015.

The issue of overcapitalisation is addressed by the provisions of Article 41 of Regulation (EU) No 1303/2013 where phased-in payments, based on achievement of concrete disbursement results, have been introduced as a general rule for all financial instruments in 2014–20.

The key performance issues are well addressed in the monitoring of financial instruments supported by ESIF, as defined in Article 46 of Regulation (EU) No 1303/2013. Moreover, the Commission points out four performance indicators enshrined in Article 12 of Regulation (EU) 480/2014.

In addition, in order to encourage the use of financial instruments, the Commission strengthened its cooperation in the field of agriculture and rural development with the European Investment Bank (EIB) and signed a Memorandum of Understanding on 14 July 2014<sup>7</sup>. This cooperation includes the possibility of utilising the experience and the knowledge of the EIB Group on financial instruments and its application in rural development.

The Commission has also launched '*fi-compass*', a comprehensive technical assistance platform, which will provide methodological guidance and awareness-raising support to the Commission, MS and stakeholders in the field of financial instruments supported by ESI Funds in the period 2014–20<sup>8</sup>. As part of its working programme, '*fi-compass*' will produce also EAFRD-specific products.

### IX (a) First bullet

The Commission accepts to identify the challenges, specific characteristics and obstacles to set up financial instruments in EAFRD.

Such analysis will be undertaken in the framework of the activities of the '*fi-compass*', a comprehensive technical assistance platform, which provides methodological guidance and awareness-raising support to the Commission, MS and stakeholders in the field of financial instruments supported by ESI Funds in period 2014–20<sup>9</sup>.

<sup>7</sup> See Statement 14/225 of 14.07.2014.

<sup>8</sup> See more at <http://www.fi-compass.eu>

<sup>9</sup> See more at <http://www.fi-compass.eu>

## Reply of the Commission

### IX (a) Second bullet

The Commission accepts this recommendation which is already partially implemented.

In the context of the ESIF technical assistance platform '*fi-compass*' general and fund-specific guidance on *ex ante* assessments is provided. This covers also the whole EAFRD, as well as specific sectors, such as agriculture and forestry.

### IX (a) Third bullet

The Commission accepts this recommendation, which is already partially implemented.

The Commission has provided standard models for loan and guarantee funds in rural development. Under the ESIF technical assistance platform '*fi-compass*' it is currently investigating the opportunity for another model such as for energy efficiency and renewable energy, which delivery is planned for end of 2015.

With regards to the cooperation with the EIB Group, the Commission signed a specific Memorandum of Understanding (MoU) in respect of cooperation in agriculture and rural development, under which it is expected the EIB will offer a specific FI scheme to MS to be implemented under the EAFRD. A specific event on this MoU is already planned for 23 March 2015.

### IX (a) Fourth bullet

The Commission accepts this recommendation, insofar as rules for the closure of rural development programmes 2007–13<sup>10</sup> are under its scope.

The Commission notes that according to the applicable EU legislation for 2007–13 the development of precise operational implementing rules, including the appropriate exit policy for each financial engineering instrument, is the responsibility of the Member States.

<sup>10</sup> C(2015) 1399 final from 5.3.2015.

### IX (b)

The Commission accepts this recommendation, which is currently being implemented.

The transitional rules for the 2007–13 period have been adopted.

With regard to 2014–20, discussions with Member States will take place when the closure of the 2014–20 period approaches and transitional rules have to be defined.

### IX (c)

This recommendation is for the Member States.

## Introduction

### 05

The EU legislation for 2007–13 does not impose a rule on reutilisation of the initial allocation used for the setting up of financial instruments. Resources not used can be reprogrammed for other forms of assistance.

### 06

The Commission notes that the programming period 2014–20 has just started and most of the ESIF programmes, including RDPs, have not yet been adopted. Moreover, financial instruments may be set up by MS at any time of the programming period.

### 12

After an updated assessment of needs by the Member States and preparation for closure of guarantee funds, the 2013 figure was reduced to 362.69 million euro by the end of 2014.

## 13

According to the principles of subsidiarity and shared management, the setting up of financial instruments, their implementation and the evaluation of the demand lie within the responsibility of Member States. This covers the adoption of all legislative, statutory and administrative provisions at national or regional level, including funding agreements.

The Commission monitors how MS implement their RDPs and in this context verifies how MS implement financial instruments supported by the EAFRD.

The Commission notes that Paying Agencies play an important role in the context of rural development policy and its implementation.

## Audit scope and approach

## 20

The Commission notes that financial instruments in rural development may support also other investment measures such as 311 (diversification of agricultural activities), 312 (creation and development of micro-enterprises in rural areas), 313 (rural tourism), 321 (basic services and infrastructure), etc ... Support provided under LEADER should also be taken into account.

## Observations

## 21

The rules for financial instruments in rural development in 2007–13 have been substantially improved in comparison with the 2000–06 period.

## 22

The Commission is of the opinion that electronic surveys carried out at closure do not fully capture the reasons for not setting up financial instruments in the beginning of a programming period.

## 23

The Commission considers that it has adequately evaluated and addressed the specific characteristics of rural development when designing the 2007–13 legal framework. In particular, Regulation (EC) No 1698/2005 outlines more than 30 different measures targeting a well-defined group of beneficiaries and incorporates the eligibility criteria as well as specific requirements with which financial instruments supported by the EAFRD have to comply. This is further elaborated in the provisions of the implementing Regulation No 1974/2006.

See also the reply to paragraph 21.

The Commission notes that beneficiaries in rural development are farms of all sizes. Small-scale farming in the EU has different dimensions and is country-, region- and/or sub-sector- specific. At the same time, farmers are not the only beneficiaries in rural development.

Cohesion policy, in principle, does not support agriculture, but similarly to rural development policy covers many micro and small non-agricultural enterprises.

## 26

The EU legal framework for the 2007–13 programming period provides for large flexibility in the implementation of rural development measures. In this context, the Commission takes the view that needs and opportunities are described with sufficient clarity to make the programming of the financial instruments appropriate and possible. When approving the RDPs or their modifications, the Commission carries out an analysis to assess that programmes and measures are consistent with the EU strategic guidelines, relevant national strategy plans and that they comply with the relevant legal provisions.



Each rural development measure under which financial instruments were supported had clearly and well-established objectives, in line with the EU legislation and the National Strategy Plans. The EU legislation does not require the setting up of solely measurable objectives.

As regards the 2014–20 programming period, *ex ante* quantified targets are set for each of the focus areas of the EU priorities in relation to the EAFRD. The content of the programme shall contain a description of the strategy and show that the selected measures in relation to the EU priorities are based on sound intervention logic supported by an *ex ante* evaluation.

### Box 2

The objectives indicated were consistent with the general situation of absence of credit facilities. RDPs develop further objectives in the context of the measures under which financial instruments are supported. Funding agreements between MS and fund managers may also contain justifications and objectives related to the respective financial instrument.

These general reasons explain the need to set up a loan fund. The details regarding the full justification for the use, the specific objectives to reach and the exit strategy are all points that are included in the 'Financing Agreement' signed between ETEAN (fund manager) and the Ministry (managing authority).

This confirms the consistency of the programming approach and its compliance with the EU legislation. Lithuania and Romania were suffering a very severe credit crunch which made it impossible for beneficiaries to secure bank loans for their projects.

Further objectives are defined under the measures.

See above for Romania.

### 27

The requirement of carrying out an *ex ante* assessment of expected losses was introduced in 2011 as regards EAFRD co-financing of operations comprising guarantee funds<sup>11</sup>. Such *ex ante* assessments shall take into account current market practices for similar operations for the type of investments and the market concerned for which the guarantee funds are to be established.

As regards the 2014–20 programming period, the undertaking of an *ex ante* assessment, the content of which is legally defined, is obligatory for any operation comprising financial instruments co-financed by the EAFRD<sup>12</sup>.

In 2007–13, the legislation required the candidates for fund managers to submit a business plan with a concrete content, which had to be evaluated by the managing authority.

The Commission notes that all financial instruments supported by the EAFRD in 2007–13 were set up in the context of the financial and economic crisis during which access to credit was burdened and liquidity problems were evident throughout Europe.

In Bulgaria, for instance, an *ex ante* assessment of the expected losses/gap analysis was done prior to fixing the exposure rate and determining the final amount of the fund's capital. In Romania, an ongoing assessment took place following the change in the 2007–13 legislation which required the undertaking of *ex ante* assessment of expected losses for guarantee funds as of 2011. In the context of the discussions in the RDC on closure of financial instruments, Italy officially confirmed its approach with regards to the undertaking of *ex ante* assessments in the 2007–13 period.

Lack of liquidity and/or difficulties for farmers in the access to credits are also serious reasons justifying the use of specific financial tools by Member States.

<sup>11</sup> Commission Regulation (EU) No 679/2011 from 14 July 2011.

<sup>12</sup> Article 37(2) of Regulation (EU) No 1303/2013.

### 28

Financial instruments in rural development are suitable for all potential investors in enterprises that could be supported by the EAFRD.

In 2007–13 period the Commission improved the legislation by introducing a requirement for *ex ante* assessment of expected losses for guarantee funds.

With regard to the 2014–20 programming period, an assessment of needs will be required in all cases where a MS decides to contribute EAFRD funding to a financial instrument<sup>13</sup>. In addition the provisions on phased-in payments provide an additional safeguard.

See also replies to paragraphs 21 and 22.

### 30

The Commission notes that contributing to funds is not sufficient for considering the contributed amounts eligible at closure.

### 31

The Commission would like to emphasise that the declared expenditure was accounted for correctly. However, the Commission has also observed during its own audits in some Member States that transfers to the funds of financial instruments have been relatively excessive in relation to the follow up uptake of the instruments by the final recipients.

The Commission notes that the nature of the financial instruments does not allow immediate spending of all amounts transferred to it. Financial instruments need time to develop into well-functioning mechanisms and need an initial liquidity to ensure smooth investments in enterprises.

The issue of overcapitalisation<sup>14</sup> is addressed by the provisions of Article 41 of Regulation (EU) No 1303/2013 where phased-in payments, based on achievement of concrete disbursement results, have been introduced as a general rule for all financial instruments in 2014–20.

<sup>13</sup> Article 37(2) of Regulation (EU) No 1303/2013.

<sup>14</sup> The Court, in its audit SR 2/2012 refers to over-sizing of financial instruments, and not overcapitalisation.

### 32

The payment of a full amount in a single contribution from the RDP to the fund was in line with the EU legislation. The amount of interest generated remained at the disposal of the Guarantee Fund for providing new guarantees. This amount will be cleared at the closure of the financial instruments.

The placement of unused EAFRD amounts into interest-bearing accounts, which generates additional income that can be used by the financial instruments, is considered a good practice. EAFRD funds that are to be used for grants under the programmes can also be placed into interest-bearing accounts.

In the case of Romania, an ongoing evaluation of expected losses has been undertaken and the overall budget of the financial instruments operating there and supported by the EAFRD has been adjusted to reflect the results from this assessment.

### 33

Article 52(3) of Regulation (EC) No 1974/2006 defines strictly what happens with resources returned to the operation during the programming period from investments undertaken by funds or left over after a guarantee has been honoured (i.e. they have to be used according to the funding agreement, or cleared in the context of the annual accounts).

A guarantee provided is backing up a loan which a final recipient is taking from a financial intermediate. By returning that loan back (and any potential interest associated with it) the final recipient confirms the implementation of an operation supported by the EAFRD and as a result it releases the guarantee, which can no longer be associated with the EAFRD budget as it is already 'consumed', i.e. used at least once. The Commission does not consider this as being against the principles of sound financial management.

At closure, the eligible expenditure of guarantee funds covers all guarantees that have been released following successful returns of loans within the programming period as well as an amount covering only the risk associated with the active guarantees (but not the overall amount of active guarantees that are issued). The part of the active guarantees which is not considered eligible is to be returned to the programme.

See also reply to paragraph 31.

### 34

Financial instruments supported by the EAFRD ensured access to funding to beneficiaries for whom the financial markets have not been offering an option of covering the project or its private co-financing part. In relation to the 2014–20 programming period financial instruments cannot be used to pre-finance grants, grants cannot be used to reimburse support under financial instruments and the combination of support provided through grants and financial instruments may cover the same expenditure item provided that the sum of all forms of support combined does not exceed the total amount of the expenditure item concerned<sup>15</sup>.

### Box 3

Financial instruments played an important role in the context of the financial and economic crisis, especially for MS where the financial conditions were tight and/or where co-financing was difficult to be provided by beneficiaries.

### 35

The Commission notes that the EAFRD contributes to financial instruments with public amounts (EAFRD and national co-financing).

Financial instruments are not necessarily an alternative to grant, as grants and financial instruments can be used together within the context of a single operation and in line with the applicable rules on state aid.

<sup>15</sup> Article 37(7) (8)(9) of Regulation (EU) No 1303/2013.

In accordance with Articles 15, 71(5) and 71(2) of Regulation (EC) No 1698/2005 applicants willing to receive support provided by a financial instrument were evaluated against the selection criteria fixed for the respective measure by the competent body, as expenditure was eligible for an EAFRD contribution only where incurred for operations decided by the managing authority of the programme in question or under its responsibility, in accordance with the same selection criteria.

The Commission considers that the programming of financial instruments was done in accordance with the EU legislation and the applicable state aid rules.

### 36

There is no EU legal requirement in rural development for the 2007–13 programming period that obliges the sum of all forms of support combined not to exceed the total amount of the expenditure item concerned. It is also to be noted that guarantees, in principle, back up to 80 % of the (private) part of the investment.

See also the replies to paragraphs 34 and 35.

### 37

See Commission reply to paragraph 34.

### 38

Commission audits also pointed out this risk. However, it is difficult to conclude that the level of the transfer in capital is automatically linked to the purpose of circumventing the N+2 rule rather than a slower than foreseen execution of the programme. In several cases, the MS transferred the full budgeted capital even though they did not have a 'N+2 issue'.

Contributions from the RDPs to financial instruments may be done at any time of the programming period.

See also the reply to paragraph 26.

### Box 4

The intention was to speed up the activation of the Loan Fund because discussions and negotiations had taken longer than anticipated. All parties involved wanted to launch the financial instruments without further delays. The administrative preparations ended in December 2013 when the Loan Fund was formally set up.

The Commission notes that even within the maximum range of these estimates, the funds remaining for grants (between 70 % and 90 %) are quite significant.

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

See also replies to paragraphs 31, 38 and 39.

### 40

The Commission acted in accordance with the rules.

The Commission notes that in case of a lower spending, MS have to return funds to the programmes which will increase the risk of de-commitment for the year in which the reprogramming occurs.

See also Commission replies to paragraphs 31 and Box 4.

### 41

See Commission reply to paragraph 31.

### 42

The Commission notes that the determination of the potential market is made *ex ante*, while the instruments may operate by the closure of the RDPs and in the context of changing financial markets and economic conditions. The situation of the financial instruments operating at EU level is similar.

The determination of the potential market, which is a very broad concept, is not the only factor used to define and estimate the fund's capital. Factors such as the total available budget under the measures, investment needs, assessment of the value added of the financial instruments, contribution of the financial instruments to measures' objectives, etc. have to be taken into account as well.

### 43

In the case of Bulgaria, the proposal covered measures under which financial instruments cannot be established.

As regards Italy, at the time of payment to the guarantee fund, the amounts declared by the regions did not appear disproportionate.

See also the reply to paragraph 39 concerning Sicily.

In the case of Lithuania, the overcapitalisation only occurred when the credit crunch eased and the banks started giving loans. Lithuania decided to reduce the size of the financial instrument.

In Romania, the overcapitalisation reflected the inability of the financial instruments to mobilise commercial credits in a context of a deep financial crisis and contraction of the demand, where the profitability of any investment was seriously questioned.

See also the reply to paragraph 32.

### Box 5

The limited use of the Fund in 2014 can be attributed to the late set up (December 2013), the continuing reluctance of investors in view of the severe economic crisis in the country, the lack of sufficient experience with this type of instruments and other developments in the country which were not conducive to investments.

The Commission considers it a good practice which shows how a MS operates with budgets in accordance with evolving financial situation in the programme area and existing demand for funding.

An *ex post* comparison does not mean that at the time of setting up the financial instruments the amount foreseen was overestimated. There were also other reasons justifying the contribution from the RDP to the Fund such as those as described in point 42.

### 44

See Commission reply to paragraph 28.

### Box 6

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

See also the reply to paragraph 31.

As regards Bulgaria, the initial investment potential proposed by the MS was reduced following the Commission's review. The responsibility for the setting up and implementation of the financial instruments, including the undertaking and examination of the *ex ante* assessment, lies with the MS. It is not for the Commission to provide specific regionalised or national type of expertise for calculation of specific technical elements linked to financial instruments.

As regards Romania, see Commission reply to paragraph 43.

### 45

Financial markets are dynamic and can change as proven by the recent financial and economic crisis. Therefore long-term predictions may prove unreliable. For this reason, the EU legislation for the 2014–20 programming period allows each *ex ante* assessment to contain provisions on possible reviews and updates in the medium to long-term to reflect accurately potential changing market conditions.

### 46

The Commission notes that there is no EU definition of the risk exposure ratio in the EU legislation for the period 2007–13.

For the 2014–20 programming period, assessment of risk exposure ratio referred to in Article 42(1)(b) of Regulation (EU) No 1303/2013 as *ex ante* risk assessment, reflects the need for appropriate programme contribution to cover expected and non-expected losses from the new loans.

### 47

The Commission considers that a guarantee fund guaranteeing 20 % of the loan portfolio and at the end having only 1 % of the guarantees called in is, in fact, an example of well-performing loans.

The multiplier ratio should be calculated on a case-by-case basis, but the 20 % in this case is rather low and should not raise questions of possible overcapitalisation (even under general state aid framework a guarantee cap of 25 % can be automatically exempted from the notification threshold cf. Article 21 of GBER).

It is also the opinion of the Commission that the low level of default reflected also the unwillingness of the banking sector to support riskier operations.

### 48

The Commission notes that the total amount of guarantees issued to final recipients by the end of 2013 is 249,6 million euro, which is about 60 % of the contribution to the funds.

The Commission notes that financial instruments audited by the Court are still active and will continue with their activities in 2014–15.

See also replies to paragraphs 12 and 39.

### 49

Such step-by-step approaches were also undertaken in Lithuania and Latvia where loan funds were set up.

### 52

The Commission notes that some financial instruments became operational at the end of the audit and still have two more years of implementation.

### 53

The average disbursement rate calculated for the entire population of financial instruments does not reflect the speed of the implementation of particular funds. In the area of the cohesion policy, a significant number of funds were established only in 2012. For these funds the low absorption rate at the end of 2012 should not be worrying.

The financial instruments can only be assessed in terms of revolving impact at the end of their life cycle, especially as regards those set up at the end of the programming period.

### 55

In reality, the situation in the financial market improved and there are fewer failures than in the past (see earlier example in paragraph 47 with a guarantee of 20 % which resulted in 1 % lost loans only).

### 56

See Commission reply to paragraph 55.

### 57

These modifications reflected the actual needs of the financial instruments. Resources not used through financial instruments were reprogrammed and used for other forms of assistance.

### 58

There is still time for disbursement of funds under these instruments. The Commission can only confirm how much is paid to final recipients at the end of the programming period.

See also Commission reply to paragraph 55.

### 59

See Commission replies to paragraphs 52 and 58.

### 60

The Commission considers that the use of public funding in well-functioning markets (or those which are significantly restoring their proper functioning) needs to be carefully evaluated for avoiding distortion of competition.

In the case of Greece, the fund was only set up in late 2013 and therefore the actual disbursement to final beneficiaries only started in mid-2014. In the case of Lithuania, the banking system managed to restart the normal credit flow at the end of 2012, rendering EAFRD resources partly unnecessary. The same was the case with Latvia where the fund had also a specific focus.

### 61

The EU legislation does not require MS to use immediately the resources paid back to the fund. The arrangements for revolving are agreed in the funding agreement and depend on the particular situation and the context in which the financial instrument operates. MS, for example, may want to 'collect' resources paid back and launch a financial instrument for a new financial product or a new target. The 2007–13 legislation allows the reuse of resources for financial instruments for an indefinite period.

### 62

For the 2014–20 period an improved system of monitoring and reporting has been put in place, enshrined in the provisions of Article 46 of Regulation (EU) No 1303/2013, allowing the assessment of performance in terms of revolving and leverage effects.

### 63

Achieving high leverage is not the main objective of financial instruments. Financial instruments are the delivery mode of support from the programme to final recipients. The effects produced by the financial instruments (e.g. revolving or leverage) are the advantages but not the objectives themselves.

The leverage which may vary between sectors, regions, financial products should be agreed on in the funding agreement in relation to the specific financial instrument.

As regards the participation of private investors, the Commission would like to refer to the state aid legislation on risk capital finance (GBER) which requires certain participation of a private investor. The Commission's definition of leverage mechanism includes all contributions (private and public) in addition to the EU funds.

### 64

The definition of leverage embedded in the Financial Regulation states that any public contribution in addition to EU Contribution counts as leverage.

The EAFRD does not represent any exception to the rest of the shared management funds.

### 65

Article 37(2) of Regulation (EU) No 1303/2013 does not provide a definition of the leverage and in no way should be treated as derogation to provisions under the Financial Regulation. It only requires the *ex ante* assessment to take into account the expected leverage effect from the setting up of financial instruments. However, Article 39(5) of CPR, for example, provides a way for calculating leverage.

In accordance with the applicable regulations, rural development policy co-financing obligation is set at the programme level. Individual operations (e.g. funds) may or may not have national co-financing.

### 66

See also replies to paragraphs 63–65.

### 67

See Commission reply to paragraph 60.

### Box 7

The Commission considers that estimates should take into account actual amounts made available to the funds after most recent RDP modifications as they impact on the calculation of leverage.

### 68

Setting up financial instruments under the EAFRD implied a whole new concept for some Member States which required a learning process. The delays were in most cases explained by the novelty of the instruments in rural development policy, public procurement and state aid-related issues.

The Commission deployed intensive promotion and information activities on the use of financial instruments throughout rural development committees, networks, trainings and awareness-raising activities, bilateral meetings with Member States and comprehensive guidelines.

For the new programming period, the Commission also provided the necessary guidance in relation to the implementation of the financial instruments. In particular, the Commission informed the Member States on the different available options to put managing authorities in a position to use the financial instruments as appropriate.

In 2014–20, the already established funds will continue or new funds based on models proposed by the Commission (such as the off-the-shelf instruments)<sup>16</sup> can be established. It is expected that in this way delays will be significantly reduced.

<sup>16</sup> Commission Implementing Regulation (EU) No 964/2014 of 11 September 2014 laying down rules for the application of Regulation (EU) No 1303/2013 of the European Parliament and of the Council as regards standard terms and conditions for financial instruments.



### Box 8

In some Member States, the financial crash and subsequent economic crisis provoked a situation of insolvent demand (failed or bankrupted companies). This, among other external factors, explains the delays and low uptake of the Funds.

### 69

The Commission considers that the assessment of performance of financial instruments should also focus on the achievement of results by the co-funded financial instruments, including the revolving and leveraging effects. Moreover, the assessment should take account of the different situations that can occur. The evolution of the values for each indicator will need to be carefully judged against the context. Indicator values taken in isolation cannot assess the performance.

Financial instruments are the means of delivering programme support to final recipients. The main performance indicator is therefore the programme contribution spent in line with the programme objectives.

The Commission considers that the effect of leverage and revolving are negatively correlated (the higher the leverage, the lower the revolving).

Moreover, the Commission points out four performance indicators enshrined in Article 12 of Regulation (EU) 480/2014.

### 70

The Commission notes that there were no common indicators for the financial instruments in the 2007–13 CMEF. However, CMEF foresees the use of additional indicators<sup>17</sup> to be defined by the MS to allow the monitoring and evaluation of the specificities of the RDPs. There is a balance to be found between a reasonable amount of common indicators to be monitored by all RDPs and the additional indicators to be monitored for some RDPs where necessary. Any performance indicators should be agreed on between the managing authority and the financial instrument.

<sup>17</sup> Article 81(2) of Regulation 1698/2005.

As regards the 2014–20 framework, performance indicators are set in Article 12 of Regulation (EU) No 480/2014. In addition, Member States are obliged to report on financial instruments on a regular basis as required by Article 46 of Regulation (EU) No 1303/2013.

### Common Commission reply to paragraphs 72 to 75

The winding up and exit arrangements are to be defined by the managing authority in the funding agreement with the fund manager, ensuring that the relevant provisions are adequately taken on board.

Under shared management and in line with the subsidiarity principle, the Commission must satisfy itself that the Member States set up adequate management and control systems.

For the period 2007–13, the Commission gave guidance to any MS which has requested it. The Commission is currently preparing guidelines on the closure of the 2007–13 programmes.

The Commission will provide more consolidated and improved guidance for the period 2014–20. The respect of the legal rules and guidance will be verified during the clearance of accounts.

### 77

These provisions are not included in the legislation. The Commission recommends to the Member States to comply with the provisions included in the guidelines.

The divergent interpretations were clarified in the context of the RDC discussions in 2014.

### 78

See replies to paragraphs 61 and 72–75.



## Reply of the Commission

### 79

The Commission notes that EAFRD resources returned to funds after being used at least once are no longer EU resources. After closure it is the responsibility of Member States to use them for the benefit of individual undertakings as established by the EU legislation, respecting the applicable rules on state aid. These resources can also be used for other financial instruments.

See also replies to paragraphs 5, 33, 61 and 72–75.

### 80

The Commission is undertaking its responsibilities in relation to the closure of RDPs 2007–13.

Any activity going beyond the closure of the programmes and not concerning the EU budget is the responsibility of the Member States.

### 82

It is the Commission's opinion that there are many other legal provisions in the new legislation applicable to financial instruments in rural development (e.g. provisions on control, eligibility of expenditure, reuse of funds, combinations of financial instruments with grants, the possibilities of appointing various bodies as fund managers, including the options provided for managing authorities, selection of intermediaries and final recipients, management costs and fees, etc.).

### 83

The Commission considers that the new legislation sufficiently addresses the issue and mitigates potential risks.

See also Commission replies to paragraphs 31 and 41.

### 84

See Commission replies to Box 4 and paragraph 31.

### 85

The legislator placed the examination of *ex ante* assessment in the remit of the managing authorities.

### 86

In addition to the mandatory *ex ante* assessments and the phased-in payments, the new legislation contains other adequate safeguards to mitigate this potential risk, such as monitoring and comprehensive reporting.

The Commission also notes that in 75 % of the cases (9 out of 12), the used risk exposure ratios are within the range of 2 to 5.

As a general rule, in 2014–20, the payment of the subsequent instalments is conditional on the previous capital absorption.

### 87

According to the EU legislation financial instruments can be set up at any time during the programming period 2014–20. The implementation in the period 2014–20 can start immediately after the adoption of the new programmes and already in 2015. For example, in January 2015 the Dutch RDP 2014–20 was adopted, which also foresees the setting up of a financial instrument supported by the EAFRD<sup>18</sup>.

See also Commission reply to paragraph 68.

### 88

Financial instruments should provide programme support in the situation of market failures and/or suboptimal investment or specific investment needs. Continuing with programme support in the market where public intervention is not needed anymore is not in line with the state aid rules and against the principle of sound financial management.

<sup>18</sup> See the respective presentation on <http://www.fi-compass.eu>

The term of the financial product will depend primarily on the type of investment to be supported. Long-term investment in infrastructure projects will have a different life cycle than short-term investments in micro-credit.

See also replies to paragraphs 43, 60 and Box 5.

### 89

See Commission reply to paragraph 5.

### 91

As regards the EAFRD, the performance is mainly assessed through evaluations. The mid-term evaluations concerning the 2007–13 implementing period came too early to evaluate the results and performance of financial instruments. Assessing the impact of rural development can only be done after sufficient time has passed, hence more results are expected in the context of the *ex post* evaluations carried out by the Member States, which will be synthesised by the Commission in 2017.

See also Commission reply to paragraph 70.

### 91

Private participation is not considered leverage in the Financial Regulation.

The leverage ratio depends on the type of financial instrument, the region and the type of projects. Therefore leverage target cannot be part of a regulatory framework. The Commission is currently developing guidance on leverage.

### 95

EAFRD support in 2007–13 is provided under the agricultural state aid rules and in line with Council Regulation (EC) No 1698/2005 and Commission Regulation (EC) No 1974/2006.

See also Commission replies to paragraphs 35 and 37.

In the period 2014–20 a common guidance is provided for the policies under shared management on issues related to financial instruments and the same approach is established towards access to funds across all these policies.

## Conclusions and recommendations

### 96

The Commission notes that financial instruments were implemented in 7 Member States in 2007/2013 which is a significant improvement compared to the 2000/2006 period where only two Member States used them.

The EU legal framework for the 2007–13 programming period provides for a large flexibility in the implementation of the rural development measures. The Commission is of the opinion that the 2007–13 legal framework takes into account the specificities of rural development and this is reflected in the financial instruments supported by the EAFRD. Council Regulation No 1698/2005 and Commission Regulation (EC) No 1974/2006 define the scope and area of intervention of the EAFRD, including specific support measures<sup>19</sup>. Each rural development measure contains various eligibility rules and provisions, which must be respected by financial instruments created under the measure and should form part of the funding agreement.

The requirement of carrying out an appropriate *ex ante* assessment of expected losses was introduced in 2011 as regards EAFRD co-financing of operations comprising guarantee funds<sup>20</sup>.

<sup>19</sup> For instance support for investments in modernisation of agricultural holdings, adding value to agricultural and forestry products, creation and development of micro-enterprises in rural areas, diversification into non-agricultural activities, village renewal, etc.

<sup>20</sup> Commission Regulation (EU) No 679/2011 from 14 July 2011.

<sup>21</sup> Article 37(2) of Regulation (EU) No 1303/2013.

As regards the 2014–20 programming period, the undertaking of an *ex ante* assessment is obligatory for any operation comprising financial instruments co-financed by the EAFRD<sup>21</sup>. The legislation provides incentives to MS to use financial instruments and gives them the possibility to immediately launch such instruments based on ready-to-implement models such as the off-the-shelf models. The Commission is also providing the necessary guidance to MS and stakeholders, and will continue doing this throughout the rest of the period 2014–20.

### 97

The Commission is of the opinion that the legal framework for the programming period 2014–20 addresses the concerns raised by the Court sufficiently well.

The issue of overcapitalisation is addressed by the provisions of Article 41 of Regulation (EU) No 1303/2013 where phased-in payments, based on achievement of concrete disbursement results, have been introduced as a general rule for all financial instruments in 2014–20.

The key performance issues are well addressed in the monitoring of financial instruments supported by ESIF, as defined in Article 46 of Regulation (EU) No 1303/2013. Moreover, the Commission points out four performance indicators enshrined in Article 12 of Regulation (EU) 480/2014.

In addition, in order to encourage the use of financial instruments, the Commission strengthened its cooperation in the field of agriculture and rural development with the European Investment Bank (EIB) and signed a Memorandum of Understanding on 14 July 2014<sup>22</sup>. This cooperation includes the possibility of utilising the experience and the knowledge of the EIB Group on financial instruments and its application in rural development.

<sup>22</sup> See Statement 14/225 of 14.07.2014.

The Commission has also launched '*fi-compass*', a comprehensive technical assistance platform, which will provide methodological guidance and awareness-raising support to the Commission, MS and stakeholders in the field of financial instruments supported by ESI Funds in the 2014–20 period.<sup>23</sup> As part of its working programme, '*fi-compass*' will produce also EAFRD-specific products.

### 98

According to the principles of subsidiarity and shared management, the setting up of financial instruments, their implementation and the evaluation of the demand lie within the responsibility of Member States.

Setting up financial instruments under the EAFRD implied a whole new concept for some Member States which required a learning process. The Commission deployed intensive promotion and information activities on the use of financial instruments throughout rural development committees, networks, trainings and awareness-raising activities, bilateral meetings with Member States and comprehensive guidelines.

The Commission considers that the new legislation provides sufficient incentives (e.g. higher co-financing rate<sup>24</sup>, national co-financing provided later during the implementation period, pre-financing of investment as opposed to reimbursement of occurred expenditure in the case of grants) and investment-related ones (e.g. different eligibility of VAT<sup>25</sup>, eligibility of working capital<sup>26</sup>) offer enough advantages in comparison with grants.

<sup>23</sup> See more at <http://www.fi-compass.eu>

<sup>24</sup> According to Article 59(4)(d) of Regulation (EU) No 1305/2013, the contribution rate applicable to the measure concerned shall be increased by additional 10 percentage points for contributions to FIs as referred to in point (b) of Article 38(1) of Regulation (EU) No 1303/2013, and shall be 100 % for Union-level FIs referred to in point (a) of Article 38(1) of Regulation No 1303/2013. Similar approach is undertaken for the contributions to FIs by the ERDF and the CF.

<sup>25</sup> Article 37(11) of Regulation (EU) No 1303/2013.

<sup>26</sup> Article 45(5) of Regulation (EU) No 1305/2013.

In 2014–20, the already established funds will continue or new funds based on models proposed by the Commission (such as the off-the-shelf instruments)<sup>27</sup> can be established.

The legislator defined financial instruments as a type of support in the 2007–13 and 2014–20 programming periods for the implementation of specific rural development measures.

### Recommendation 1

The Commission accepts to identify the challenges, specific characteristics and obstacles to set up financial instruments in EAFRD.

Such analysis will be undertaken in the framework of the activities of the *'fi-compass'*, a comprehensive technical assistance platform, which provides methodological guidance and awareness-raising support to the Commission, MS and stakeholders in the field of financial instruments supported by ESI Funds in period 2014–20.<sup>28</sup>

The remaining elements of the recommendation are addressed to the Member States.

### 99

According to the principles of subsidiarity and shared management, the setting up of financial instruments, their implementation and the evaluation of the demand lie within the responsibility of Member States.

Financial instruments need to have certain liquidity to ensure smooth investments in enterprises.

<sup>27</sup> Commission Implementing Regulation (EU) No 964/2014 of 11 September 2014 laying down rules for the application of Regulation (EU) No 1303/2013 of the European Parliament and of the Council as regards standard terms and conditions for financial instruments.

<sup>28</sup> See more at <http://www.fi-compass.eu>

### Recommendation 2

The Commission accepts this recommendation which is already partially implemented.

In the context of the ESIF technical assistance platform *'fi-compass'* general and fund-specific guidance on *ex ante* assessments is provided. This covers also the whole EAFRD, as well as specific sectors, such as agriculture and forestry.

### 100

The Commission considers that the performance is mainly assessed through evaluations. Assessing the impact of rural development can only be done after sufficient time has passed, hence more results are expected in the context of the *ex post* evaluations carried out by the Member States, which will be synthesised by the Commission in 2017.

Managing authorities reported specific information on operations comprising financial instruments as an annex to the annual progress reports, such as leverage and performance.

The Commission considers that it has performed its supervisory duties adequately.

### Recommendation 3

The Commission accepts this recommendation, which is already partially implemented.

The Commission has provided standard models for loan and guarantee funds in rural development. Under the ESIF technical assistance platform *'fi-compass'* it is currently investigating the opportunity for another model such as for energy efficiency and renewable energy, which delivery is planned for end of 2015.

With regard to the cooperation with the EIB Group, the Commission signed a specific Memorandum of Understanding in respect of cooperation in agriculture and rural development, under which it is expected the EIB will offer specific FI scheme to MS to be implemented under the EAFRD. A specific event on this MoU is already planned for 23 March 2015.

**101**

Financial markets are dynamic and can change as proven by the recent financial and economic crisis. Therefore long-term predictions may prove unreliable. For this reason, the EU legislation for the 2014–20 programming period allows each *ex ante* assessment to contain provisions on possible reviews and updates in medium to long-terms to reflect accurately potential changing market conditions.

**Recommendation 4**

The Commission accepts this recommendation, which is currently being implemented.

The transitional rules for the 2007–13 period have been adopted.

With regard to the 2014–20 period, discussions with Member States on closure will take place when closure of the 2014–20 period approaches and transitional rules have to be defined.

The Commission provided in 2014 its guidance to managing authorities on financial instruments in ESIF programmes 2014–20.

**Recommendation 5**

This recommendation is for the Member States

**103**

The Commission notes that it is the responsibility of the national authorities to ensure that individual operations are implemented in accordance with the applicable legal provisions. The Commission evaluates the issues related to financial instruments during its audit missions.

According to the applicable EU legislation for 2007–13, the winding up and exit arrangements are to be defined by the managing authority in the funding agreement with the fund manager, ensuring that the relevant provisions are adequately taken on board. Under shared management and in line with the subsidiarity principle, the Commission must satisfy itself that the Member States set up adequate management and control systems.

For the period 2007–13, the Commission gave guidance to any MS which has requested it. The guidelines on closure of the 2007–13 rural development programmes were adopted in 2015<sup>29</sup>. The respect of the legal rules and guidance will be verified during the clearance of accounts.

The Commission will provide more consolidated and improved guidance for the period 2014–20.

**Recommendation 6**

The Commission accepts this recommendation, insofar as rules for the closure of rural development programmes 2007–13<sup>30</sup> are under its scope.

The Commission notes that according to the applicable EU legislation for 2007–13 the development of precise operational implementing rules, including the appropriate exit policy for each financial engineering instrument, is the responsibility of the Member States.

29 C(2015) 1399 final from 5.3.2015.

30 C(2015) 1399 final from 5.3.2015.



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The Court examined the success of financial instruments (loan and guarantee funds) in rural development during 2007-2013 and their potential for the 2014-2020 period. It found that they had so far been unsuccessful, mainly because they were overcapitalised and had not fulfilled their potential in terms of the desired leverage and revolving effects. As for 2014-2020, despite improvements in the background legislation, the Court concluded that it would still be a considerable challenge to achieve the desired impact.



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