The Role of Financial Instruments and their Impact on the SME Sector

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Abstract

This paper deals with the role of the financial instruments and with their impact on the SME sector, in connection to the Cohesion Policy 2014-2020 and the objectives of Europe 2020 Strategy. For this purpose, the first part of the work presents several general considerations on the financial instruments, while the second part analyzes the main types of financial instruments, with a focus on their importance and role in the SME sector.

Keywords: *financial instruments, SME, Cohesion Policy, Europe 2020 Strategy*

JEL classification: M10, M20

Introduction

In 2014-2020, 351.8 billion Euros (approx. one third of the total EU budget) have been allocated to the Cohesion Policy, having in view the fact that this is the main EU investment policy that addresses all EU regions and supports job creation, business competitiveness, economic growth, sustainable development and improved life quality (see EU Cohesion Policy 2014-2020, available http://ec.europa.eu/regional_policy/sources/docgener/informat/basic/basic_2014_en.pdf).

Cohesion Policy has a strong impact in many fields. For the period 2014-2020, cohesion policy primarily focuses on (see EU Cohesion Policy 20142020 availlable at http://ec.europa.eu/regional_policy/sources/docgener/informat/basic/basic_2014_en.pdf):

- the employment;
- the innovation;
- the social inclusion;
- the climate/energy;
- the education.

"The financial instruments are an effective way - in terms of resource - for the mobilization of the resources from the Cohesion Policy, in order to achieve the growth objectives agreed in the Europe 2020 strategy (see Europe Strategy 2020, available at ec.europa.eu/eu2020) on employment, innovation, education, social

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inclusion and climate/ energy.

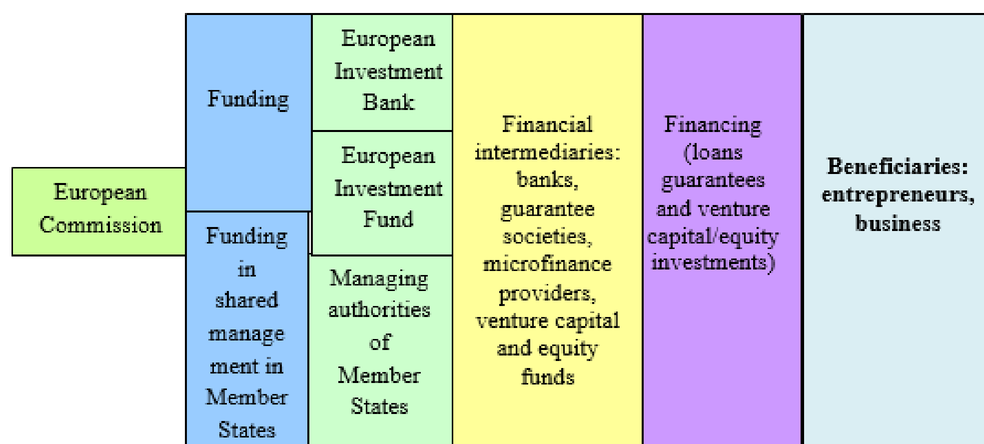
Targeted towards projects with potential economic viability, these financial instruments provide support for investments through loans, guarantees, equity investments and additional risk-bearing mechanisms, which can be combined with technical assistance, interest rate subsidies or contributions to the guarantee fees within the same operation" (see http://ec.europa.eu/regional_policy/ ro/information /publications/brochures/2014/financial-instruments-in-cohesion-policy-2014-2020).

1. Financial Instruments within the Cohesion Policy 2014-2020 in the EU. General Considerations

The role of financial instruments has greatly increased (the financial instruments are used in order to perform investments with structural funds, starting with the programming period 1994-1999) in the current period, i.e. 2014-2020, as a result of the current economic situation. In this regard, the current background is characterized by increasingly limited public resources and benefits, evident in the long term, by the re-use of the funds originally allocated and by the mobilization of private funds alongside public funding provided by financial instruments (see Financial instruments in ESIF programmes 2014-2020 available at http://ec.europa. eu/regional_policy/sources/thefunds/fin_inst/pdf/fi_esif_2014_2020.pdf).

Figure 1 below presents the working of the EU financial instruments.

Figure 1. The working of financial instruments



Source: The Investment Plan for Europe current and future, Brussels, 26 January 2017

For the current programming period, the European Commission encourages Member States to redouble their investments from European Structural and Investment Funds (ESIF) 2014-2020 through financial instruments, in accordance with the objectives of the Investment Plan (Junker).

- In order to encourage and increase the use of financial instruments in the current period, as a more efficient and sustainable alternative that complements

the traditional financing based on grants, a legal and policy framework were provided for the period 2014-2020, that (see Financial instruments in ESIF programmes 2014-2020 available at http://ec.europa.eu/regional_policy/ sources/thefunds/fin_inst/pdf/fi_esif_2014_2020.pdf):

- provide greater flexibility for Member States (MS) and EU regions in terms of target sectors and implementing structures;

MS and managing authorities (MA) may use financial instruments related to all the thematic objectives covered by their Operational Programmes (OP) 2014-2020, for all funds, if this is efficient and effective.

- financial instruments can be combined with other forms of support (such as grants);
- ensure the compatibility with the financial instruments set up and implemented at EU level;
- provide a stable framework for implementation, based on a clear and detailed set of rules, on existing guidelines and concrete experiences.

The EU Financial Regulation no. 966/2012 includes a section on Financial Instruments (in general), i.e. Title VIII (articles 139-140), describing the scope, the principles and the conditions applicable to financial instruments (see Financial Regulation, http://ec.europa.eu/smart-regulation/evaluation/docs/ syn_pub_rf_mode_ en.pdf); these are detailed in the Implementing Rules of the Financial Regulation, namely the Commission Delegated Regulation (EU) no. 1268/2012, articles 216-226.

The Regulation (EU) laying down common provisions (CPR no. 1303/2013) includes a separate section on the Financial Instruments funded from the 5 European funds reunited under the title European Structural and Investment Funds (ESI Funds), Title IV (articles 37-46), which present clearly the particularities of financial instruments, the setting and implementation of financial instruments. It also presents the contributions from European structural and investment funds (ESIF) 2014-2020 to the financial instruments for SMEs, their management and control, use and reuse of the resources allocated to financial instruments, their reporting. Details on the implementation of the provisions relating to the financial instruments of the General Regulation (CPR), mentioned above, are included in (see http://ec.europa.eu/regional_policy):

- Commission Delegated Regulation (EU) no. 480/2014 supplementing Regulation no. 1303/2013 (i.e., criteria for selecting the implementation bodies of financial instruments, level of financial corrections; thresholds for costs and management fees);

- Implementing Regulation (EU) no. 821/2014, laying down detailed rules for applying Regulation no. 1303/2013 regarding the arrangements for the transfer and management of the contributions to the Programmes, reporting financial instruments, information and communication features, recording and storing data system;

- Implementing Regulation (EU) no. 964/2014, laying down detailed rules for applying Regulation no. 1303/2013 as regards the standard terms and conditions of financial instruments.

2. Types of Financial Instruments within the Cohesion Policy 2014-2020 in the EU

Since this is a special spending category of European funds, the development and successful implementation of financial instruments depends on the correct assessment of the shortcomings and identifying market needs. For the period 2014-2020, the financial instruments to be used in an OP must be recommended by an *ex-ante* assessment, in order to identify market deficiencies or suboptimal investment situations, respective investment needs, possible participation of the private sector and the added value of the financial instrument in question (according to art. 37 of Regulation no. 1303/2013). Such an *ex-ante* evaluation should contribute to avoiding the overlaps and inconsistencies between the funding instruments implemented by different actors on different levels (see Financial instruments in ESIF programmes 2014-2020 available at http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/fi_esif_2014_2020.pdf):

The types of financial instruments available for 2014-2020 are:

- Financial instruments established at EU level and managed (directly or indirectly) by the European Commission under the provisions of Financial Regulation (no. 966/2012) of the EU.

The ESI funds can be combined with other sources of the EU budget and with EIB/ EIF resources, in order to stimulate bank lending to SMEs. Such financial instruments that receive allocations of operational programs should provide support for investments falling within the objectives of that OP (see EFSI and ESIF Funds available at http://www.europarl.europa.eu/RegData/etudes/STUD/2016/573449/IPOL_STU(2016)573449_EN.pdf).

- Financial instruments set up at national/ regional, transnational or cross-border level and even managed directly by the managing authority or accountability.

A management authority is able to allocate resources within the operational program to:

- "Personalized" Financial Instruments –already existing or newly created (adapted to the specific conditions and needs identified in the *ex-ante* assessment);
- "Standardized" Financial Instruments (off the shelf), for which the terms and conditions are defined in advance and established by an act of the European Commission for implementation.

These financial instruments, established by Regulation (EU) no. 964/2014, are (see http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX% 3A02014 R0964-20160805):

- a portfolio risk sharing loan, based on risk sharing between public and private resources;

It takes the form of a loan fund to be established by a financial intermediary based on a contribution from the Operational Programme and on an own contribution of at least 25%. The Loan Fund finances a portfolio of newly granted loans (the refinancing of existing loans is excluded).

The Risk Sharing Loan fulfils the terms and conditions of Regulation no. 964/2014, and it is intended to provide better finance access for SMEs.

- a capped portfolio guarantee;

The capped portfolio guarantee provides coverage for the credit risk on each loan, at a rate not exceeding 80% of the guarantee, in order to create a portfolio of newly granted loans to small and medium enterprises. The maximum amount of losses does not exceed 25% of the risk exposure at the portfolio level (see http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02014R0964-20160805).

The capped portfolio guarantee complies with the terms and conditions set out in Regulation no. 964/2014 and it is intended to provide better finance access for SMEs.

- a renovation loan, which is based on risk sharing between public and private resources;

The renovation loan takes the form of a loan fund to be established by a financial intermediary on the basis of the contributions from the program and an own contribution of at least 15%. The Loan Fund finances a portfolio of newly granted loans, excluding the refinancing of existing loans (see Research for Regi Committee - Financial Instruments In The 2014-20 Programming Period: First Experiences Of Member States available at http://www.europarl.europa.eu/RegData/etudes/STUD/2016/573449/IPOL_STU(2016)573449_EN.pdf).

Unlike the two financial instruments described above, the final beneficiaries of this instrument are owners (individuals or legal entities holding spaces/ acting on behalf and for the benefit of owners) that implement energy efficiency measures or renewable energy sources.

The renovation loan fulfils the terms and conditions of Regulation no. 964/2014.

In July 2016, the European Commission launched two new financial instruments for SMEs: co-investment mechanism, which provides support for the development of small and medium enterprises in various stages of development.

This instrument provides financing for both new businesses and SMEs, in order to develop business models and attract additional funding through a collective investment program managed by a main financial intermediary. The total investment, by combining public and private resources, can rise to 15 million/ SME (see http://ec.europa.eu/regional_policy/en/newsroom/news/2016/07/07-11-2016-commission-launches-two-new-financial-instruments-to-boost-investments-in-start-ups-and-sustainable-urban-development).

The co-investment mechanisms should develop the local capital market and attract more capital investment in SMEs through an approach based on the partnership with private investors.

- Urban Development Funds, which support sustainable urban projects, in public transport, energy efficiency or regeneration of urban areas. The projects must be financially viable and be part of a strategy of sustainable and integrated urban development.

The total investment, by combining public and private resources, can rise to 20 million Euros/ project. The support will take the form of a loan fund managed by a financial intermediary, with resource funds and an ESI contribution of at least 30% private capital (co-investment from private investors).

- Financial instruments consisting solely of loans or guarantees.

This category of instruments can be implemented directly by the managing authority of an operational program, in which case it is considered an implementing body of the financial instrument (or fund of funds that implements financial instruments) (see Financial instruments in ESIF programmes 2014-2020 available at http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/ fi_esif_2014_2020.pdf).

Figure 2 below presents in a schematized way the financial instruments 2014-2020, for a better understanding of their importance and role in the SME sector.

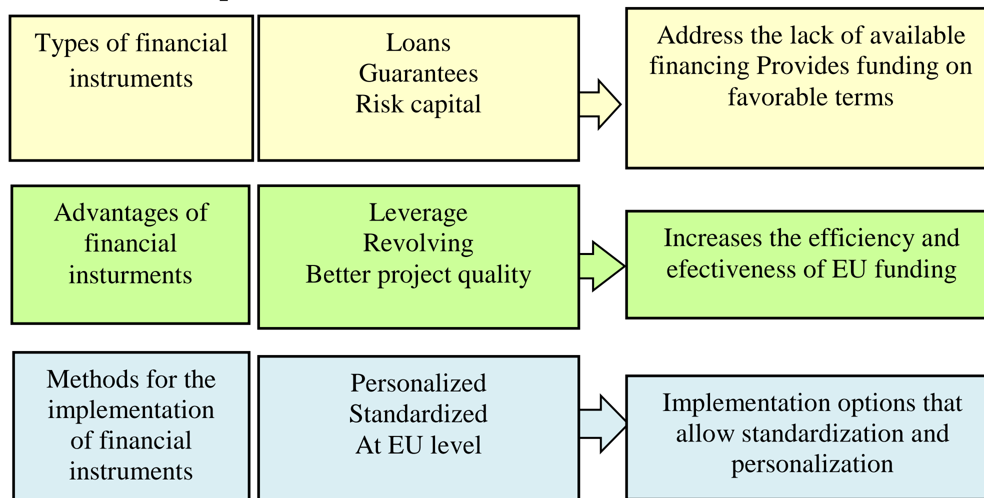
Figure 3 below presents the principles, the advantages and the methods of the financial instruments in connection to the European Structural and Investment Funds 2014-2010.

Figure 2. Financial Instruments 2014-2020

<table>
<tr><td></td><td colspan="2">Financial Instruments managed (centralized) by the European Commission, by EIB/EIF (Financial Regulation, no.966/2012)</td><td>European Strategic Investment Fund</td><td>Financial Instruments, management shared with Member States - ESIS (General Regulations for ESI Funds, no.</td></tr>
<tr><td>Research, Development, Innovation</td><td colspan="2">Horizon 2020
Risk Capital and Shared risk instruments</td><td rowspan="2">SMEs Window</td><td rowspan="4">European Structural and Investment Funds
➢ Financial Instruments established at EU level
- Financial instruments set up at national/ regional level
- standardized instruments
- personalized instruments (newly created/ existing)</td></tr>
<tr><td rowspan="2">Growth, Employment, Social Cohesion</td><td>Competitivity and SMEs (COSME)
Risk capital and guarantees</td><td>Creative Europe
Guarantees</td></tr>
<tr><td>Employment and Social Innovation
Guarantees</td><td>Erasmus +
Guarantees</td><td rowspan="2">Infrastructure and Innovation Window</td></tr>
<tr><td>Infrastructure</td><td colspan="2">Connecting Europe Facility
Instruments with shared risk and capital risk</td></tr>
</table>

Source: Financial instruments in ESIF programmes 2014-2020, European Commission, 02/07/2014

Figure 3. Principles of Financial Instruments- ESIF (European Structural and Investment Funds) 2014-2020



Source: Financial instruments in ESIF programmes 2014-2020, European Commission, 02/07/2014

Conclusions

Financial instruments are catalysts of public and private resources that can help Member States to achieve the strategic investments necessary to implement the Europe 2020 Strategy.

Applied widely and properly matched to the specific needs of regions and target recipients, financial instruments contribute significantly to improving the access to finance for a wide range of socio-economic actors, such as companies that invest in innovation; individuals who wish to implement their business ideas; public infrastructure or productive investment projects; administrate investing in improving the energy efficiency of their households.

The conclusions are divided into two broad categories:

1. The effects of using financial instruments on the development of SMEs:

- increasing number of SMEs
- amplification of the human and economic potential
- enhancing innovation in SMEs
- generating a considerable number of new jobs in the EU economy
- reducing unemployment especially among the youth

2. Accelerating operational of the financial instruments which are much less developed compared to the EU. It is necessary **to facilitate SMEs access to finance** by:

• **Stimulating business funding through alternative instruments**:

A. Diversification and amplification of guarantee and counter guarantee services for businesses (particularly SMEs), valuing the best practices from EU

B. Improving the lending policies of the state-owned banks

• **The increase of transparency and reducing of bureaucracy in the banking sector**

A. Adequacy the banking system requirements according to the assessment criteria, without excessive inquiries.

B. Eliminating all additional declarative obligations – limiting the documents and information required from entrepreneurs by the bank, to the essential ones, which are directly taken into account in the process of granted or rejected credit evaluation.

C. Centralizing the data concerning the financial products offered by commercial banks (AER, ceilings, eligibility requirements, etc.) on a public portal, enabling visualization and comparison of several products in real time.

D. Establishing and promoting, according to European best practice, the SMEs credit ombudsman.

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