

July 2007

**Note of the Commission services**  
on  
**Financial Engineering**  
in the  
**2007-13 programming period**

This note has been prepared by the Directorates-General for Regional Policy and for Employment, Social Affairs and Equal Opportunities.

A draft of this note was discussed on 25 April 2007 in the Committee for the Coordination of the Funds (COCOF).

The note sets out the reading that the two Directorates-General will give to the relevant articles of the Regulations on this issue in their dealings with Member States.

**1. Definitions: "Operation" and "beneficiary" in the case of financial engineering under Article 44 of Regulation 1083/2006.**

**1a) Operation**

In respect of financial engineering instruments under Article 44 of Regulation 1083/2006, such as venture capital funds, guarantee funds, loan funds and urban development funds, the 'operation' is constituted by both the contribution from an operational programme to the financial engineering instrument, and the subsequent investment by that financial engineering instrument in, or provision of loans or guarantees to, enterprises, or urban projects, within the scope of the operational programme. The operational programme can of course be regional or national.

As is clear from the first subparagraph of Article 44 of Regulation 1083/2006, the operation necessarily includes the contribution from an operational programme to a financial engineering instrument. That provision states that the Structural Funds may finance expenditure "*in respect of an operation comprising contributions to support financial engineering instruments for enterprises, ... such as venture capital funds, guarantee funds and loan funds, and for urban development funds*" (underlining added).

It follows from Article 2(3) of Regulation 1083/2006 that the operation also necessarily comprises investment in, or provision of loans and guarantees to, enterprises or urban projects. This provision defines 'operation' as "a project or group of projects ... allowing achievement of the goals of the priority axis to which it relates". It is the provision of assistance, by way of equity investment, loans and guarantees, to enterprises or urban projects that will allow achievement of the priority axis' goals and this investment or provision of loans and guarantees must therefore be considered as part of the operation.

For the avoidance of doubt, since an operation comprises contributions from a given operational programme to a financial engineering instrument for use within the scope of that operational programme, it is possible to have contributions from more than one operational programme to the same financial engineering instrument.

In such cases, the holding fund and the financial engineering instrument must keep separate accounts or maintain *an adequate accounting code* for the contribution from each operational programme, for reporting and audit purposes, in order to ensure compliance with Article 60(d) of Regulation 1083/2006 and Article 15 of Regulation 1828/2006.

### **1b) Beneficiary**

Article 2(4) of Regulation 1083/2006 defines beneficiary as an operator, body or firm, whether public or private, responsible for initiating or initiating and implementing operations.

The beneficiary is the financial engineering instrument itself. It is the financial engineering instrument itself which implements the operation through the provision of assistance to enterprises or urban projects, by way of equity investment, loans and guarantees.

This is confirmed by Article 78(6) of Regulation 1083/2006, according to which the eligible expenditure accepted at closure is that effectively paid by a financial engineering instrument in implementing the operation.

Where holding funds are used, they initiate operations comprising contributions to support financial engineering instruments. In such cases, holding funds are beneficiaries since they are responsible for initiating operations (cf. Article 2(4) of Regulation 1083/2006). For the purposes of Article 78(6) of Regulation 1083/2006, the eligible expenditure to which the co-financing rate will apply at closure will be the amount paid out by the holding fund and which has in turn been invested, provided or committed as a guarantee, or paid in eligible management costs, under sub-paragraphs (a), (b), (c) and (d) of Article 78(6) of Regulation 1083/2006.

## **2. Implementing financial engineering: selection of holding funds, selection of financial engineering instruments, selection of operations, management costs, major projects**

### **2a) Selection of holding funds**

Article 44 of Regulation 1083/2006 lays down two forms for implementing financial engineering operations organised through holding funds.

The first of these, set out in Article 44(a), is through the award of a public contract in accordance with applicable public procurement law.

The second possibility, laid down in Article 44(b), involves the award of a grant. Article 44(b) of Regulation 1083/2006 provides that financial engineering operations organised through holding funds may be implemented "*in other cases, where the agreement is not a public service contract within the meaning of public procurement law, [through] the award of a grant, defined for this purpose as a direct financial contribution by way of donation*".

This second possibility is defined by distinguishing it from the first. Thus, it applies where the agreement [between the national authority and the holding fund] is not "*a public service contract within the meaning of public procurement law*" and where it can be qualified as a grant.

Where the agreement between the national authority and the holding fund is not "a public service contract" and it can be qualified as a grant, Article 44 provides for a grant to be given directly to the EIB or the EIF or, if pursuant to a national law compatible with the Treaty, a financial institution. A grant, for the purposes of Article 44, is defined as a "direct financial contribution by way of donation".

**The term "donation" as used here therefore concerns the case of grant contributions from operational programmes to European or national financial institutions serving public policy objective. It is different from the purchase of services under public procurement provisions.**

In addition, the grant from operational programmes to holding funds implies no loss of responsibility by the relevant authorities for those resources under the Structural Funds regulations. Such grants to holding funds, have no impact on the definition of the functions and exercise of responsibilities of the managing, certifying and audit authorities concerning investment in financial engineering instruments of contributions from operational programmes to holding funds, and the subsequent investment of such contributions in enterprises, primarily SMEs, or in urban projects. In this context attention is drawn to the specific control and audit requirements set out by the Structural Funds regulations, with a view to ensuring the legality and regularity of expenditure, and sound use of public funds.

Regarding national law compatible with the Treaty allowing the direct award of a grant for the purposes of Article 44(b)(ii) to a national (or regional as the case may be) financial institution, it is expected that the law will:

- a) designate the financial institution in question;
- b) present the public policy objectives justifying the direct award of a grant to it; and
- c) justify the existence within this financial institution of the expertise necessary for the successful accomplishment of the holding fund tasks.

In its Declaration on Article 44 of Regulation 1083/2006, the Commission encourages Member States and managing authorities to select a holding fund "by awarding a grant" to the EIB or the EIF. The Commission's Declaration reflects the special status of the EIB and the EIF as Community bodies which emanate from the EC Treaty.

## **2b) Selection of financial engineering instruments - Selection of operations and role of managing authorities and monitoring committees**

A transparent procedure for the selection of financial engineering instruments<sup>1</sup> and for taking decisions on contributions from operational programmes to them, should be applied by the managing authority or the holding fund, as the case may be. This selection procedure should be based on specific and appropriate selection criteria relating to the objectives of the operational programme, criteria which should be approved by the monitoring committee.

The managing authority or the holding fund, as the case may be, should examine whether their contributions from operational programmes to specific financial engineering instruments

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<sup>1</sup> The term "financial intermediaries" is also used in Article 44(2) of Regulation 1828/2006 to characterise those bodies which may subsequently be selected as financial engineering instruments.

would correspond to public procurement of services governed by the EC or national public procurement law. In this event, managing authorities or holding funds should act in accordance with applicable Community and national rules. Article 44 of Regulation 1083/2006 should not be read as meaning that where holding funds are not used to organise financial engineering instruments, there is no obligation to comply with applicable public procurement law.

Where operations comprising financial engineering instruments are financed by the Structural Funds, the business plan of candidate financial engineering instruments must be submitted and evaluated in accordance with Articles 43(2) and 44 of Regulation 1828/2006, either by the managing authority or by the holding fund.

The managing authority or the holding fund should select financial engineering instruments and sign funding agreements with them (cf. Articles 43(5), 43(6) and 44 of Regulation 1828/2006). Where possible, **more than one financial engineering instrument** should be selected, with a view to producing the best possible leverage effects for scarce public resources contributed by the operational programme, and in order to involve any available energy, resources and expertise of good quality from the private sector, and to achieve the investment and development objectives of the operational programme.

In the case of financial engineering organised through holding funds, a funding agreement between the managing authority and the holding fund should, pursuant to Article 44(2)(c) of Regulation 1828/2006, make provision for the appraisal, selection and accreditation of financial engineering instruments by the holding fund. Where such funding agreements include specific provisions for the criteria applicable to the selection of operations, these criteria should be considered and approved by the monitoring committee (cf. Article 65(a) of Regulation 1083/2006).

### **2c) Management costs eligible for the Structural Funds**

Management costs eligible for the Structural Funds **may not exceed**, on a yearly average, the ceilings set out by Article 43(4) of Regulation 1828/2006, unless a competitive procedure reveals that higher ceilings might be necessary. The rates referred to in this Article to calculate the **ceilings of management costs** are applicable to contributions from operational programmes to holding funds or to financial engineering instruments.

The eligible amounts of management costs are calculated having regard to contributions from the operational programme to the holding fund or financial engineering instruments, as the case may be. The term 'contributions from the operational programme' should be understood as referring to the EC and national public funds, as well to private funds if the priority axis concerned is expressed in total cost, that are set out as originating from the operational programme in the funding agreement provided for by Articles 43(5), 44(1), and 44(3) of Regulation 1828/2006.

The funding agreement may envisage front-loaded payment of management costs which exceeds the limits set out by Article 43(4) of Regulation 1828/2006 for one or more years, such as for example the first years of the programming period. This payment structure might

be justified by the fact that holding funds or fund managers may incur significant costs before investments, loans or guarantees in enterprises effectively take place.

**However, the eligible management costs for the Structural Funds, at the partial or final closure of operational programmes,** should not exceed, averaged on a yearly basis over that part of the programming period for which the holding fund or financial engineering instrument effectively manages an operation, the limits set out in Article 43(4) of Regulation 1828/2006.

The rates for management costs in Article 43(4) of Regulation 1828/2006 are maximum rates, unless an open competitive procedure reveals that higher rates are necessary. The Commission expects the managing authority or holding fund to negotiate management costs in accordance with the principles of sound financial management.

It is recommended that the funding agreements link the remuneration to the amounts which will finally be actually invested in, or loaned out or committed as guarantees to, enterprises. Actual expenditure is a condition of the eligibility at closure of the expenditure other than management costs, under Article 78(6) of Regulation 1083/2006. Linking eligible management costs to the volume of finance contributed from operational programmes and finally disbursed to or committed for guarantees to enterprises, would create an incentive for holding funds and financial engineering instruments to be active in promoting development and expansion of enterprises and in particular SMEs.

## **2d) Contributions from operational programmes to holding funds or financial engineering instruments as possible major projects**

Contributions from operational programmes to venture capital, loan or guarantee funds for enterprises, primarily SMEs, constitute operations or projects in the sense of Article 2(3) of Regulation 1083/2006. Such contributions must be subsequently invested in, loaned out or committed for guarantees. Such investments, loans or guarantees do not constitute an "indivisible task of a precise economic or technical nature" within the meaning of Article 39 of Regulation 1083/2006, and hence they cannot be considered to be a major project.

Where a single equity investment or single guarantee commitment, co-financed by an operational programme pursuant to Article 44 of Regulation 1083/2006, made in respect of a single enterprise is in excess of 50 million euros, it could constitute a major project, and a procedure under Articles 40 and 41 of Regulation 1083/2006 should be launched.

Contributions from operational programmes to urban development funds could be invested in urban projects constituting an "indivisible task of a precise economic or technical nature". Such investments in urban projects could be considered, where appropriate, to be major projects within the meaning of Article 39 when their total cost exceeds 25 million euros in the case of environment and 50 million euros in other fields.

### **3. State aid and financial engineering**

#### **3.1 Contributions from operational programmes to holding funds**

The Commission has already made clear, in point 3.2 of the Community Guidelines on State Aid to promote Risk Capital investments in Small and Medium sized Enterprises<sup>2</sup>, that it considers that *"[i]n general, [...]an investment fund or an investment vehicle is an intermediary vehicle for the transfer of aid to investors and/or enterprises in which investment is made, rather than being a beneficiary of aid itself. However, [...] measures involving direct transfers in favour of an investment vehicle or an existing fund with numerous and diverse investors with the character of an independent enterprise may constitute aid unless the investment is made on terms which would be acceptable to a normal economic operator in a market economy and therefore provide no advantage to the beneficiary"*.

Where Member States or managing authorities implement an operation comprising contributions to support financial engineering instruments through holding funds, in the forms provided for in Article 44(b) of Regulation 1083/2006, provided the conditions enunciated above are respected, the holding fund would be simply initiating investments and would be an intermediary vehicle and so would not be a beneficiary of aid, as is set out in the abovementioned point 3.2 of the Community Guidelines on Risk Capital.

Point 3.2 of the Community Guidelines on Risk Capital also sets out the Commission's view that, *"aid to the fund's managers or the management company will be considered to be present if their remuneration does not fully reflect the current market remuneration in comparable situations."*

The ceilings for the management costs of the holding fund, capped at a yearly average of 2% in accordance with Article 43(4) of Regulation 1828/2006, reflect current market remuneration. Provided these ceilings continue to reflect market remuneration, payment of management costs to holding funds should not constitute State aid to them.

#### **3.2 Investments in financial engineering instruments and SMEs**

When contributions from operational programmes to financial engineering instruments are invested, loaned or committed for guarantees in enterprises, primarily SMEs, or urban projects, state aid may be present. State aid rules must then be respected by Member States and managing authorities, assisted by the holding fund where appropriate.

### **4. Retention of supporting documents for expenditure under financial engineering instruments**

The retention of supporting documents for expenditure by the Structural Funds is required in order to prove that the funding conditions at the various levels, including that of the small or medium-sized enterprise (SME), have been observed. To determine what supporting documents have to be kept and by whom, it is necessary to look at the funding conditions and how their observance is documented.

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<sup>2</sup> OJ C 194, 18.8.2006, p. 2.

The conditions imposed on an SME receiving funds (venture capital or loans) or guarantee cover, generally include:

- (a) the start-up or expansion of business activity, where such activity is capable of contributing to regional development in accordance with the purposes of the Structural Funds set out in Articles 158 and 160 of the EC Treaty;
- (b) the transfer of shareholdings (venture capital) or the making of repayments and the payment of interest or guarantee premia;
- (c) acceptance of monitoring and reporting obligations over the period of the investment, loan or guarantee; and
- (d) compliance with Community and national legislation, including State aid rules and environmental and equal opportunities legislation.

In the majority of cases, it is not a condition that the SME must incur expenditure on particular goods and services, which might be required, for example, for specific investment projects. Instead the capital, loan or guarantee is often given to the SME for the development or expansion of its general business activity, including necessary working capital.

The supporting documents attesting to observance of these funding conditions may include:

- (a) application forms with supporting documents, including business plans and previous annual accounts, checklists and reports of the venture capital fund or loan intermediary assessing the application, and entry in a commercial register;
- (b) the signed investment, loan or guarantee agreement (guarantee agreements are often between the loan intermediary and the guarantee fund, and the enterprise is therefore not always involved);
- (c) reports by the enterprise, reports on visits and board meetings, annual accounts, and reports by the loan intermediary to the guarantee fund supporting claims; and
- (d) environmental approvals, equal opportunities reports, and declarations made in connection with receipt of *de minimis* aid.

Evidence of expenditure in the form of receipted invoices and proof of payment for goods and services by the enterprise is only required as part of the audit trail to justify financial assistance from the Structural Funds where the equity, loan or guarantee offered to an SME is conditional on certain expenditure on particular goods and services. However, in all cases, there must be proof of the transfer of the capital or loan by the venture capital fund or loan intermediary to the enterprise.

It is the responsibility of the managing authority to ensure that supporting documents are kept for three years after the partial or final closure of the operational programme (Article 90 of Regulation 1083/2006). It can be decided that they should be kept by the venture capital fund, loan intermediary or guarantee fund (or the loan intermediary whose loans are underwritten) or by the SME. However, the normal expectation is that the venture capital fund, guarantee fund or loan intermediary would keep all the documents required, and only where the equity, loan or guarantee offered to an SME is conditional on certain expenditure on particular goods and services would it be necessary to audit documents in the SME itself. In that latter case the SME would be obliged to keep documents for the entire period required by EC law, instead of only for the period required under national law.