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REPLIES OF THE COMMISSION TO THE SPECIAL REPORT OF THE EUROPEAN COURT OF AUDITORS

"ARE FINANCIAL INSTRUMENTS A SUCCESSFUL AND PROMISING TOOL IN THE RURAL DEVELOPMENT AREA?"

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EXECUTIVE SUMMARY

I. While the attraction of private capital is one of the value-added associated with financial instruments, the EU legislation[1] in the field of rural development in 2007-2013 does not explicitly links financial engineering instruments to private funding.

III. The Commission notes that the programming period 2014-2020 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 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 2007-2013 programming period provides for a large flexibility in the implementation of the rural development measures. The Commission is of the opinion that the 2007-2013 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[2]. 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[3]. As regards the 2014-2020 programming period, the undertaking of an ex ante assessment is obligatory for any operation comprising financial instruments co-financed by the EAFRD[4]. 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 2014-2020.

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.

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[1] Council Regulation (EC) No 1698/2005 and Commission Regulation (EC) No 1974/2006

[2] 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.

[3] Commission Regulation (EU) No 679/2011 from 14 July 2011

[4] Article 37(2) of Regulation (EU) No 1303/2013

The Commission notes that as regards the period 2007-2013, it gathered important reporting information on existing financial instruments. Moreover, a comprehensive reporting on financial instruments is designed for the 2014-2020 programming period.[5]

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 2007-2013, 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 2007-2013, the Commission gave guidance to any MS which has requested it. The guidelines on closure of the 2007-2013 rural development programmes were adopted in 2015.[6] 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 2014-2020.

VIII. The Commission considers that the new legal framework for the programming period 2014-2020 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 2014-2020.

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 to 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 co-operation in the field of agriculture and rural development with the European Investment Bank (EIB) and signed a Memorandum of Understanding on 14 July 2014.[7] This co-operation 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 period 2014-2020.[8] As part of its working programme, "*fi-compass*" will produce also EAFRD-specific products.

IX.

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[5] Article 46 of Regulation (EC) n° 1303/2013

[6] C(2015) 1399 final from 5.3.2015.

[7] See Statement 14 / 225 of 14.07.2014

[8] See more at http://www.fi-compass.eu

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 2014-2020.[9]

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.

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 the co-operation with the EIB Group, the Commission signed a specific Memorandum of Understanding (MoU) in respect of co-operation in agriculture and rural development, under which it is expected the EIB to 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.

Fourth bullet: The Commission accepts this recommendation, insofar as rules for the closure of rural development programmes 2007-2013[10] are under its scope.

The Commission notes that according to the applicable EU legislation for 2007-2013 the development of precise operational implementing rules, including the appropriate exit policy for each financial engineering instrument, is the responsibility of the Member States.

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

The transitional rules for the 2007-2013 period have been adopted.

With regards 2014-2020, discussions with Member States will take place when the closure of 2014-2020 period approaches and transitional rules have to be defined.

(c) This recommendation is for the Member States

INTRODUCTION

5. The EU legislation for 2007-2013 does not impose a rule on re-utilisation of the initial allocation used for setting up of financial instruments. Resources not used can be reprogrammed for other forms of assistance.

6. The Commission notes that the programming period 2014-2020 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.

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[9] See more at http://www.fi-compass.eu

[10] C(2015) 1399 final from 5.3.2015.

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 2007-2013 have been substantially improved in comparison with the 2000-2006 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 2007-2013 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 2007-2013 programming period provides for a large flexibility in the implementation or 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 2014-2020 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 – Examples of objectives used for financial instruments

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[11]. 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 2014-2020 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[12].

In 2007-2013, 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 2007-2013 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 2007-2013 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 the undertaking of ex ante assessments in 2007-2013 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.

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

In 2007-2013 period the Commission improved the legislation by introducing a requirement for ex ante assessment of expected losses for guarantee funds.

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[11] Commission Regulation (EU) No 679/2011 from 14 July 2011

[12] Article 37(2) of Regulation (EU) No 1303/2013

With regards to the 2014-2020 programming period, an assessment of needs will be required in all cases where a MS decides to contribute EAFRD funding to a financial instrument[13]. 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[14] 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 2014-2020.

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 interests 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 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.

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[13] Article 37(2) of Regulation (EU) No 1303/2013

[14] The Court, in its audit SR 2/2012 refers to over-sizing of financial instruments, and not overcapitalization.

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 2014-2020 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[15].

Box 3 –Structural difficulties in obtaining access to credit in Romania

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.

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 2007-2013 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 to 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 – Situation as regards the "N+2" rule in Greece

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

[15] Article 37(7) (8)(9) of Regulation (EU) No 1303/2013.

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 re-programming 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 a 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 – Examples of the overcapitalisation of financial instruments

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

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 2014-2020 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.

46. The Commission notes that there is no EU definition of the risk exposure ratio in the EU legislation for period 2007-2013.

For the 2014-2020 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 2014-2015.

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 2 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 2007-2013 legislation allows the reuse of resources for financial instruments for an indefinite period.

62. For the 2014-2020 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 – Leverage estimated by the Court

The Commission considers that estimates should take into acount 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 2014-2020, the already established funds will continue or new funds based on models proposed by the Commission (such as the off-the-shelf instruments)[16] can be established. It is expected that in this way delays will be significantly reduced.

Box 8 – In Greece and Italy (Calabria), timing reduced the performance of the funds

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 instrument 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 to four performance indicators enshrined in Article 12 of Regulation (EU) 480/2014.

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[16] 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.

70. The Commission notes that there were no common indicators for the financial instruments in the 2007-2013 CMEF. However, CMEF foresees the use of additional indicators[17] 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.

As regards the 2014-2020 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 to75:

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 2007-2013, the Commission gave guidance to any MS which has requested it. The Commission is currently preparing guidelines on the closure of the 2007-2013 programmes.

The Commission will provide more consolidated and improved guidance for the period 2014-2020. 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.

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 2007-2013.

Any activity going beyond the closure of the programmes and not concerning the EU budget is of 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, re-use 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 intermediates 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.

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[17] Article 81(2) of Regulation 1698/2005

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 2014-2020, 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 2014-2020. The implementation in the period 2014-2020 can start immediately after the adoption of the new programmes and already in 2015. For example, in January 2015 the Dutch RDP 2014-2020 was adopted, which also foresees the setting up of a financial instrument supported by the EAFRD.[18]

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.

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 different life cycle than a 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 2007-2013 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 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 2007-2013 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.

[18] See the respective presentation on http://www.fi-compass.eu

In the period 2014-2020 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 2007-2013 programming period provides for a large flexibility in the implementation or the rural development measures The Commission is of the opinion that the 2007-2013 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[19]. 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[20].

As regards the 2014-2020 programming period, the undertaking of an ex ante assessment is obligatory for any operation comprising financial instruments co-financed by the EAFRD[21]. 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 2014-2020.

97. The Commission is of the opinion that the legal framework for the programming period 2014-2020 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 2014-2020.

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 to 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 co-operation in the field of agriculture and rural development with the European Investment Bank (EIB) and signed a Memorandum of Understanding on 14 July 2014.[22] This co-operation 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

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[19] 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.

[20] Commission Regulation (EU) No 679/2011 from 14 July 2011

[21] Article 37(2) of Regulation (EU) No 1303/2013

[22] See Statement 14 / 225 of 14.07.2014

and stakeholders in the field of financial instruments supported by ESI Funds in 2014-2020 period.[23] 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[24], 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[25], eligibility of working capital[26]) offer enough advantages in comparison with grants.

In 2014-2020, the already established funds will continue or new funds based on models proposed by the Commission (such as the off-the-shelf instruments)[27] can be established.

The legislator defined financial instruments as a type of support in 2007-2013 and 2014-2020 programming period 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 2014-2020.[28]

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.

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[23] See more at http://www.fi-compass.eu

[24] 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

[25] Article 37(11) of Regulation (EU) No 1303/2013.

[26] Article 45(5) of Regulation (EU) No 1305/2013.

[27] 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.

[28] 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 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 regards the co-operation with the EIB Group, the Commission signed a specific Memorandum of Understanding in respect of co-operation in agriculture and rural development, under which it is expected the EIB to 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 2014-2020 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 2007-2013 period have been adopted.

With regards the 2014-2020 period, discussions with Member States on closure will take place when closure of 2014-2020 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 2014-2020.

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 2007-2013, 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 2007-2013, the Commission gave guidance to any MS which has requested it. The guidelines on closure of the 2007-2013 rural development programmes were adopted in 2015.[29] 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 2014-2020.

Recommendation 6

The Commission accepts this recommendation, insofar as rules for the closure of rural development programmes 2007-2013[30] are under its scope.

The Commission notes that according to the applicable EU legislation for 2007-2013 the development of precise operational implementing rules, including the appropriate exit policy for each financial engineering instrument, is the responsibility of the Member States.

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[29] C(2015) 1399 final from 5.3.2015.

[30] C(2015) 1399 final from 5.3.2015.