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Comments on the Functioning of the European Fund for Strategic Investment

The European Fund for Strategic Investment (EFSI)[1] is to help overcoming the current investment gap in the EU by mobilizing private financing for strategic investments. EFSI as one of the three pillars of the Investment Plan for Europe should unlock additional investment. Legally, EFSI is neither a financial instrument[2] under the Financial Regulation applicable to EU level budgetary operations nor under the definition of the regulation applicable for European Structural and Investment Funds. The common point is however that EFSI should provide financing for economically viable projects using loans, guarantees and equity investments.[3]

EFSI was established in a very short time frame[4] by skipping a number of important steps in the preparatory and planning phases.[5] EFSI was originally a EUR 16 billion guarantee from the EU budget, complemented by a EUR 5 billion allocation of the EIB's own capital which provides additional guarantee permitting higher risk-taking to the EIB project finance. A higher risk profile is possible in the projects finance as compared to standard EIB activities and the pricing policy could also be different due to the support of the EFSI guarantee. Additionally, a dedicated governance structure for EFSI decision process has been established. This has been put in place to ensure that the investments

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1 Regulation (EU) 2015/1017 of the European Parliament and of the Council of 25 June 2015 on the European Fund for Strategic Investments, the European Investment Advisory Hub, and the European Investment Project Portal and amending Regulations (EU) No 1291/2013 and (EU) No 1316/2013 – the European Fund for Strategic Investments, OJ L169, 01.07.2015. 1 (the "EFSI Regulation") entered into force on 4 July 2015.

2 FIs are defined also in Financial Regulation as measures of *"financial support provided from the budget in order to address one or more specific policy objectives by way of loans, guarantees, equity or quasi-equity investments or participations, or other risk-bearing instruments, possibly combined with grants"*.

3 Nyikos, Györgyi (2016): *Financial Instruments in the 2014–20 Programming Period: First Experiences of Member States*. Brussels, European Parliament, Policy Department B: Structural and Cohesion Policies.

4 From the moment the IPE was announced in November 2014 to the signature of the agreement between the Commission and the EIB in July 2015 it took only eight months.

5 e.g. ex-ante analysis.

made under EFSI remain focused on the specific objective of addressing the market failure in risk-taking which hinders investments in Europe. EFSI has two channels to support projects: an Infrastructure and Innovation Window (IIW) to be deployed through EIB[6] and an SME Window (SMEW) to be deployed through the EIF[7] to support SMEs and mid-caps.[8]

After the initial investment period, the European Commission proposed to double the duration and size of EFSI. On 12 December 2017, Members of the European Parliament voted to adopt the Regulation to extend and enhance EFSI.

However, questions also arise about the impacts and effective functioning of the EFSI.

The first issue is whether EFSI is reacting to the challenge of fostering investments and *addressing market failures* in Europe. According to several studies and analyses there is an investment gap, but it can be understood in two different ways. Looking at the figures and facts,[9] EFSI being an additional guarantee as an immediate stimulus offers nothing of substance. For dealing with long-term investment needs, it makes more sense. However, the geographical bias – so far not towards lower-income countries[10] – would seem undesirable in this context.

This result could come from the fact that on the one hand even though in Eastern Europe the lack of finance is more obvious, still at the same time this has to be related to the market demand (e.g. a lack of projects). Furthermore, the lack of projects is not necessarily the sign of lack of finance, but the lack of proper administrative capacity to develop and implement a project. On the other hand, investments need financing and the conditions for financing are different in the Member States and the availability of different types of financing from ESI-funds (e.g. grants) led subsequently to different results in terms of EFSI implementation. There are huge differences between Western and Eastern Europe and one size fits all is not the best approach.

The measurement of the financial gap and the best way to address it links to another area: the *proper preparation of the instrument*. For the establishment of financial instruments in cohesion policy ex-ante analysis is obligatory to answer this question. In case of EFSI the political decision was put in practice without an ex-ante assessment for the rationale or approach of the fund. The overarching question is the following: is it acceptable that EU-policy decision making is made in a way that the relevance is inadequately justified and that the effectiveness and efficiency are unproven? There was an amount available (as much as could be agreed within political constraints) and a target (the most that could conceivably be hoped for on the basis of past EIB experience), so the

6 European Investment Bank.

7 European Investment Fund.

8 There is no common EU definition of mid-cap companies. While SMEs are defined as having fewer than 250 employees, mid-caps are broadly said to have between 250 and 3000 employees.

9 EFSI is 0.5% of EU GDP in 3 years, launched in 2015, 7 years after the crisis.

10 As at 31 December 2017, 47% of the financing under the IIW is concentrated in three Member States, exceeding thus the IIW geographical concentration limit of 45% in any three Member States as set in EFSI's Strategic Orientation. See projects http://www.eib.org/efsi/efsi-projects/index.htm (Accessed: 30.07.2018)

whole process and the established structure was based only on the existing practice of the EIB.

At that point arises the next question about the *additionality of the instrument.* Even though the definition of additionality is vague[11] and there are different ways to interpret and assess it. When looking at additionality, the starting point should be the "policy of additionality", which would subsequently ensure the additionality of operations. The additionality of the EFSI at both level is hard to judge because decisions are not taken in a transparent way.

At the operative level especially in the *IIW* is a good reason to believe that many projects are typical of past EIB practice. Despite the claims, there is no clear evidence to show that they really are riskier. Transparency is one of the most important issues regarding the additionality of EFSI operations and because the EIB provides very limited information on the EFSI projects. With no information on the riskiness, subordination and maturity, it is very difficult to assess their additionality.

In the case of *SMEW* EFSI made it possible to frontload the other instruments which is positive. The question here is whether this SME programs are useful or they are *crowding out* private investors, private banks, and national schemes or even other EU funds (e.g. CEF DI, COSME EFG and Innovfin Large Projects). It could be especially problematic, because EFSI is not coordinated with other EU instruments and works by different rules. Compared to other tools financed by the ESI-funds financial instruments' implementation through the ElF is more flexible (procedural wise), as it does not involve procurement or state aid issues, which areas are the biggest obstacles in the implementation of ESIF FIs. The differences in setup and rules create huge obstacles that make it almost impossible to combine different sources of funding. An integrated approach is useful and necessary. Looking also at the SMEW distribution the question arises again if the funds went to the countries having the strongest need. The Member States using the most of the SMEW money are countries which do not have huge difficulties in accessing finance.[12]

The explanation could be two folded: there is a trade-off between the *focus on volume* (315 billion Euros) and the additionality and risk profile of EFSI operations. In the context of EFSI, so far it appears that the *finance is not necessarily going to the projects in need, but the funding is going to well-developed and low risk projects.* The defined high multiplier (15) can only be achieved in developed countries, and it is not realistic for high risk projects: the higher the multiplier, the lower the risk of the project. In the light of this context it was maybe a conceptual mistake to set the target volume and the leverage effect as the most important indicators for EFSI, as they became criteria against which EFSI is judged at the expense of development and other qualitative objectives. The projects are selected in order to meet this high multiplier. If riskier projects were selected in less developed parts of the EU, then the multiplier of 15x would not be realistic.

It is also important to notice, that the *multiplier effect reflects the outputs, but not the real economic impact.* In order to measure EFSI's performance and to assess additionality

[11] In the preamble of the EFSI regulation it is addressed, but there is no practical mechanism to test the additionality of EFSI.

[12] Again the same three Member States account for 38% of the financing: France, Italy and Portugal.

beyond the financial aspect, the Cost Benefit Analysis (CBA), or in case of financial instruments, the Economic Rate of Return (ERR), are more relevant indicators.

Thus, the focus on volume impacts the geographical and sectorial distribution of EFSI investments, because of the differences considering aspects such as technical assistance, the way projects are prepared, and the development of financial markets.

If the aim is to achieve more useful investments in countries where investment has fallen the most, then a *more comprehensive policy approach* is needed. The *advisory services* on offer look much too week and small a step to overcome existing weaknesses. A more proactive approach and more *technical assistance* would be advisable. For better integration between the different tools *mapping of all existing FIs* would be also needed.

EFSI should stay if it could be really additional, transparent. Even if EFSI financing is not granted to a riskier type of project, it still could be a good tool to finance useful, innovative but projects with a higher level of risk, particularly in the innovation R&D sectors, but an integrated approach is necessary (EFSI vs. ESIF and other EU tools).