The European Bank Coordination ("Vienna") Initiative

The Role of Commercial Banks in the Absorption of EU Funds
Report by the Working Group

Approved by the EBCI Full Forum Meeting

16-17 March 2011, Brussels

Executive summary

At its Full Forum meeting in Athens on 19 March 2010, the European Bank Coordination ("Vienna") Initiative (EBCI) decided to set up two working groups. One working group focuses on the development of local currency markets and another on the role banks could play in the absorption of EU funds. This report summarise the analysis and recommendations of the second working group.

The essence of the EBCI agreements is the maintenance by participating banks of certain exposure levels within the countries covered by the Initiative. Meeting these exposure commitments is, however, costly in the absence of investment opportunities, as large shares of liquidity in subsidiaries have been lying idle in these crisis-stricken countries. A better absorption of EU funds by national authorities, and the closer involvement of banks in the selection, pre-financing and co-financing of structural funds projects could create new business opportunities for banks, facilitate meeting their exposure commitments and thus contribute to reinvigorate the economy.

While there is a large variation among Member States, the absorption of EU funds is overall disappointing and particularly so in Romania. In Romania, only 13 per cent of the funds available under the Financial Perspectives 2007-2013 have been disbursed to date. If cash advances, which are transferred independently of project evaluation or implementation, are subtracted, the absorption ratio is even lower at 3 per cent compared to 9 per cent for the new Member States, on average comparable to the performance of the old Member States. Bulgaria, which is outside the EBCI Initiative, exhibits a similar lack of absorption, and is considered in a similar manner in this report.

There are many reasons for the poor absorption of EU funds in some new Member States, largely related to their relatively recent adoption of the EU acquis. This report focuses on the role banks could play in overcoming these bottlenecks. Experience and best practices in other EU Member States provide some valuable lessons. The working group identified a potentially significant role for banks in the selection, implementation and financing of projects consistent with present EU regulations on structural funds.

Depending on the Operational Programme, the lending opportunities could be significant, if a better absorption of EU funds could be ensured. As an example, assuming a co-financing rate of 25 per cent of the annual absorption in the Operational Programme Economic Competitiveness in Romania, additional lending worth about EUR 100 million could be generated per year or 0.25 per cent extra credit growth per year (for all structural funds: EUR 830 million or 1.7 per cent additional credit growth).

Based on discussions in the three EBCI countries, but also in Bulgaria and through research on the 'old' EU Member States, such as Greece and Italy, the working group has arrived at a number of recommendations for a strengthening of the role of banks in the absorption process. These recommendations identify an important role not only in project financing, where a Letter of Comfort could be helpful, but also in the evaluation phase based on criteria developed jointly with the Managing Authority as well as in project monitoring. Innovative financial instruments, including PPPs, could be used to leverage structural funds. Some of these proposals hold immediate potential; others may need to be introduced in individual pilot projects, while more wide-ranging proposals may require a re-design in the context of the next budgetary period. The recommendations are intended to inform market participants, policy makers and the general public about agreed approaches and best practices. They in no way should restrict future policy options, including regulatory decisions.

Introduction

> *"The EU budget review makes a strong case for increasing the leverage effect of the EU budget. New forms of finance for investment have been developed in the 2007- 2013 programming period, moving away from traditional grant-based financing towards innovative ways of combining grants and loans.*

> EU Commission: Investing in Europe's Future - Fifth Report on Economic, Social and Territorial Cohesion, November 2010.

The task of this EBCI working group arose out of the observation that EU structural funds – the second most important budgetary instruments of the EU – have been underutilised in many new EU Member States, whereas credit activity has been stagnant or recovering only slowly. Better utilisation of structural funds may hold the promise of stimulating public and private investment, strengthening productivity in sectors that are key for competitiveness and growth while, at the same time, offering considerable co-financing and pre-financing opportunities for the private financial sector.

Private financial actors could contribute to leverage EU grant funds through their knowledge of local corporate sectors and on-going search for innovative entrepreneurial concepts and financial instruments. In the process this may alleviate constraints on co-financing that the official sector has experienced, in particular in times of budget consolidation. Coupled with their efficiency in project evaluation and monitoring commercial banks may bring the needed dynamism to local industry and services.

This report summarises the findings of the working group which has studied this issue between August and December 2010, based on research in a number of Member States[1]. The findings in principle apply to Operational Programmes under all three structural funds. That said, pre-and co-financing activities through conventional lending by commercial banks will primarily apply to Operational Programmes aimed at the private sector (i.e. those with the objective "competitiveness" and primarily targeted at SMEs). To the extent that banks may be involved in other financial products, in particular PPPs, the findings could also be relevant for Operational Programmes primarily for the public sector under the objectives "convergence" or "cooperation". The report draws on the experience in the three EBCI countries within the EU – Hungary, Latvia and Romania – along with that in 'old' Member States such as Greece and Italy. The conclusions and recommendations will focus primarily on Romania and also on Bulgaria, which has experienced similar problems.

The report is structured in four sections. The first section puts EU funds in perspective, including through an overview of the funds available under the different operational priorities. While the magnitude of potential funds yet to be disbursed could have a substantial impact, in terms of both overall growth and development of specific sectors, the section sketches some of the constraints that have held back the absorption of funds. The second section surveys the experience with private sector involvement in relevant EU Member States

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[1] Filip Keereman, Head of Unit, DG ECFIN European Commission, chaired the group, which also comprised Corina Weidinger Sosdean (DG ECFIN), Anita Halasz (DG ECFIN), Giorgio Charion Casoni (DG ECFIN), Alexander Lehmann (EBRD) and Meglena Plugtschieva (special adviser EBRD). The report benefited from meetings with and comments from DG REGIO in the European Commission, in particular Jean-Marie Seyler (Director), Angela Martinez Sarasola (Head of Unit) and Eduardo Barreto (Deputy Head of Unit), along with comments from Alexander Auboeck and Mandeep Bains (both EBRD).

and draws some lessons for the countries examined here. The following section reviews the input given in meetings in Romania and Bulgaria, where the greatest shortfall in absorption exists. Based on this input, the fourth section draws the key conclusions and recommendations of the working group for a closer involvement of banks in EU fund absorption within the current regulatory framework.

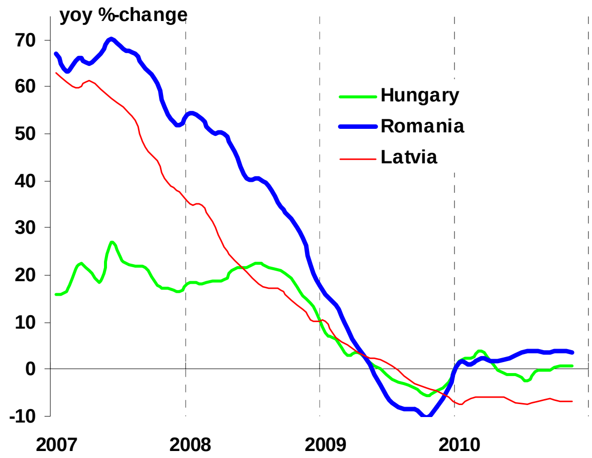
I. The EU funds in perspective

1. The European Bank Coordination ("Vienna") Initiative and EU funds

Global banking groups have a strong presence in Central and Eastern Europe. Branches and subsidiaries of foreign banks have a market share of about 75 per cent in the total assets of the banking system in Hungary and Latvia and close to 90 per cent in Romania. All three EU Member States have received balance of payments support from the international financial community. Under the European Bank Coordination ("Vienna") Initiative[2], parent banks are invited to remain committed towards these countries, as part of the burden sharing arrangement among the stakeholders in the stabilisation effort of the economy. The EU, IMF, World Bank, EIB and EBRD have provided balance of payments support and other emergency financing during the crisis, whereas national authorities have committed to take the necessary budgetary, monetary and structural measures to bring back their economies on a sound footing.

The commitment of the parent banks is essentially twofold: first, subsidiaries in the designated countries were to maintain adequate capital buffers and second, each bank group would maintain certain exposure levels. With these commitments, which are voluntary, a destructive 'run to the exit' in any of the crisis-stricken countries was successfully averted.

Chart 1: Loan growth in the EBCI countries



Source: European Commission

Exposure is considered net of liabilities and defined in broad terms vis-à-vis the country as a whole, including claims on the subsidiary (both assets and capital), loans to households, firms, financial institutions as well as government bonds. The funding of the subsidiaries

2 Also the neighbourhood countries Serbia and Bosnia-Herzegovina are part of the European Bank Coordination ("Vienna") Initiative.

constitutes the largest exposure component. Banks have generally fulfilled their exposure commitments, but have pointed out that in a shrinking economy with subdued loan demand, some of the liquidity they held in their subsidiaries remained idle in the absence of investment opportunities. Indeed, credit growth is still subdued in Romania, hovers around zero in Hungary and remains negative in Latvia (Chart 1). Given risk management considerations within banks, the rising financing needs of the government could only be partially a satisfactory response to the request for investment opportunities. Therefore, a key challenge going forward is to reinvigorate the economy and increase the demand for credit by the private sector.

2. The EU structural funds

EU structural funds could play an important role in stimulating economies into a sustained recovery. This could be beneficial for banks in search of investment opportunities in two ways. First, banks may take advantage of a recovery in investment and growth, which eventually will increase the demand for loans in all sectors. Second, at the microeconomic level, banks can contribute directly to the financing of projects eligible for EU funds. This report is concerned with this second aspect and assesses the role banks can play in a better absorption of EU funds through pre- and co-financing, though also in the administrative functions of project selection and monitoring.

There are three objectives under the 2007-2013 cohesion policy: Convergence, Regional Competitiveness and Employment as well as Territorial Cooperation. The EU has made available a total amount of EUR 178 billion available to the new Member States over the period 2007-2013 (about 19 per cent of aggregate 2010 GDP, see Table 1) under three main instruments:

- the European Regional Development Fund (ERDF), which finances: *(i)* investment in companies (in particular SMEs) to create sustainable jobs; *(ii)* infrastructure linked notably to research and innovation, telecommunications, environment, energy and transport; *(iii)* financial instruments (capital risk funds, local development funds, etc.) to support regional and local development and to foster cooperation between towns and regions and *(iv)* technical assistance.

- the European Social Fund (ESF) which seeks to improve employment by supporting actions in the following areas: *(i)* adapting workers and enterprises through lifelong learning schemes and innovative working organisations; *(ii)* access to employment for job seekers, the unemployed, women and migrants; *(iii)* social integration of disadvantaged people and combating discrimination in the job market and *(iv)* strengthening human capital by reforming education systems.

- the Cohesion Fund (CF) is aimed at Member States whose Gross National Income per inhabitant is less than 90 per cent of the Community average (this includes all ten new members) and finances activities under the following categories: *(i)* trans-European transport networks and *(ii)* environment including renewable energy, rail and public transport.

In total, these three funds represent about 35 per cent of the EU budget. The ten new Member States receive just over half (51 per cent) of funds available under these three funds. Member States defined Operational Programmes at the beginning of the budgetary period. These

Operational Programmes set out national priorities and may cover one or several activities, often spanning several regions within a country and drawing on several funds.

Table 1: Structural funds available to the new Member States compared to EU as a whole

	2007-2013			2010		2011	
New Member States	bn EUR	% of 2010 GDP	% of total	bn EUR	% of GDP	bn EUR	% of GDP
Structural funds for growth and convergence							
Bulgaria	6.9	19.3	3.8	1.0	2.9	1.1	3.0
Czech Republic	26.7	18.3	15.0	3.8	2.6	4.0	2.6
Estonia	3.5	25.0	1.9	0.5	3.5	0.5	3.6
Cyprus	0.6	3.7	0.4	0.1	0.5	0.0	0.3
Latvia	4.6	27.7	2.6	0.7	3.9	0.7	4.2
Lithuania	6.9	26.7	3.9	1.0	3.8	1.1	3.9
Hungary	25.3	26.2	14.2	3.6	3.8	3.8	3.8
Malta	0.9	14.5	0.5	0.1	2.1	0.1	2.0
Poland	67.3	19.0	37.8	9.4	2.7	10.0	2.7
Romania	19.7	16.0	11.0	3.1	2.5	3.3	2.5
Slovenia	4.2	11.7	2.4	0.6	1.7	0.6	1.7
Slovakia	11.6	17.6	6.5	1.7	2.5	1.8	2.5
Total	178.1	19.0	100.0	25.6	2.7	27.1	2.7
Other funds							
Rural development	37.6	4.0		5.6	0.6	5.5	0.6
Fisheries	1.4	0.1		0.2	0.0	0.2	0.0
All funds	217.0	23.2		31.4	3.4	32.8	3.3
The EU budget	bn EUR	% of 2010 GDP	% of total	bn EUR	% of GDP	bn EUR	% of GDP
Total	975.8	8.0	100.0	141.0	1.2	143.0	1.1
Struct. funds for growth and conv.	346.1	2.8	35.5	49.4	0.4	50.6	0.4
Rural development	96.4	0.8	9.9	14.4	0.1	14.4	0.1
Fisheries	4.3	0.0	0.4	0.6	0.0	0.7	0.0
All funds	446.8	3.7	45.8	64.4	0.5	65.7	0.5

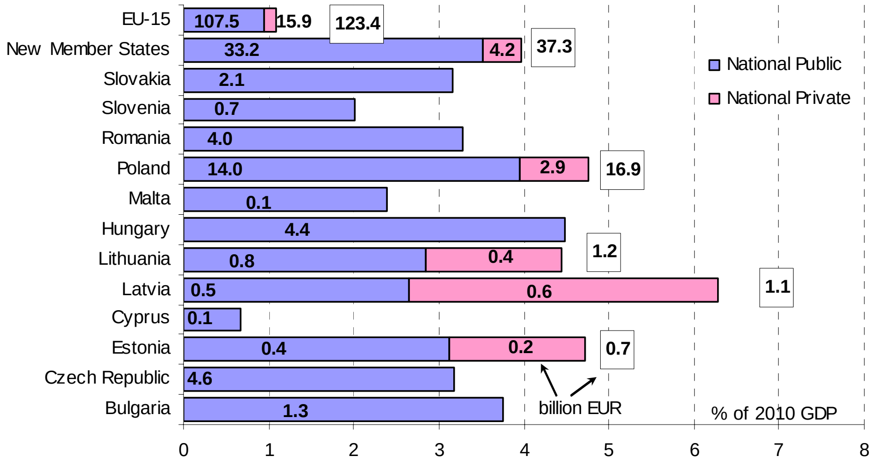
Source: European Commission

In addition to the structural funds specifically designed to foster growth and convergence, there are also the smaller European Agricultural Fund for Rural Development (EARDF) and the European Fisheries Fund (EFF), under which the new Member States could receive EUR 37.5 billion and EUR 1.4 billion, respectively, in the Financial Perspective 2007-2013. These two funds provide funding to the farming and fishing communities to help them adapt to changing conditions and become economically resilient, though will not be considered further here.

3. The need for co-financing

EU structural funds require national co-financing to strengthen project ownership and sound management. The EU co-financing rates in the Structural and Cohesion Funds are modulated on the basis of the relative level of development of the Member State supported, on the basis of the cohesion policy objective and the fund under which the support is provided. For Member States whose GDP was below 85 per cent of the EU average over the period 2001-2003, the grant financing from ERDF, ESF and CF is at a maximum of 85 per cent of the eligible investment costs of a project. For more developed Member States, the EU co-financing rates mostly vary in the range of 50 to 85 per cent.

Chart 2: National contribution to EU funded projects in 2007-2013



Source: European Commission

Given the projected funding volumes, the new Member States committed EUR 37.3 billion to co-financing (about 4 per cent of the 2010 GDP) over the period 2007-2013 (Chart 2). Of this total, the larger share (EUR 33.2 billion) was foreseen in government budgets and supplemented by private funds (EUR 4.2 billion). From a fiscal point of view, Hungary, Bulgaria and Poland need to make a substantial effort to absorb the EU funds, as more than 3.5 per cent of the 2010 GDP or 0.5 per cent per year during 2007-2013 has been earmarked in their national budgets. However, it is important to point out that Member States are not required to increase their public expenditures to provide national public co-financing. They can earmark existing expenditure and meet the co-financing needs by aligning the structure of national public eligible expenditure with the available EU resources.

4. Lack of absorption of the EU funds

4.1. The overall picture

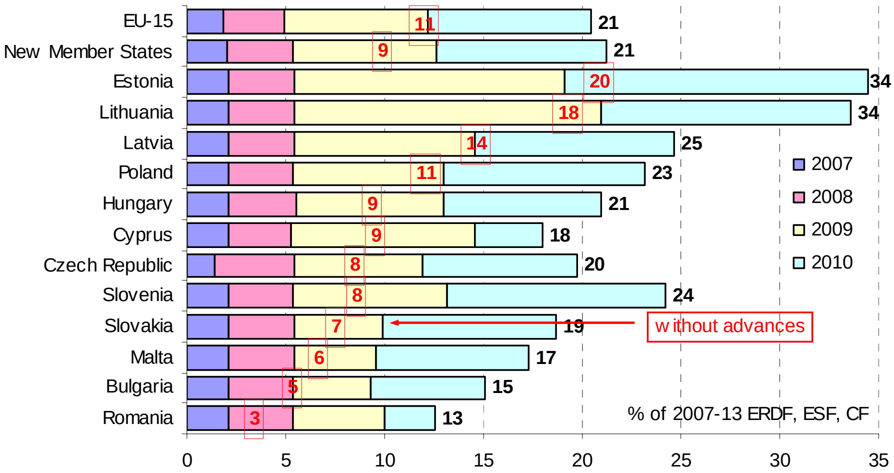
While considerable funds are available for the Member States – and particularly for those of Central and Eastern Europe – absorption has been disappointingly slow in most countries (Chart 3). The lack of absorption has been a particular problem in Romania and Bulgaria, where only 13 per cent and 15 per cent, respectively, of the funding available under the ERDF, ESF and CF in the Financial Perspectives 2007-2013 has been mobilised. Once payments of cash advances are subtracted, the absorption rate drops to 3 per cent and 5 per cent, respectively. These figures reflect better progress in project implementation as cash advances disbursed in 2007-2009 were unconditional and unrelated to the progress with the implementation of individual projects.

For 2007-2013, a common reason for the delayed absorption in the EU27 is the late agreement on the multi-annual financial framework, which has caused consequent delays in the negotiations of the National Strategic Reference Frameworks and of the Operational Programmes. Most programmes were adopted in 2007, some only at the end of 2007. Moreover, given the nature of the policy, slow absorption in the first year of the programming period after the adoption of the programmes is expected. However, in 2007-2013, the late start of programmes was coupled with the subsequent economic and financial crisis.

The absorption rates continued to be low despite the changes introduced in the approval process in 2008 to speed up disbursement in the wake of the financial crisis. These changes in essence introduced greater flexibility in allocating funding under different programmes, and reduced the administrative burden. Moreover, some flexibility in co-financing rates was introduced, allowing full grant financing under some programmes.[3]

Part of the explanation for the low absorption rate Bulgaria and Romania is their relatively recent accession to the EU in 2007, prior to which there was little time to become familiar with the relevant procedures. The new Member States as a whole, however, perform only marginally worse than the rest of the EU, as the absorption rate excluding advances is roughly 9 per cent versus 11 per cent for the old Member States.

Chart 3: Absorption of EU funds in new and old Member States until mid-2010



Source: European Commission

More than half of the Financial Perspective 2007-2013 has elapsed, but far less than 50 per cent of the available funding has been absorbed. Bottlenecks in fund absorption are encountered at different stages of the programme implementation process and differ according to Operational Programmes and country. Before focusing on the EBCI countries which belong to the European Union, a broader picture may be helpful.

Overall, the differences between the new and the old Member States are small. While for the new Member States as a whole the absorption rate including advances is similar to the EU-15 countries (21 per cent), the bottleneck in the new Member States is situated more upstream. The new Member States have a lower commitment ratio (51 per cent versus 57 per cent) meaning less efficiency in the evaluation and selection of projects which could be eligible for EU funding (Table 2). While the Commission, together with the EIB, EBRD and Kreditanstalt für Wiederaufbau, is supporting the twelve new Member States in their preparation of large projects through the JASPERS Initiative[4], in these countries, it is more demanding to contract for big amounts. By contrast, once a project is approved, the implementation, invoicing and certification of interim bills is faster, as underlined by a higher

[3] World Bank (2010): EU-10 regional study, July.

[4] JASPERS (Joint Assistance to Support Projects in European Regions) assists the twelve Central and Eastern EU Member States in the preparation of major projects to be submitted for grant financing under the Structural and Cohesion Funds. The aim is to increase the quantity and quality of projects to be sent for approval to the services of the European Commission, so as to accelerate the absorption of the available funds.

payment ratio (42 per cent versus 37 per cent). It should be noted, however, that the payment ratio includes the cash advances, which in relative terms have been more generous for the new Member States, notably for the Cohesion Fund. In the period 2007-2013, roughly 9.5 per cent of the available EU funds (ERDF, ESF and CF) have been received in advanced payments by the new Member States compared to 7 per cent for the old Member States.

4.2. Absorption in Hungary, Latvia and Romania

Among the EBCI countries, Latvia has a high payment ratio leading to an overall good absorption of EU funds. However, due to a commitment ratio of 50.5 per cent, project selection and evaluation remains below average. In the group of the new Member States, Hungary is an average performer, mainly due to a good commitment ratio (63.4 per cent) for the Operational Programmes fostering regional development to which a large amount of EU funds (EUR 5.8 billion) were allocated. For the other two big ticket items - the Operational Programmes for Transport (EUR 6.0 billion) and for Environment and Energy (EUR 4.2 billion) the performance has been less satisfactory.

Table 2: Absorption in Romania, Latvia and Hungary according to Operational Programmes

Operational Programme (billion EUR)	EU funds (1)	Committed (2)	Paid (3)	Commit-ment ratio (2)/(1)	Payment ratio (3)/(2)	Absorption ratio (3)/(1)
Romania						
Human Resources Development	3.5	1.5	0.5	44.1	30.7	13.6
Administrative Capacity	0.2	0.1	0.0	62.9	25.0	15.7
Regional Operational Programme	3.7	1.7	0.5	45.6	27.9	12.7
Economic Competitiveness	2.6	1.2	0.3	47.6	27.8	13.2
Transport	4.6	2.0	0.6	44.6	27.8	12.4
Environment	4.5	2.0	0.6	43.7	28.8	12.6
Technical Assistance	0.2	0.1	0.0	47.7	26.9	12.8
Total	19.2	8.7	2.5	45.1	28.5	12.9
Latvia						
Human Resources and Employment	0.6	0.3	0.2	50.2	82.1	41.2
Entrepreneurship and Innovations	0.7	0.4	0.3	50.1	72.6	36.4
Infrastructure and Services	3.2	1.6	0.6	50.7	39.6	20.1
Total	4.5	2.3	1.1	50.5	50.1	25.3
Hungary						
Economic Development	2.9	1.5	0.7	51.5	45.5	23.4
Environment and Energy	4.2	1.9	0.7	44.6	34.9	15.6
Transport	6.0	2.7	1.3	44.6	48.4	21.6
Social Infrastructure	1.8	1.0	0.3	54.2	29.3	15.9
Implementation	0.3	0.1	0.1	45.0	98.4	44.3
Operational Programmes for several regions	5.8	3.7	1.5	63.4	41.0	26.0
Social Renewal	3.5	2.0	0.6	57.6	30.8	17.7
State Reform	0.1	0.1	0.0	64.6	42.3	27.3
Electronic Public Administration	0.4	0.2	0.1	61.8	44.9	27.7
Total	24.9	13.1	5.3	52.6	40.4	21.3
New Member States	178.1	90.5	37.8	50.8	41.8	21.2
EU-15	168.0	95.1	35.0	56.6	36.8	20.8

Note: Payments include advances and thus overestimate absorption.
Source: European Commission

Romania is on all scores a poor performer and has difficulties at all levels of programme implementation, starting with the evaluation and selection of the projects. Usually, the lack of administrative capacity has been the main reason for the poor EU funds absorption, and, Romania is not an exception. In order to improve the administrative capacity there is a specially designed Operational Programme with an EU allocation of EUR 0.2 billion, where the absorption is somewhat better.

In the EBCI countries which are all subject to the Excessive Deficit Procedure and receive balance of payments support[5], the budgetary room to supply the national contribution is limited (Table 3). However, these countries have made efforts to ensure the requested national public contribution. Furthermore, the policy conditionality in the adjustment programmes accompanying the balance of payments support aims to ensure that sufficient resources are earmarked in the national budgets, so as to facilitate the absorption of EU funds in these countries[6].

Table 3: National budgets and their contribution to EU funding in selected countries

% of GDP	2010		2011	
	Contribution	Budget deficit	Contribution	Budget deficit
Latvia	0.4	7.7	0.4	7.9
Hungary	0.7	3.8	0.7	4.7
Romania	0.5	7.2	0.5	4.8
New Member States	0.5	6.6	0.5	5.5
EU-15	0.1	6.8	0.1	5.1

Source: European Commission

Private resources can also be foreseen to complement a tight national budget. This has been the case in Latvia, where the private national contribution amounts to EUR 0.6 billion compared to EUR 0.5 billion planned for the national budgets during the Financial Perspectives 2007-2013, amounting in total to 6.5 per cent of 2010 GDP (Chart 2). This might also explain the good absorption rate of Latvia despite tight public finances. In Hungary, the national contribution is planned to come entirely from the budget.

4.3. The potential significance of bank involvement

Banks can play a role in the absorption of EU funds, even if they will not be able to supplant efforts to strengthen administrative capacity. First, it is likely that banks' knowledge of project evaluation and selection can be usefully applied to EU structural funds, in particular among SME recipients but also among municipalities. Second, banks can speed up project execution, by providing pre-financing in anticipation of the disbursement of the EU grants. This could be a complement to the advances of about 10 percent of the total allocation that the EU already provided and to the cash advances that are handed out to the projects by the Managing Authorities. Third, banks could co-finance EU projects as not all expenditure related to a project is eligible for EU grants. This may be the largest loan opportunity for banks. The second part of the report examines the bottlenecks standing in the way of a better involvement of banks and suggests remedies to the current situation.

The lending opportunities for the banks can be put into perspective by assuming that 25 per cent of the expenditure non-eligible for EU funds is co-financed (Table 4). Furthermore, the assumption is made that the non-eligible part of the project costs is equal to the share eligible for EU funding. This could lead to an additional credit growth between 1.1 per cent (Latvia) and 1.8 per cent (Romania, Hungary) on average per year during 2007-2013. If it is assumed that 50 percent can be co-financed by banks, these numbers have to be doubled. As not all Operational Programmes are equally attractive to banks, the so calculated figures seem an

5 Hungary received balance of payments support until November 2010.

6 E.g. in the Third Supplemental Memorandum of Understanding with Romania from November 2010, it was requested that within the budget envelope, additional resources will be allocated to investment in the first half of 2011 so as to improve absorption of EU funds.

upper bound. The Operational Programmes related to Competitiveness, Transport or Energy could offer banks more involvement opportunities than some others.

Table 4: EU funds and lending opportunities in Romania, Hungary and Latvia

Operational Programme (annual average in 2007-2013)	EU funds	budget contribution	private contribution	total	co-financing at 25%	contribution to total credit growth
	million EUR				million EUR	annual %
Romania						
Human Resources Development	496.6	87.6	-	584.2	146.0	0.30
Administrative Capacity	29.7	5.4	-	35.1	8.8	0.02
Regional Operational Programme	532.3	93.9	-	626.2	156.6	0.33
Economic Competitiveness	364.9	65.3	-	430.2	107.5	0.22
Transport	652.3	161.7	-	814.0	203.5	0.42
Environment	644.6	156.9	-	801.6	200.4	0.42
Technical Assistance	24.3	6.1	-	30.4	7.6	0.02
Total	2744.7	576.9	-	3321.6	830.4	1.73
Latvia						
Human Resources and Employment	78.7	8.4	5.5	92.5	23.1	0.14
Entrepreneurship and Innovations	105.2	14.8	34.8	154.9	38.7	0.23
Infrastructure and Services	458.7	44.4	52.4	555.4	138.9	0.81
Total	642.6	67.6	92.6	802.9	200.7	1.17
Hungary						
Economic Development	408.4	72.1	-	480.5	120.1	0.21
Environment and Energy	597.0	105.3	-	702.3	175.6	0.31
Transport	861.0	151.9	-	1013.0	253.2	0.44
Social Infrastructure	254.6	44.9	-	299.5	74.9	0.13
Implementation	45.0	7.9	-	53.0	13.2	0.02
Operational Programmes for several regions	824.5	145.5	-	970.0	242.5	0.42
Social Renewal	497.5	87.8	-	585.3	146.3	0.26
State Reform	20.9	3.7	-	24.6	6.2	0.01
Electronic Public Administration	51.2	9.0	-	60.2	15.1	0.03
Total	3560.2	628.3	-	4188.4	1047.1	1.83

Notes: The co-financing rate is applied to the part in a project which is not eligible for EU funds and assumed to be equal to the eligible part. Usually the share of non-eligible costs is lower, particularly in poorer regions and smaller companies and represents about 30-40% of eligible costs. This lowers the co-financing part of the banks. However, the co-financing rate is likely to be higher than 25%. The contribution to credit growth is calculated vis-à-vis total outstanding private credit in November 2010

Source: European Commission

Banks seem to have a comparative advantage especially for projects involving SMEs. For illustrative purposes a closer look at Romania reveals that the Operational Programme for Economic Competitiveness has an annual allocation of EUR 430 million of which 85 per cent is co-financed by EU funds. If these resources are made available to the economy, there could be lending opportunities for the banks. Assuming that the non-eligible part is equal to the part eligible for EU funding and a 25 per cent co-financing ratio, EUR 107.5 million in loans could be granted leading to an additional credit expansion of 0.25 per cent per year.

The involvement of commercial banks in lending to SMEs using already existing frameworks may unfold *via* the JEREMIE Initiative.[7] This initiative offers to the Member States the possibility to use part of their EU funds to finance SMEs by means of loans, equity and guarantees, through a Holding Fund which acts as an umbrella. The JEREMIE Holding Fund can provide SME-focused financial instruments through selected financial intermediaries (e.g. private commercial banks), including guarantees, co-guarantees and counter-guarantees, equity guarantees, (micro) loans, export-credit insurance, securitization, venture capital etc.

[7] JEREMIE (Joint European Resources for Micro to Medium Enterprises) is a joint initiative developed by the European Commission, EIF and EIB to promote increased access to finance for micro, small and medium-sized enterprises.

JEREMIE has the ability to involve the banking sector either at the Holding Fund level, with additional capital from financial institutions or at the level of financial instruments through co-financing.

Since 2007, several Managing Authorities have started the JEREMIE implementation. By the end of 2010, 30 holding funds were set up in 15 Member States with roughly EUR 3.7 billion (of which some EUR 2.7 billion from Structural Funds) legally committed to these holding funds. A conservative estimate based on the available data indicates that EUR 1.6 billion were committed to financial intermediaries such as loan funds, guarantee funds and equity funds (and other financial intermediaries) and therefore available to final beneficiaries (SMEs).

For the EBCI countries and Bulgaria, roughly EUR 1 billion were legally committed to the JEREMIE holding funds. In Romania, for instance, further progress has been made to utilise the resources available in the JEREMIE Holding Fund. In January 2011, the European Investment Fund (which acts as holding fund manager) signed agreements with two Romanian commercial banks for a guarantee product called "First Loss Piece Guarantee". In exchange of a guarantee coverage of EUR 63 million, the two banks have committed to provide new loans amounting to EUR 315 million to roughly 2000 SMEs.

II. Role of the private sector in the absorption of EU funds in selected Member States

The involvement of the private sector (e.g. through commercial banks) and of profit oriented companies in various phases of the selection and implementation of EU co-financed projects has contributed to the improvement of EU funds absorption in several Member States. For instance, Italian commercial banks performed functions of intermediary bodies in the financial perspective. Furthermore, Greek commercial banks have been closely involved in the process of EU funds absorption since 2001.

In Hungary, the improvement of EU funds absorption in the last couple of years has been the corollary of the changes introduced in 2006 in the management model of EU structural funds. To ensure a more efficient management of operational programs, Hungary introduced in 2006 a centralized management model of EU structural funds. At the same time, profit oriented companies were allowed to assume functions of intermediary bodies.

Currently, the National Development Agency is the central government agency responsible for the programming, managing and implementation of EU co-financed projects. The Agency works under the supervision of the Minister responsible for the national development and in close cooperation with line ministries. From 2006 onwards, the Managing Authorities of all Operational Programmes have operated as separate organisational departments of the National Development Agency.

In this new model, the absorption process of EU structural funds has received a new impetus due to the involvement of profit oriented companies. For instance, the Managing Authority for the Operational Programme Economic Development has an intermediary body (the Hungarian Economic Development Centre – MAG) as well as financial body (Venture Finance Hungary Ltd) acting as profit oriented companies. The Hungarian Economic

Development Centre was founded in September 2006 by the Hungarian Development Bank at the initiative of the National Development Agency and the Ministry of Economy and Transport.

Venture Finance Hungary was established in May 2007 under the JEREMIE Initiative with the aim of developing and running financial programmes which will expand the financing options of the Hungarian SMEs. Venture Finance Hungary, which belongs to the Group of the Hungarian Development Bank, has as sole activity the management of financial resources committed by the EU and Hungary. Designated as Holding Fund Manager, Venture Finance Hungary is supervised by the Hungarian Financial Supervisory Authority.

Finance Venture Hungary selects through open calls several private financial intermediaries to execute the programmes, provide microcredit and credit guarantees or manage venture capital funds. The intermediaries bring private experience and private funding into the programmes, while Finance Venture Hungary partially refinances their activities within this framework.

III. Exploring a role for commercial banks in Romania and Bulgaria

Bulgaria and Romania are confronted with the greatest challenge in absorbing EU structural funds. The overall absorption rate is low relative to both funds allocated and national income overall, and, given the context of an ongoing economic and credit contraction, national authorities are committed to taking steps to raise absorption, including through a closer involvement of commercial banks. While an above average performer, also in Latvia initiatives were taken to further improve the absorption of EU funds (Box 1).

Box 1: The role of commercial banks in Latvia

On 1 June 2010, a meeting with Scandinavian banks operating on the Latvian market took place in Riga to explore opportunities for a better involvement of banks in the process of EU funds absorption. The meeting was instrumental in designing the policy conditionality in the Third Supplementary Memorandum of Understanding between the European Union and Latvia. Following this meeting, in view of facilitating bank lending for EU co-financed projects, the Latvian authorities committed to establish a mechanism for the regular involvement of banks in the design of new EU co-financed programmes, as well as in the assessment of the viability of EU projects prior to approval by government agencies.

The assessment in this section is based on a number of meetings in Bulgaria and Romania with commercial banks, but also with Managing Authorities. Given potential concerns by Managing Authorities seeking to meet the requirements of EU regulations on structural funds, not all proposals made by banks in these meetings are ultimately reflected in the recommendations of the working group included in section IV.

Representatives of parent banks of the large foreign-owned banks operating in Romania and Bulgaria agreed that an improvement of EU funds absorption coupled with an increased involvement of banks in this process might offer alternative investment opportunities for banks and, consequently, could contribute to reviving credit activity. To improve the absorption of EU funds through a closer involvement of banks the following key issues need to be addressed.

3.1. The involvement of commercial banks in Romania

Meetings addressing the issue of a closer involvement of banks in the process of EU funds absorption took place in Bucharest on 6 August and 14 September 2010. The meetings were attended by the nine largest foreign-owned banks participating in the European Bank Co-ordination Initiative for Romania, the Romanian authorities (i.e. Ministry of Finance and the line ministries involved in the management of the Operational Programmes competitiveness and environment), the Romanian Banking Association, the European Commission and the IFIs (IMF, EIB and EBRD).

To improve the absorption of EU funds in Romania *via* a better involvement of banks the following issues need to be addressed:

"Bankability" of projects. Currently a small share of the projects selected by the Managing Authorities for Structural Funds fulfils the financial assessment criteria of banks that would allow the conclusion of a financing contract. This is all the more remarkable, given the substantial grant element involved in funding a beneficiary. There are mainly two measures, which are likely to increase the ability of selected projects to secure bank financing:

- Harmonization of the eligibility criteria of projects used by Managing Authorities with the financial assessment criteria of banks. The low "bankability ratio" of selected projects is a corollary of the assessment process of the Managing Authorities, which focuses on the viability of projects and their ability to meet social or development goals. Managing Authorities do not assess the creditworthiness of the beneficiary, which from the point of view of banks constitutes the key pre-requisite for the decision to finance a project. Albeit necessary to reduce the number of selected projects that cannot secure bank financing, the harmonization of eligibility criteria has proven to be a difficult task. The assessment of the creditworthiness of the beneficiary by banks constitutes a process which uses both quantitative and qualitative criteria, with the latter involving a sizeable judgemental component. To reach agreement between authorities and banks on a set of harmonized criteria, stakeholders need to make further progress. So far, no consensus has been reached on the proposals made to the Romanian Banking Association by the Managing Authority of the Operational Programme Competitiveness.

- Use of a Letter of Comfort by banks as part of the documentation submitted by companies in the evaluation/selection phase of projects. The issuance of a Letter of Comfort at an early rather than at a later stage in the selection process may send an important signal to the Managing Authorities from the outset that the project is bankable. A binding Letter of Comfort gives more certainty to beneficiaries on the intentions of banks to provide the necessary co-financing. The design of the Letter of Comfort, such as the type of the letter to be used (binding *vs.* non-binding) and the main clauses, constituted an important aspect of the discussions between banks, Managing Authorities and the Ministry of Finance. As of 2011, at the moment of project submission, a binding Letter of Comfort will be required for the calls for project proposals addressed to companies, which have a state aid/*de minimis* component and therefore, a high co-financing requirement.[8]

Table 5: Overview of other proposals to improve EU funds absorption made by banks

Area	Proposed measures
Administrative capacity	• Enhance the administrative capacity of Managing Authorities, especially for highly demanding Operational Programmes to better cope with the administrative burden of project assessment and payments • Improve the incentive scheme for civil servants dealing with EU co-financed projects by introducing performance-linked remuneration
Pre-selection phase of projects: beneficiary guide	• Include minimum requirements for the own financial contribution of the beneficiary in the beneficiary guide in order to ensure a better valuing of projects
Evaluation/implementation of projects and verification of repayment requests	• Launch a tender for the outsourcing of the activities of Managing Authorities to banks with the aim of involving them in the implementation phase of non-major projects • Launch a tender for outsourcing of, or centralizing in a single entity, a pilot call for projects within the Operational Programmes or other financing schemes which focus especially on SMEs • Involve financing banks in the oversight of projects during the implementation phase
Public procurement	• Improve public procurement procedures to speed up the project implementation phase
Human resources	• Organise regular training sessions with representatives of banks and Managing Authorities to create a common understanding of tasks, activities, goals, benchmarks and legal as well as other operational requirements

Source: This overview is based on further suggestions made by banks during the meetings held on 6 August and 14 September 2010. Following banks submitted proposals: Bancpost (Eurobank EFG), Banca Românească (National Bank of Greece), BRD (Société Générale), CEC, BCR (Erste Bank), Raiffeisen Bank, Unicredit and Volksbank.

Improved dissemination of information by the Managing Authorities. Further measures are necessary to increase the transparency of information provided by the Managing Authorities on the calendar of the call for projects and tenders as well as on the list of selected and contracted projects. Recently, however, further progress has been made in the area of information dissemination. The Ministry of Economy, for instance, launched a tender on consultancy services for projects funded through under the Operational Programme Competitiveness, which for the first time was open to both banks and consultancy firms. Furthermore, the Authority for Coordination of Structural Instruments developed a web tool which gives banks the possibility to obtain information on the geographical location of beneficiaries. Moreover, banks are no longer excluded from the tenders organised by the

[8] The Letter of Comfort has a single format for all relevant Operational Programmes. The minimum amount of the credit facility for which the Letter of Comfort is issued equals the own eligible contribution of the project beneficiary. A Letter of Comfort is requested only for the projects for which the own eligible contribution of the beneficiary equals or exceeds EUR 100,000.

Managing Authorities/Intermediary Bodies for contracting specialised support services related to project appraisal, monitoring and payment claim verification.

Modification of the provisions in the beneficiary guide concerning the insurance of financed assets. The provisions in the beneficiary guide according to which after the final reception of financed assets/goods, the insurance policy for these goods/assets taken out by the beneficiary has to be ceded in favour of the Managing Authority needed to be changed. Following the agreement reached between the Ministry of Finance, Managing Authorities and commercial banks, the insurance policy will be ceded in favour of the financing bank instead.

Appropriate incentives. Through their involvement in the selection of structural funds projects banks will gain additional business, in which spreads on lending to primarily grant-funded projects should reward for risks thereby taken on.

3.2. The involvement of commercial banks in Bulgaria

To discuss options for a better involvement of commercial banks in the process of EU funds absorption, several meetings were held in Sofia since June 2010. These meetings were attended by the largest banks operating on the Bulgarian market as well as the representatives of the Ministry of Finance and other line ministries involved in the management of EU funds (i.e. the Ministry of Economy, Energy and Tourism, the Ministry of Agriculture and Food). Furthermore, a working group which includes the Ministry of Economy, Energy and Tourism, various Managing Authorities for EU funds, the Bulgarian Banking Association as well as several commercial banks was set up.

To improve the absorption of EU funds under the Operational Programme Development and Competitiveness for the remainder of the current financial perspective and for building up capacity for the next financial perspective, the Ministry of Economy, Energy and Transport has developed a new model. In a first phase, this model will be tested in 2011 through a pilot project aiming at enhancing the competitiveness of Bulgarian companies by introducing energy efficient technologies and equipment. During this phase, in which the pilot project will also benefit from the support and assistance of the EBRD, banks will mainly perform the following tasks: *(i)* assess the financial situation of the company and the conditions for granting a loan; *(ii)* issue a verification of financial admissibility; *(iii)* Sign a loan contract after the beneficiary has submitted a contract for non-repayable EU funding; *(iv)* grant a loan to the company after verifying the procedures held by the beneficiary for selection of contractors.

In a second phase, this model entails the option of a closer involvement of banks operating on the Bulgarian market (e.g., banks may take over several functions of the intermediary body) in the absorption process. However, given the differences compared to the current managerial structure for EU funds absorption, this option needs to be screened by the national audit authority to comply with regulatory requirements (i.e. "Compliance assessment" exercise). Moreover, the public authority will have to maintain its control and bear the full responsibility for this option.

IV. Conclusions and recommendations

Conclusions

The EU structural funds constitute significant resources available to EU Member States. These funds are particularly important for the new Member States, for which the funds yet to be disbursed could amount to up to 2 per cent of GDP per year for the remainder of the current financial perspective. While absorption rates have been also low in the old Member States, the lack of capacity to better absorb EU funds has been particularly acute in the new Member States. The latter have been lately confronted with subdued economic growth, constraints in bank funding to the private sector as well as budgetary constraints on public investment.

The majority of Member States have decided to manage structural funds directly or through state agencies. However, in the new Member States this approach has been faced with sizeable difficulties given the constraints in institutional capacity, and the relatively recent adoption of the EU *acquis* prior to the accession rounds in 2004 and 2007. The current financial crisis forces governments to explore more efficient mechanisms for delivering EU grants in support of companies and to reduce financing gaps in the public sector, in particular in view of the fact that unutilised funds will no longer be available three years after they were first granted.

Several Member States have experimented with utilising banks as intermediary bodies outside the public sector to accelerate EU funds absorption, in particular in channelling funds to SMEs. Banks may perform, *inter alia*, the functions of project assessment, fund disbursements, monitoring and reporting to public administrations and on-site inspections.

This may entail several advantages for public administrations, as banks will select eligible projects which they are also prepared to support through pre-financing and co-financing, thereby leveraging grants available. Moreover, banks can become adept and develop efficiencies in providing certain administrative tasks, and to monitor projects throughout the entire financing period.

By involving commercial banks in these activities a number of concerns need to be addressed. First, banks look legitimately after their business interests in the provision of commercial loans focussing on the bankability of projects, which not necessarily matches the public interest motivation behind the grant financing by the EU. This may lead to conflicts of interest when banks are involved in both the selection of projects and financing. There may be also doubts that those banks which are ultimately motivated by developing lasting client relationships with private clients will act as impartial agents for the Managing Authorities in project selection and monitoring. This concern may also be shared by banking sector supervisors which may have apprehensions regarding large exposures or an unbalanced or unsustainable earnings structure. Second, from the perspective of the national Managing Authorities, a suitable procurement process will need to identify qualified banks delivering such services at a competitive price. Public payments to commercial banks will need to stay clear of concerns over state aid, to avoid the distortion of competition.

A third concern may arise from involving banks in a process that has been frequently criticised for leading to fraud and misuse of funds. This may expose banks to certain reputational risks, in particular where recipients are large relative to the bank's overall balance sheet. Concerns expressed in the media or held by the public over integrity of key bank clients, may implicate bank management for colluding in fraudulent practices, and could lead to instability in the bank's funding relationships, including from retail deposits. At the same time, this risk underlines the potential from involving banks, which through their established customer relationships will carefully scrutinize projects they commit funding to, and which they will feel in a position to monitor on an ongoing basis.

Recommendations

In light of the Working Group engagement in Bulgaria and Romania, the following recommendations are made for a re-designed implementation of structural funds in these two countries. A number of recommendations may require a more wide-ranging re-design of the management of structural funds which may only be possible on a pilot basis in the short run before being introduced on a more comprehensive basis in the next budgetary period, if the experience with the pilot is successful.

Role of national bank associations. Joint working groups should be established between the national banking association and the line ministries involved in managing Operational Programmes for EU funds, to focus on the identification of a set of indicators for the financial assessment of projects to be used by the Managing Authorities to reduce the number of non-bankable selected projects.

Relation between Managing Authorities and banks. Managing Authorities should concentrate on the formulation of strategic objectives of individual programmes, regulation of procedures and control on the basis of simple checks. Regular consultative meetings with banks should allow banks to assess future financing needs and understand the criteria for project approval. Such criteria can be prepared in cooperation between the banks and public authorities.

Ensuring financing by commercial banks. During the evaluation/section phase of a project, banks should issue a Letter of Comfort after performing their own assessment of projects. This Letter of Comfort would oblige banks to provide specified funding over a period of three months, though would become non-binding following that period, if the selection process is not completed.

Conducive environment for innovative financing instruments. National authorities need to develop the framework for public private partnerships to attract private lending into a wider range of sectors eligible for structural funds. PPPs in which special purpose vehicles are funded through both structural fund and commercial banks, have been utilized by a number of new Member States.

Involvement of commercial banks as intermediary bodies may be considered as an option in the medium rather than the short run. The service to be provided by banks may include administrative functions (e.g. receiving applications and examining viability of projects), the associated financing relationships as the project progresses, and certain monitoring functions on behalf of the Managing Authorities. However, any change in the managerial structure of EU funds absorption has to be re-assessed by the national audit authorities and validated by the European Commission, as it is on this basis that the EU reimburses payment claims. Consequently, the modification in the set-up of the managerial structure needs to be the outcome of a thorough assessment to avoid any further delays in the absorption process. Furthermore, any conflict of interest should be also carefully considered.

Selection procedure for banks as intermediary bodies. Where there is scope for the involvement of commercial banks as intermediary bodies there needs to be a structured, disciplined and transparent tendering process, fully observing European procurement standards.[9] Following the public procurement procedures takes time as well as the adaptation of the administrative and legal framework related to the management of the Operational Programmes.

Phasing in and learning from the involvement of banks. The proposed functions of banks could be phased in and evaluated through pilot projects in certain regions, as supported by efforts to raise public awareness for programs funded by participating banks.

Coherence with existing facilities. The involvement of banks in the management of structural funds oriented to the SMEs should be seen as a tool that complements the already used EU financial instruments, in particular JEREMIE. Experience and best practices in other EU member countries provide some valuable lessons which can be applied.

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[9] The selection of intermediary bodies should be made on the basis of the restricted procedure, as defined in Article 28 of Directive 2004/18/EC on the coordination of procedures for the award of public works contracts.