advancing with ESIF financial instruments

Setting up a microfinance financial instrument

Factsheet

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Abbreviations

Abbreviation	Full name
CPR	Common Provision Regulation
EEA	European Economic Area
EC	European Commission
EU	European Union
EMN	European Microfinance Network
EPMF	The European Progress Microfinance Facility
ERDF	European Regional Development Fund
ESF	European Social Fund
ESI Funds	European Structural and Investment Funds
GBER	General Block Exemption Regulation
GGE	Gross Grant Equivalent
OP	Operational Programme
SME	Small and medium-sized enterprise
TO	Thematic objective
YEI	Youth Employment Initiative

Introduction

The scope of this factsheet is to serve as guidance for European Social Fund (ESF) managing authorities that decide to set up a microcredit[1] financial instrument. In order to support vulnerable persons and micro-enterprises, a microcredit is a suitable financial instrument to combine European Union (EU) funds with public and private resources to provide access to finance, in particular, loans for business purposes, to vulnerable groups usually excluded from mainstream finance.

A microcredit should target vulnerable persons and micro-enterprises who have limited access to finance, while small-sized loans normally carry higher interest rates. A dedicated financial instrument backed by ESF would bridge the financing gap and provide more funds at preferential conditions, together with non-financial services.

The factsheet constitutes a step-by-step guidance on the key points of setting up a financial instrument based on the experiences and lessons learned in the 2007-2013 and the present programming period and is articulated in ten steps which answer to the following questions:

WHY and for whom a financial instrument?

1. **Choosing the aim of the financial instrument**
2. **Defining the target group – final recipients**

WHO is involved?

3. **The managing authority's role**
4. **Identify the implementing bodies**

WHAT kind of financial product?

5. **Define the financial product**
6. **Lending policy**
7. **Pricing policy**

HOW shall the financial instrument be implemented?

8. **Non-financial services**
9. **State aid implications**
10. **Reporting and targeted results**

For each of the ten steps, besides providing synthetic operational suggestions, alternative implementing options are presented and discussed. In addition, to better understand the overall framework and to stimulate further thinking, data and additional technical information are contained in a short paragraph (facts and insights) at the end of each step.

Further reading
■ Introducing financial instruments for the European Social Fund (Manual)
■ Financial instruments working with microfinance (Factsheet)
■ Financial instruments working with social entrepreneurship (Factsheet)
■ Financial instruments working with personal loans (Factsheet)

1 The European Commission's current definition of microcredit is 'a loan of up to EUR 25 000' – EU Regulation No 1296/2013.

1. CHOOSING THE AIM OF THE FINANCIAL INSTRUMENT

The first step is to identify the aim or objective of the financial instrument. This must be done in line with the objectives of the related ESF Operational Programme (OP) priority axis, and the results of the ex-ante assessment.

Thematic Objective (TO) 8, TO 9 and TO 10 can be pursued through financial instruments. Possible aims of the financial instrument can be:

- increase the supply of, and access to finance of vulnerable groups, addressing concretely identified market gaps and social challenges;
- promote quality and sustainable employment;
- combat and prevent social exclusion and poverty;
- promote equality between men and women.

However, the ESF OP contribution from the managing authority to a financial intermediary:

- **shall not distort the market by crowding out financing** available from other private or public investors;
- shall provide funding to build up **a portfolio of new loans**, and may participate in the losses/defaults and recoveries of the microcredits in the portfolio on a loan by loan basis and in the same proportion as the OP contribution to the financial instrument (*pari passu* terms);
- shall ensure that the full financial advantage of the ESF OP contribution be **passed on to the final recipients** (e.g. as a reduction of the interest rate of the underlying loan and/or collateral reduction and/or repayment schedule).

Figure 1: Options for financial instruments in ESF

Thematic Objective 8
Promoting employment and supporting labour mobility

Microcredits can be used to support self-employment and small business creation.

Thematic Objective 9
Promoting social inclusion and combating poverty

Microfinance can support minorities and marginalised communities with developing economic activities, thus promoting active inclusion.

Thematic Objective 10
Investing in education, skills and lifelong learning

Student loans are particularly suitable given the flexibility and efficiency of the instrument and can therefore encourage further education.

Facts and insights

In the 2014-2020 programming period, at 31 December 2017, financial instruments co-financed by the ESF have been established in seven Members States. Moreover, EUR 557 million of OP contribution had been committed to financial instruments. Of the European Structural and Investment Funds (ESI Funds) share, EUR 361 million were ESF resources and EUR 20 million were Youth Employment Initiative (YEI) resources.

Figure 2: Member States with financial instruments in two programming periods

Period/MS	BG	DE	HU	DK	EE	IT	LT	LV	PL	SI	SK
2007-2013		√		√	√	√	√	√	√	√	
2014-2020	√	√	√			√	√		√		√

Figure 3: Amounts committed to financial instruments under ESF OPs (EUR million)

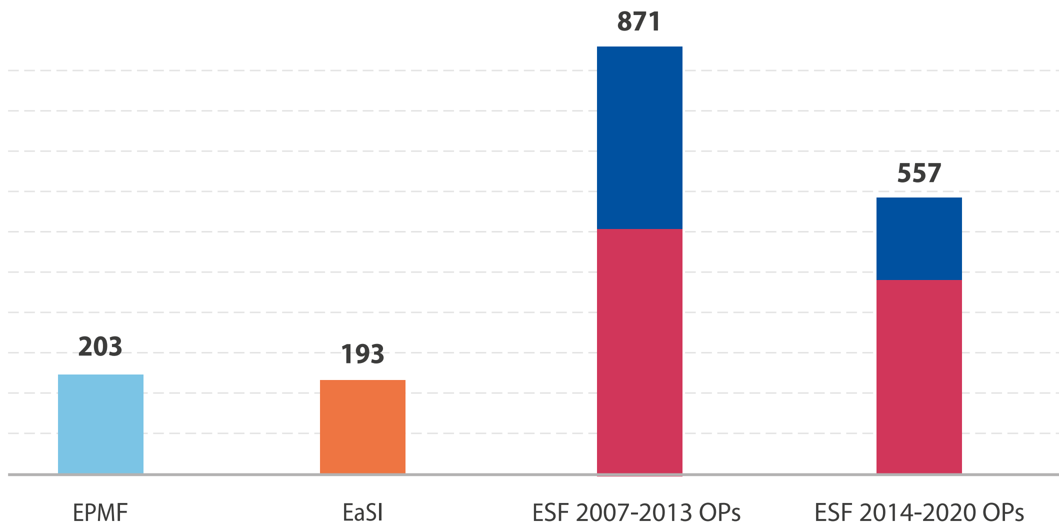
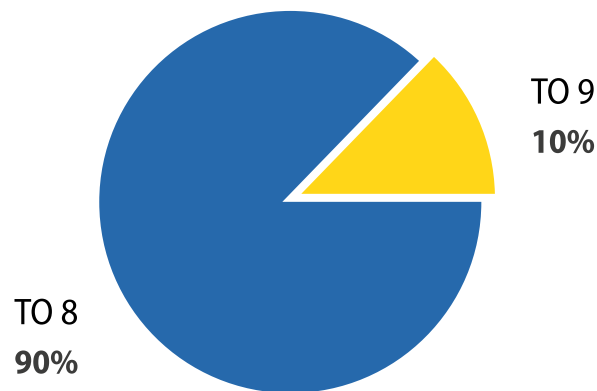


Figure 4: Commitments to financial instruments as total commitment by thematic objective (ESF and YEI, 2014-2020 programming period)



2. DEFINING THE TARGET GROUP – FINAL RECIPIENTS

The identification of the target group is an important initial step and should already be identified in the ex-ante assessment in accordance with Article 37 of Regulation (EU) No 1303/2013. In the ESF programming context, the final recipients are commonly vulnerable persons or micro-enterprises, especially micro-enterprises which employ vulnerable persons. The final recipients shall be eligible under EU and national law, the relevant OP and funding agreement. The following eligibility criteria shall be met at the date of the signature of the loan:

- a vulnerable person who has lost or is at the risk of losing the job, or who has difficulties entering or re-entering the labour market, or who is at risk of social exclusion or is socially excluded and who is in a disadvantaged position about access to the conventional credit market and who wishes to tart up or develop own micro-enterprise, including self-employment;
- shall be a micro-enterprise (including individual entrepreneurs/self-employed persons) as defined in Commission Recommendation 2003/361/EC;
- shall not be an enterprise active in the sectors defined in point (d) – (f) of Article 1 of the *de minimis* aid Regulation;
- shall not be part of on one or more restricted sectors[2];
- shall not be a firm in difficulty as defined by State aid rules;
- shall not be delinquent or in default in respect of any other loan or lease either granted by the financial intermediary or by another financial institution pursuant to checks made in accordance with the financial intermediary internal guidelines and standard credit policy.

In addition, at the time of the investment and during the reimbursement of the loan, final recipients shall be a resident or have a registered place of business in a Member State and the economic activity for which the loan was disbursed shall be located in the relevant Member State and Region/Jurisdiction of the ESF OP.

2 The following economic sectors are together referred to as the 'restricted sectors'. (a) illegal economic activities: any production, trade or other activity, which is illegal under the laws or regulations of the home jurisdiction for such production, trade or activity. (b) Tobacco and distilled alcoholic beverages. The production of and trade in tobacco and distilled alcoholic beverages and related products. (c) Production of and trade in weapons and ammunition: the financing of the production of and trade in weapons and ammunition of any kind. This restriction does not apply to the extent such activities are part of or accessory to explicit European Union policies. (d) Casinos. Casinos and equivalent enterprises. (e) IT sector restrictions. Research, development or technical applications relating to electronic data programs or solutions, which (i) aim specifically at: (a) supporting any activity included in the Restricted Sectors referred to a to d above; (b) internet gambling and online casinos; or (c) pornography, or which (ii) are intended to enable to illegally (a) enter into electronic data networks; or (b) download electronic data. (f) Life science sector restrictions. When providing support to the financing of the research, development or technical applications relating to: (i) human cloning for research or therapeutic purposes; or (ii) Genetically Modified Organisms (GMOs).

Options for final recipient eligibility	Pros	Cons
Only disadvantaged final recipients (listed)	Initiative is fully focused on the social aspect.	Increased difficulty to manage, high risk, financial intermediaries may not have the ability to deal with this. Reduces flexibility and could make the financial instrument difficult to implement.
Any SME or entrepreneur that qualifies	Greater reach to final recipients, moderate risk, financial gain.	No focus on disadvantaged groups and no guarantee of a direct impact in social terms.
Any SME or entrepreneur but disadvantaged individuals have priority	The social aspect has priority over the financial one.	Complicated to assess and rank the credit worthiness and risk profile of final recipients.

Facts and insights

During the 2007-2013 programming period, the financial instruments focused primarily on micro and/or social enterprises, often targeting specific populations, such as self-employment and/or disadvantaged people. This was reflected in the final recipients, where about half of those supported are individuals and the other half are micro-, small and medium-sized enterprises.[3] Of the SMEs supported by the ESF, 90% were micro-enterprises, a significantly higher ratio than for the European Regional Development Fund (ERDF), which is 42%.

3 European Commission, Summary of data on progress in financing and implementing financial engineering instruments reported by the managing authorities in accordance with Article 67(2)(j) of Council Regulation (EC) No 1083/2006 – Programming period 2007-2013 – Situation as at 31 March 2017 (at closure).

3. THE MANAGING AUTHORITY'S ROLE

The managing authority can have **different roles in implementing financial instruments**. The ex-ante assessment shall define the governance structure of the financial instrument. Four implementation options are foreseen by Article 38 of the Common Provision Regulation (CPR), namely contributing with ESI Funds resources to EU level financial instruments, investing in the capital of an existing or newly created legal entity, undertaking implementation tasks direct or entrusting implementation tasks to another entity.

The latter is the most common option: managing authorities appoints a financial institution for public interest under public control (which is normally a national or regional development bank or promotional bank or promotional agency) or an International Financial Institution (IFI) or the European Investment Bank (EIB) Group:

- as a manager of fund of funds (body implementing a fund of funds); or
- as a manager of a specific financial instruments/products (financial intermediary).

This option provides the managing authority with a robust structure, which is well equipped and used to manage funds and investments according to recognised standards of independence and professional management. Therefore, the option could be used where a long term partner for entrustment is sought.

The **managing authority's liability** in relation to the financial instrument shall be as set out in Article 6 of Delegated Regulation (EU) No 480/2014. The losses covered are principal amounts due, payable and outstanding and standard interest (but excluding late payment fees and any other costs and expenses).

Alignment of interest between the managing authority and the financial intermediary shall be achieved through performance fees, as provided by Articles 12 and 13 of the Delegated Regulation (EU) No 480/2014.

Furthermore, in case the financial instrument is designed to be State aid free at the level of the financial intermediary, the alignment of interest shall be ensured by an appropriate sharing of risk and profit on a normal commercial basis and compatible with State aid rules. For instance:

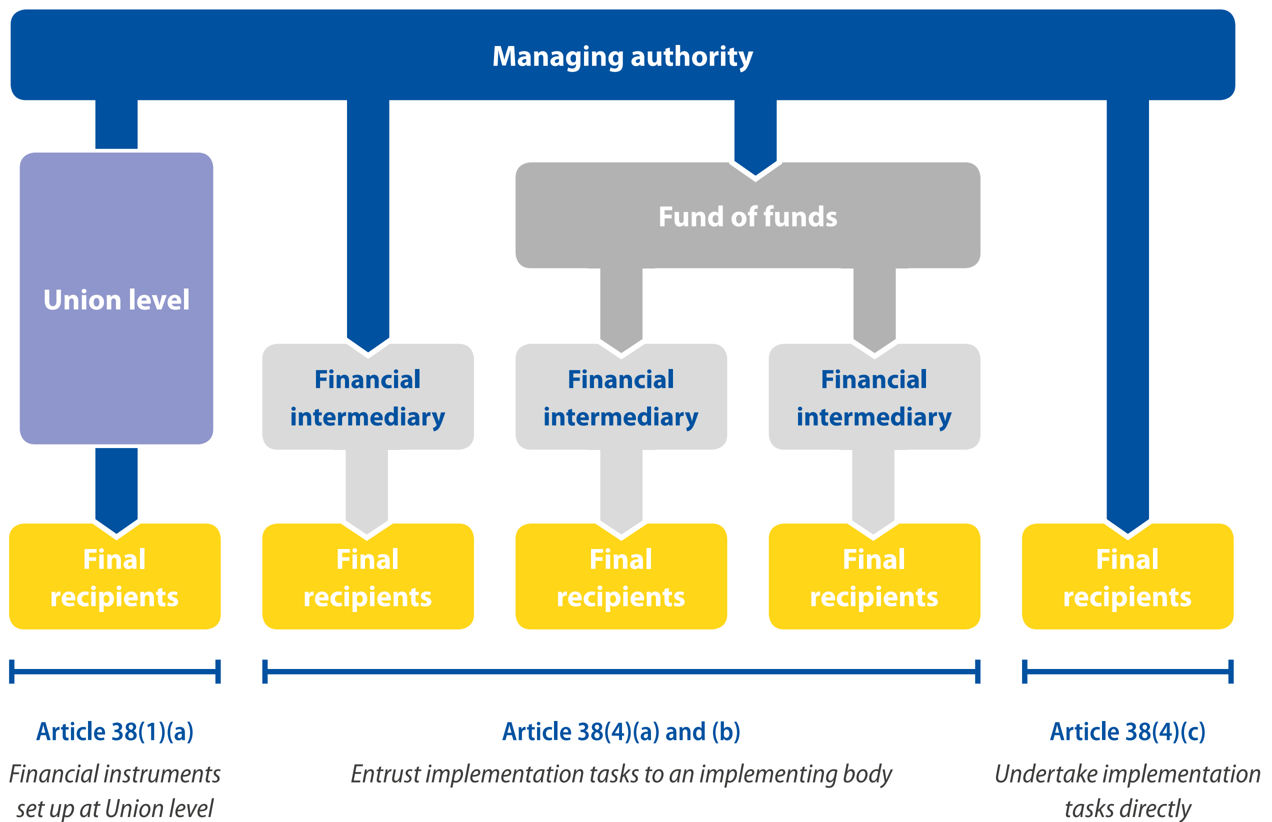
- the financial intermediary's contribution is in line with local market conditions and amounts to at least 30% of the total financing commitment for lending to final recipients; and/or
- the losses and recoveries impact pro rata the financial intermediary and the managing authority, in accordance with their respective liability.

4 EU Regulation No 1303/2013 of the European Parliament and of the Council of 17 December 2013.

5 *fi-compass*, Ex-ante assessment methodology for financial instruments in the 2014-2020 programming period – General methodology covering all thematic objectives, Volume I.

Further options for implementing financial instruments	
Direct implementation of the financial instrument by the managing authority	This option can be used exclusively when the financial product to be provided by the financial instrument is a loan or a guarantee. The managing authority or the intermediate body may have a significant experience and good knowledge on financial instruments. In addition to the in house expertise, also resources in the managing authority or an intermediate body are needed, since it will have to ensure the full scope of activities involved in the financial instrument implementation, including due diligence, treasury management, risk management, monitoring and reporting. The advantages of this option are as follows: • The possibility to draw non grant finance from ESI Funds without establishing a dedicated financial instrument, which could be complex and potentially time consuming; • Avoids introducing additional layers of reporting and monitoring; • Leverage the competences when the managing authority already holds in house expertise.
Contribution from ESF to EU level financial instruments	The managing authority can contribute to a EU-level financial instrument. Inter alia, EaSI (EU Programme for Employment and Social Innovation) is very relevant for ESF addressing specifically microfinance theme. The main elements to consider for the managing authority to find the best possible financial instrument are: • Avoiding duplication and increasing efficiency by taking advantage of an already existing financial instrument, instead of creating a new one and reaching a sufficient critical mass is essential for the success and the effectiveness of the envisaged financial instrument; • Reducing the risk taken when setting up financial instruments, by relying on a tested vehicle, a proven set of procedures and implementation structure established by the European Commission (EC); • Capitalise on EU wide experience to develop regional and national capacities over time to possibly set up, e.g. a tailor made financial instrument in the future and the possibility to increase the co-financing rate up to 100%; • The managing authority shall not carry out on-the-spot verifications of operations (it shall receive regular control reports from the bodies entrusted with the implementation of these financial instruments). At the same time, the audit authority shall not carry out audits of such financial instruments and of management and control systems relating to these instruments.

Figure 5: Implementation options for the managing authority (under Article 38 of the CPR)



Facts and insights

When implementing a financial instrument, the managing authority's responsibilities are defined in the CPR. The box below presents an indicative – not exhaustive – list of the key activities and relevant article of the EC Regulations.

Managing authority's activity	Regulation
The managing authority's liability in relation to the financial instrument	Article 6 of Delegated Regulation (EU) No 480/2014
Performance fees for the implementing bodies	Articles 12 and 13 of the Delegated Regulation (EU) No 480/2014
Tranches and ceilings of the transfer of the public contributions from the OP	Article 41 of Regulation (EU) No 1303/2013
The use of interest and other gains generated by support from the ESI Funds to financial instruments	Article 43 of Regulation (EU) No 1303/2013
The re-use of resources paid back to the financial instrument	Articles 44 and 45 of Regulation (EU) No 1303/2013

4. IDENTIFY THE IMPLEMENTING BODIES

A crucial point when setting up a financial instrument is to determine the institutions that are eligible to be selected as **financial intermediaries** and, where appropriate, as a fund of funds.

As a principle, they should be public and private bodies established in a Member State which shall be legally authorised to provide loans to persons and enterprises operating in the jurisdiction of the OP which contributes to the financial instrument. Such bodies are financial institutions and any other institution authorised to provide loans.

In the selection of financial intermediaries, the managing authority or the fund of funds ensures the most suitable bodies are chosen in accordance with applicable law, including that on public procurement, and according with the criteria provided in Article 7 of the EU Regulation No 480/2014. These include inter alia economic and financial viability, capacity to implement the financial instrument, effective and efficient internal control and accounting systems, robust methodology for selecting final recipients and the ability to add financial resources.

In the case of a **fund of funds structure**, it shall transfer the contribution from the ESF OP to the financial intermediary(ies).

In addition to the ESF OP contribution, the fund of funds may provide its own resources which are combined with the financial intermediary resources. The fund of funds shall in this case take the pro rata part of the risk sharing between the different contributions in the portfolio of loans. State aid rules shall, in all cases, be respected and complied with.

Private co-investment from the implementing bodies is one possible option that helps increase the leverage of public resources and achieves best alignment of interest between the managing authority and the financial intermediary. This should also help address any potential State aid concerns (see next sections). In case the implementing bodies choose to co-invest, the size of the financial contribution should be economically significant (e.g. at least 30% of the total financing commitment for lending to final recipients).

In relation to **loss recoveries**, the financial intermediary shall take recovery actions in relation to each defaulted microcredit financed by the financial instrument in accordance with its internal guidelines and procedures. Amounts recovered (net of recovery and foreclosure costs, if any) by the financial intermediary shall be allocated pro rata to the risk sharing between the financial intermediary and the managing authority or the fund of funds.

Options for co-investment requirements (financial intermediary)	Pros	Cons
Minimum co-investment rate specified	The risk is shared between the managing authority and the financial intermediary, resulting in alignment of interest, additional incentive for the financial intermediary.	Could be unattractive for financial intermediaries.
Co-investment request or as additional selection criterion, but no rate specified	Greater flexibility could encourage participation of financial intermediaries and could be tailored based on target final recipients.	Potentially very limited leverage of public resources.
No co-investment (only ESF funding)	Potentially easier to understand by managing authorities and financial intermediaries.	No leverage and entire risk borne by ESF.

Facts and insights

In addition to the selection criteria required by the Regulation, the managing authority may consider further criteria. In general, these could include training for internal staff of the financial intermediaries as well as effective marketing and communication plans for potential final recipients. Specifically, in the ESF, award criteria can include capacity of financial intermediaries to adequately support the final recipients throughout the entire life cycle of the loan. These criteria could be formulated either as a compulsory requirement (eligibility criteria) or as an advantage in the selection (award criteria). In the case of non-bank financial intermediaries, one criterion could be the compliance with the European Code of Good Conduct for Microcredit Provision, or the commitment to become compliant within three years after the signature of the funding agreement, could be considered as an advantage during the selection process.

The European Code of Good Conduct for Microcredit Provision[6]

The code of good conduct was designed by the EC to promote best practices in the field of microcredit. It provides a set of standards in terms of management, governance, risk management, reporting, and consumer and investor relations that are common to the microcredit sector in the EU.

Its purpose is to detail a set of approved standards recognised in the EU as essential in terms of the operation and reporting of microcredit providers. The principles regarding governance and management reflect best practices across the sector. The institutions covered by the Code of Good Conduct are primarily non-bank microcredit providers that provide loans of up to EUR 25 000 to micro-entrepreneurs. However, the microcredit sector in the EU is diverse in terms of size, institutional set-up and the markets in which they operate.

The intended audience of the Code of Good Conduct are microcredit provider managers, directors, customers, investors, funders, owners, regulators and partner organisations. It is designed to be a tool for microcredit provider board members, stakeholders and managers in improving the operation of the sector. For customers, it is a tool to ensure that they are treated in a fair and ethical way. For investors and funders, it ensures that the sector operates with transparent and pan-EU reporting standards. For regulators, it gives some reassurance that the sector operates according to sound business practices and principles, and that it is well governed.

6 http://ec.europa.eu/regional_policy/sources/thefunds/doc/code_bonne_conduite_en.pdf.

5. DEFINE THE FINANCIAL PRODUCT

The **identification of the financial product** must be done in the ex-ante assessment and, specifically, in the investment strategy in accordance with Article 37 of Regulation (EU) No 1303/2013. The financial product must be selected on the basis of the identified financial gap and on its estimated added value. The most common financial product offered by the financial instruments financed under the ESF has been microcredit. The microcredit fund shall be in the framework of operations which are part of the priority axis defined in the OP co-funded by the ESF.

Indeed, managing authorities who wish to implement financial instruments should signal this in the OP.

Moreover, the **eligible expenditures and permitted purposes** must be listed. An indicative list is:

a. Investments in tangible and intangible assets;
b. Working capital related to development or expansion of activities that are ancillary (and linked) to activities referred to in (a) above (which ancillary nature shall be evidenced, inter alia, by the business plan of the final recipient and the amount of the financing).

The following eligibility criteria shall be met at all times by the loans included in the portfolio:

c. Microcredits shall be newly originated, to the exclusion of the refinancing of existing loans;
d. The principal amount of a microcredit included in the loan portfolio
    i. shall be up to and including EUR 25 000 based on the ex-ante assessment, and
    ii. shall be provided under such conditions that would not cause the gross grant equivalent (GGE) with respect to each final recipient to exceed EUR 200 000 over any period of three fiscal years; eligible micro-enterprises could potentially apply more than once for loans allocated in the context of this financial instrument provided that the above-mentioned GGE limit is fully respected;
e. Loans shall provide financing for one or more of the permitted purposes in EUR and/or national currency in the relevant jurisdiction and, as the case may be, in any other currency;
f. Loans shall not be in the form of mezzanine loans, subordinated debt or quasi equity;
g. Loans shall not be in the form of revolving credit lines;
h. Loans shall have a repayment schedule, including regular amortising and/or bullet payments;
i. Loans shall not finance pure financial activities, infrastructure, land or real estate development when undertaken as a financial investment activity and shall not finance the provision of consumer finance;
j. Loans shall have a minimum maturity of 3 months including the relevant grace period (if any) and a maximum maturity of up to 120 months.

Other possible financial products	Pros	Cons
Risk-sharing loan	Not particularly difficult to administer (so there are limited management costs/ fees). A defined repayment schedule makes budgeting easier. The lending mechanism is well understood, reducing the need for capacity building and the risk of misunderstandings. Loans preserve the equity of the final recipients as there is no claim on the ownership of the enterprise.	Funded products such as loans require more initial resources than unfunded products such as guarantees. It is sometimes difficult to establish the probability of default, especially with a lack of history of final recipients. The advantage for the final recipients is almost entirely financial. There are limited additional benefits as know-how is not transferred.
Capped guarantee	Guarantees can preserve the equity of final recipients as there is normally no claim on the ownership of the enterprise. Potential benefits for final recipients could include inter alia, lower or no guarantee fees, lower or no collateral requirements as well as lower risk premiums. Since OP contributions cover only certain parts of loans (appropriate multiplier ratio), there is a high leverage effect. The investment risk for third party lenders is reduced (because they only bear part of the risk of default). Unfunded products such as guarantees require less initial support than funded products such as loans.	Potentially very limited leverage of public resources.

Facts and insights

In the 2007-2013 programming period, loan schemes were the most frequent type of ESF co-financed financial instruments, although some managing authorities supported guarantee funds (Germany, Estonia and Italy) and more rarely, equity funds (Germany and Denmark).

In the 2014-2020 programming period, based on the available information[7], the majority of financial products are loans and microcredits, followed by equity and quasi-equity funds.

7 European Commission (2016), Summaries of the data on the progress made in financing and implementing the financial instruments for the programming period 2014-2020 in accordance with Article 46 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council, Directorate-General for Regional and Urban Policy.

6. LENDING POLICY

Disbursement from the managing authority or fund of funds to the financial intermediary: following the signature of a funding agreement between the managing authority and the fund of funds or the financial intermediary, the managing authority transfers public contributions from the OP to the fund of funds or the financial intermediary which places such contributions in a dedicated loan fund. The transfer shall be in tranches and respect the ceilings of Article 41 of Regulation (EU) No 1303/2013.

The target lending volume and range of interest rate shall be confirmed within the ex-ante assessment in accordance with Article 37 of Regulation (EU) No 1303/2013 and shall be taken into account to determine the nature of the instrument (revolving or non-revolving instrument).

Origination of a portfolio of new loans. The financial intermediary shall be required to originate within a pre-determined limited period of time a portfolio of new eligible loans in addition to its current loan activities, partly funded from the disbursed funds under the OP at the risk sharing rate agreed in the funding agreement.

The financial intermediary shall implement a consistent lending policy, especially regarding portfolio diversification, enabling a sound credit portfolio management and risk diversification, while complying with the applicable industry standards and while remaining aligned with the managing authority's financial interests and policy objectives.

The identification, selection, due diligence, documentation and execution of the loans to final recipients shall be performed by the financial intermediary in accordance with its standard procedures and in accordance with the principles set out in the relevant funding agreement.

Others

Interest and other gains generated by support from the ESI Funds to financial instrument shall be used as referred in Article 43 of Regulation (EU) No 1303/2013.

Facts and insights

Two important aspects of portfolio are linked to the duration and the reuse of resources.

In relation to duration of the financial instrument, it cannot exceed the limits imposed by the ESF and State aid Regulations. The duration to create the portfolio of loans should be aligned with the findings of the ex-ante assessment and the capacities of the implementing body. An indicative duration to create the portfolio of loans could be up to 5 years from the date of signature of the funding agreement.

Concerning the reuse of resources paid back to financial instrument, interest and other gains generated by support from the ESI Funds to financial instrument shall be used as referred in Article 43 of Regulation (EU) No 1303/2013.

Resources paid back to the financial instrument shall either be reused within the same financial instrument (revolving within the same financial instrument) or, after being paid back to the managing authority or the fund of funds, shall be used in accordance with Article 44 of Regulation (EU) No 1303/2013.

Alternatively, if the managing authority or the fund of funds is directly repaid, the repayments shall occur regularly mirroring:

i. principal repayments (on a pro rata basis on the basis of the risk sharing rate),

ii. any recovered amounts and losses deductions (according to the risk sharing rate) of the loans, and

iii. any interest rate payments.

These resources have to be used in accordance with Articles 44 and 45 of Regulation (EU) No 1303/2013.

7. PRICING POLICY

When proposing its pricing, the financial intermediary shall present a pricing policy and the methodology to ensure the full transfer of the financial advantage of the OP public contribution to the eligible final recipients. The pricing policy and the methodology shall include the following elements:

1. The interest rate on the financial intermediary participation is set at market basis (according to the financial intermediary's own policy).
2. The overall interest rate, to be charged on loans must be reduced proportionally to the allocation provided by the public contribution. This reduction shall take into account any fees that the managing authority might charge on the OP contribution and the risk sharing arrangements.
3. The GGE calculation as presented in the State aid section shall be applied on each loan included in the portfolio.
4. The pricing policy and the methodology shall remain constant during the eligibility period.

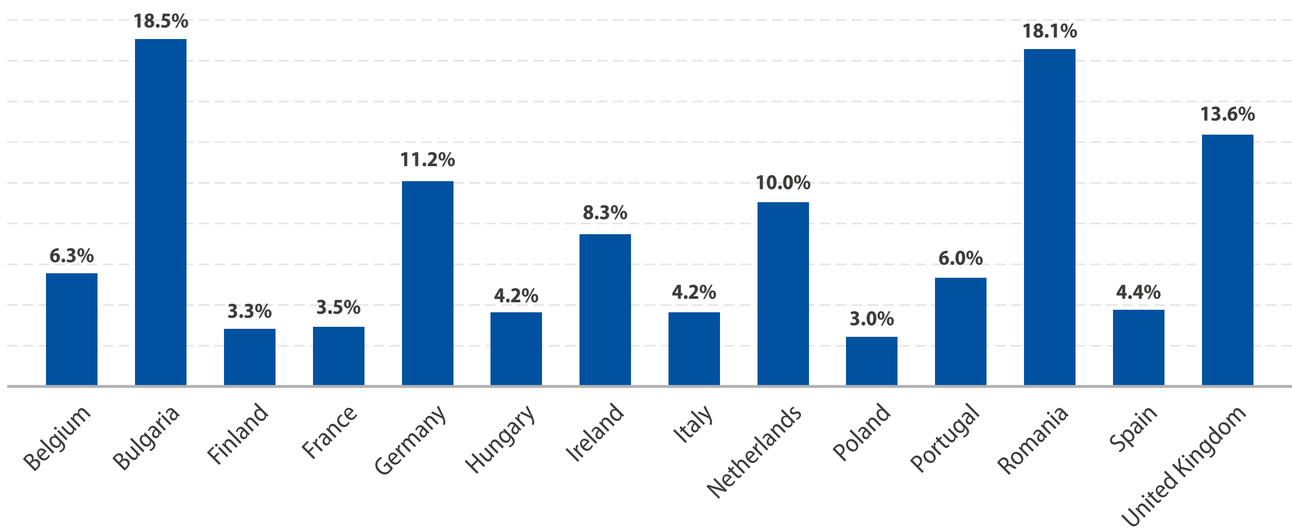
Options for pricing policy for final recipients	Pros	Cons
Market rate	The initiative is in line with market conditions and acts as 'healthy competition' for the microfinance sector (among microfinance institutions and financial institutions providing microcredits at competitive prices).	Final recipients could have difficulties in meeting the terms and conditions of the loan (collateral, interest rate, etc.). Market price of microfinance instruments can be high in many Member States.
Below market rate	Potentially reaching more vulnerable individuals for whom market rates would be untenable.	Crowding out private financial intermediaries, State aid issues.

Facts and insights

Concerning the interest rates on microfinance products, according to the European Microfinance Network's (EMN) analysis[8], there are significant variations across different Member States, mainly due to differing microcredit amounts and terms, and regulatory environments (usury laws and interest rate ceilings): from as low as 4% (Italy, France) to a maximum of 15-16% (Bulgaria, Romania).

In order to reach the more vulnerable final recipients, microcredits could be offered at an interest rate below market level (which is the scope of ESF intervention) but should avoid the option of a 0%-interest rate. However, since the purpose of the intervention is 'social' and not 'commercial', the market rate is not seen as a relevant benchmark, and the financial advantage of the intervention should be fully transferred to the final recipients in the form of a reduced interest rate.

Figure 6: Average annual interest rate for business microcredit (by country)



Source: EMN

8 EMN Microfinance in Europe: A Survey of EMN-MFC Members, December 2016.

8. NON-FINANCIAL SERVICES

A microcredit is typically accompanied by non-financial services offered to final recipients.

These can be provided either directly by the financial intermediaries or indirectly through third parties (by sub-contract or pro bono). In the case of lending to start-ups, a sufficient follow-up of the final recipient in the form of mentoring, training, coaching or advice should be ensured.

Non-financial services might include inter alia:

- tutoring, mentoring, coaching and counselling programmes;
- skills and competence assessment;
- guidance and support for the business plan development;
- legal, administrative, tax and commercial consulting;
- monitoring of activity, outcomes and results.

As a particular case, the provision of the above-mentioned non-financial services prior to the identification of the final recipients is only possible through a separate operation if financed by the ESF OP, in accordance with the Regulation (EU) No 1303/2013.

The provision of non-financial services could entail State aid. Hence, in general terms, the value of any non-financial services provided for the benefit of a single final recipient should be summed with any other grant support and/or the calculation of the GGE (see State aid section) to determine the State aid implications. A way to simplify this is to be limited to a maximum ceiling expressed either in nominal terms (for example, below EUR 1 500), or as a percentage of the microcredit size (e.g. 50% of the maximum value of the microcredit).

Type of non-financial services offered	Pros	Cons
Pre-application support (business plan, accounting courses, risk assessment, etc.)	A standard procedure, easy to implement.	Does not guarantee the success of the operation, more limited mitigation of the credit risk.
On-going assistance during the lifetime of the loan (legal and commercial support)	A more comprehensive approach throughout the entire life time of the loan.	More complex and costly.

Facts and insights

According to the European Progress Microfinance Facility (EPMF) interim evaluation, half of financial intermediaries provide training and/or mentoring as part of their credit agreement with final recipients. The types of training differ widely. Training and mentoring are sometimes offered for free, while other intermediaries require a small fee, mainly to cover the costs of training, material and organising volunteers. Some microfinance institutions provide E-learning or provide guidelines on the internet.

In most cases non-financial services are delivered before and after the microlending contract is signed. In some cases, they were available throughout the life cycle of the microfinance scheme. Making non-financial services available prior to applying for microlending is important because:

- ensure a better understanding, by the final recipient, of the financial instrument and related contractual obligation;
- carry out a more specific preliminary assessment of the business idea/project to be supported by the financial instrument, which is very relevant for all parties involved;
- pave the way to the development of a sustainable business project, thus lowering the default risk and, at the same time, allow entrepreneurs to concentrate more on the contents of the project (rather than on administrative and legal aspects) from the beginning.

It is particularly important to set up ex-ante a scheme ensuring that the management of the two forms of support is aligned and coordinated. There two different approaches in delivering the non-financial services:

- provided directly by the financial intermediary or by third parties directly contracted by the financial intermediary (i.e. subject to verification by the managing authority/fund of funds). In this case, it is particularly important to assess during the selection process, the effective capacity of the financial intermediary to provide tailored non-financial services and/or to involve and coordinate actors delivering the services. A specific issue is where financial intermediaries could have a conflict of interest in the delivery of non-financial services before the selection of the final recipients.

- provided by third parties not directly linked with the financial intermediaries. This typically occurred where grants covered the cost of non-financial services and required increased efforts from the managing authority to coordinate the different actors managing different operations.

Finally, different methods have been also adopted in implementing non-financial services. To tailor support to the specific needs of final recipients, these services have been delivered in groups and as individual sessions (i.e. one-to-one with the entrepreneur), as live presentations and also through webinars.

Figure 7: Examples of non-financial services offered alongside microcredit

QREDITS, Netherlands
Offers a mentoring/coaching module to microfinance borrowers, using a network of over 600 experienced entrepreneurs and young professionals (volunteers), that are either business coaches or associates of financial institutions (commercial banks, consultancies, etc.). The module consists of 12 meetings over a period of one year and is provided for the price of EUR 200 excluding Value-Added Tax (VAT). Revenues from the coaching programme together with grants are intended to cover the administrative and travel expenses, overhead costs and investments while the wages of the trainers are provided pro bono by their employers as part of their Corporate Social Responsibility (CSR) activities.[9] The guidance covers various fields, among which: • Writing a business plan; • Finance and Administration; • Marketing and Sales; • Human Resources; • Crisis Management and Reorganisation; • Personal effectiveness. Moreover, also an E-learning module, teaching how to write a business plan and providing templates, is available for borrowers before the loan, at a price of EUR 50.
ADIE, France[10]
Offered a wide range of non-financial services to borrowers, ranging from training and tutoring to legal and commercial support. The services varied across regions, depending on the needs of the final recipients, local conditions, and availability of resources (volunteers). The services were not mandatory and were provided during all the stages of the life cycle and at no cost to the borrower. The cost was estimated at approximately EUR 2 000 per entrepreneur and was covered partially by ADIE (30%) and from a public grant (70%).

9 European Commission (2014), Interim Evaluation of The European Progress Microfinance Facility – Final Report, November 2014, p. 46.
10 *fi-compass* case study – Microcredits for Social Inclusion, France.

9. STATE AID IMPLICATIONS

The financial instrument could be designed as a State aid free at all the levels (i.e. market-conform remuneration for the financial intermediary, full transfer of the financial advantage to the final recipients, and the financing provided to the final recipients under the applicable *de minimis* aid Regulation).

Aid at the level of the **financial intermediary** and the fund of funds is excluded when:

1. The financial intermediary and the managing authority or fund of funds bear at any time the losses and benefits in proportion to their contributions (pro rata) and there is an economically significant participation of the financial intermediary.
2. The remuneration (i.e. management costs and/or fees) of the financial intermediary and the fund of funds reflects the current market remuneration in comparable situations, which is the case when the latter has been selected through an open, transparent, non-discriminatory and objective selection procedure or if the remuneration is aligned with the Articles 12 and 13 of Delegated Regulation (EU) No 480/2014 and no other advantages are granted by the State. Where the fund of funds only transfers the ESF contribution to the financial intermediary, and has a public interest mission, and has no commercial activity when implementing the measure, and is not co-investing with its own resources – therefore it is not considered a beneficiary of aid – it is enough that the fund of funds is not overcompensated.
3. The financial advantage of the OP public contribution to the instrument shall be fully passed on to the final recipients in the form of an interest rate reduction. When selecting the financial intermediary, the managing authority shall, in line with the Article 7(2) of Delegated Regulation (EU) No 480/2014, asses the pricing policy and the methodology to pass on the financial advantage to the final recipients. Where the financial intermediary does not pass on all the financial advantage to the final recipients, the undisbursed public contribution shall be transferred back to the managing authority.

At the level of the **final recipients**, there is aid present when the interest rate of the microcredit is lower than the market interest rate, and one option to becoming State aid compliant is to fall under the *de minimis* aid Regulation. For each microcredit inserted in the portfolio regarding final recipients with an economic activity, the financial intermediary shall calculate the GGE by using the following calculation methodology (see below). For *de minimis* aid, the awarding body must check that the threshold is not breached, and the final recipient must be informed that support is provided on the basis of the *de minimis* aid Regulation.

	de minimis **aid**
Pros	• Fast implementation enables small amounts of support to 'avoid' having to comply with more complex State aid rules • Broad eligibility criteria • Amounts are not calculated as percent of project cost, but subject to the financial ceiling and the cumulation rules
Cons	• Requires declarations or a national database to track amounts of *de minimis* aid received • Needs special attention how to capture *de minimis* aid at the financial intermediary level and where relevant ensure a full pass on of the aid • Amount is limited (more so if a recipient has already had some *de minimis* aid) so may not cover financing needs of the investments

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Where aid is granted in a form other than a grant, the aid amount shall be the GGE of the aid. The total amount of aid calculated with the GGE cannot be above EUR 200 000 over a 3 years fiscal period taking into account the cumulation rule for final recipients in the *de minimis* aid Regulation.

Technical support grant or another grant provided to the final recipient shall be cumulated with the calculated GGE. The value of the non-financial services provided to the single final recipient must be summed with the below-mentioned calculation. If the non-financial services are offered for price, this has to be reasonable and proportionate to the size of the microcredit.

The two different methods of calculating the GGE of the aid comprised in loans are foreseen in Article 4 of the *de minimis* aid Regulation (No 1407/2013), as follows:

Option 1 – Article 4.3(a)-(b)	
Case 1	Case 2
Loan • *secured by collateral covering at least 50 %* • *nominal amount less than EUR 1 000 000* • *for 5 years or less*	*Loan* • *secured by collateral covering at least 50 %* • *nominal amount less than EUR 500 000* • *for 10 years or less*
GGE = (Nominal amount of the loan / EUR 1 000 000) * (Duration of the loan / 5 years) * EUR 200 000	GGE = (Nominal amount of the loan / EUR 500 000) * (Duration of the loan / 10 years) * EUR 200 000

Calculation example	
Loan • *secured by collateral covering 50%* • *amount: EUR 25 000* • *for 5 years*	GGE = (EUR 25 000 / EUR 1 000 000) * (5 years / 5 years) * EUR 200 000 = EUR 5 000
Non-financial services	EUR 1 000
Total cumulated GGE	**EUR 6 000**

Option 2 – Article 4.3(c) *The GGE is calculated on the basis of the reference rate applicable at the time of the grant*	
Loan • *amount: EUR 25 000* • *for 5 years* • *interest rate (market) = 5%* • *interest rate (of the loan) = 3%* • *discount rate = 0.8%* *Non-financial services = EUR 1 000*	$$GGE = \sum \frac{P_t*(r_m-r)+NFS_t}{(1+i)^t}$$ *P_t = the principal of the loan for year t;* *r_m = market interest rate;* *r = yearly interest rate of the loan;* *NFS_t = estimated value of the non-financial services related to the loan for year t;* *i = discount rate calculated in accordance with the Reference rates Communication.*

Year	Calculation	Non-financial services provided	GGE of the aid (including non-financial services)
1	(€25 000 * 0.02 + €1 000) / 1.008^1	€ 1 000	€ 1 488,10
2	€20 000 * 0.02 / 1.008^2	€ 0	€ 393,68
3	€15 000 * 0.02 / 1.008^3	€ 0	€ 292,91
4	€10 000* 0.02 / 1.008^4	€ 0	€ 193,73
5	€5 000 * 0.02 / 1.008^5	€ 0	€ 96,09
		Total cumulated GGE	**EUR 2 464,51**

10. REPORTING AND TARGETED RESULTS

Financial intermediaries shall provide the managing authority or fund of funds with at least quarterly information in a standardised form and scope, including all the relevant elements for the managing authority to fulfil the conditions of Article 46 of Regulation (EU) No 1303/2013.

Member States shall also fulfil their reporting obligations pursuant to the *de minimis* aid Regulation.

Additional reporting indicators	Pros	Cons
ESF common indicators which can be requested in addition to the module of Regulation 821/2014 are: • disadvantaged participants in employment, including self-employment; • participants with improved labour situation; • number of projects promoted by disadvantaged participants implemented; • other similar.	More consistency in reporting and specific attention to social impact is assured, especially since financial losses are more likely in microfinance. This could ensure social impact data collection and enable future assessments of financial instrument achievements.	The list of OP indicators is exhaustive and this might be perceived as an additional burden.

Facts and insights

To enable managing authorities to report on financial instruments in a consistent and comparable manner, the EC provided a model for reporting on financial instruments in Commission Implementing Regulation (EU) No 821/2014 – Annex I, model for reporting on financial instruments. The model for reporting on financial instruments makes it possible for the EC to publish summaries of the data on progress made in financing and implementing the financial instruments.

Compared to the 2007-2013 programming period, the 2014-2020 legislation sets out more comprehensive reporting requirements from the outset with one reporting model for all five ESI Funds. The legislation also defines which information of the reporting exercise should be reported every year and which parts should be provided in the years 2017, 2019 and final report. Therefore, the scope of the summaries of data will be determined by these requirements.

The main changes concern the introduction of new elements as set out in Article 46(2) of the CPR and in line with the Financial Regulation i.e.:

- inclusion of reporting on financial instruments that are implemented directly according to Article 38(4)(c) of the CPR;
- reporting by priority axis or measure from which support from ESF is provided to the financial instrument;
- additional information on steps of implementation (ex-ante assessment, selection etc.);
- information on interest and other gains generated by support from ESF to the financial instruments;
- resources paid back to financial instruments from investments or from the release of resources committed;
- the value of equity investments;
- total amounts re-invested by the financial instrument;
- progress in achieving the expected leverage;
- total amount of investment mobilised through investments made by ESF financial instruments;
- and contribution of the financial instrument to the achievement of the indicators of the priority axis or measure concerned.

The model asks for the minimum level of information but, in addition to the common indicators of the priority axis of the ESF OP (employment increase, number of SMEs, etc.) other indicators can be suggested. However, indicators must be aligned with the specific objectives of the relevant priority of the ESF OP financing the financial instrument and on the expected results of the ex-ante assessment. Example of result indicators monitored from an ESF OP:

Indicators
Participants in employment, including self-employment, six months after leaving.
Participants in self-employment, six months after leaving.
Women who received support for self-employment.
Number of start-ups supported.
Participants in employment, including self-employment, upon leaving.
Social entrepreneurs and social enterprises employees who improved their business and work-related skills.
Number of supported micro, small and medium enterprises (including cooperative enterprises, enterprises of social economy)

Source: Ex-ante assessment reports

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