European Investment Bank *The EU bank*

Using Financial Instruments in England during the 2014-2020 Programming Period

SME Access to Finance Market Assessment
Block Two
Conclusion

September 2016

Final Report

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1 Background

The Block One and Two phases of analysis and resulting deliverables have been developed by the EIB Group with the purpose of assisting the Managing Authority (MA) in England, namely the Department of Communities and Local Government (DCLG), to complete their SME ex-ante assessment process in the programming of financial instruments under the ESI Funds 2014-2020. This short concluding chapter provides further detail on the State aid implications of the proposals, the potential level of preferential remuneration and sets out the provisions and processes which should be considered by DCLG to ensure the key findings and recommendations of the ex-ante assessment remain relevant.

It should be noted that in parallel with undertaking this assignment , DCLG has progressed discussions with the UK National Promotional Bank – the British Business Bank, with a view to achieving economies of scale in the delivery of two multi-regional fund of funds. The Northern Powerhouse – a fund of fund comprising the Northwest, Yorkshire and Humber and Tees Valley areas and the Midlands Engine - a fund of funds covering the West and East Midlands areas. Whilst the EIB assignment supports the need to explore multi-regional fund of funds as delivery mechanisms, as the development process for these fund of funds advances, further refinement may be required to the conclusions reached to date, particularly in relation to the proposed investment strategies. DCLG should ensure that any material changes are properly documented and assessed in updating their ex-ante assessment.

2 State Aid and Potential Level of Preferential Remuneration to private investors

The individual block two proposed investment strategies estimate the level of public and private resources to be potentially generated by each proposed instrument, they also set out possible State aid implications. In parallel with the development of the investment strategies, EIB has also provided support to the UK Government in relation to their discussions with DG COMP about the proposed SME financial instruments (FIs).

In its discussions with DG COMP, the UK Government noted that Article 21(13)(c) of the General Block Exemption Regulation (Regulation 651/2014) ("GBER") states that, "in the case of asymmetric loss-sharing between public and private investors, the first loss assumed by the public investor shall be capped at 25 % of the total investment". The UK stated that the proposed co-financing structure that it wished to implement, particularly with BBB and EIB as fund of fund manager and co-financier, does not imply asymmetric loss-sharing as between the debt and ESIF tranches of the capital structure of the fund of funds. The debt and ESIF contributions will be separate transactions that take place on different terms and conditions. In its letter of 19 May, DG COMP confirmed that based upon the material provided, the proposed structure was within the scope of Article 21 of GBER.

In addition, it should be noted that the proposed layered structure, is in accordance with the principles established in the ESIF/EFSI Complementarities brochure.[1] The brochure notes the possibility of layered funds, structured around different classes of risk and reward. It also highlights the potential for ESIF funds to finance the first loss piece/equity tranche and for the remuneration and/or reimbursement of the first loss piece/equity tranche to take place after the remuneration and/or reimbursement of the senior and mezzanine tranche holders respectively in line with normal market practice.

The UK Government has also highlighted that it will also seek to competitively procure underlying financial intermediaries who are able to attract further private sector capital either, at the level of the FI or SME final recipient investments. In the event that this competitive process demonstrates a need for preferential remuneration to this lower level co-funding, this may need a further independent assessment. This assessment should consider the expected profit or loss and risk of the FI and the expectations of the possible private investors and estimate the level of asymmetric profit sharing which may be required.

[1] European Structural and Investment Funds and European Strategic Fund for Investments Complementarities, European Commission, February 2016: http://ec.europa.eu/regional_policy/sources/thefunds/fin_inst/pdf/efsi_esif_compl_en.pdf

3 Provisions for Update

As market conditions and investment trends may evolve before and during the implementation phase of the FIs, Article 37 (2) (g) CPR requires that the ex-ante assessment includes provisions for its revision and update.

Possible indicators to trigger an update include:

- **Significant anticipated variances between the proposed targets and observed and forecast results**
- **Demand – both in terms of inadequate volume of the financing to meet the observed demand, or lower demand than anticipated**
- **Miscalculation of the risk to be taken by the FIs**: A situation may occur where the risk profile of the FI is significantly higher than expected, leading the FI to incur significant losses and thereby compromising its revolving nature
- **Material change to the economic conditions and funding supply**

The need for update and review of the ex-ante assessment could be signalled through:

- Regular reporting/monitoring of the FI
- Through ad hoc or planned evaluations (e.g. ongoing evaluations).

Furthermore, the MA has advised that it will set out the conditions by which a formal review of the financial instrument will be triggered, in the proposed Funding Agreements and associated guidance.

The MA plans to monitor performance against financial and non-financial targets on a quarterly basis, and the proposed FoFs will be required to submit a suite of management information to the MA demonstrating how each sub-fund and the FoFs overall are performing. This will enable the MA and FoF to assess cumulative performance.

In addition, at mid-point, and in conjunction with other financial instruments where appropriate, the MA has advised that it will assess the FoFs and the ex-ante assessment will be reviewed for ongoing relevance. The precise timing of this mid-point review will be determined at a later stage, but the MA anticipates it will take place during years 2 or 3 of the fund.