European Union
European Regional
Development Fund

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

SME Access to Finance Market Assessment
Block Two
Proposed Investment Strategy for Cornwall & Isles of Scilly

November 2017

Final Report

Contents

1. Proposed Investment Strategy

This Proposed Investment Strategy was developedby the Department of Communities and Local Government (DCLG) with input from the cooperating Local Enterprise Partnership (LEP) within the geographical region known as Cornwall and Isles of Scilly. This particular 'Proposed Investment Strategy' (PIS) has been developed based upon a detailed review of the Ex-ante Assessment (Block One) undertaken by EIB Group with support from Regeneris Consulting and is intended to be fully consistent with the Common Provisions Regulation Article 37.2 and its requirements. It should be read in close connection with the Block One report and in particular with the 'Area Market Overview' for this region.

1.1 SME Market Analysis - the Summary of Findings

The main market failures, and potential financing gaps, analysed in the Ex-ante Assessment (Block One) at a summarised national level were found to be as follows:

- There are significant structural market failures affecting parts of the finance market for SMEs;
- Whilst these market failures vary across England to some extent (for example, access to private venture capital can be better for some classes of SMEs in London and the South East for example), they nevertheless exist and restrict access to finance for start-ups and growing SMEs across England as a whole;
- The financial crisis has exacerbated these issues facing SMEs, especially in terms of the behaviour of the high street banks which have both reduced their lending overall and concentrated on lending larger amounts to less risky SMEs as part of their strategy of rebuilding their balance sheets;
- Survey evidence points to SMEs in England experiencing more difficulties in securing the finance they need for working capital and new investment over the past 3-4 years;
- As the economy recovers, the evidence points to an improvement in the level of business start-up, the growth of existing SMEs and indeed an upswing in business confidence, which is feeding into a greater demand for external finance;
- As a consequence there is a substantial finance gap affecting SMEs even allowing for the range and scale of public sector backed initiatives that are operating in this space (although many of the existing ERDF backed schemes have now or will cease investing in 2015).

The Block One report concluded that at a national level and drawing on existing survey evidence, **"around £1.6 billion per year of theoretical unmet demand for external finance from SMEs, assuming on a fairly cautious basis that 10% of the businesses seeking and unable to secure finance are viable."**

1.1.1 A Regional Perspective

The Block One report went further to provide a more regional perspective and provided an 'Area Overview' for the geographical region known as the South West with particular reference to Cornwall and Isles of Scilly. This regional perspective provided clear further evidence of market failure and/or sub-optimal investment situations for the region. By using the BIS SBS survey date and then regionalising the findings, the analysis indicates that, assuming the experience of SMEs in the region is similar to those in the UK as whole:

- In 2012 there were around 26,700 SMEs in the region looking for external finance, of which 20,500 were microbusinesses.
- Of these, 12,600 experienced difficulties of some sort in obtaining this finance
- 8,600 SMEs obtained none of the finance they were looking for, and 1,600 received some, but not all of what they were seeking (the national data indicates that the likelihood of successfully obtaining finance varies directly with business size)
- 5,900 SMEs had a need for finance did not apply, for the reason that they thought they would be rejected.

The Area Overview goes further to suggest "It is possible to use national survey data on the amount of finance being sought by businesses of different sizes to generate indicative estimates of the scale of unmet demand. **This analysis shows that total unmet demand in the region could be of the order of £1.7 billion in one year** (Section 1.4.2 Theoretical Unmet Demand – Area Overview**)**. It is not possible to determine from this type of analysis how much of this comes from SMEs that had viable business plans (i.e. those that, as a class of firms, could be supported in such a way that the financial and economic returns to the public sector from doing so would represent value for money, and hence constitute a market failure). However, scenarios on the proportion of firms that might have been viable have been set out below to illustrate the potential scale of market failure. For example, if 10% of these were viable, this would imply unmet demand of:

- Around £5 million per year for microfinance and c. £90 million for larger amounts of finance sought by other micro-businesses
- Around £80 million per year of unmet demand amongst small and medium sized businesses

It should be noted that this is, in effect, the gap over and above that what is already being addressed by JEREMIE and other public sector backed initiatives.

1.2 Proposed Investment Strategy and Implementation Arrangements

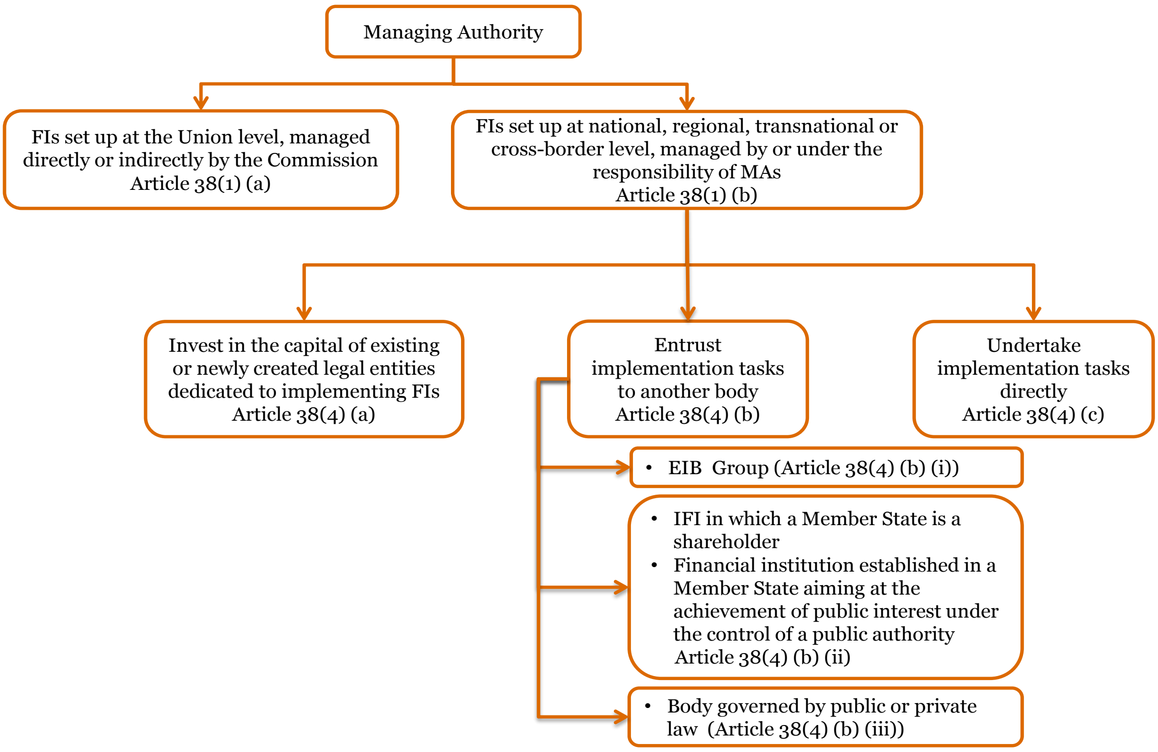
1.2.1 Options for implementation arrangements

Article 37 (2) (e) CPR specifies that the proposed investment strategy will include an examination of options for implementation as foreseen by Article 38.

A comprehensive picture of the implementation options for the setting up of a financial instrument, as provided in the general ex-ante methodology[1], is shown in the figure below.

[1] "Ex-ante assessment methodology for financial instruments in the 2014-2020 programming period. General methodology covering all thematic objectives. Volume I", European Commission, European Investment Bank, PriceWaterhouseCoopers, April 2014.

Figure 1: Implementation options for the setting up of an FI



Source: European Commission, EIB, PwC, 2014.

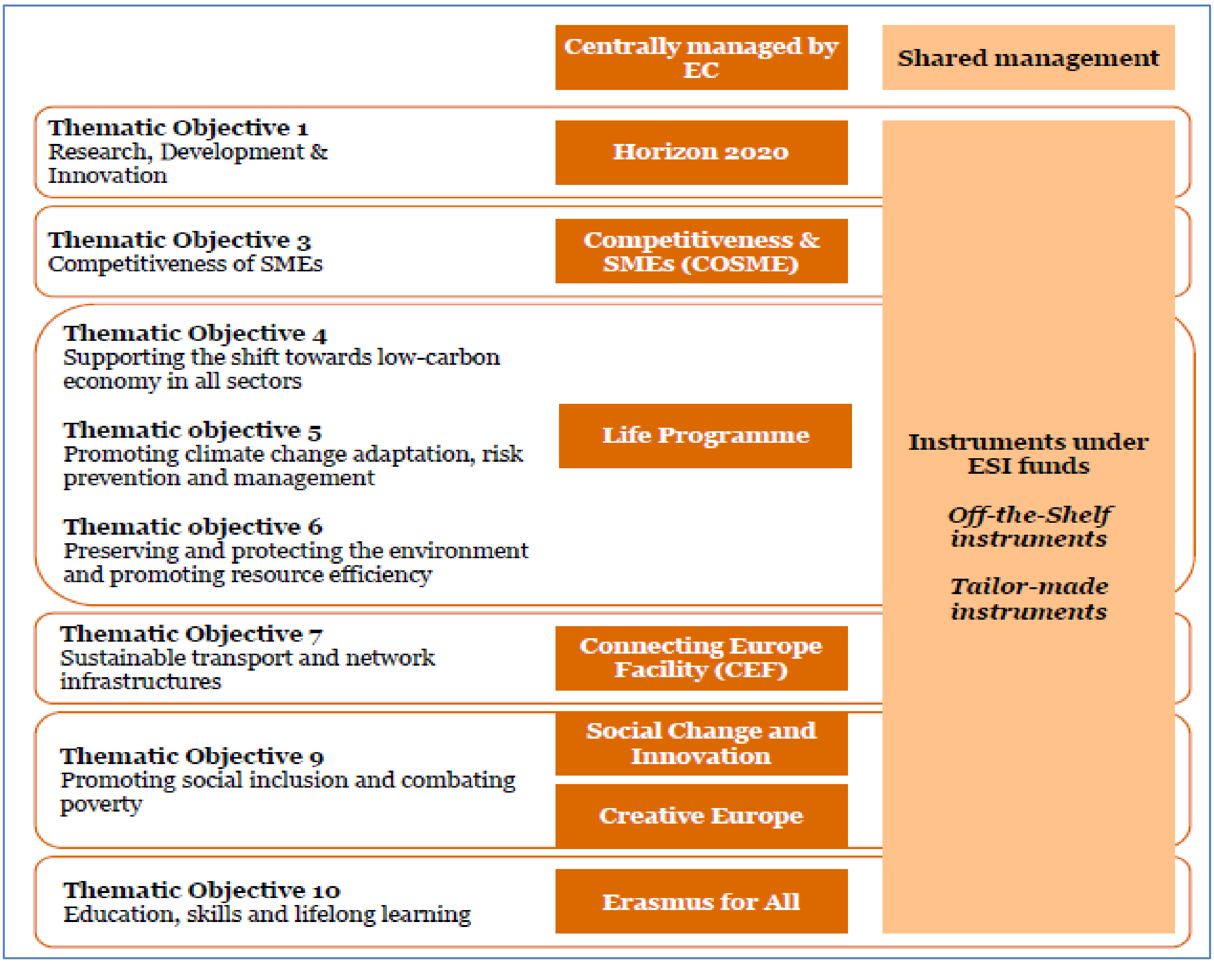
The proposed investment strategy includes an analysis of the following options:

A. Implementation options for financial instruments within the meaning of Article 38,
B. Financial instruments on offer,
C. Targeted beneficiaries and the proposed terms of combining financial instruments with grants.

Financial Instruments created centrally at the level of the EU and managed directly or indirectly by the EC - Article 38 (1) (a)

The possibility to contribute ESI funds to centrally launched and managed instruments is a new possibility introduced for the 2014-2020 programming period and is foreseen in Article 38 (1)a).

Figure 2: Article 38 of the new CPR



Source: PwC Financial instruments in Cohesion Policy 2014-2020: Ex-ante assessment training, June 2014

Apart from the SME Initiative, covered further below, the centrally launched instruments, directly or indirectly managed by the EC, and which most target SMEs, are COSME and HORIZON 2020 (see table above). The implementation of these instruments has been mandated by the EC to EIF. In early August 2014, EIF launched calls for expression of interest with regard to COSME and HORIZON 2020[2], targeting financial intermediaries across the EU involved in lending, the provision of equity (venture capital), and others active in SME financing.

Under COSME, EIF will support equity investments as well as lending to eligible SMEs, including at the higher risk early stage and start-ups and, as always, through financial intermediaries. Under Horizon 2020, EIF will issue guarantees and counter-guarantees to interested and selected lending intermediaries for loans to innovative enterprises of between EUR 25k and EUR 7.5m.

These instruments will, therefore, allow financial intermediaries in the UK to apply directly as partners of EIF for SME financing outside of any nationally-launched initiative.

Also at Union level is the EU SME Initiative: a joint instrument, blending EU funds available under COSME and Horizon 2020 and ESIF resources in cooperation with EIB/EIF, for which a single ex-ante assessment has already been prepared by the EIB Group and issued by the EC. Three implementation options are available: the Joint SME Guarantee Instrument and the Joint

2 See: www.eif.org/what_we_do/news/2014/eu-finance-sme.htm

Securitisation Instruments for both new and existing SME loan portfolios. It is understood that to date the UK authorities has already declined to contribute to the EU SME Initiative, and therefore this option is not explored in detail.

Table 1: Advantages and disadvantages of FIs managed by the EC

Financial Instruments created centrally at the level of the EU and managed directly or indirectly by the EC	
ADVANTAGES	DISADVANTAGES
• Effectively a delegation of tasks to an entity experienced with using EU structural funds for supporting SME access to finance. • Quicker implementation (selection of financial intermediaries, conclusion of funding agreements etc.). • A centrally managed instrument can contain several compartments and thereby achieve greater critical mass and benefit from certain economies of scale. • There would likely be no need for the managing authority to carry out on-the-spot checks, or any need for the audit authorities to cover either these operations or the associated management and control systems (to be confirmed by DG REGIO). • Allows for relaxing of ESIF eligibility criteria.	• A certain loss of control at the level of the managing authority. • A certain loss of targeting instruments to meet regional marker failures and suboptimal investment solutions. • More detached monitoring and controls: the managing authority still remains responsible for the operations, including payments and reporting when contributing to a centrally managed instrument. • Limited synergies between the instruments.

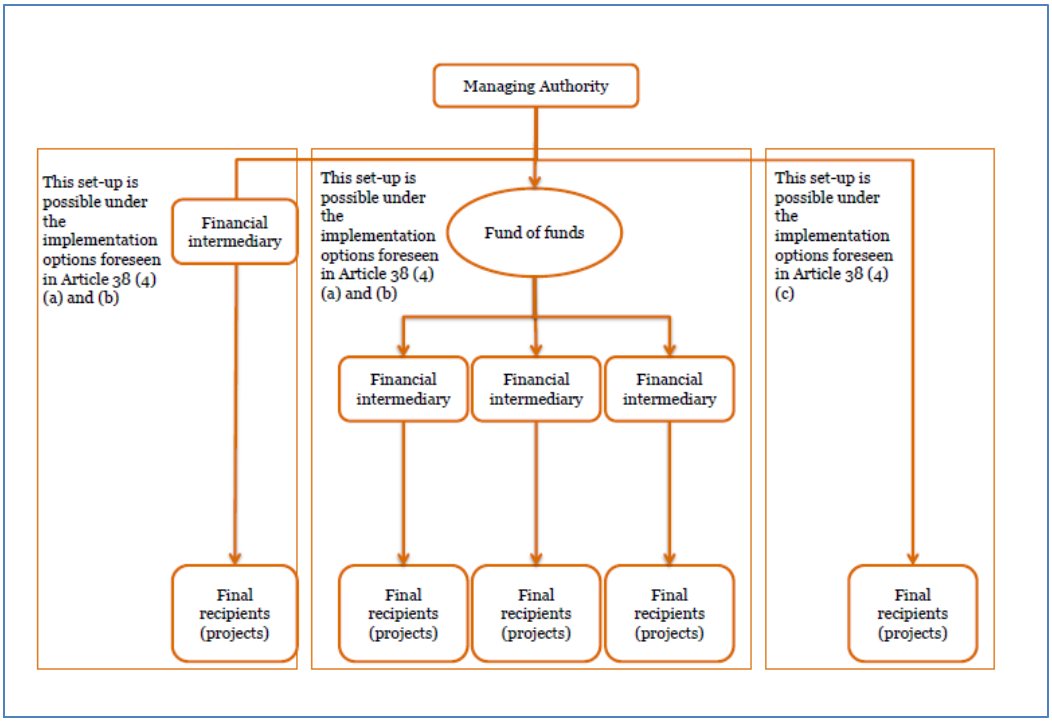
Source: EIB

In the general ex-ante methodology, it is further stated "this choice may be appropriate for instances when the technical capacity and/or the expertise of the MA is considered insufficient or where the critical mass for establishing an FI has not been reached and the existing EU-level instruments are well aligned with the Programme objectives. This option avoids duplicating FIs at lower levels and gives assurance to MAs that resources will be used through tested vehicles and experienced teams." Given the good levels of experience of the relevant authorities in the UK having experience of implementing financial instruments for several decades now and the comparatively mature levels of market infrastructure that exists, it is understandable that a conclusion could be drawn not to utilise the possibility foreseen in Article 38 (1) (a).

Financial Instruments created and managed directly by a managing authority or under its responsibility – Article 38 (1) (b)

The figure below displays the options available under this implementation route.

Figure 3: Implementation options for the governance of FIs



Source: PwC Financial instruments in Cohesion Policy 2014-2020: Ex-ante assessment training, June 2014

The individual options set out in the above figure, which are to be managed under the responsibility of the managing authority, are currently being explored. Careful consideration will be undertaken by the central Managing Authority (DCLG) to select the best option for the English Regions with reference to all the relevant regulations. However, it is fair to say that the previous experience of the 'Fund of Funds' implementation route in the UK has been positive and is considered to have delivered important levels of access to finance for SMEs when implemented with appropriate critical mass factors. The Managing Authority will assess this experience when finalising its implementation choice and could consider the following advantages and disadvantages.

Table 2: Advantages and disadvantages of FIs managed via 'Fund of Funds'

Financial Instruments created via the Fund of Funds mechanism.	
ADVANTAGES	DISADVANTAGES
• Closely managed control by the Managing Authority with effective delegation to an entity acting as manager of the Fund of Funds • Targeted instruments that meet regional market failures and suboptimal investment solutions • Close monitoring and controls: the managing authority still remains responsible for the operations, including payments and reporting when contributing to a centrally managed instrument.	• Potential lack of availability of local expertise in complex regulatory matters. • Speed of implementation may suffer due to learning curve aspects of implementation. • Potential for costs to rise above reasonable levels.

• Build-up of expertise and experience in management activities • Potential to attract additional investors at the FoF Level	

1.2.2 Other points with respect to implementation options

"Off-the-shelf" instruments

In the case of option B, the MA is also able to use "Off-the-shelf" instruments (outlined in Article 38 (3)(a)). This is a possibility foreseen by the EC, which is working on the development of product specifications for such instruments.

For SMEs, these will consist primarily of:

i) A loan instrument;

ii) A guarantee instrument; and

iii) An equity instrument.

For each instrument, the EC develops term sheets. The declared objective of DG Regio is to ensure the exemption for these instruments from the need for a notification under state aid rules.

Table 2: Advantages and disadvantages of the "Off-the-shelf instruments"

Off-the-shelf instruments	
ADVANTAGES	DISADVANTAGES
• Benefit of defined product terms for convenience and speed of implementation; • Oversight over implementation terms and conditions; • These would represent clear examples of what the EC perceives as suitable financial instruments for ESI funds.	• Even if the these instruments have been developed on the basis of EC experience from the 2007-2013 programming period, certain new parameters envisaged for these instruments are yet to have been deployed; • To be assessed whether the off-the-shelf instruments are able to cater for any potential national or regional specifics. The instruments would also need to potentially be adjusted for any local jurisdiction requirements; • Lack of assurance on the possibility of exemption from notification requirements under State aid rules, meaning that notification cannot be excluded.

Source: EIB

Most of the financial instruments (FIs) currently or previously available in UK, with perhaps the exception of the previous regional JEREMIE instruments, are, or have been, implemented by public institutions of a centralised nature. This is a perfectly understandable position to take and does entail certain advantages. However, after several reviews and considerations, a major rebalancing of responsibilities for economic development between central and local government, and between government and the private sector took place. As a result, 39 Local Enterprise Partnerships (LEPs) have been formed across England with a key role to drive local development priorities. It is therefore entirely understandable that the most appropriate delivery model for financial instruments within the ESIF 2014-2020 period is the one that is most closely aligned to the local economic development infrastructure, namely Article 38 (1) (b).

Implementation options under consideration by the Managing Authority

Within Article 38 (4) (b), there are a number of delivery routes – namely:

(i) The EIB;

(ii) International financial institutions in which a Member State is a shareholder, or financial institutions established in a Member State aiming at the achievement of public interest under the control of a public authority; and

(iii) A body governed by public or private law

Following consideration of the merits of each option, and having regard for European Commission guidance on selection of Financial Instruments, DCLG as MA has indicated that's its preference is for entrustment of a body governed by public or private law.

Appropriate Delivery Vehicles

Given the MA's preference for entrustment to a publicly owned or controlled entity, the Managing Authority will need to be satisfied that appropriate delivery vehicles exist, or could be identified, to deliver either approach and are compliant with EU rules.

1.2.3 Proposed financial instruments - Summary

On the basis of the above analysis and consultation process and pursuant to the priorities established in the relevant Partnership Agreement and the Operational Programme, FIs were proposed for the South West Region namely Cornwall and the Isles of Scilly, taking account of the market analysis identified in the Block 1 report, whilst maintaining the ability to adapt the strategy and allow for possible subsequent re-allocations between financial instruments, depending on the actual implementation experience and economic circumstances.

The overarching proposed Investment Strategy for the Cornwall and Isles of Scilly LEP area is described below.

Table 3: Financial Instruments – Programming Period 2014-2020 – Cornwall and Isles of Scilly

Financial Instrument	Proposed contribution £ m and ranges
Equity	£20m Provision of business loan (£25,000-£1m)
Debt	£20m Early stage and later stage (£50,000-£2m)
TOTAL	**Approximately £40m**

Source: EIF

The overall sizing is considered both suitable and implementable given the economic size of the region and relevant previous experience.

This portfolio of instruments is best structured as a Fund-of-Funds (FoF) structure for the implementation of these instruments which offers the significant added value.

Whilst some instruments are similar in nature they are not identical and are intended to co-exist in a complimentary manner whilst enabling the flexibility to reallocate capital should any particular instrument face difficulties in the implementation process or underperform. An experienced implementing entity will be selected to undertake the role of manager of the FoF working closely with the central Managing Authority (DCLG) in this process. It would also be expected that any regional FoF structure such as this will require appropriate governance structures to ensure implementation is completed as planned. When selecting entities for this role, the MA must consider the relevant Articles (Articles 7 (1) and (2)) in the Commission Delegated Regulation (CDR) EU No 480/2014 and further guidance via the EGESIF process, in particular, when referring to the 'legal, financial, economic and organisational capacity' of the body being considered.

In the paragraphs below, there is a short form explanation of each instrument that is proposed to become a constituent part of the overall PIS. Specific State Aid considerations for each instrument will be considered in detail at a later stage but are mentioned where relevant below. In principle, it is expected that all instruments will be either state aid free or fully compliant with the relevant state aid schemes. No additional state aid notification processes are to be expected.

Fund One – Equity (£20m)

The Block 1 EAA notes existing providers of early stage equity finance; for example, Business Angels, crowdfunding, government interventions and ERDF-backed projects. Many of these sources confirm the existence of a strong concentration of activity with a large proportion of innovation active businesses in the South West. However, evidence suggests that there remains high caution amongst financial intermediaries in respect of early stage high risk ventures. Government-backed schemes appear to have only gone a small way in addressing regional supply disparities.

There appears to continue to be demand for finance to support riskier expansion activity and it is unclear at what speed previous investors will return to the market.

The project will be able to facilitate the provision of early stage equity which will focus on the needs of early stage technology companies and by building strong links with universities, incubators and accelerators across the region.

Fund Two – Debt (£20m)

The Block 1 EAA notes that whilst traditional lenders, government initiatives and ERDF-backed provision have helped to close the funding gap, some of the sources are modest in size and perhaps not suitable for riskier parts of the market. Strong unmet demand evidence exists from established SMEs for debt financing and the EAA identifies the persistence of market failure. In addition, as the economy recovers the expectation is that SMEs are likely to expand and re-invest at an increased rate thus stimulating further demand for debt.

The project will support National Policy to improve access to finance for SMEs.

Overall Demand

There are two broad sets of market failures that CIoSIF seeks to address – supply-side and demand-side market failures. In terms of supply-side, the market failure relates to finance markets supplying less finance than is optimal as a result of imperfect or asymmetric information between the financial institution and the small business, and private sector investors not taking into account positive spill-over benefits.

Information failures affect the demand side for businesses seeking finance. SMEs may not fully understand the potential benefits to their business of raising external finance or their likely probability of success, which ultimately means they do not apply. This may restrict the growth of these businesses. A lack of investment readiness also leads to SMEs lacking the ability to present themselves as investable opportunities due to inadequate management skills or poor business plans.

The EIB conducted an ex-ante assessment of the South West region to estimate the potential unmet demand for finance from SMEs in the region. They noted that:

"It is not possible to directly observe or measure the finance gap affecting SMEs or the part of this gap caused by market failure (as opposed to unviable businesses of investment propositions)."

With this caveat in mind an indicative estimate is made which suggests total unmet demand in the South West region of £1.7 billion in one year. If the assumption is that businesses in the Cornwall and Isles of Scilly region face similar access to finance conditions as the wider South West and demand is proportionate to the business population, this would suggest unmet demand of around £142m in one year. Much of this unmet demand may be from businesses who would not meet lending or investment criteria, however, only a very small proportion of businesses need to be creditworthy (approximately 6%) for there to be potential demand for funding from a CIoSIF of £40m over a 10-year investment period.

Further analysis was conducted by Blue Sky on behalf of the Cornwall and Isles of Scilly LEP in 2016. This report included a survey of stakeholders located in the region who identified an equity gap in start-up, early stage and development capital.

Partners in the South West had commissioned a study of the SME finance gap specifically in the Cornwall and Isles of Scilly LEP area, from PwC. Key findings from this analysis were:

- An estimated 200 to 600 growth businesses per year were unable to obtain finance from traditional sources, the majority of which were micro-enterprises who were unable to gain funding at that level;
- Emerging and innovative sectors lacked development capital and early stage support (these included marine technology, e-health, digital, aerospace, creative and renewables); and
- There was a lack of locally available equity financing. The PwC report did not provide an estimate of the equity gap, but called for a fund of £8-13m, catering for 40-65 investments of approximately £200k.

PwC estimate demand from these high growth businesses to be in the region of £15-30 million, and suggest potential demand in the Cornwall and Isles of Scilly area from all areas (high growth, micro, equity and mezzanine amongst others) to be approximately £61-91million over a seven-year ERDF funding period (2014-2020).

The value of equity investment is significantly lower in the Cornwall and Isles of Scilly area than would be expected for an economy of this size and given the proportion of high growth businesses in the area. Approximately 1% of all UK private sector businesses are located in Cornwall and Isles of Scilly, whereas only 0.1% of UK equity investments by value take place in the area. Low levels of equity investment are due to issues on both the demand and supply side.

Demand for equity investment is limited in the area due to limited awareness and understanding of this type of finance. BBB research indicates much lower awareness of venture capital and business angel investment in areas outside of London. One of the objectives of CIoSIF is to build the access to finance ecosystem within the Cornwall and Isles of Scilly, which includes increasing awareness of the availability and benefits of equity investments to stimulate business demand.

Using small business survey data which allowed for the size of the SME and variations in the amount of finance sought by type of finance, the report determined that around 8% of the overall unmet demand was likely to be accounted for by equity finance (and 82% by debt finance and a further 10% by other forms of finance). This would imply a total unmet demand of around £140 million per annum for debt (if 10% of propositions were viable) and around £14 million per annum for equity (again if 10% of propositions were viable), in addition to that which was already being met by publicly backed initiatives, again at the time.

Target market

As illustrated, there are clear benefits for the financial instruments to be set up at a regional level through a fund of funds, thereby ensuring their cohesive, effective implementation, critical mass, and efficient deployment in the targeted regions and groups of regions. Additionally, the Block One report Area Overview has given some insight into the industries and sectors where this region has established a degree of comparative advantage which creates a good foundation to be built upon and therefore involvement of the appropriate skill sets in sectors of comparative advantage is considered an important success factor.

Target final recipients

As recognized in the general ex-ante methodology, predefining final recipients of future financial instruments “can be particularly challenging on a time horizon of up to ten years (i.e. the duration of the eligibility period, running until 31 December 2023), especially in some sectors such as microcredit. Therefore, the proposed investment strategy should set a target for the final recipients, leaving room for changes (e.g. sectors of industry classified as innovative may develop over time) and be sufficiently prudent when selecting the financial product. Indeed, during the implementation phase, a reasonable level of flexibility can be beneficial to the effective disbursement of the funds.”

From gathered implementation experience, being too prescriptive in the definition of targets can lead to implementation difficulties and limited market impact and hence a more general and flexible approach is advised as long as the target final recipients of the proposed FIs are still within the EU definition of SMEs.

1.2.4 Envisaged combination with grant support

Eligibility rules under the ERDF-funded FIs in the 2007-2013 period did not allow for the combination of FIs and grants for the same eligible expenditure. This was seen as a problem by the Member States, especially given the difficulties faced by grant beneficiaries to secure the pre-financing or co-financing necessary to implement investment projects.

Whilst pre-financing will continue to remain ineligible, in the 2014-2020 programming period the CPR allows a combination of grants and FIs, as detailed in the EC’s Short Reference Guide: “For the combination of ESIF financial instruments with ESIF grants or other assistance, there are two possibilities.

- Firstly, it will be possible for certain types of grants (interest rate subsidy, guarantee fee subsidy or technical support as specified in Article 5 of the Delegated Act) and financial products to be combined within the same operation and to be treated as a financial instrument. Other types of grants cannot be presented under a single financial instrument operation.
- Secondly, it will be possible for the grant operation and financial instrument operation support to be combined to finance the same investment at the level of final recipient, however as separate operations.
- The overall guiding principle for all cases is that the same expenditure cannot be declared twice to the Commission. Grants shall not be used to reimburse support received from financial instruments and financial instruments shall not be used to pre-finance grants.”

Whilst in the instruments currently proposed, no combination with grants is foreseen, one of the issues raised by grant-FI combination is the compliance with state aid/de minimis aid cumulation rules. Final recipients may have the option to benefit from a grant and also from co-financing ESIF-funded loans, as long as the total aid intensity thereby provided does not breach the maximum intensity allowable under state aid rules. FIs and grant combination options could be even predefined at the instrument design stage, either by imposing certain structures derived ideally from the de minimis, or from the GBER rules for ease of implementation.

1.3 Lessons learnt

The Lessons learnt from the use of FIs have been developed in the Block One report. However, another overview is provided in the following section to complement the PIS.

1.3.1 The relevant past experience

The implementation of financial instruments in the 2007-2013 programming period was undertaken only to a limited extent in the European Union. Yet, given that SMEs were the main recipients of the instruments, existing implementation processes provided sufficient experience to draw some lessons learnt to be considered for the purpose of this document.

1.3.2 Lessons learnt – UK specific

Whilst the UK has significant experience of setting up and implementing a variety of financial instruments, a new type of structure was developed with EIB Group and implemented with four different regional authorities in the 2007-2013 period. This new structure involved EIB lending to the regional structure to boost the critical mass of capital alongside allocated ERDF funding. These 'leveraged' JEREMIE Holding Funds were implemented in Wales, the North West, the North East and the Yorkshire & Humberside region. As this was a new concept, understandably the EIB looked closely for any lessons that could be learned from the process and undertook an internal mid-term review. From this exercise, certain lessons were learned which have influenced the views of EIB and hence impacted certain aspects of the PIS for the 2014-2020 period. These can be briefly summarised as follows:

- In order to maintain the overall critical mass of capital in the structure dedicated to be invested into financial instruments, any expected management fees and similar costs need to be covered by sources of funding outside of the structure itself. This is to ensure that costs do not erode the critical mass of funding available for the underlying funds and hence reduce diversification and the ability to generate repayments.
- In order to maintain the required levels of implementation diligence and timely focus on deliverables, appropriate levels of independent corporate governance will be required.
- In order to respond to differences in implementation success of the underlying instruments and to accommodate any unforeseen changes in economic conditions, a flexible approach to capital allocation at the Fund of Funds level is to be recommended wherever possible.
- In order to avoid any unintended difficulties in the implementation and resultant utilisation of capital commitments within the underlying instruments, the central authorities are asked to consider carefully the impact of any national initiatives.

Additional feedback received directly from financial intermediaries involved in the implementations in the current programme includes the following points:

- The biggest factor perceived at limiting the impact of the existing activities has been the sector restrictions imposed on the investment scope. In particular, the exclusion of the 'retail' and 'business to customer (B2C)' sectors has hindered the provision to a greater number of enterprises.

- The restriction preventing investments that are categorised as ‘management buy-outs’ are regarded as further limiting factors.
- The formal EC definition of SME’s can be too restrictive with the upper limits on medium-sized enterprises preventing investments that are needed.
- The ESIF period end dates prevent the possibility to have follow-on investments into successful businesses thereby undermining the potential to create positive returns to investors. (now resolved under the ESIF Regulations for 2014-2020 period).

1.3.3 Lessons learnt - general

Clear, market-oriented and flexible eligibility rules

At a higher level, it should also be noted that the implementation of the financial instruments at the very outset of the previous programming period 2007-2013 had been impeded by the initial lack of clear regulatory provisions related to the implementation of financial instruments under Structural Funds. The publication of a comprehensive COCOF guidance note on the implementation of Financial Instruments in 2011 clarified the majority of questions relating to the eligibility of expenditure. It was later amended (in 2012) to address the urgent need for financing on working capital, which for instance continues to remain the bulk of demand in the current economic context.

The new regulatory framework for the 2014-2020 period, generally represents an acceptable basis for the future implementation of decentralised financial instruments. However, the following principles are to be carefully considered in all future implementations.

Flexibility

Given that eligibility and state aid rules may hamper final recipients in benefitting from FIs, it is important to limit the eligibility rules only to the strictly necessary ones, and to try and preserve for the instruments as much flexibility in meeting demand as possible. It is also important to allow for an easy re-allocation of resources from the non-performing to performing instruments, by grouping them under a fund of funds structure at regional or national level.

Suitability of the selected FIs

The role of the FIs in the deployment of funds is crucial to maximise such benefits of instruments portfolio as: utilisation of public resources, leveraging of private resources and investors, deployment of the instrument in accordance with the contractual obligations to ensure transfer of benefits to the beneficiaries with transparency, accountability and compliance with national legislation and EU regulations. The selection of the FIs should be carried out in the framework of all the above with full impartiality, and on the basis of a thorough assessment that includes technical expertise and know-how.

Availability of funds

During the previous programming period, all funds were available at the beginning of the operations. This ensured that the HF manager could enter into agreements and deploy financial instruments of varying risk profiles and of duration exceeding the programming period. This could be achieved without any additional conditions that could reduce the benefits transferred to the final beneficiaries, diverge from market practice, or trigger additional legal provisions. In the 2014-2020 period, the new concept of tranching of ESIF payments presents an additional operational aspect to the implementation of FIs which has to be carefully considered.

Combination with grants

As the new regulations allow to combine grants with financial instruments, it is up to the implementing bodies to decide if grants and instruments should work as an embedded or connected product(s) and potentially be managed by the financial instruments manager, or if the grant element would better work as an external component to be managed separately (perhaps in collaboration with a grant focussed authority).

Appropriate evaluation of financial results

An accurate evaluation of the results of financial instruments can only be made after the instruments have been wound down, returns fully generated and any losses have been incurred, and the equity funds have closed. It is well known that such instruments have a slow start and most equity gains or guarantee portfolio losses occur towards the end of their lives. Furthermore, the indicators used in the FIs evaluation must be different from those used in grant evaluation.

Capital Relief

In the course of implementation of certain debt instruments under the previous programming period, the intermediaries expressed interest in the applicability of regulatory capital relief under guarantee and debt products. The provision of regulatory capital relief should be carried out in a way that is compatible with national legislation and capital markets regulatory framework in close connection with legal experts and the national regulator, respectively.

It is expected that the provision of regulatory capital relief will remain a key element for the future implementation of debt products under ESIF and for that reason it should be considered at the stage of Funding Agreement negotiation whether its provisions would be compatible with this objective.

In accordance with the Basel regulatory framework, the benefit of the capital relief can be fully utilised when the entity providing the guarantee enjoys the maximum credit rating.

Transfer of benefits

Most of the instruments that are deployed through banks as FIs incorporate an element of support that is directed at the final beneficiaries. Continuous monitoring and sophisticated reporting through contractual arrangements with the FIs are required to ensure that the full benefit is transferred to the SMEs in a transparent and uninterrupted manner.

Attracting quality fund managers /Performance Management

Small country-specific funds rarely manage to attract top talent, as far as concerns fund managers, due to their size. To counterbalance that, equity instruments could offer an attractive fee/carry ratio. This approach would require a careful balancing act between the interests of fund managers and private investors, and must in any case retain the alignment of interest principle. A more attractive carry might make investors less interested, and so such incentives might only be possible with regard to public participation in the fund. More generally, the governance structures and remuneration mechanisms for fund managers, need to ensure a performance management culture, that better ensure alignment of interest and reward performance in an appropriate way. Thereby addressing some of the concerns in relation to management fees during the current period, reflecting market norms and address the requirements of both the match funder and GBER.

Local and committed teams

Strong local teams, or international teams with substantial capacity on the ground, have been shown to help an equity instrument achieve the impact sought by ESIF funding, especially from the developmental perspective.

1.4 Value added of the financial instruments

1.4.1 Value added of the proposed financial instruments

Qualitative value added

Given the market failures identified in the relevant chapter, the qualitative value added of financial instruments is significant in many respects, including:

- A more responsible approach, better performance and financial discipline at final recipient level in the case of financial instruments ("repayable assistance") compared to non-reimbursable assistance.
- Stimulation of a new generation of entrepreneurs in the innovative sector through the early stage equity investments;
- Supporting the build-up and modernisation of the financial system, including also the non-banking financial institutions previously not used as intermediaries under the ERDF FIs, by using new instruments and gaining new SME customers, including in the social economy.
- Creating a degree of competition and complementarity among banks, fund managers, and other intermediaries which, as it has been shown in the past, usually leads to better terms for the final recipients;
- The mathematical leverage effect is supplemented by the stimulation of greater interest of private investors in a country or sector they would not have considered otherwise, potentially leading to further investments undertaken by them in the future.

Quantitative value added

The main element of quantitative value added of the proposed FIs is the leverage on ESIF resources and the subsequent market impact. At instrument level, leverage can occur at multiple different layers in the proposed structure. The underlying instruments can be designed to attract additional investment either by the selected fund managers themselves (to ensure alignment of interest) or other private investors wishing to engage in this opportunity (as limited partners) and to respect the relevant regulations. Furthermore, particularly for equity instruments, additional equity investment can often enable to enterprise to be in a position to secure additional loan financing.

However, the quantitative leverage is perhaps best viewed at the FoF or instrument portfolio level, which gives an overall aggregated account of the effectiveness in the spending of ESIF resources from the point of view of stimulating private financing.

Table 4: Indicative leverage effect of the proposed instrument.

Financial Instrument	Instrument size £ m	Estimated total SME loans/investments facilitated	Potential Leverage
Debt Fund	£20m	157	FOF Level £12.9m
Equity Fund	£20m	26	FOF Level £19.4m
TOTAL	**Approximately £40m**	**184**	

Source: EIB

An important additional benefit to the leverage effect calculated above, while difficult to estimate in advance, consists in the revolving nature of the current (JEREMIE) and future ESIF FIs. Even with the assumed losses, the revolved resources, which will need to be again targeted towards SMEs, will add further value in the form of further “rounds” of SME financing (Legacy Funds).

1.4.2 Consistency of the proposed financial instruments with the OPs’ objectives

1.4.2.1 England Operational Programme (OP)

The central Managing Authority (DCLG) has finalised this Operational Programme which has a significant total financial allocation of ERDF. ERDF (and ESF) can be spent on a number of objectives defined in EU legislation and known as Thematic Objectives. The England programme will cover the following objectives:

(1) Strengthening research, technological development and innovation;

(2) Enhancing access to, and use and quality of, Information Communication and Technology;

(3) Enhancing the competitiveness of Small and Medium Sized Enterprises;

(4) Supporting the shift towards a low carbon economy in all sectors;

(5) Promoting climate change adaptation, risk prevention and management;

(6) Preserving and protecting the environment and promoting resource efficiency;

(7) Promoting sustainable transport and removing bottlenecks in key network infrastructures;

(9) Promoting social inclusion, combating poverty and any discrimination.

For the purpose of this Investment Strategy the focus will be on Priority Axis (PA) 1 “Promoting Research and Innovation and Priority Axis (PA) 3 namely “Enhancing the Competitiveness and Growth of SMEs”. The following is a justification for each priority provided within the OP.

Priority Axis 1

”Smart Specialisation in England recognises that geographies and patterns of innovation are complex and variable and that more needs to be done to ensure that firms and research institutions are not hindered by artificial or administrative geographies.

Across England, there is significant variation in levels of overall investment in research and development but these do not match exactly against the breakdown of regions according to the *categorisation of more developed, less developed and transition. Areas well ahead of the 3% target set for the European Union as a whole include not only London, the East, and the South East but also some parts of the North West. The disparity of activity across firms of different sizes across England is as much a function of the sectoral distribution across the economy as wider geographical factors.*

The types of actions needed to address England's challenges in terms of converting excellent research into innovation and economic outcomes are the same across the country, regardless of the category of region. The objective of improving how small and medium sized enterprises commercialise research and how they collaborate with research institutions will be taken forward through activities such as knowledge exchange, business engagement, networking and investment support in all parts of England, with the choice of sectors and technologies reflecting the approach of smart specialisation.

Priority Axis 3

"*There is a wide variation in the competiveness of small and medium sized enterprises. The majority do not show growth in any given year. Separate research shows that only approximately seven per cent of small and medium sized enterprises between 2002 and 2010 could be classified as 'high growth' according to the Organisation for Economic Co-operation and Development definition and these were responsible for creating nearly a quarter of all new jobs over three years.*

There are various factors that limit the ability of a small and medium sized enterprise to grow:

- *Business owner awareness of and access to business support. Businesses report significant benefits from using business information and advice. However, less than half of United Kingdom small and medium sized enterprises currently use business support due to difficulties in accessing information or advice and; doubts about the benefits of business support;*
- *The internal capacity and capability of a business including their ability to innovate;*
- *The external environment including procurement, access to finance and exporting.*

Access to finance is a particular area of difficulty for small and medium size enterprises. While 38 per cent of small and medium sized enterprise employers consider obtaining finance an obstacle to their business success, seven per cent of these employers report it as the main obstacle. Finance is also a disproportionately important obstacle for high growth firms compared to other businesses. Evidence suggests there has been a decline not only because of reduced supply of funding but also a reduced demand appetite for risk.

Exporting small and medium sized enterprises are more productive, innovative and resilient than non-exporting firms. The contribution of small and medium sized enterprises is significant – contributing to 80 per cent of the quantity of exports. A recent study found that 25,000 to 150,000 non-exporting United Kingdom small and medium sized enterprises have the potential to be competitive in export markets. "

As a direct result of these factors, the OP lays out that use of Use of European Regional Development Fund will be focussed on:

"*Small and Medium sized Enterprises are therefore seen by the EC and by Local Enterprise Partnerships as the highest priority for the 2014-2020 Growth Programme in terms of value of* *investment, focussed predominantly on access to finance and business support measures. There are three separate investment priorities in this axis which are:*

- *Access to finance through grants, loans and equity to help businesses grow where some groups of Local Enterprise Partnership areas are looking to build on current financial instruments to improve access to finance for small businesses while others look to collaborate to set up new financial instruments*
- *Business support including advice services for entrepreneurship, commercialisation, and exports;*
- *Business support for new business start-ups;*
- *Premises for SMEs including managed workspaces and business incubators where demand is shown to exceed supply.*

The support provided through this priority will aim to increase the growth capability and capacity of Small and Medium Sized Enterprises and in doing so develop the pipeline of future high growth business as well as increase entrepreneurship across England, but there will also be a particular focus on territories with low levels of enterprise activity, and amongst under-represented groups. The projected number of enterprises receiving support from the funds (including match funding) by 2023 is about 65,000."

The creation and the acceptance of the OP lays out the background and framework for this PIS and enables a high level of consistency between the overall national priorities and the more regional focus of both the PIS and the subsequent implementation.

1.4.3 Consistency with other forms of public assistance addressing the same market

1.4.3.1 Consistency with current SME financing instruments

Block One of the Ex-ante Assessment undertaken by EIB with the support of Regeneris Consulting has covered this subject in depth and explained the array of previous and current initiatives to support greater SME access to finance within England and the UK. It is therefore not the intention of this PIS to duplicate that analysis however it is important that any final decisions on financial instruments at a regional level take into account activities planned at a national level, particularly those of the British Business Bank (BBB). Block One of the report has argued that the overall size of the market failure or suboptimal investment situation is significant and that a mixture of national and regional activities are considered appropriate to address the needs and stimulate further growth.

1.4.3.2 Consistency with activities of the British Business Bank (BBB)

Given its role, the BBB works closely with central government authorities to devise value-adding financing instruments for the SME marketplace. The British Business Bank's Small Business Finance Markets report, published in December 2014, shows that increased numbers of smaller businesses are expected to seek finance for growth in the coming years, as nearly half (46%) of small businesses plan to grow their turnover in the next 12 months, with 17% of these expecting to fully or part fund this expansion with commercial finance. The BBB website (www.british-business-bank.co.uk) lists the following debt and venture capital solutions to encourage lenders to fund smaller businesses:-

- Debt programmes
- Start-Up Loans
- Enterprise Finance Guarantee
- Equity programmes
- Enterprise Capital Funds (ECFs)
- Business Angel CoFund
- UK Innovation Investment Fund
- Aspire Fund

Whilst these initiatives are predominantly national in nature and do not target regional weaknesses, they remain an important part of the publicly-funded SME financial instrument landscape.

1.4.3.3 Consistency with EU-level instruments managed by EIF

The newly launched central EU instruments have been entrusted to EIF for implementation by the EC and implementation activities have already begun. These instruments are open to engagement with financial intermediaries across all Member States and it should be expected that a certain volume of transactional activity will result in England. These instruments, do not specifically address the local market needs and their predecessors CIP and FP7 RSSF, as well as the first PROGRESS Microfinance, have been used only to a limited extent in the country. The EU-level instruments include the COSME Loan Guarantee Facility (successor of the CIP SMEG) and InnovFin Guarantee (HORIZON 2020) instruments amongst others and also remain an important part of the publicly-funded SME financial instrument landscape.

1.4.4 Possible State Aid implications

Block One of the report has covered this subject in detail and utilises external advice of this matter. Hence, this paper will not cover this subject in detail other than to state that each of the instruments detailed above needs to be carefully considered against State Aid regulations. As EU funds create advantages for SMEs on a selective basis, and their utilisation is decided upon by the state, they have the potential to be considered state aid under Article 107 of the TFEU. Although the new EC regulations for block exemption and de minimis aid entered into force in 2014, the principles of state aid are the same, with the following categories of financial instruments:

- State aid free instrument – e.g. loans at market rates, guarantees priced at market rates or at “safe harbour” rates, as defined by the EC
- Instruments with a state aid element but considered compatible with the TFEU and thus exempt from notification:
  - De minimis instruments under Reg. 1407/2013, not requiring notification – e.g. investments under the de minimis ceiling amount, or guarantees/loans where the aid element (gross grant equivalent) falls below the de minimis threshold.
  - Instruments exempt from notification under Reg. 651/2014, such as risk capital funds with at least 40% private participation and complying with all the other conditions set

out in the GBER 651.

- Outside of these categories, instruments with a state aid element require a formal notification to the EC in coordination with the national state aid point of contact if considered required.

Since notified instruments may take longer to be approved, and state aid free instruments may not be interesting for market players and final recipients, the EIF's experience in the former programming period is that the block exemption rules (GBER and de minimis) are the best option to be used for financial instruments.

For each financial instrument, a careful assessment of state aid compatibility is needed, not only at final recipient level, but also at the level of the intermediary and (in the case of equity funds) of a private investor. As with any EU projects, it is essential to make the state aid elements a part of the instruments' design process, in tandem with the ESIF eligibility rules. This ensures that the principles are duly respected and, if required, a state aid, or a de minimis aid scheme, is proceeded with well in time for the implementation of the instruments.

1.5 Potential for additional resources to be raised by the financial instruments

1.5.1 Identification of potential sources of funding

Certain underlying financial instruments may need to attract additional independent private investment (leverage) to varying degrees at either the level of the financial intermediaries or the eligible undertakings in order to increase the available capital pool and comply with any relevant regulations (for example: risk finance measures/instruments operating under the General Block Exemption Regulation 651/2014 will need to respect Article 10). This effect can bring clear benefits in terms of critical mass and impact for the region.

Additionally, a further source of funding to be considered is the legacy returns generated from the successful implementation of previous activities. These funds can either be used to add to the regional commitment to the FoF or allocated outside of the FoF to cover management costs likely to be incurred.

1.6 Consistency of the expected results with the operational programmes

In line with the objectives of the Operational Programmes and specific Priority Axes, the following are possible result indicators in the assessment of the performance of the proposed FIs.

Table 5: Potential result indicators to be monitored for the implementation of the proposed FIs

Output Indicator	Number
C1- Number of enterprises receiving support	184
C3- Number of enterprises receiving non-financial support	184
C4- Number of enterprises receiving financial support	10
C5- Number of new enterprises supported	6
C7-Private investment matching public support to	£32,413,324

enterprises	
C8- Employment increase in supported enterprises	**314**
C28- Number of enterprises supported to introduce new to the firm products	**2**
C29- Number of enterprises supported to introduce new to the firm products	**19**

1.7 Monitoring of the financial instrument and revision of the Ex-Ante Assessment

1.7.1 Monitoring and Controls

It is anticipated that each FoF will be a special purpose vehicle whose role will deliver this programme of activity alone. Rigorous, effective and efficient control systems will be implemented and maintained by the FoF, which will need to be staffed with personnel who are experienced in managing publicly funded financial instruments and the audit, control and verification environment that brings, in order to comply with Article 7 of the Delegated Regulation. These requirements include;

- Adequate capacity to implement the financial instrument, including organisational structure and governance framework providing the necessary assurance to the managing authority.
- An effective and efficient internal control system; and
- The use of an accounting system providing accurate, complete and reliable information in a timely manner.