info@Lynheath.co.uk

Financial Instruments (FIs) and European Structural and Investment Funds (ESIF)

LEP Summary Briefing Note 3: 10 points for reflection

Publication of Regulation (EU) No 1303/2013 of the European Parliament and of the Council on 17 December 2013 laid out the common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealed Council Regulation (EC) No 1083/2006 – the 2007-13 common provisions regulation.

The secondary legislation including the Implementation Act is now awaited – to be delivered by Easter2014 at the latest. Once this is published LEPs will be able to move forward in their planning to deliver Financial Instruments to support their local elements of the national Operational Programme. Prior to the Implementation Act there are already a number of changes in identified which will mean simple duplication of 2007-13 FI processes and structures will not be possible. 10 are set out below for reflection.

1. **Ex Ante Assessment.** Identifying a market failure and the appropriateness of using Financial Instruments as a mechanism to overcome these failures has been common practice in the UK. The current rules however are more proscribed than previously and failure to follow the rules can lead to problems in later implementation. Knowing the rules, linking them to State Aid regulations and an understanding of commercial finance is essential. Did you know for example that:
    - Unless a specific market justification is given in the ex ante assessment for a loan provider to be repaid their loan and interest before 2023 then the private sector match funding from debt providers will be impractical.
    - The method of ongoing / final evaluation of a FI needs to be established at the start but BIS and the Business Bank are currently reviewing how FIs are to be evaluated in future (as they do not believe the HMT Green Book provides the answer). Until this is resolved LEPs will be unable to set out acceptable evaluation methodologies in their ex ante assessment reports.

2. **Option to combine Financial Instruments with grant delivered Access to Finance and technical support measures for SMEs.** Directly linking supply and demand side initiatives within one instrument will help coordinate activity and provide a rounded support package to SMEs as long as conflicts of interest are overcome. LEPs with limited resources to match ESIF will also be able to increase the allowable intensity of EU funding intensity by 10% (to 60%) if they allocate a specific Priority Axis such as TO1 Research and Innovation, TO3 Business Competition or TO4 Low Carbon economy.

3. **Phased Contributions to FIs**. Unlike in previous ESIF rounds it will not be permissible to establish a FI and draw down 100% of its forecast funding upon establishment. Only tranches of 25% of total EU funding (and match funding) will be possible for FIs going forward. After the initial 25% tranche is drawn a second tranche will be allowed only when 60% of first tranche has been applied for eligible expenditure. Subsequent tranches have more onerous drawdown restrictions and this may adversely impact on negotiations for match funding with any possible private sector partners.

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4. **Flexibility for equity funds.** A fundamental problem with previous EU rules for FIs was the inability to provide follow on funding for equity investments after the formal end of the eligible expenditure period. Good news - there is now limited scope for this to overcome dilution problems.

5. **State Aid cleared 'off the shelf' FI schemes to be available.** The commission is preparing five standard FIs to be available for ease of implementation;
   - Loan for SMEs
   - Guarantee for SMEs
   - Venture Capital for SMEs (based on co-investment model)
   - Renovation loan (for low energy/ urban renewal)
   - Urban Development Fund

   These should be released alongside the Implementation Act and be particularly valuable to LEPs without an existing legacy FI structure to build upon.

6. **EU co-financing (*currently not to be allowed in UK*).** The option of piggy backing existing EU run FI schemes and integrating more effectively the different strands of EU funded schemes has been rejected by BIS as administratively too difficult for them. The UK misses out again on access to finance funding– time to lobby BIS again (?) as this is not the same as their proposed scheme, rejected by LEPs, last May that Capital for Enterprise manage a top sliced element of LEP budgets.

7. **Reporting structures**. As with the ex ante assessment there is a new degree of proscribed reporting for FIs but none of this is on the face of it onerous. The problems come when different interest / stakeholder groups each want different levels of reporting (including BIS / Business Bank). Central government departments need to coordinate their reporting requirements and timings when FIs are established to overcome data overload.

8. **Audit requirements.** Good news is that final beneficiaries (SMEs) are not to be routinely audited by the national audit authority (DCLG), as long as FI fund managers maintain clear audit trails. Consequently expect the audit requirements be strengthened for fund managers and the EU Court of Auditors still requires absolute right of access to final beneficiaries so not all good news here.

9. **Purpose**. Good news in the new rules in that there are clearer definitions of eligible investment criteria including working capital for growth and management buy outs but land purchases for expansion remain difficult under EU rules.

10. **Mischief** – If Scotland votes to leave the Union in September 2014 and, as is likely, they do not get automatic right of entry to EU, who then gets their unspent allocation of ESIF funding that has not been committed by 2016?

Feb 2014