European Commission

EU level and "Off-the-shelf" Financial Instruments

MADRID, 8 November 2013

Financial instruments and IFI Relations
Directorate-General for Regional and Urban Policy

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- **Overview on Off-the-Shelf Instruments**

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CPR Art.33(1)- Managing authority may provide financial contribution to:

a) ***Financial instruments set up at <u>EU level</u> (e.g. H2020, COSME, etc., i.e. financial instruments managed by the Commission);***
b) *Financial instruments set up at national, regional, transnational or cross-border level (i.e. financial instruments managed or under the responsibility of the managing authority).*

CPR Art.33(3)- Managing authority may provide financial contribution to:

a) ***Financial instruments complying with the standard terms and conditions laid down by the Commission = <u>off the shelf instruments,</u>***
b) *Already existing or newly created financial instruments, specifically designed to achieve the specific objectives set out under a relevant priority **= <u>tailor made instruments.</u>***

EU level

Financial Instruments

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MA contributing OP allocation to EU level instrument

- OP allocation ring-fenced and to be invested in the OP area
- Set-up phase is skipped (selection of FoF/Financial Intermediaries, preparation of parameters of FIs…) as EU level instrument delivery system is used
- MA ultimately responsible for this operation (CPR rules apply – eligibility, geographical limitation, end date of eligibility…) - but can rely on structures designed by the Commission in cooperation with the EIB Group
- Rules on payments, reporting do not change
- MA shall not carry out on-the-spot Management Verifications
- AA shall not carry out system audits/audits of operations (rely on framework audit contracts negotiated by the Commission)

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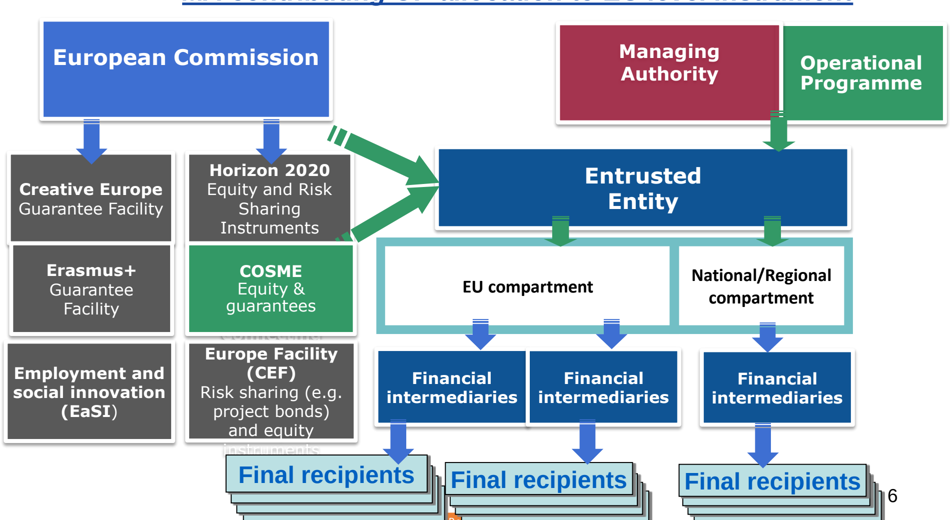
MA contributing OP allocation to EU level instrument



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Why to contribute with ESI Funds to a EU Level FI?

- **Alignment with EU policy objectives**
- **Reinforcement of EU funds and scale effect (investors interests)**
- **Easier, no much of management (design, tendering, legal, financial, audit, reporting, administrative costs…)**
- **High co-financing rate (up to 100%)**
- **Early start maximise impact**
- **The entities entrusted by the EU to implement will set forth the conditions for MAs to invest ESI funds in a specific compartment**

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Horizon 2020

- **Objectives (Market failure addressed) -** Difficulties in obtaining funding to carry out research and innovation due to information asymmetries, high transaction costs, the credit crunch, and a low supply of venture capital in Europe
- **Alignment with Cohesion Policy Thematic Objectives -** Research, development and innovation
- **Final recipients' eligibility:** Legal entities of all sizes, particularly SMEs and small midcaps with potential to carry out innovation and grow rapidly
- **Financial characteristics:** Direct loans; intermediated loans, direct and intermediated hybrid or mezzanine finance; guarantees or counter-guarantees; intermediated risk capital.
- **Contact for more information: DG RTD**

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COSME

- **Objectives:** Ease access to finance for SMEs and reinforce EU Venture Capital industry
- **Alignment with the Cohesion Policy Thematic Objectives:** Enhance SME competitiveness
- **Final recipients' eligibility:** SMEs according to EU definition, COSME participating countries
- **Financial products offered:** Direct and counter guarantees, securitisation / direct investments in risk capital funds and funds-of-funds (later)
- **Financial characteristics of the product:** Guarantees are capped on a portfolio basis and according to expected cumulated losses. Free of charge.
- **Contact for more information: DG ENTR**

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"Off-the-shelf" Financial Instruments

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Objectives:

- Help managing authorities to deliver faster and safer financial means to the final recipients;
- Alignment and complementarity with the EU level instruments (*no overlapping but complementary*);
- Combining public and private resources, seek for leverage EU (and/or public) contributions;
- Switch from grant dependency to a more sustainable way of project finance.

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Principles:

- Not mandatory;
- Keep Managing Authority able to decide to select directly financial intermediaries or to pass through a Fund of Funds manager (*not total outsourcing but working hand in hand*);
- Flexible: keep adaptability to the needs of various type of regions;
- Based on lessons learned from past implementation experience;
- Focus on the most commonly used type of instruments;

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Principles:

- Compatibility with the state aid rules (no need for notifications within the boundaries of the off-the-shelf instruments);
- Common term sheets and harmonized funding agreement template;
- No crowding out / overlap with existing financial instruments;
- Implementation of the instruments according to market practice.

Term sheets:

- Structure of the financial instrument
- Aim of the instrument
- State aid implication
- Lending/ guarantee/ investment policy
- Pricing policy
- Programme contribution to the financial intermediary (product details)
- Programme contribution to financial instrument (activities)
- Managing authority's liability
- Duration
- Alignment of interest
- Eligible financial intermediaries
- Targeted results (reporting, monitoring and evaluation)
- Final Recipients eligibility
- Characteristics of the product for the final recipients
- Evaluation of the economic benefit

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Types of instruments proposed:

1. **Loan for SMEs** based on a portfolio risk sharing loan model (RS Loan);

2. **Guarantee for SMEs** (partial first loss portfolio) (Capped guarantee);

3. **Equity Investment Fund for SMEs** and start-up companies based on a co-investment model (Co-investment Facility);

4. **Loan for energy efficiency** and renewable energies in the residential building sector (Renovation Loan);

5. **Loan for sustainable Urban Development** (UD Fund) *(under progress).*

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1. Loan for SME's - Portfolio Risk Sharing Loan:

- Aim of the instrument: **combining public and private resources** to finance SMEs at better/preferential conditions (new loans);
- Programme contribution for the instrument: typically between **EUR 1m and EUR 100m**;
- Risk-sharing: **80%/20%**, i.e. the financial intermediary shall contribute with its own private funds for a minimum of 20% (at market conditions);
- State aid:
  - **state-aid free at the level of the financial intermediary** and
  - Compliant with ***de minimis*** rule at the level of SMEs
- Duration: typically **4 years** after the signature of the funding agreement between the managing authorities and the financial intermediary;

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1. Loan for SMEs - Portfolio Risk Sharing Loan:

- Purpose of the loan: **financing tangible & intangible investments** as well as the **working capital linked** to the investment financed;
- Target: Eligible **SMEs** (*according to EU recommendation*); Excluded: SME in difficulty, active in the agriculture/fishery sectors, *de minimis* exclusions, delinquent/default, etc.
- Loan maturity: **between 1y and 10y** (including grace period);
- Loan amount: **up to EUR 1m**;
- Advantage for the SMEs: access to finance at **preferential conditions** (interest rate reductions)

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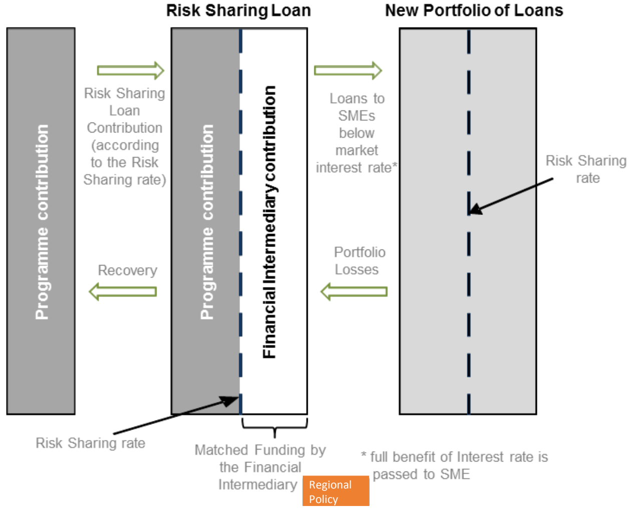
1. Loan for SMEs - Portfolio Risk Sharing Loan:



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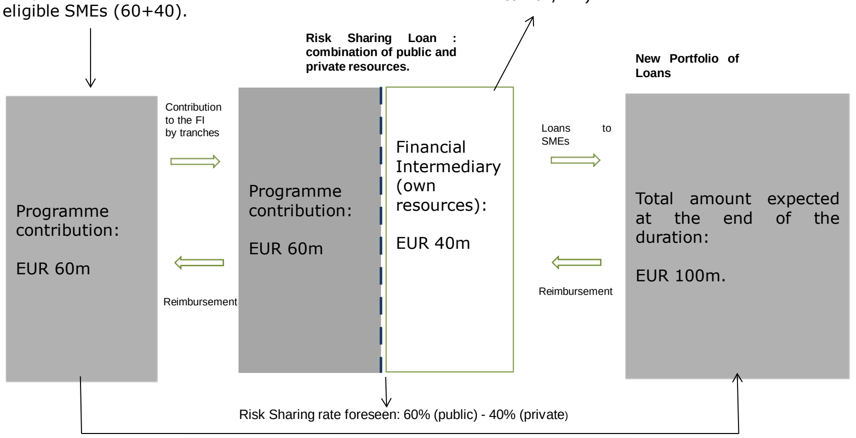
Following ex-ante, it is decided that **EUR 60m** will be allocated for this financial instrument with a risk sharing rate **60% - 40%**, i.e. in fine, EUR100m will have to reach the eligible SMEs (60+40).

Financial Intermediary selected trough a CfEoI / open tender (responsible for implementing the instrument + reporting to FoF/MA).



*Relatively low leverage **1.6x** in this example*

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Example of the advantage for eligible SMEs

If the Financial Intermediary originates a loan for an amount of EUR 300 000. Therefore:

EUR 180 000 from the programme contribution (at a better condition) and EUR 120 000 from the financial intermediary (i.e. bank own resources, likely at market condition).

The aggregation of the combined resources makes the loan very interesting/ affordable for SMEs.

		40%	60%	100%
1=2 +3	Interest rate (including base rate)	945	0	378
2	Base rate	EURIBOR 12m 132	0	EURIBOR 12m
3=4 +5	Margin above rate of which:	813	0	325
.4	* Cost of funding p.a	293	0	117
5	* Risk margin (above cost of funding)	520	0	208
6	Other fees (administrative / cancellation fees, etc.)	125	0	50

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What happens in case of a default?:

Assumptions:
- Loan amount : **EUR 300 000**
- Co-financing FoF/MA and Financial Intermediary: 60%-40%

Default occurred:
- Default amount: **EUR 200 000**
- FoF/MA loss: EUR 120 000
- Bank loss: EUR 80 000

Recovery actions take place:
- Amount recovered: EUR 150 000 (out of EUR 200 000)
- Part for the FoF/MA: 150 000*60% = EUR 90 000
- Part for the Financial Intermediary: EUR 60 000

To conclude:
- Total amount lost:
  EUR (-120 000 + 90 000) + (– 80 000 + 60 000) = EUR - 50 000
- With this instrument the Financial Intermediary has lost:
  EUR 80 000 – 60 000 = EUR 20 000

2. Guarantee for SMEs - Capped Portfolio Guarantee

- Aim of the instrument: **credit risk coverage** up to a certain limit allowing the financial intermediary to facilitate SMEs access to finance at better/preferential conditions;
- Programme contribution for the instrument: typically between **EUR 5m and EUR 30m**;
- Guarantee rate: up to **80%** on a loan by loan basis (credit risk retains by the financial intermediary in no case less than 20%);
- Cap rate to be determined in the ex ante risk assessment (No more than 25%);
- Multiplier: **min.5x**;
- State aid:
  - **state-aid free at the level of the financial intermediary** and
  - Compliant with ***de minimis*** rule at the level of SMEs

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2. Guarantee for SMEs - Capped Portfolio Guarantee

- Duration: typically **4 years** after the signature of the funding agreement between the managing authorities and the financial intermediary;
- Purpose of the loan guaranteed: **financing tangible & intangible investments** as well as the **working capital linked** to the investment financed;
- Target: Eligible **SMEs** (*according to EU recommendation*); Excluded: SME in difficulty, active in the agriculture/fishery sectors, *de minimis* exclusions, delinquent/default, etc.
- Loan maturity: between **1y and 10y** (including grace period);
- Loan amount: up to **EUR 1.5m**;
- Advantage for the SMEs: access to finance at **preferential conditions** (*interest rate and collateral reductions*).

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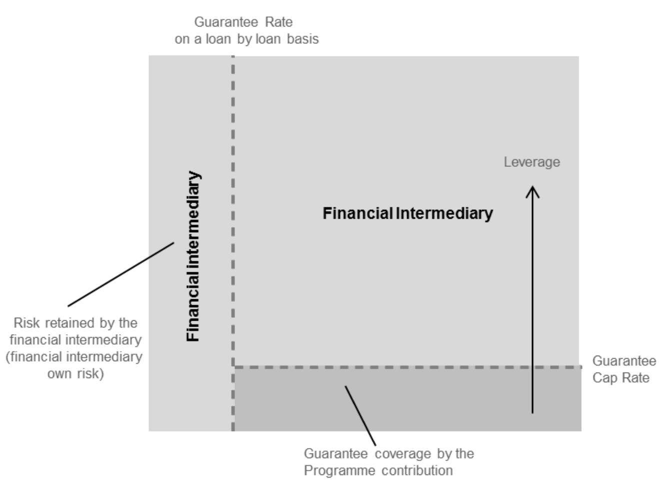
2. Guarantee for SMEs - Capped Portfolio Guarantee



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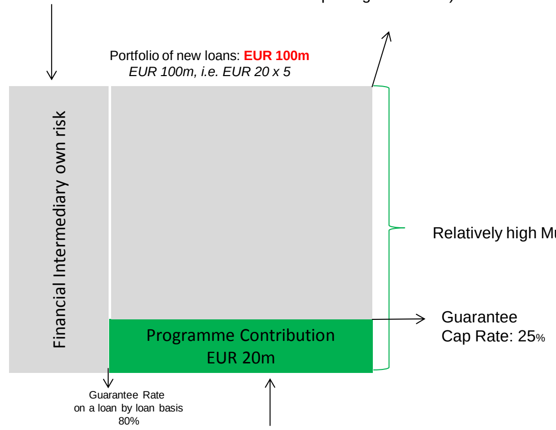
Risk retained by the financial intermediary (financial intermediary own risk): **20%** i.e. 100%-80%

Financial Intermediary selected trough a CfEoI / open tender (responsible for implementing the instrument + reporting to FoF/MA).



Relatively high Multiplier: 5x

Guarantee
Cap Rate: 25%

Following ex-ante, it is decided that **EUR 20m** will be committed for this financial instrument with a Guarantee Rate set up at **80%**, and a Cap Rate calculated at **25%** i.e. in fine, **EUR 100m** will have to reach the eligible SMEs (20x5).

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Example of the advantage for eligible SMEs:

If the Financial Intermediary originates a loan for an amount of **EUR 300 000.** Therefore: **EUR 300 000** from the bank own money is disbursed to the eligible SMEs.

The loan is covered up to 80%, but up to the programme contribution (here EUR 20m) .

The coverage makes the loan interesting/ affordable for SMEs.

SME rating	Current pricing policy of a Financial Intermediary		New Pricing policy proposed by the Financial Intermediary		advantage
	Final Interest rate	Margin over the Base Rate (245 bps)	Final Interest rate	Margin over the Base Rate	
BBB+	3.74%	1.29%	3.45%	1.00%	0.29%
BBB	4.20%	1.75%	3.76%	1.31%	0.44%
BBB-	4.83%	2.38%	4.12%	1.67%	0.71%
BB+	5.62%	3.17%	4.57%	2.12%	1.05%
BB	6.40%	3.95%	5.03%	2.58%	1.37%
BB-	6.87%	4.42%	5.29%	2.84%	1.58%

Current collateral policy of a Financial Intermediary	New collateral policy proposed by the Financial Intermediary
110%	60%

In addition, the Collateral requirement will be reduced

90% of Eligible SMEs will benefit of an Interest Rate reduction ranging between 0.44 p.p. and 1.58 p.p.

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What happens in case of a default?:

Assumptions:
- Loan amount : EUR 300 000
- GR: 80%
- CR: 25%
- Multiplier: 1/(80%*25%)=5

Default occurred:
- Outstanding amount: EUR 200 000
- Bank call the default to the FoF/MA
- **FoF/MA pays the default in 60 days**: 200 000 * 80% = 160 000

Up to the Cap amount (programme contribution)

Recovery actions take place:
- Amount recovered: EUR 150 000 (out of EUR 200 000)
- Part for the FoF/MA: 150 000*80%= EUR 120 000
- Part for the Financial Intermediary: EUR 30 000

To conclude:
- Without this instrument the Financial Intermediary would have lost :
  EUR 200 000 – 150 000 = EUR 50 000
- With this instrument the Financial Intermediary has lost:
  EUR 200 000 – 160 000 – 30 000 = EUR 10 000

Very interesting for the Financial Intermediary

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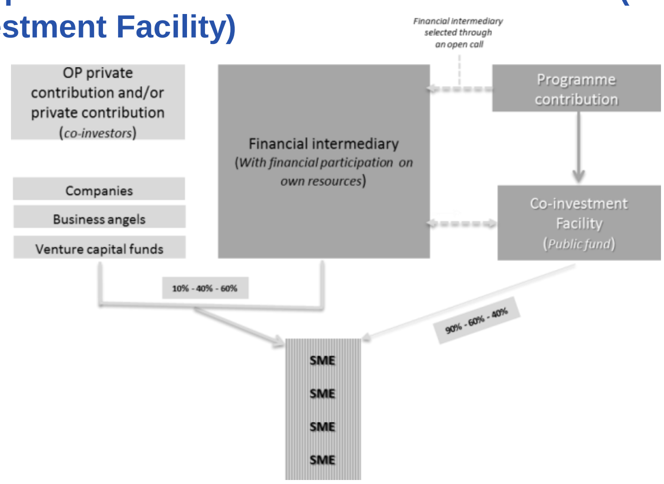
3. Equity Investment Fund for SMEs and start-up companies based on a co-investment model (Co-investment Facility)



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3. Equity Investment Fund for SMEs and start-up companies based on a co-investment model (Co-investment Facility)

- Aim of the instrument: **combining public and private resources to provide equity to SMEs**;
- Programme contribution for the instrument: typically between **EUR 10m and EUR 50m**;
- Duration the funds: typically **10 years after the signature of the funding agreement** between the managing authorities and the financial intermediary;
- Investment period into SMEs: up to **31 December 2023**;
- Type of investment: **equity**;
- Investment amount: **max EUR 10m / SME** (including follow-on investments);

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3. Equity Investment Fund for SMEs and start-up companies based on a co-investment model (Co-investment Facility)

- Target:
  - **Eligible SMEs (according to EU recommendation). Excluded: SME in difficulty, active in the agriculture/fishery sectors, *de-minimis* exclusions, delinquent/default, etc.;**
    - SMEs prior to their first commercial sale; or
    - <5y following their first commercial sale; Since inception, turnover not exceeding 10% of the total investment amount; SMEs with a view to entering a new market-product; or
    - follow on investment.
- Public and private contribution: depending on the type of investment target, the private contribution (matching the contribution programme) shall be of a min. **10%/40%/60%** of the overall amount invested into an SME;
- State aid: if all conditions of **GBER** fulfilled the instrument is state aid compatible (i.e. no notification to the EC needed);
- Advantage for the SMEs: supporting SMEs growth in a very difficult funding environment.

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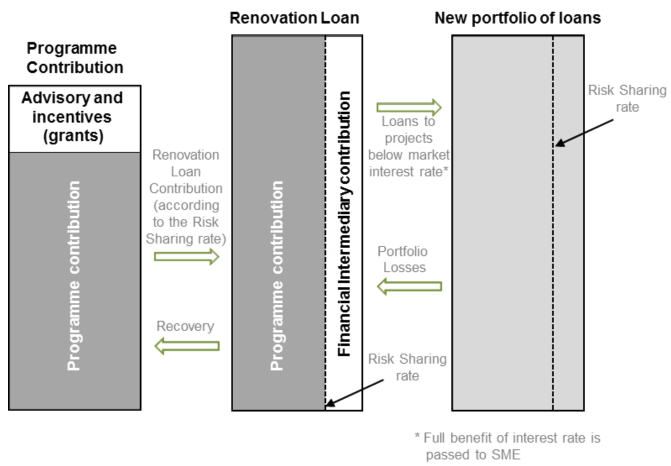
4. Loan for energy efficiency and renewable energies in the residential building sector (Renovation Loan)



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4. Loan for energy efficiency and renewable energies in the residential building sector (Renovation Loan)

- Aim of the instrument: **combining public and private resources** to finance natural persons owning premises/private owners at preferential conditions **to invest in renewable or efficiency energy assets**;

- Programme contribution for the instrument: typically between EUR 5m and EUR 30m;

- Risk-sharing: **85%/15%**, i.e. the financial intermediary shall contribute with its own private fund for a minimum of 15% (at market conditions);

- State aid:
  - State aid free at the level of the financial intermediary and
  - Compliant with *de minimis* rule when there is economic activity (independent professionals, legal persons).
  - Private owners – no state aid involved

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4. Loan for energy efficiency and renewable energies in the residential building sector (Renovation Loan)

- Purpose of the loan: energy efficiency or renewable measures (e.g. replacement or refitting of the heating, Improvement of heat insulation, replacement of windows and entrance doors, roof insulation, etc.;
- Target: natural, legal persons or independent professionals (economic activity), as well as administrators or other legal bodies acting on behalf and for the benefit of owners, owning premises (apartment or individual household), social housing companies, etc.
- Loan maturity: up to 20 years (including grace period);
- Loan amount: up to EUR 50.000 / owners;
- Advantage for the owners: access to finance at preferential conditions (interest rate and collateral reductions)

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Q&A time

Muchas Gracias

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