Financial instruments structures:
Loan instruments

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Debt finance

Financial instruments

- ✓ co-funded by the European Structural Investment Funds (ESIF)
- ✓ a sustainable and efficient way to invest in growth and development
- ✓ can support a broad range of development objectives to the benefit of a wide range of final recipients (FRs)

Revolving effect

Additional flows of money - generated through repayments or cost savings as well as realisation of investments, - that can be reused for further investments

Leverage effect

Capacity to attract additional public and private resources.
It is "the sum of ESIF funding and additional public and private resources raised divided by the nominal amount of the ESI Funds contribution"

State aid: FIs must be implemented in accordance with State aid rules

What are the financial products?

Loans

Agreement which obliges the **lender** to make **available** to the **borrower** an agreed sum of money for an **agreed period** of time and under which the borrower is **obliged to repay** that amount plus interest within the **agreed time.**

Guarantees

Written commitment to **assume responsibility for** all or part of a **third party's debt** or obligation **if an event occurs** which **triggers** such **guarantee**, such as a loan **default.**

Equity

Provision of capital to a firm, invested directly or indirectly **in return** for partial **ownership** of that firm. Equity investor may assume some management control of the firm and may share the firm's profits.

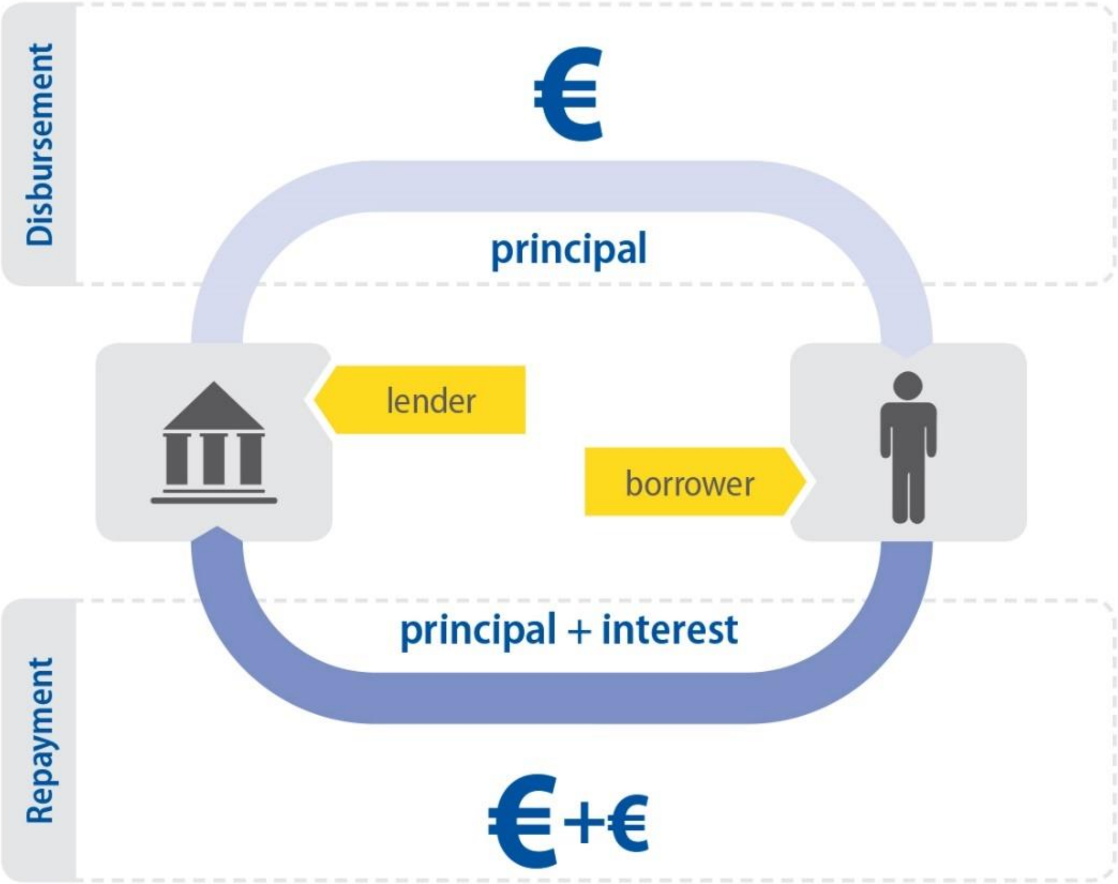
Debt finance

- High **importance of SMEs** in the EU economy.
- Debt finance instruments: **Loan + Guarantee.**
- High **reliance of SMEs on Bank loans** for getting funding.
    - Debt finance provides funding to finance the **Short-Medium-Long term debt** of SMEs.
    - Debt finance is a **Liability** for SME and an **Asset** for Banks.
    - With Equity instruments, MAs buy shares of SMEs.
    - Equity backs-up the **liabilities** of the SME.
- **Debt finance** → significant number of SMEs access to finance vs **Equity** → more elitist.

Debt finance - ctd.

- A loan is extended by a lender which bears the **risk** that the borrower might not repay it.
- A loan is for temporary use (i.e. within a specific **maturity** period defined between the lender and the borrower).
- SMEs apply for a loan through lending organisation which might be:
  - a commercial bank,
  - a cooperative bank,
  - a public bank, or
  - other lending organisations like microfinance entities.
- The interest rate charged is the price for the loan. Typically, an interest is composed of:
  - funding costs,
  - administrative costs (including margin for the bank),
  - risk costs.

How does a loan work?



Key features:

- **lower** than market **interest** rates
- **longer** repayment **periods** (incl. grace periods)
- **reduced** collateral requirements

=> soft loans

Loans – pros and cons

PROS

- **Not** too **difficult** to administer (limited manag.t costs/fees)
- Budgeting easy, due to **defined repayment schedule**
- The **lending mechanism** is **well understood**, need for **capacity building** is **limited**
- Loans **preserve** the **equity** of FRs

CONS

- Funded product: requires **more resources** than unfunded products
- **Limited additional benefits** as know-how of the F.Int is not transferred

Risk sharing loan

The RS loan is a loan pooling together ESIF funds and funds from the financial intermediary, where the latter shall contribute at least 25% (alignment of interest) – Commission Implementing Regulation (EU) No 964/2014

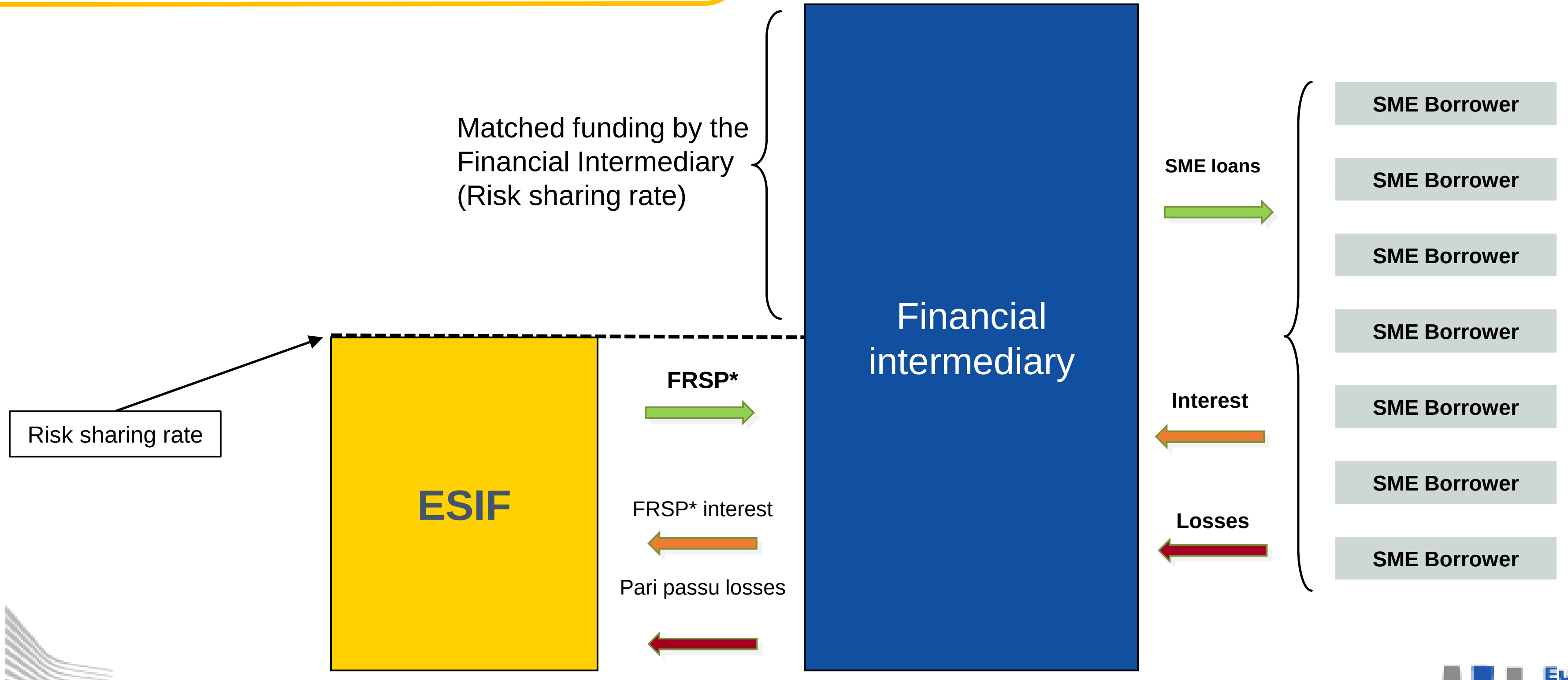
Objectives:

- to provide the better access to finance to targeted SMEs and credit risk sharing to intermediaries.
- to leverage ESIF resources to support financing for SMEs.

Risk sharing loan

$$Leverage = \frac{1}{risk\ sharing\ rate}$$

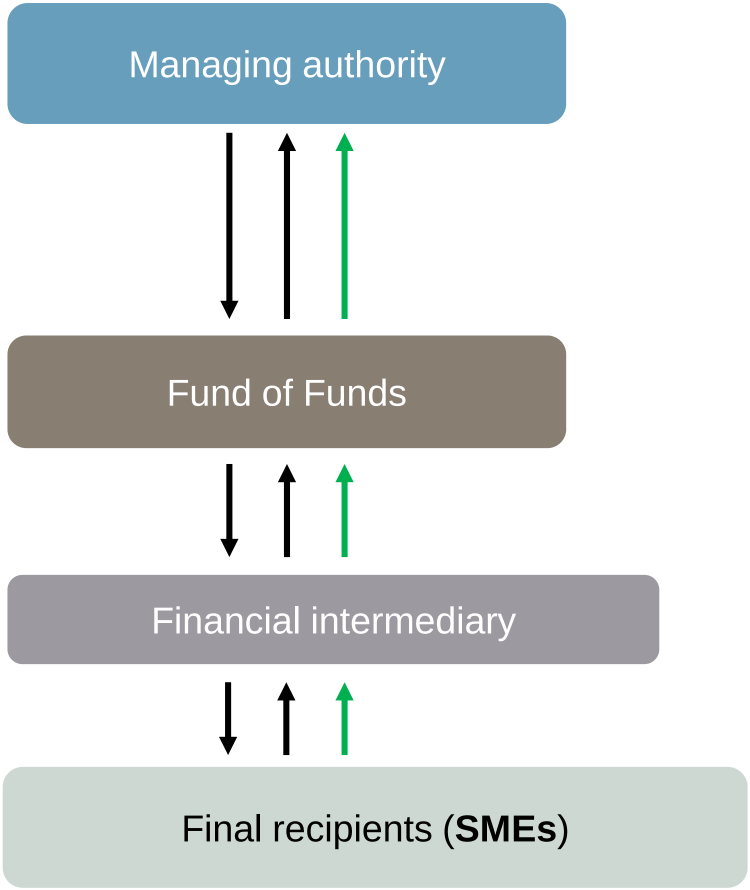
**FRSP – Funded Risk Sharing Product*



Flow of money

Flow of € loan:

- Payment/Re-payment
- Recovery



Risk sharing loan

Further key features:

- Lending methodology to ensure that the full financial advantage is passed on to SMEs, by blending the rate of financial intermediary funding (market) and ESIF funding (reduced).
- Portfolio must include **new loans** (no refinancing!), up to EUR 1 million each (granularity), for a term of 1 to 10 years. *(Lending policy – CIR 964/2014)*
- All product specifications must be in line with the CPR provisions in case of ESIF-supported financial instruments.
- Loans for:
    - Investments in tangible/intangible assets, including for take over of other enterprises if transfer is between independent investors. But no pure financial activities, real estate development or consumer finance can be supported.
    - Working capital related to development or expansion ancillary to investments.

Portfolio effect

Risk sharing loan

Further key features (*continued*):

- Eligibility criteria to be aimed at (i) reaching a large number of recipients, and (ii) achieving sufficient portfolio diversification → no overspecialisation!
- No revolving credit lines, no equity, no subordinated or mezzanine debt.
- Alignment of interest:
    - Performance fees,
    - FInt. to always contribute at least 25% to each loan (counterparty risk shared) – MA may manage its risk, e.g. by setting a minimum rating,
    - ESIF and FInt. funding always pari passu, including on losses and recoveries.

Risk sharing loan

State aid:

- At FoF and FInt. level, State aid free as long as:
    - remuneration in line with Regulations and market – FInt. selected in open call,
    - FInt. contributes at least 20% to SME loans, and contributions are pari passu,
    - financial advantage fully passed on to SMEs.
- At SME level, under *de minimis* as long as:
    - GGE is below EUR 200k (including cumulations) over 3-year period,
    - other general rules regarding *de minimis.*

Risk Sharing Loan:
What happens in case of a default?

Assumptions:

- Loan amount: **EUR 300 000**
- Co-financing ESIF OP and Financial Intermediary: 60%-40%

Default occurred:

- Default amount: **EUR 200 000**
    - ESIF OP loss: EUR 120 000
    - Financial Intermediary loss: EUR 80 000

Recovery actions take place:

- Amount recovered: **EUR 150 000** (out of EUR 200 000)
    - Part for the ESIF OP: 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

Financial advantage passed onto SMEs (FRSP example)

If the Financial Intermediary originates a loan for an amount of **EUR 300 000 with a co-financing rate 60%-40%.**

<u>Therefore :</u>

- **EUR 180 000** from the MS 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:

(in basis points)	Current pricing policy	Pricing proposed by the selected FI, taking into account the MS Contribution at 0% over 60% of the overal amount.
Co-financing rate		*40%*
Interest rate p.a.	945	378
Base rate (EURIBOR 12)	132	52.8
Margin above base rate	813	325.2
cost of funding p.a.	*293*	*117.2*
above cost of funding p.a.	*520*	*208*
Other fees	125	50

Co-financing rate		40%	SME benefit
Nominal Amount	300,000.00	300,000.00	
Interest rate	0.0945	0.0378	
loan maturity (in month)	96	96	
Monthly payment	4,465.41	3,626.16	
Overall credit cost	128,679.42	48,111.34	80,568.07

Concrete financial advantage for the SME

Main advantages of RS loan instruments

For MA:

- Alignment of interest (FInt. “skin in the game”),
- Finance viable investment, in line with OP eligibility.

For Banks:

- Improves bank reputation (more willing to extend loans to SMEs).

For SMEs:

- Easier access to finance, through a reduced interest rate,
- Collateral reduction.