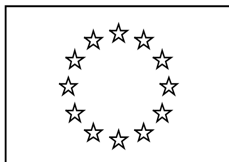

EUROPEAN COMMISSION
Directorate General for Regional Policy

# Guide to Risk Capital Financing in Regional Policy

August 2002

Status of this document:

This is a draft document (August 2002) for consultation.

*Centre for*
**Strategy & Evaluation Services**

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# Introduction

*This section provides an outline of the objective and scope of the guide, and the background and context to venture financing in regional policy, including competition policy issues*

## 1.1 Objective and Scope of the Guide

This guide is designed to help those who are involved in the design or operation of regional development programmes supported by the European Commission's Structural Funds. They might include:

- Regional authorities;
- Partner organisations from the public and private sectors;
- SME support organisations;
- Banks and other financial institutions.

The Guide describes Risk Capital Financing techniques which allow funds allocated for SME development to be recycled every few years – thus potentially increasing the impact of public intervention. It contains information on the types of instruments which might be used, how they can be set up and operated, and sources of help and further information. Reference is made to case studies illustrating examples of good practice from existing schemes. An appendix contains templates summarising individual schemes.

## 1.2 What is Risk Capital Financing?

Risk Capital Financing is the term used in this Guide to describe schemes that make public funds for SMEs available on a basis where they can both be recycled and also leverage additional private sector finance.

These schemes include loans, the provision of venture capital including equity finance, guarantees and other instruments. Other techniques may be used both to encourage the supply of finance, and the investment readiness of SMEs.

All Risk Capital Financing schemes must meet the Commission's requirements on state aid – summarised later in this Guide. Normally, the schemes will have investment criteria which require them to invest only where the SMEs concerned have not had access to commercial finance.

## 1.3 Role of Risk Capital Financing in Regional Policy

The 2000-2006 Structural Fund Regulations give Member States the option of providing an additional 10% of assistance to SMEs for those parts of an investment

project funded in other ways than by direct government aid. The Regulations place increased emphasis on the use of Risk Capital Financing instruments such as equity-based venture capital and innovative loan schemes as a more cost-effective and sustainable public policy instrument than traditional grant-based aid.

In line with the Commission's policy on the need for public sector intervention where there is market failure, the Commission has proposed that in regions eligible for Structural Funds aid, Risk Capital Financing interventions may take the form of the co-financing of risk capital funds for SMEs. Relevant extracts of the new Regulations are set out in the appendices

During the 1994-99 period there were considerable variations in the level of use of Risk Capital Financing instruments across EU Member States. According to an assessment prepared for the Commission, total expenditure amounted to €570 million. There were wide variations between Member States, with five countries not using Risk Capital Financing instruments at all. In the remaining ten Member States, the proportion of expenditure on Risk Capital Financing varied between 0.5% and 13.2% of total Structural Fund expenditure.

Compared with the 1994-99 period, there has been a significant increase in Structural Fund expenditure on Risk Capital Financing under the current 2000-06 programmes. The analysis shown below, based on information given to DG REGIO by member states to July 2002, suggests that total expenditure on Risk Capital Financing has increased from the estimated €570 million during 1994-99 to €3,292 million in the current programming period to date. Of this expenditure, 35% comes from EU sources, 25% from national sources and 40% from private sources.

*Estimated expenditure on Risk Capital Financing (2000-06) by funding source (MEUR)*

| Country | EU | National | Private | Total |
|---|---:|---:|---:|---:|
| Austria | 0.2 | 0.2 | 1.1 | 1.5 |
| Belgium | 35.5 | 35.7 | 1.4 | 72.6 |
| Denmark | 0.0 | 0.0 | 0.0 | 0.0 |
| Germany | 54.9 | 49.8 | 3.2 | 107.9 |
| Spain | 230.1 | 100.3 | 0 | 330.4 |
| Finland | 5.5 | 8.4 | 6.5 | 20.4 |
| France | 94.4 | 165.8 | 216.1 | 476.3 |
| Greece | 103.5 | 50.1 | 39.7 | 193.3 |
| Ireland | 0.0 | 0.0 | 0.0 | 0.0 |
| Italy | 71.3 | 80.2 | 146.7 | 298.2 |
| Luxembourg | 0.0 | 0.0 | 0.0 | 0.0 |
| Netherlands | 24.4 | 38.2 | 43.1 | 105.7 |
| Portugal | 274.6 | 92.9 | 691.2 | 1058.7 |

| | | | | |
|---|---|---|---|---|
| Sweden | 0.0 | 0.0 | 0.0 | 0.0 |
| UK | 267.2 | 187.8 | 168.6 | 455.0 |
| Cross border | 2.3 | 0.8 | 0.4 | 3.5 |
| **Total** | **1163.9** | **810.2** | **1318.0** | **3292.1** |
| *Percentage* | *35.4* | *24.6* | *40.0* | *100* |

*Source: European Commission, codes 155,165, 1304, notified by member states to July 2002*

There are a number of sources of EU support for Risk Capital Financing. These include the:

- Structural Funds;
- European Investment Bank;
- European Investment Fund.

There are also a number of specialised schemes to tackle particular objectives such as research and development. The national, private and EU total shown in the table combines planned expenditure on all types of Risk Capital Financing schemes i.e. main programmes, specific schemes for rural areas and large business.

## 1.4 Community Initiatives on Risk Capital

The emphasis on Risk Capital Financing in regional policy must be seen in the context of the Community's policy in respect of provision of risk capital. A 'Risk Capital Action Plan[1] (RCAP) was adopted by the Cardiff Summit in June 1998 and three progress reports[2] have subsequently been issued.

The annual reports on the RCAP point to the rapid growth of risk capital in the EU up to the period covered by the latest report (2000). As the report indicates:

> The total volume of venture capital investments in Europe, covering seed, start-up, expansion and replacement phases of company development, grew spectacularly from about €10 billion (0.14% of GDP) in 1999 to over €19.6 billion (0.23% of GDP) in 2000.

The RCAP contains measures designed to remove barriers to the provision of risk capital, including cross border barriers, and measures in the area of taxation, where there are major differences between Member States. The scheme benefits all sizes of companies wishing to raise capital. But much of its emphasis is on the formal sector where the average deal size is relatively large (average €5 million). At the local level

[1] Based on Commission Communication ***"Risk Capital : A key to Job Creation in the European Unio***n", SEC(1998) 522, April 1998

[2] COM(1999) 493 of 20.10.1999 and COM(2000) 658 of 18.10.2000 and COM(2001) 605 of 25.10.2001

there is a need to ensure that the benefits of the RCAP also flow to smaller companies who may not be targeted by the major venture capital funds. It is here that there may be a role for the regional funds.

## 1.5 Complying with the Rules on State Aid

In setting up any Risk Capital Financing scheme, there is a need to comply with the rules on State Aid. Under the Common Market rules of the EC Treaty, (article 87 (1))

> Any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market'. [3]

The EC Treaty also sets out the rules governing state aid exemptions compatible with the Common Market. Exemption from the state aid rules can be granted in a variety of circumstances. Aid can be granted, for example, to assist disadvantaged regions, i.e. 'to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment'. Similarly, 'aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest' is also compatible with the Common Market. [4]

The Commission is obliged under the EC Treaty, in conjunction with Member States, to keep under constant review all systems of aid and to propose measures to ensure the progressive development and functioning of the Common Market (Article 88 – ex 93). If the Commission finds that Member States are not adhering to the principle of the state aid rules, it may decide that the 'State concerned shall abolish or alter such aid'. If the State concerned does not comply with the Commission's ruling, it may report the matter to the European Court of Justice.

Regional authorities must notify the Commission before launching regional risk capital measures. Before the Commission can grant approval for a regional venture capital scheme, regional authorities must provide evidence of market failure.

### *1.5.1 Communications on State Aid and Risk Capital and Guarantees*

Until recently, state aid rules were not well adapted to risk capital measures. In order to be compatible with the rules, state aid had to be linked to certain types of expenditure, such as fixed investments, R&D, training etc., known as 'eligible costs'. This requirement was difficult to meet for many risk capital measures. However, in light of the need to promote dynamic risk capital markets at Community level, the Communication allows governments to take measures to promote risk capital so long

[3] Article 87 (1) of the EC Treaty (ex Article 92)
[4] Article 87 (3) of the EC Treaty (ex Article 92)

as they are directed at creating and sustaining new and innovative businesses and that the measures is designed to minimise distortion of competition.

In March 2000, the Commission published detailed guidelines on the application of Articles 87 and 88 of the EC Treaty on state aid in the form of guarantees.[5] This communication set out conditions to ensure that a state guarantee scheme does not breach the rules on state aid. This guide deals with those conditions in the section dealing with guarantees

In order to clarify the Commission's position on state aid and risk capital, and for the benefit of national and regional authorities, the Competition Directorate General adopted a Communication on State Aid and Risk Capital in August 2001. This sets out the criteria by which it will assess and approve measures designed to promote the growth of risk capital markets.[6] The Commission has identified a role for public funding of risk capital measures limited to addressing identifiable market failures. The guidelines were drawn up to reflect the Commission's general policy in favour of promoting risk capital, outlined in the 1998 paper, Risk capital, a key to job creation in the European Union, reinforced by the RCAP.

There is a special exemption for small amounts of aid. The de minimis rules, set out in an updated Commission Regulation (EC No 69/2001) of 12 January 2001, state that if there is public aid of €100,000 or less to each enterprise over a three year period, then any aid to these enterprises is within the limits set by the Regulation.

[5] Commission notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, Official Journal C 71 of 11.03.2000

[6] State Aid and Risk Capital (2001/C 235/03)

# Financing Of SMEs

*This section of the Guide summarises the range of financial instruments described in the Guide in the broader context of issues relating to SME development.*

## 2.1 Financing of SMEs

Sources of SME finance can vary by stage of development and by country. The definitions used by the European Venture Capital Association identify the following stages in a company's development. Possible financing sources at each stage are also shown.

| *Financing sources of SMEs by stage of development* | |
|---|---|
| *Seed stage* | Informal equity from founder and associates. Bank loan if available and needed |
| *Start-up stage* | Informal equity from founder and associates and contacts. Bank loan if available. Leasing for equipment |
| *Expansion stage* | Equity from original sources, plus trade investments or venture capital. Loans from bank. Other sources of finance including leasing and factoring |
| *Replacement Capital* | Trade investment, venture capital or IPO. |

Whilst the Commission does not consider that there is a general market failure in respect of the provision of finance, there is evidence of shortcomings in the provision of finance to some groups of SMEs which may mean they are unable to access appropriate funding. For example, a commercial bank may be unable to provide finance to a viable SME because of:

- Lack of a track record;
- Inadequate security;
- Breach of a threshold limit;
- A credit rating outside an acceptable range.

Compounding this is often an 'information failure' - even where appropriate (public or private) schemes exist, SMEs may not be aware of them. Sometimes the process of applying for finance may be so complex and time-consuming that even where SMEs are aware of schemes, they are unwilling to make use of them.

## 2.2 Financial Instruments included in this Guide

This Guide seeks to cover the main elements of SME financing which are likely to be considered for support by the Structural Funds and other EU instruments. Some types of financing (leasing and factoring) are excluded because there are well developed

existing sources. Likewise, the personal investment by owners in their businesses is not dealt with in the Guide. The main financial instruments included in the guide are therefore as follows:

| *Type of Instrument* | *Typical sources* |
|---|---|
| Formal equity- venture capital | Venture capital funds, banks |
| Informal equity – business angels | Networks of investors and individual investors |
| Loan finance | Banks and funds, |
| Micro credits | Specialist funds |
| Guarantee | Guarantee funds e.g. from public authorities |

SMEs will, of course, require a range of financing instruments including the instruments listed above, and other sources not dealt with in the Guide, such as leasing and factoring, overdrafts, etc. To meet the needs of SMEs, funding sources supported by public authorities often offer a range of financing solutions and do not just concentrate on one instrument. Similarly, funding organisations often concentrate on assisting particular types of SMEs (e.g. firms at different stages of development).

The table below relates the types of financing instruments described in this Guide to the financing needs of SMEs at each stage of development.

*Relationship between Financing Instruments and SME Stage of Development*

*Venture Financing Methods*

| | Formal equity | Informal Equity | Loans | Guarantees |
|---|---|---|---|---|
| Micro credits | | | ✓ | ✓ |
| Seed capital | ✓ | ✓✓ | ✓✓ | ✓ |
| Start up | ✓ | ✓✓ | ✓✓ | ✓✓ |
| Expansion | ✓✓ | ✓ | ✓✓ | ✓✓ |
| Replacement | ✓✓ | | ✓✓ | |

The next section of the Guide describes each of the main types of instrument shown in the top row - formal equity (venture capital), informal equity (business angels), loans and guarantees. In practice, SME financing organisations will use a combination of these methods.

# Venture Capital

**Summary**

*Equity is an important component of the financing of SMEs. Equity can come from a number of sources – the entrepreneur and his associates, business angels, financial institutions, and others. This section deals with venture capital funds often combined with the provision of loans or other forms of finance. We concentrate on equity-based venture capital funds. Loans are considered in a later section.*

*Equity provides the highest risk element of an SME's financing structure. Sufficient equity can improve the credit rating of the company allowing it to access commercial loans or other forms of finance.*

*From the point of view of regional development, it is necessary to determine whether there is a gap in the provision of equity below a certain size – many commercial venture capital funds will have minimum size investments and the role of EU-supported intervention will be to address this market failure.*

*A template summarising the main characteristics is contained in Appendix A*

## 3.1 How Equity Funds Work in Practice

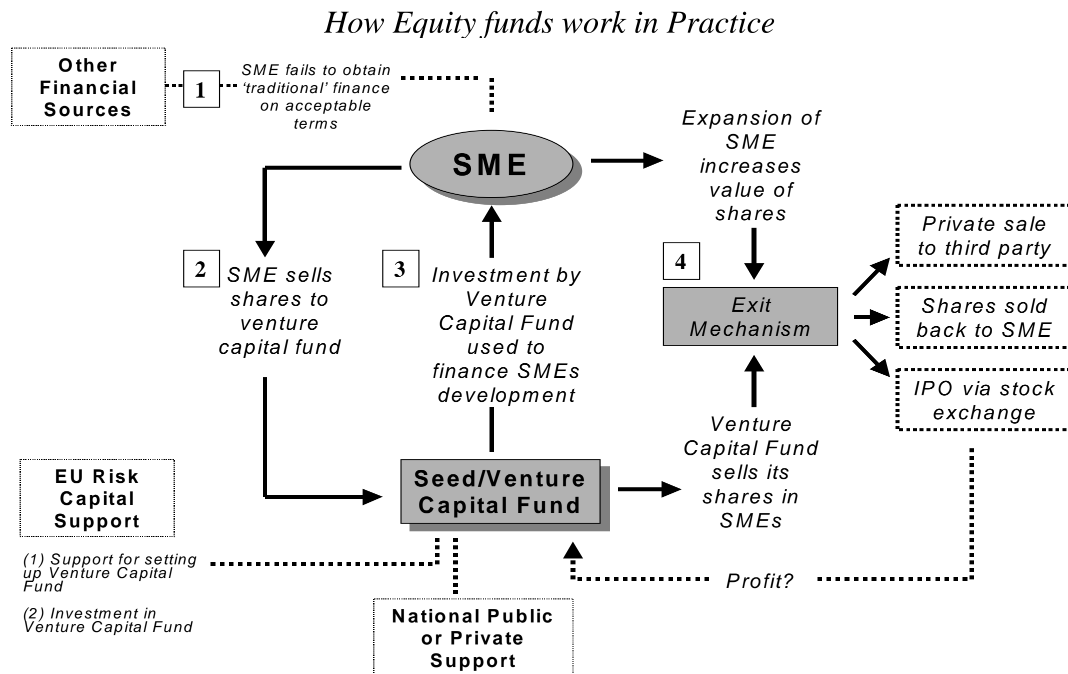
Figure 1illustrates how an equity fund can work in practice. In summary:

- An SME applies for finance. The SME may already have exhausted commercial sources of finance. Its financing structure will be such that it needs further equity to access other forms of capital, such as loans.
- The fund will acquire equity shares in the company. Typically, these shares will be new shares issued by the company with the proceeds going to the company to meet some of its financing needs.
- In some cases, shares may be issued at a premium to face value. They may also be accompanied by the provision of other finance, such as loan finance. Also, hybrid instruments such as convertible loan stock may be used.
- During the period of the investment, the fund will monitor the investment, sometimes providing management advice to the SME.
- In due course, the fund will seek to sell its stake in the SME. For successful companies, exit routes may be through the private sale of the investment to a trade investor, or by means of an IPO. All three mechanisms can provide high

returns reflecting the high risk involved. For less successful SMEs, the exit route for the fund may be problematic.

- In a significant number of cases, the SME may undergo a financial restructuring and the whole of the equity capital will be lost.

*How Equity funds work in Practice*




There are of course variations on this basic model: some schemes have very specific eligibility criteria and target markets whilst others are open to most SMEs. The types of equity provision can also vary and typically a package will include loans and, potentially, other types of finance.

## 3.2 Advantages and Disadvantages of Equity funds

Equity funds have both advantages and disadvantages for the various stakeholders. The table below provides a summary:

| Advantages | Disadvantages |
|---|---|
| • For SMEs, a source of risk capital which will improve the balance sheet structure and may enable the company to access further | • For SMEs, the sale of a part of the business which will both dilute the proprietor's interest and will bring in a minority owner |

| | |
|---|---|
| finance through loans etc<br>• For the investment fund, a high risk investment which may offer the possibility of high returns<br>• For public authorities, a high risk investment which may offer good leverage to other sources of capital with the prospects of a return on the investment | whose interest must be respected<br>• For the investment fund, a minority stake in a business which may be difficult to sell when the fund is looking to exit its investment unless the company grows. |

## 3.3 Current EU support

Under the EU's risk capital action plan a number of actions have been implemented to improve the supply of risk capital, including measures to improve the regulatory context.

## 3.4 Factors to consider in Setting Up an Equity Fund

A number of common factors apply to setting up all Risk Capital Financing measures and these are considered in Section 8 of this Guide. In respect of equity funds, public authorities will need to take account of some additional special factors as follows:

*Investment policy* - venture capital funds will need to have an investment policy and set up a mechanism to administer it. Some successful funds have administered their investment policy using private sector managers who are given discretion to select investments according to agreed criteria, but as far as possible on a commercial basis free from external constraints.

*Exit route* - there needs to be an exit mechanism, i.e means of disinvestment at the end of the life of the fund. Exit routes vary according to the success of the investment. The most successful investments will be the subject of a trade sale, or an IPO. It is likely, however, that the fund will be left with a number of small equity stakes in SMEs which cannot be disposed of in this way. Some fundshave made arrangements for these investments to be transferred into a trust at the end of the life of the fund and for the trust to be managed for the benefit of the area concerned.

*Guarantees* - in number of cases, public authorities provide a guarantee to cover the provision of equity finance, rather than providing the finance themselves. Clearly, such a guarantee offers the possibility of high leverage, but also high risk to public authorities.

## 3.5 State Aid Rules

*EU Regulations on State Aid Applying to Risk Capital*

As with all financial instruments with a publicly funded component, venture capital funds must conform to the EU's rules on state aid.

The Commission issued guidelines in October 2001 on 'State Aid and Risk Capital' [7] in order to clarify the position on the application of the rules on state aid set out in Article 87(1) of the EC Treaty in respect of risk capital measures. The guidelines provide new criteria on the compatibility of risk capital measures with the common market.

When assessing the competition aspects of proposed risk capital measures, the Commission first considers whether the proposed measure confers state aid. This is assessed at three levels, namely whether the measure constitutes an:

- Aid to investors;
- Aid to any fund or other vehicle through which the measure operates (in the case of a fund of funds aid may be conferred at multiple levels);
- Aid to the companies invested in i.e. final beneficiaries.

### *3.6.1 Assessment of compatibility of risk capital measures under the state aid rules*

Where a risk capital measure is deemed to constitute a state aid, the Commission must then assess whether the aid is compatible with the Common Market under Articles 87 (2) and 87 (3). In the context of regional policy, the Commission has adopted tests under which state aid for risk capital measures can be authorized and considered compatible with the Common Market. Compatibility has largely been authorized on the basis of Article 87 (3), paragraphs A and C.

| *Article 87 (3) of EC Treaty – paragraphs relevant to risk capital measures* |
|---|
| • Article 87 (3) (a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment |

[7] State Aid and Risk Capital (2001/C 235/03)

- Article 87 (3) (c) aid to facilitate the development of certain economic activities or of certain economic areas, where aid does not adversely affect trading conditions to an extent contrary to the common interest

Aid can be authorised up to a level representing a grant equivalent of a fixed percentage of certain of the beneficiary enterprise's costs. These costs are known as eligible costs and are principally fixed investments in land, buildings, new productive equipment and intangible assets (patents, know-how etc) labour costs linked to fixed asset investment and the cost of consultancy services.

In practice, however, experience has shown that some risk capital measures have been found not to be compatible with the State aid rules. Various difficulties have been identified, notably:

- The difficulty of establishing a 'grant equivalent' of equity capital;

- The complications of establishing a link with eligible costs;

- The lack of any legal basis for authorising such aid for measures providing aid at the level of investors.

*3.6.3 Basis for authorising risk capital measures*

The Commission does not believe that there is a general risk capital market failure but accepts that there are market gaps for some types of investments at certain stages of an SME's life cycle. In the context of regional policy, the Commission also recognises that there are particular difficulties in regions qualifying for assistance under Articles 87(3)(a) and (c) (assisted areas).

Under Article 87 (3) (a) and (c) of the EC Treaty, the principal basis on which the Commission may authorise risk capital measures falling outside the scope of existing rules is that certain types of SMEs seeking investment during the start-up and early developmental stages of the enterprise life cycle, notably innovative and/ or high-tech start-up businesses, face major obstacles in terms of accessing equity finance for smaller amounts. Amongst the main factors for this 'equity gap' are imperfect information, the risk-averse nature of investors particularly in respect of SMEs and start-up businesses and the limited guarantees and business track record that SMEs can offer potential investors. Other obstacles to the provision of equity capital are the high transaction and due diligence costs relative to the equity capital being provided.

*3.6.4 What the Commission requires to demonstrate market failure*

The Commission requires evidence of market failure before being prepared to authorise risk capital measures falling outside the scope of existing rules. It may

however be prepared to accept market failure where each financing round from risk capital measures wholly or partially financed through State aid will contain a maximum of €500,000 or €750,000 in regions qualifying for assistance under Article 87(3)(c) or €1 million in regions qualifying for assistance under Article 87(3)(a).

The Commission will require provision of evidence of market failure where the ceilings for transaction sizes set out above are exceeded.

#### *3.6.5 Criteria for Assessing Compatibility*

There is a range of criteria for assessing the compatibility of risk capital measures with the state aid rules which the Commission has set out in 'State Aid and Risk Capital'. The criteria are assessed on positive and negative elements. Not all the elements have equal weight, and no single element is essential, nor can any set of them be regarded as sufficient on its own to ensure compatibility. In some cases their applicability, and the weight attached to them, may depend on the form of the measure. The Commission's assessment will take account the prevailing regional socio-economic context of proposed measures.

### 3.6 Examples of Venture Capital funds

Examples of venture capital funds set up with assistance from the Structural Funds include:

In the **UK**, Merseyside Special Investment Fund, which provides venture capital to SMEs in an Objective 1 area. Venture capital provided includes equity and loan finance. Some funds also allocated to community/social enterprises. The fund was first established under the 1994-99 Objective 1 programme and will shortly recycle funds from the first programme.

In **Ireland**, Enterprise Ireland which established a venture capital fund under an earlier ERDF programme.

*[more example will be contained in the final version]*

# Business Angels

**Summary**

*Business angels ('informal venture capital') can play an important part in providing early stage equity capital to SMEs. They also provide businesses with advice and mentoring (both informal and formal) – which can make an important contribution to SME development.*

*Business angels are typically high worth individuals who wish to invest some of their funds in new ventures. Often the individuals concerned will be highly motivated entrepreneurs who have considerable experience of running growing companies.*

*Business angel networks provide matching services to put potential investors in touch with SMEs. They do not usually investigate the potential for an investment– it is for the investor and the SME to do this and to come to an agreement. Networks may charge a success fee or a registration fee.*

*Regional development schemes may have a role to play in improving the mechanisms for putting SMEs who require capital or advice in touch with business angels who wish to invest. In some areas, networks providing matching services already operate – and some are funded by regional governments.*

*The EU has provided assistance to the setting up of business angel networks and there are various national schemes that provide assistance.*

*A template summarising the main characteristics is contained in Appendix A*

## 4.1 How Business Angel Networks Operate in Practice

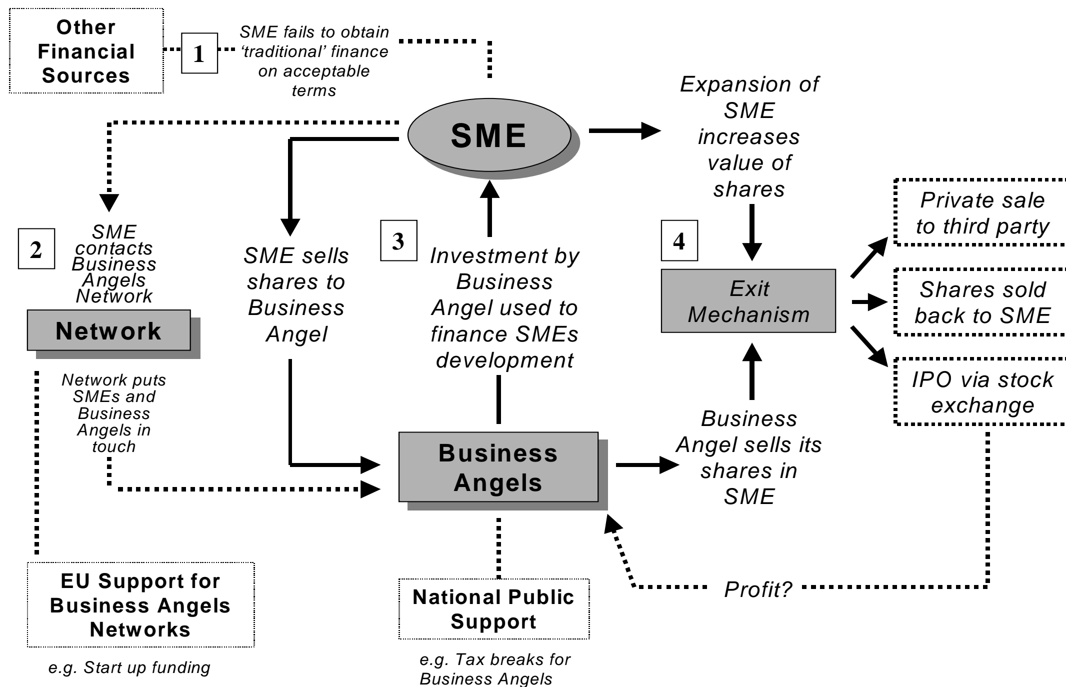
Figure 2 illustrates how these business angel networks operate in practice. In summary:

- A network is set up and is advertised as a contact point for investors and entrepreneurs – the network will be managed by one or more people;
- The network places potential investors and SMEs directly in contact with each other. Both the investor and business angel may pay a fee for this service;
- The investor and the SME negotiate an agreement under which the business angel supplies capital and in many cases advisory support in return for an equity stake in the company. It is for both parties to come to an agreement and to carry out necessary due diligence.

- In many cases, the business angel is not paid for his time but receives a return from growth in the value of the business. In other cases, a fee might be negotiated.

- Eventually, the business angel may sell his or her stake in the company, particularly when a trade investor buys a stake.

*How Business Angel networks operate in Practice*




Some Member States provide tax incentives to encourage business angels to acquire equity stakes in SMEs. For example, the UK authorities allow investors to set some of their investment against income tax and give an exemption from capital gains tax. In the US, substantial tax breaks against both income and capital taxes have helped drive this market.

## 4.2 Advantages and Disadvantages of Business Angel networks

Business angel schemes have advantages - and disadvantages – to the various stakeholders. The table below provides a summary:

| Advantages | Disadvantages |
|---|---|
| • For the SME, a source of capital and advice at an early stage in the development of the | • For the SME, there is a need to sell part of |

| | |
|---|---|
| company. The right advice can strengthen the company.<br>• For the investor, the opportunity to make high returns from investing at an early stage in an SME, together with tax breaks where available<br>• For public authorities, business angel schemes can increase the supply of risk capital and advice at little cost to public funds | the equity stake in the company. Some companies are unwilling to bring in an external investor<br>• For the investor, there is a high level of risk. Research suggests that only one investment in five provides significant profits. And a minority stake in an SME provides little control and may be difficult to sell.<br>• For both the investor and the SME, there is a risk that the relationship between the investor and the SME manager might break down |

## 4.3 Current EU Support

In order to stimulate the development of the business angels concept, a small number of networks have been set up at regional and national level to promote the idea in regions where the concept is not yet working. These networks provide a platform for SMEs and business angels to contact one another, and give businesses potential access to a new source of finance. The Commission part-finances feasibility studies for the creation of such networks, as well as pilot actions aimed at setting up a regional or national network.

## 4.4 Factors to Consider in Supporting a Business Angel Network

A number of common factors apply to setting up all Risk Capital Financing measures and these are considered in Section 8 of Guide. In respect of business angel networks, public authorities will need to take account of some additional special factors as follows:

*Role of public authorities in providing funding* - the role of public authorities in helping set up business angel networks is likely to be limited to financial assistance in the management and set up costs of the network, rather than any contribution to investment funds themselves. Public authorities may wish to take the initiative in approaching a national business angel association to cooperate in setting up a network in a region where they do not exist.

*Creating a culture of entrepreneurship* - measures in setting up a business angel network can improve the operating of the market in supplying finance and advice, but they are likely to be successful only where there is a culture of entrepreneurship that encourages the development of new businesses. Setting up a business angel network should ideally form part of an integrated package of measures to encourage the development of new businesses and to promote ‘investor readiness’.

## 4.5 EU Regulations on State Aid

There are no specific regulations on State Aid applying to the setting up of business angel networks, but the general regulations in respect of State Aid will of course apply. In many cases, the amount of state aid may be below €100,000 where the *de minimis* rule applies.

## 4.6 Examples of Business Angel Networks

*[ examples will be contained in the final version]*

# Loan Capital

*Summary*

*Loans are the most important source of external financing for SMEs and a simple model of a revolving loan fund is a relatively common instrument in regional development.*

*A loan fund supported by the Structural Funds can be leveraged by using private capital to create a greater impact. Consideration needs to be given to the period of loans and their use, interest rates, and in regions eligible for Structural Fund assistance, the use of interest rate subsidies or interest rate rebates. The size of individual loans is likely to affect the administrative costs of the fund. Small loans will be more expensive to administer but may have a particularly important role in filling a financing gap.*

*Loan funds may be targeted at particular groups and are likely to be one of the main means of supporting the development of micro SMEs.*

*A critical issue is assessing the creditworthiness of the borrower. A loan fund will seek to avoid displacing the commercial provision of loans – if an SME borrower can obtain funding from a commercial source it should do so. Accordingly, SMEs with the lowest credit risks (including those offering security) are likely to be excluded. The objective is to find the most appropriate borrowers from the remaining group.*

*A template showing the main characteristics is contained in Appendix A*

## 5.1 How Loan Funds work in Practice

The diagram on the next page illustrates how a loan fund can work in practice. In summary:

- A loan fund will be set up for a fixed period, financed with a combination of national and EU funding supplemented by private financing (1). Private funding may be obtained from bank borrowings or from other sources.

- The loan fund may be co-financed by structural funds and guaranteed by the EIB or EIF (2).

- The loan fund will have clear investment objectives which will include identifying borrowers that can contribute to regional development targets and have an adequate credit profile, but who are not able to get funds from commercial sources (3).

- SMEs will apply to the fund for a loan and an assessment will be made of the applicant's credit profile, business plan and objectives (4).

- The interest rate charged by the fund will usually be on a commercial basis. Typically, this may be at a rate equivalent to cost of funds plus 4% to 6% (5).

- During the period of the investment, the fund will monitor the investment, sometimes providing management advice to the SME (6).

- In due course, the SME will either repay the loan, or default if it fails financially (7).

At the conclusion of the life of the loan fund, private borrowings will be repaid and any remaining funding will be held for reinvestment in accordance with the original objectives.

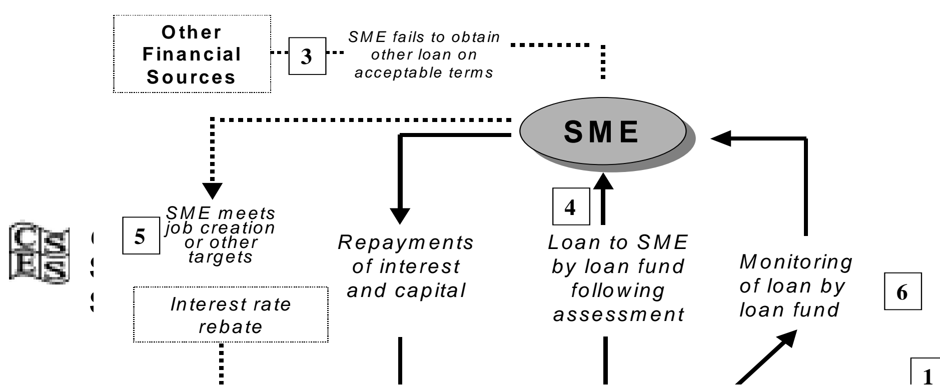
In areas eligible for Structural Fund assistance, there are two main types of loan schemes targeted at SME beneficiaries. The objectives of both are to stimulate SME development, promote local and regional economic growth and critically, to promote new job creation. However, the process aspects of both schemes differ.

*Interest rate subsidies* are a relatively straight forward instrument whereby the SME receives a direct EU and / or national subsidy which reduces the interest rate repayment on the loan, typically by between 1 and 3%. The managing authorities responsible for implementing such schemes are required under Structural Fund regulations to keep monitoring data on the number of companies assisted, new jobs created etc.

*Interest rate rebates* are dependent on SME beneficiaries of Structural Fund supported loan schemes meeting certain targets, for example in respect of job creation or the level of new investment. A rebate of a third of interest rate costs is not uncommon in such circumstances.

The diagram on the next page illustrates how loan schemes typically operate in practice.

***How Loan funds work in Practice***



There are of course numerous variations on this basic model:

- Loan funds often obtain private investment from bank borrowings. With the introduction of the euro, European capital markets have become deeper and loan funds might consider issuing a bond – disintermediation may help to reduce the cost of capital for loan funds.

- Some schemes have very specific eligibility criteria and target markets whilst others are open to most SMEs.

- Some funds will make available part of their funds for micro credits. The administration of micro credits poses particular issues and we deal with this in a later chapter.

- Some schemes may offer an interest rate subsidy or 'soft loan' to particular target groups e.g. women entrepreneurs, young entrepreneurs, micro firms.

- The types of loan facility may vary and equity funding may also be provided. In respect of larger loans, funds may provide loans using convertible loan stock, under which the fund may be able to convert all or part of a loan to equity if the SME succeeds.

## 5.2 Advantages and Disadvantages of Loan funds

Equity funds have both advantages and disadvantages for the various stakeholders. The table below provides a summary:

| Advantages | Disadvantages |
|---|---|
| • Loan schemes are a major source of capital for SMEs seeking developmental finance<br>• Some loan fund schemes can offer loans on an unsecured basis, thereby facilitating SME access to finance<br>• For public authorities, a medium risk investment which may offer good leverage to other sources of capital with the prospects of all or some of the original investment being available for re-use. | • Usually, lenders will require collateral or will go through a credit scoring process which may discriminate against start-up companies, which often lack collateral, and may therefore have to pay a guarantee premium to obtain credit<br>• Loans must be seen in the context of other forms of finance, including an adequate amount of equity capital |

## 5.3 Current EU support

In regions eligible for Structural Funds assistance, ERDF funding may be available to fund interest rate subsidies on loan schemes to achieve specific or general objectives such as an improvement in the participation rate of women entrepreneurs or to encourage investment by SMEs leading to new job creation. Any subsidies must be consistent with the state aid rules.

The European Investment Fund (EIF) also co-finances some types of loan scheme, for example in respect of loan funds targeted at start-up companies.

## 5.4 Factors to consider in setting up a Loan Scheme

A number of common factors apply to setting up all Risk Capital Financing measures. These are considered elsewhere in this guide. In respect of loan funds, public authorities will need to take account of some additional factors as set out below:

- The commercial availability of loans at regional level for different types of SMEs and the need to avoid distorting the market
- The role of public authorities in providing loan funding
- The extent to which private sector funding can be leveraged
- EU Regulations on State Aid Applying to Loan Funds – these are similar to the regulations described in the section on Venture Capital.

## 5.5 Examples of Loan Schemes

In **Finland**, Finnvera (see case study write-up) offers interest rate subsidies (or 'soft loan' schemes) for specific types of loans e.g. developmental loans, environmental loans, start-up loans and micro-lending. The schemes are supported by both EU (ERDF) and national funding and target disadvantaged social groups such as women

entrepreneurs, the self-employed and entrepreneurs of micro companies. The level of default, at 3% is very low whilst the survival rate of companies assisted is significantly above the norm, at 88% for the women's entrepreneurs scheme and 82% for the small loans scheme.

In the **UK**, Merseyside Special Investment Fund provides both loans and equity capita; to SMEs in and Objective 1 area. It is a long running scheme which includes both loans for SMEs and micro credits

*[more examples will be contained in the final version]*

# Micro Credits

*Summary*

*The business segment "Micro-credits" is relatively new on the European financial stage, as a product intended to facilitate access to small amounts of finance for self employed and micro-entreprises. These businesses are, as a rule, unable to access the usual banking distribution network because of the small loan amount, the high cost of a credit assessment and the riskier projects in the start-up phase of the entreprise life cycle.*

*Micro finance can be aimed at very specific target groups of individuals or micro businesses. Typical schemes include:*

- *Schemes for micro businesses – this encompasses a wide range of instruments, some of which are covered by other sections of the Guide (e.g. mutual guarantees). The common feature is that the finance is intended for single traders or small businesses with less than 5 employees.*
- *Finance for disadvantaged social groups – for example, credit schemes for the long term unemployed, people with special needs, ethnic minorities, etc (sometimes referred to as 'social' finance);*

*Micro finance instruments are not fundamentally different to those covered by earlier sections of this Guide – especially loan schemes and mutual guarantees. The difference is that they are focused on very specific target groups and usually involve smaller sums of money. As with other Risk Capital Financing, the emphasis is on refundable or revolving schemes rather than grants.*

*A template summarising the main characteristics is contained in Appendix A*

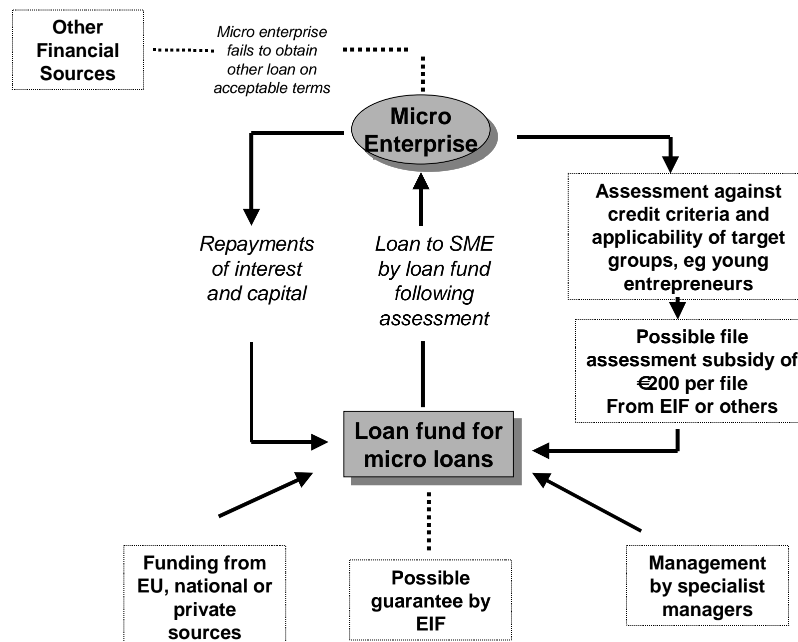
## 6.1 How Micro Credits work in Practice

In operational terms, the micro credit sector has many similarities to the loan sector. The principal differences are

- The high cost of credit assessment in relation to the loan size, and
- The high cost of loan administration in relation to loan size

As a result, many microfinance schemes are implemented by specialist agencies. These agencies may be set up for the specific purpose, or may be attached to an existing melding institution such as a bank. A summary of these factors is shown below:

*How Micro Credit Schemes work in Practice*




## 6.2 Advantages and Disadvantages of Micro credits

Equity funds have both advantages and disadvantages for the various stakeholders. The table below provides a summary:

| Advantages | Disadvantages |
|---|---|
| • Meets a market failure in starting and developing micro businesses<br>• Some micro finance schemes can offer loans on an unsecured basis, thereby facilitating SME access to finance<br>• For public authorities, a means of developing micro businesses and | • The costs of setting up and administering loans will be high in relation to the loan amounts involved |

| reaching disadvantaged people | |
|---|---|

## 6.3 Current EU Support

The EIF has recently introduced a guarantee scheme for micro credits which refunds costs of file analysis (200€ per file ) and counter-guarantees the main guarantor to an extend of 75%. The objective of this scheme is to overcome the main difficulties of microfinance, in respect of the costs of loan administration and obtaining security

## 6.4 Factors to consider in setting up a micro credit scheme

There are a number of particular factors to consider in setting up a micro credits scheme (common aspects are discussed in Section 8).

*Operating costs* - how can the ratio of operating costs to loans be minimised – by streamlining credit assessment procedures or other means?

*Specialist Agency* - in some countries, there is an added legislative complication in the operation of micro credits schemes. Given that the typical loan amount for a micro credits scheme is usually too low to be considered commercially viable (due to high transaction and processing costs), the management, administration and disbursement of micro loans is often delegated by financial institutions providing the loan finance to organisations which do not have legal status as financial institutions. In some countries, national legislation prevents non-financial institutions from disbursing loans. You will need to check the position in your country

*Guarantees* - is it appropriate to support the scheme with a guarantee from a public agency, potentially underpinned by an EIF guarantee?

## 6.5 State Aid

Micro-credit schemes may constitute state aid to the company. However, under certain circumstances, state aid is permissible. In the case of micro-credits, the amount of state aid involved by definition will be under €100,000 and should therefore fall within the scope of the *de minimis* rules.

## 6.6 Examples of micro finance schemes

***Finnvera* -** the microloan financing product form a part of the Finnish national development scheme called "Programme for Entreprise and Entrepreneurship (1995-2005)". The product was launched in April 1996.

***MSIF*** - Merseyside Special Investment Fund have allocated part of their funding to a microfinance scheme which is managed by a specialist external manager.

*[more examples will be included in the final version]*

# Guarantee Schemes

***Summary***

*A guarantee is a legally binding commitment given by a third party to pay the remaining balance of a loan including unpaid interest in the event of default by the main borrower.*

*Guarantee Societies issue guarantees to SMEs in order to facilitate access to external finance (mainly loan-based, but also equity) in return for a fee to cover both the risk and administrative and processing costs. Guarantees are an appropriate financial instrument in cases where SMEs are unable to provide the lender – typically a bank or leasing company - with the necessary collateral to gain access to finance on reasonable terms. The guarantee instrument is typically used by new business start-ups, fast-growing, innovation-oriented or exporting companies.*

*There are two main types of guarantee schemes, with some degree of convergence between the two:*

- *Guarantee Funds – these are usually publicly funded by regional or national authorities. They provide guarantees either directly to SMEs, or indirectly by counter-guaranteeing loan commitments made by mutual guarantee societies. Some guarantee funds also offer loans targeted at SMEs/ micro-enterprises.*

- *Mutual Guarantee Societies - established by SMEs, business federations or Chambers of Commerce, sometimes in partnership with banks. By grouping together as a cooperative, mutual guarantee societies are able to negotiate bank loans on preferential financial terms and are often also able to provide professional business support services to clients, drawing on their in-depth specialised knowledge of the business sectors in which they operate.*

*Guarantees work on the principle of shared risk between the lending institution and the guarantee society, which typically covers between 40 and 80% of the loan value, significantly reducing the degree of risk for the lending institution.*

*In the context of regional policy, guarantees schemes can play an important role in improving access to finance, leveraging private sector funding and encouraging the development of SMEs and derivative benefits such as economic growth and new job creation.*

*A template summarising the main characteristics is contained in Appendix A*

### 7.1 How Guarantee Societies work in Practice

The diagram on the next page illustrates how Guarantee Societies work in practice. In summary,

- An SME applies to a financial institution for a loan.

- If requested by the financial institution, an SME can seek a guarantee from a Mutual Guarantee Society or Guarantee Fund on a proportion of the loan.

- Following a comprehensive analysis of the viability of the business plan and a risk assessment based on a range of criteria, the Guarantee Society provides a guarantee to the bank, enabling the SME to access loan finance.

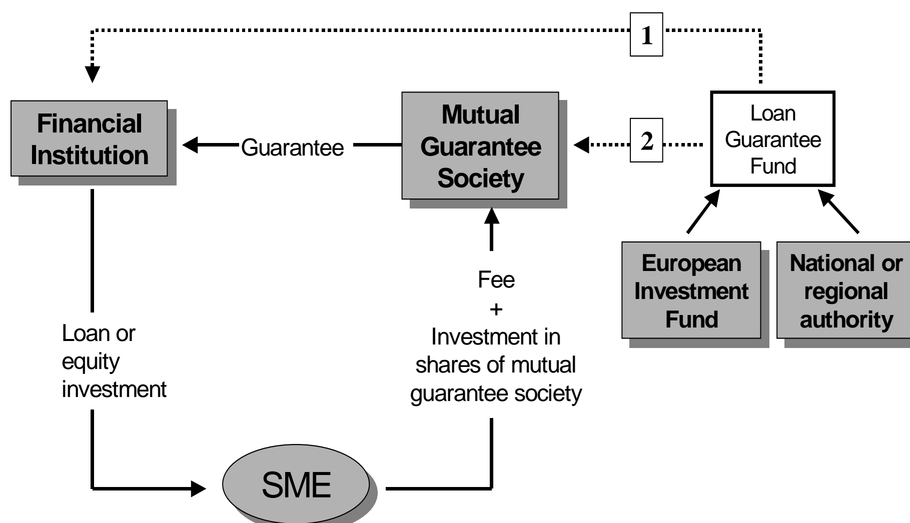
- The SME pays the Guarantee Society a premium (typically 1% per year on the guarantee outstanding). In the case of a guarantee issued by a Mutual Guarantee Society, the SME subscribes to the mutual guarantee society's share capital. This can, on request, be reimbursed at the end of the commitment.

- In some countries, (e.g. Spain, Germany's 'no-bank' guarantee system, Italian 'start-up schemes'), SMEs can obtain a guarantee from a guarantee institution prior to approaching the lender of their choice.

- In the case of SME guarantees backed by an EIF counter-guarantee, the risk is shared between the guarantee society and the counter-guarantor, without any further risk analysis. In the majority of cases, no fee is levied by the counter-guarantor on the guarantee society.

- In case of loan default by the SME – and based on terms clearly defined in the contract- - the guarantor will reimburse the lender immediately upon notification of repayment default. The entrepreneur's collateral is then sold and any losses incurred are borne by the guarantee society. In the case of guarantees backed by a counter-guarantee, the Guarantee Society can recoup a proportion of its losses through its counter-guarantor and reduce its "risk given default".

*How Guarantee Schemes Work in Practice*



There are a number of variations on this basic model:

- Some schemes target specific groups (young entrepreneurs, women entrepreneurs) specific types of investment (e.g. in innovation, in improving the availability of risk capital) whilst others target specific sectors (e.g. craft, industry etc.).

- The percentage of the loan principal covered by guarantee varies between 40% and 80%. The fee SMEs are required to pay for the guarantee varies according to a number of factors - the duration of the guarantee, an analysis of risk factors and the proportion of the loan covered by guarantee). Other terms and conditions also vary.

- The type of sponsoring organisations also varies: pure Guarantee Funds are reliant on funding from public sector organizations such as national or regional authorities, whilst private or mixed Guarantee Societies are owned and managed by a combination of SME representatives, banks and other intermediaries.

- The extent and nature of support available from public authorities varies from country to country and from region to region.

- The degree of advisory support and assistance provided to the SME varies considerably. In some instances, the role of the guarantee society is confined to the granting of the guarantee alone whilst in other cases, the guarantee is offered as part of a package of services, including business support and progress monitoring.

Guarantee Societies are usually subject to national financial regulations. When they receive public support, guarantee societies must also adhere to EU competition rules governing state aids.

## 7.2 Advantages and Disadvantages of Guarantee Societies

The table below provides a summary from the viewpoint of the various stakeholders.

| Advantages | Disadvantages |
|---|---|
| • Facilitates access to loan finance on improved financial terms for those SMEs (i.e. | • Guarantee Societies usually cover only part of the credit risk and often apply to only a |

| | |
|---|---|
| self employed, micro-entreprises, start-ups) which cannot easily get access to finance (poor credit history, little or no collateral, lack of trading record)<br>• Principle of risk sharing between the guarantee society and lending institution reduces risk and leverages private sector lending It also reduces their capital requirement under the Basle rules.<br>• For Public Authorities, guarantee Societies help to leverage private sector finance for SME promotion and wider regional development.<br>• Rigorous screening procedures and detailed knowledge of the business sectors in which clients operate reduces risk of SME default<br>• Guarantee societies provide local input and tailored business support and advice<br>• Guarantee societies revolve the use of their own funds They have a high leverage ratio (average leverage ratio is 10 times the guarantee capital) and low default rates | limited range of financial instruments.<br>• EIF-backed schemes cannot be used for working capital and there are only a few schemes available for the cover of equity investments<br>• By reducing the exposure of banks to risks, guarantee schemes may also reduce the extent to which banks vet new loan applications.<br>• The extent to which guarantee societies receive support from public authorities varies across the European Union and is mainly dependent on the prevailing banking culture (e.g. UK, Ireland, Sweden, Greece) |

## 7.3 Current EU support

The European Investment Fund (EIF) provides support to guarantee societies in the form of counter-guarantees of commitments undertaken by Guarantee Funds and Mutual Guarantee Societies.

During the period 1998 - 2001, the SME Guarantee Facility offered to cover 50% of the losses incurred by guarantee funds. In return, guarantee societies are expected to increase their risk profile by supporting higher risk SME investments with the objective of fostering "growth and employment". Assistance was provided either directly to Guarantee Societies or via intermediaries such as publicly funded guarantee schemes.

The Multiannual programme for 2002-2006 builds on the work of the earlier programme and provides additional support in respect of counter-guarantees for micro-loans and ICT investments. The guarantee programme is also now open to EU pre-accession countries.
In preparation for EU accession, the EU has also made financial subsidies available to help establish new Mutual Guarantee Societies in new EU Member States and/ or activity areas. This covers up to 50% of the cost of feasibility studies.

## 7.4 Factors to consider in setting up and developing a Guarantee Society.

A number of cross-cutting factors apply to setting up financial engineering measures in the context of regional policy - these are considered elsewhere in the guide. In respect of Guarantee Societies, public authorities must consider the following issues:

*Feasibility Study* - the feasibility study must cover the following issues including addressing market failure, avoiding distorting existing private sector operators providing loan finance, the need for robust corporate governance structure to ensure accountability and the need for in-depth local knowledge of the local operating environment/ banking culture before launching a guarantee fund.

*Type of Guarantee Fund* - should public authorities support the creation of a publicly funded Guarantee Fund administering SME guarantees directly or should public support be administered through an intermediary i.e. mutual guarantee society?

*Regulatory Framework* - specific mechanisms and procedures must be put in place to check applications, assess and regularly monitor risk and regulate transactions between SMEs and lending institutions.

*EU Regulations on State Aids* - as with all financial instruments with a publicly funded component, guarantees must conform to the EU's rules on state aid. In addition to provisions that apply to financial engineering schemes there are a number of regulations that are specific to guarantee schemes.

In March 2000, the Commission published detailed guidelines on the application of Articles 87 and 88 of the EC Treaty on state aid in the form of guarantees.[8] The following conditions must be met to ensure that a state guarantee scheme does not breach the rules on state aid:

| *EU Regulations on State Aid Applying to Guarantee Schemes* |
|---|
| • Guarantees cannot be granted to borrowers in financial difficulty;<br>• Beneficiaries of assistance (i.e. borrowers) should in principle be able to obtain a loan at commercial market rates from the financial markets without any intervention by the State;<br>• Guarantees must be linked to a specific financial transaction, be for a fixed maximum amount, must not cover more than 80% of each outstanding loan or other financial obligations (except bonds and similar instruments) and must not be open-ended;<br>• The terms of the scheme must be based on a realistic risk assessment so that premiums paid by beneficiaries increase the likelihood of the scheme becoming self-financing;<br>• The scheme must set out the financial terms of future guarantees and the overall financing of the scheme must be reviewed at least once a year;<br>• The premiums must cover both the risks associated with granting the guarantee and the administrative costs of the scheme, including, where the State provides the initial capital for the start-up of the scheme, a commercial return on capital. |

Guarantee schemes must inform the Commission of any state aid (over €100,000) through the official notification procedure prior to the launch of the scheme. The Commission then considers whether the proposal is compatible with the rules on state aid and the common market.

[8] Commission notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, Official Journal C 71 of 11.03.2000

### 7.5 Examples of Guarantee Societies

Examples of Guarantee Schemes set up with assistance from the Structural Funds include:

In **Italy**, Eurofidi is a mutual guarantee fund providing loan guarantees to small and medium sized enterprises.. Its primary objective is to facilitate access to finance for SMEs in the Piedmont Region. It also assists financial institutions in screening loan applications and in risk management

.

In **Finland**, Finnvera offers SMEs three main categories of financial instrument; loans, guarantees and export credit guarantees. This case study focuses on Finnvera's portfolio of guarantee products, which are tailored according to the needs of SMEs depending on the business sector in which they operate and on their developmental needs and objectives.

*[more examples will be included in the final version]*

# Setting up schemes

*In this section we describe the key steps in setting up a Risk Capital Financing scheme. Section 9 then outlines good practice with regard to operating schemes.*

## 8.1 Overview

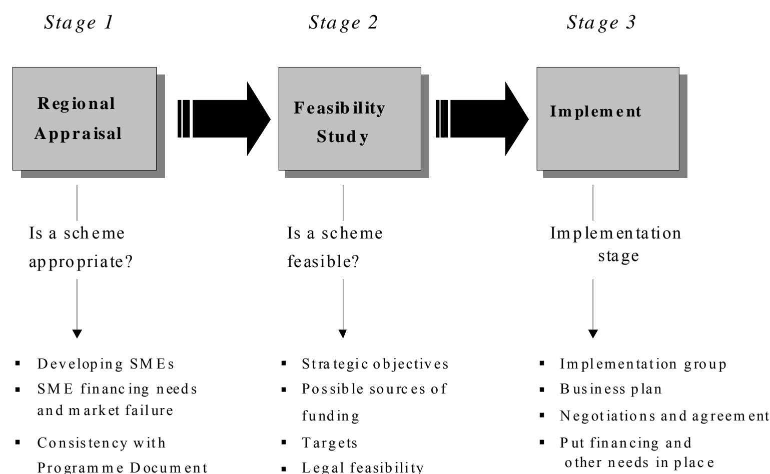
There are a number of common steps that should be taken by regional authorities and their partners to set up new EU-supported Risk Capital Financing schemes:

- *Stage 1* - A appraisal should be undertaken to determine how a Risk Capital Financing scheme will contribute to **regional development aims**;

- *Stage 2* - Assuming positive conclusions, a **feasibility study** should then follow examining options with regard to how the Risk Capital Financing scheme might operate, possible sources of funding, targets, compatibility with EU competition and state aids rules, etc;

- *Stage 3* – Assuming positive conclusions to the feasibility study, and following discussions with key partners (EU, national and regional authorities, private sector, business support organisations, etc), the next step will be to prepare a full **business plan** for the scheme.

The diagram below summarises these stages and links between them:




Experience suggests that two years may be needed from the point of inception to the stage where funding is raised and managers are appointed to actually launch a Risk Capital Financing scheme. The importance of thorough investigations is underlined by the fact that several initiatives had to be terminated during the recent Structural Fund programming period because of complications that should have been anticipated at the planning stage. Professional advice will be needed on many issues and at an

early stage it may be appropriate to contact some of the organisations listed in this Guide. The opportunity could be taken to identify similar schemes already implemented and hold discussions with them.

Below, we discuss each of the stages in the development process for new Risk Capital Financing schemes in more detail.

## 8.2 Contribution to Regional Development Aims (Stage 1)

Structural Fund regulations place emphasis on Risk Capital Financing as a regional development tool but there are several specific issues that should be investigated to confirm the case for introducing a scheme:

- Is one of the objectives of the Structural Fund programme the **development of SMEs**? Are there particular targets, such as promoting particular sectors with growth potential, helping people from disadvantaged communities establish their own businesses?
- Is the **financing of SMEs** one of the constraints that has to be overcome, or are there different constraints on SMEs?
- If financing of SMEs is a requirement, will any of the **schemes** set out in this document meet the requirement?
- What provision is made in the **Programme Documents** for a scheme and is the (indicative) allocation of EU and national funding appropriate?
- What evidence is there of '**market failure'**, i.e. is there a gap in existing provision of finance that might be filled by a Risk Capital Financing scheme?

If a Risk Capital Financing measure is included, some if not all of these issues should have been addressed in the Programme Document. However, given possible time-lags in programme adoption and implementation, there will almost certainly be a need to update the assessment by either drawing on more recent research undertaking fresh investigations. Typically this might include survey work to ascertain business needs with regard to financing methods.

The outcome of this stage should be a strategic study to confirm (if appropriate) the case for a scheme and the type or types of schemes to be used.

## 8.3 Feasibility of Risk Capital Financing Scheme (Stage 2)

Having established the case for a Risk Capital Financing scheme from a regional development perspective, there is then a need to determine the technical feasibility of proceeding. The objective of this stage is to decide whether or not to move to the implementation stage. Key issues include:

- Based on the assessment of 'market failure' what sort of **strategic objectives** should be defined - the type(s) of Venture Finance to be provded, target beneficiaries, etc – and is this compatible with state aids regulations?
- What level of **funding** is needed and where might it come from – EU sources, national/regional authorities, the private sector, etc?
- What are the options for **corporate structure and management**, taking account of the advice set out in the Structural Fund regulations (see appendix B)?
- What **financial objectives and other targets** might be reasonably expected and, given different assumptions (e.g. with regard to bad debts, level of subsidies), will the Risk Capital Financing scheme be financially viable?
- Is the scheme likely to be able to meet all legal requirements including **national legal issues** and **Community issues including state aid**?
- What are the views of **regional and national authorities** and what issues will need to be discussed with the **European Commission**?
- What sort of agency could **implement the scheme** – and how should the appropriate agency be chosen?

The outcome of this stage should be a feasibility study containing clear conclusions on the technical feasibility of proceeding with the scheme and a risk assessment, together with an implementation plan. Professional advice – both legal and financial – is likely to be needed in preparing the study. There will also need to be discussions with external parties including possible scheme managers.

### 8.4 Implementation stage (Stage 3)

Assuming positive conclusions to the feasibility study, the next step will be to move to the implementation stage. This stage will involve substantial work but will result in an operating scheme. A preliminary step might be to choose an agency to carry out the implementation stage – in some cases this might be an existing public agency but in other cases it might involve a tender process.

The steps in the implementation plan will be developed as part of the feasibility study but might include the following

- **Set up the implementation team –** possibly core elements in house by the agency that will be responsible for the work, but it may be possible to outsource much of the work and it will certainly be necessary to have a team of professional advisers.

- **Develop a business plan –** issues to be covered might include:

| **Possible contents of business plan** |
|---|
| • **Specific aims** of the scheme, i.e. targets for the number and type of beneficiaries, average size of loans/investments, target returns, etc;<br>• An **operating framework** including project appraisal criteria, standard terms and conditions for assistance (e.g. length of loans, repayment terms), how the portfolio will be monitored, etc;<br>• **Financing structure** – including possible investors, contributions from Regional Funds, etc<br>• **Corporate structure –** which will need to meet the requirements of investors and others<br>• **Management arrangements,** i.e. who will operate the scheme and under what terms and conditions, etc<br>• **Performance indicators -** relating both to the purely financial aspects of the scheme and regional development outcomes (e.g. number of jobs created or saved).<br>• Assess how the scheme is to meet the Commission's **requirements on State aid** |

- **Negotiate and agree the business plan** with interested parties including potential investors, local and national government and the European Commission.

- **Implement the business plan** – including setting up the corporate and legal structure, negotiating and agreeing finance, obtaining personnel and investment managers and other steps which will have been set out in the business plan

The scale of work in this stage – and in particular the time taken to implement it – should not be underestimated. Setting up Risk Capital Financing schemes can be a complex exercise involving a large number of partners and requiring significant professional advice

# Operational issues

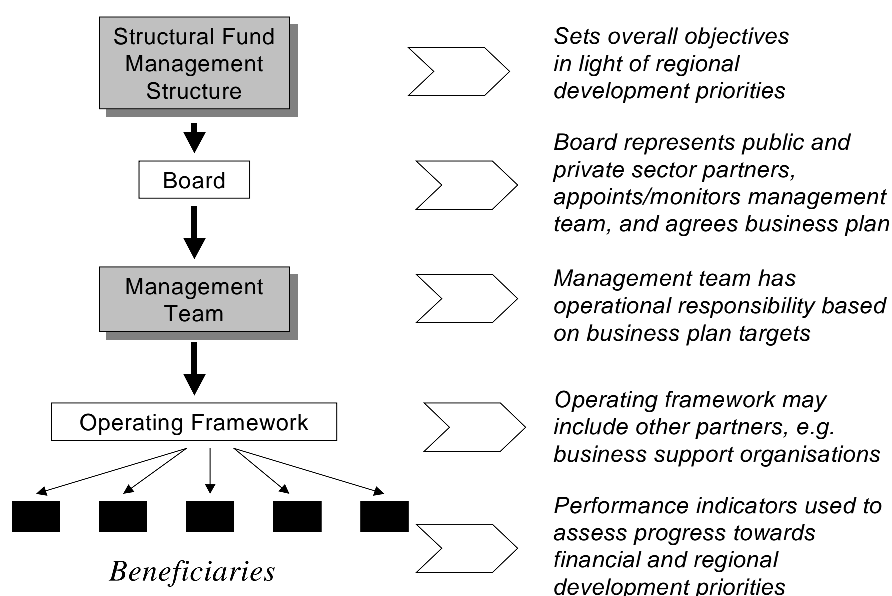
*Experience suggests that there are a number of key 'good practices' in operating Risk Capital Financing schemes.*

## 9.1 Overview

Experience suggests that there are a number of key good practice lessons to be learnt with regard to managing the operation of Risk Capital Financing schemes:

- The extent to which financial engineering schemes have **professional management** is a key factor determining the success of interventions;
- Leveraging **private sector support** is important, not just as a means of increasing the resources available for investment but also as a way of ensuring that private sector expertise is brought to bear on the way in which schemes are managed;
- The provision of financial assistance to SMEs should be combined with other financial and **business support services** to achieve the best results;
- The approach adopted to monitoring and **performance measurement** should combine financial indicators with a method of assessing the contribution of EU-supported Risk Capital Financing schemes to regional development.

The typical operating framework for a Risk Capital Financing scheme – combining the over-arching Structural Fund management structure with elements that are specific to the particular scheme – is summarised in the diagram below.



There will of course be variations in this basic model to reflect both local circumstances and priorities, institutional structures, and the nature of the Risk Capital Financing scheme (for example, loan schemes are more likely to be operated by public authorities than venture capital funds).

### 8.1 Professional Management

Experience from the last Structural Fund programming period strongly suggests that Risk Capital Financing schemes operate more successfully where:

- Public authorities decide overall priorities but professional managers have responsibility for **day-to-day management**;

- Rigorous **project appraisal standards** are maintained and there is a well-defined **market focus** enabling fund managers to develop specialist sector knowledge;

- The performance of the scheme is monitored closely against **business plan targets** with the ultimate sanction of replacing the managers if there is persistent under-performance.

EU-supported Risk Capital Financing schemes will of course be subject to the overall scrutiny of Monitoring Committees and Programme Management Units who have responsibility for managing Structural Fund programmes. However, it is important that at an operational level, scheme managers have the discretion to introduce procedures that reflect their judgement of professional best practice.

Venture Finance managers will often have to balance conflicting requirements: the need, on the one hand, to demonstrate positive social and economic impacts in the short-term to satisfy regional authorities (which may suggest an early exit from investments); and, the need to maximise the profitability of schemes (which in many situations may mean delaying the exit to allow investments to realise their full potential), on the other. Reconciling these requirements can be difficult and, again, clear exit rules are needed that balance the interests of all partners.

### 8.2 Leveraging Private Sector Support

A key to the success of most forms of Risk Capital Financing is that public intervention has a leverage effect and leads to additional funding being raised from the private sector. There are a number of reasons why the private sector should support Risk Capital Financing schemes including:

- The private sector can minimise its risk profile by working in partnership with the public sector to develop innovative financial instruments. The **risk sharing principle** enables lending institutions to free-up resources of the balance sheet for investment elsewhere;

- Lending institutions can reduce their overall levels of risk by pooling SMEs together as part of a large and more **balanced portfolio** e.g. in the case of guarantee schemes;

- Risk Capital Financing enables SMEs to access finance who would otherwise not be able to invest in innovation and development, key competitiveness drivers which boost growth and contribute to employment creation, which in turn means **more profitable business for lending institutions** in the long term;

- Large firms often need a **local supply chain**. It is therefore in their interests to support public interventions that seeks to strengthen the SME base and encourage regional economic development and jobs growth;

Whilst there is a strong case for private involvement, there is a need to strike a balance between the desirability of maximising the leverage of private sector funding, on the one hand, and ensuring that Risk Capital Financing scheme retain their essentially public character commitment to regional development aims, on the other.

### 8.3 Combining Venture Finance with Business Support Services

An important feature of most Risk Capital Financing schemes is that they usually combine the provision of financial aid with business advice and support. This can take a number of forms:

- In the case of equity instruments, the investor may be represented on the company's board and provide advice in a mentoring capacity;

- Many schemes network closely with business support organisations and signpost their clients to appropriate sources of advice. In some cases, this can be a requirement;

- With Business Angels and micro-finance, the provision of advisory support may be less formalised but nevertheless an important feature.

Whilst finance is important, experience suggests that many start-ups and SMEs will not be successful unless supported in other ways. For example, many would-be entrepreneurs start off with a good idea for a new product and may have the required technical know-how but lack the basic business skills necessary to turn the idea into a viable commercial success. Similarly, established businesses often fail when they enter the transition phase from being very small firms to medium-sized undertakings, typically because of management shortcomings.

With micro-finance, the level of expertise required to advise clients may be relatively unsophisticated. In contrast, equity funds may have to develop very specialised, sector-specific knowledge to operate effectively.

## 8.4 Performance Measurement

The evaluation of EU-supported Risk Capital Financing schemes undertaken in the late 1990s concluded that:

> Where targets are set, they tended to relate to financial inputs and activity indicators (e.g. number of SMEs to be assisted) rather than financial performance, outputs and impacts. As a result, it is difficult to see precisely what contribution many of the financial engineering measures were expected to make to wider SPD objectives beyond simply increasing the availability of SME finance (Ernst & Young, 'Evaluation of Financial Engineering Schemes', 1998)

EU-supported Risk Capital Financing schemes should be assessed using two sets of criteria – first financial performance and, secondly, their contribution to wider regional development objectives.

### *8.3.1 Financial Indicators*

Taking the first of these, although the criteria will vary according to nature of the financial instrument and the specific objectives of stakeholders, it is nevertheless possible to define a number of basic indicators that will be common to most schemes. These include:

- **Leverage** of private sector finance;
- In the case of loan schemes, the level of **bad debts**;
- With equity funds, the **rate of return** on funds that are invested;
- In all cases, the rate at which there is a **reinvestment** of funds in new projects.

The main difference between Risk Capital Financing Schemes with regard to financial indicators will be between loan schemes and equity-based initiatives.

### *8.3.2 Regional Development Indicators*

Risk Capital Financing schemes that receive EU support should also be able to demonstrate the contribution being made to regional policy objectives. A balance needs to be struck here between operating Risk Capital Financing schemes on a basis that is commercially sound, on the one hand, and ensuring that public policy objectives are promoted on the other. However, the basic criteria that might be used are summarised below:

- The **number** and type of entrepreneurs and existing SMEs that are assisted;

- At the firms level, the extent to which **additionality** is demonstrated, i.e. projects that would not go ahead on the same basis/at the same time without support (this should be assessed at the project appraisal stage);

- **Outcomes** achieved – these might include the number of jobs created or saved, higher SME turnover, or evidence of an increased level of investment in R&D – and the cost effectiveness of these outcomes (e.g. cost per job);

- How the outcomes contribute to **regional priorities** – for example, promoting new start-ups in sectors of the local economy with growth potential or helping individuals from disadvantaged groups to set up their own businesses.

Precise targets for these and other performance indicators must, of course, reflect the particular circumstances of Risk Capital Financing schemes and the environment in which they operate. There are also methodological issues in obtaining information for performance indicators, for example whether to rely only on feedback from beneficiaries or to use control group techniques.

This appendix contains templates summarising the main characteristics of forms of financial instrument which might be used in providing finance to SMEs.

**VENTURE CAPITAL TEMPLATE**

**1. Outline description of scheme**

Provision of equity finance to SMEs. Scheme will typically be run in conjunction with loan schemes

**2. Sources of finance for scheme (Community, national, private)**

Typical sources of finance might be:

- Equity capital from Regional fund sources
- Private equity capital
- Loans from private sources

**3. Private capital return**

Preference is often given to the return of loan capital, but normally private equity capital will be *pari passu* with public equity capital

**4. Target groups**

Target groups will be confined to SMEs in the area covered by the fund. Such SMEs might have their main office in the local area or the majority of their employment in the local area

**5. Overall targets (for current period)**

There are a series of quantified targets. Amongst these are:

- Number of companies assisted
- Number of jobs created/ jobs saved
- Funds returned for reuse

**6. Terms of assistance (typical amount, time, terms of financing)**

As indicated above, a typical venture capital scheme will include both loans and equity. In respect of equity, there will be no maximum period for the investment but the intention will be that the scheme has an exit mechanism.

Exit routes are likely to include:

- A trade sale or IPO of successful companies
- Placing equity stakes of middle performing companies in an ongoing trust until disposal
- Loss of investment in poor performing companies

**7. Management arrangements**

The structural fund regulations (rule 8) set out suggestions on management arrangements (see appendix B). Equity funds are required to be managed by independent professional fund managers and must be set up as an independent legal entity governed by agreements between shareholders or as a separate block of finance within an existing financial institution. Before an equity fund can be approved, a business plan must be submitted by the co-financiers or sponsors of the fund specifying the target market, eligibility criteria, terms and conditions of financing, operational budget, ownership and co-financing partners. The justification for the use of Structural Funds and how the Structural Fund component will be utilised must also be specified.

**8. Key advantages of scheme**

Amongst the key attributes of the scheme are:

- The ability to recycle funding after loans have been repaid or equity sold
- A fund structure that allows ERDF funding to be leveraged using private sector funding
- A portfolio of different funds aiming at the needs of different sizes of companies

| • Professional and independent fund management operating on a commercial basis<br>• Clear investment guidelines designed to target investment to the area being helped, and concentration of assistance on companies who would not otherwise obtain finance i.e. on market failure<br>• The dedication of funds to community/social enterprises targeted at deprived areas, which encourages entrepreneurship as a regeneration and social inclusion catalyst | |
|---|---|
| **9. Competition Issues** | |
| The scheme, as with all other schemes, will need to comply with competition policy requirements in respect of state aid. | |
| **Is the scheme located in an Objective area?** | Please tick as appropriate |
| Yes, Obj 1 area (Treaty art. 87,3,a) | √ (e.g.) |
| Yes, Obj 2 area (Treaty art. 87,3,c) | |
| No, not located in an Obj area (Treaty art 87,1) | |
| **Does the scheme involve state aid?** | Yes /No (If yes, fill in response below) |
| **If the scheme does constitute a state aid, how does it comply with the rules on state aid?** | Please tick as appropriate |
| Compatible (with state aid rules on venture capital schemes) | |
| De minimis rules (state aid under €100,000) | √ (e.g.) |

## BUSINESS ANGELS TEMPLATE

**1. Outline description of scheme**

Provision of informal venture capital to SMEs, often tied to advisory and mentoring support. May also include the provision of loans or a combination of loan and equity financing.

**2. Sources of finance for scheme (Community, national, private)**

Finance is provided by high-worth individuals either acting alone or as part of a business angels network. Public sector involvement is confined to supporting the set up and operation of networks which bring together angel investors and SMEs

**3. Private capital return**

Not relevant since the public sector does not make funding available to co-invest with angel investors. Public sector involvement is confined to supporting angels networks.

**4. Overall targets**

The types of indicators typically used by angel investors might include;

- Return on investment (ROI)
- Attainment of general or specific social objectives, depending on the angel investor's objectives and motives
- Networks whose running cost is supported by public finance may have targets in terms of the number of companies supported or job creation targets.

**5. Target groups**

High-growth SMEs or SMEs with high-growth potential across a broad sectoral spectrum. Some angel investors will have particular expertise in a given sector so may concentrate their investments in that sector.

**6. Terms of assistance (typical amount, time, terms of financing)**

As indicated above, informal venture capital can include both loans and equity. In respect of equity investments, the angel investor will seek a viable exit mechanism for their investment – although the time period for this is unlikely to be pre-determined and will depend on a number of factors;

Potential exit routes are likely to include:

- Trade sale or Initial Public Offering (IPO)
- Placing equity stakes of middle performing companies in an ongoing trust until disposal
- Loss of investment in poor performing companies

**7. Management arrangements**

Angel investors typically take an active role in overseeing the performance of their investments in order to achieve their commercial and/ or social objectives. They will often take a seat on the board of the company in which they have invested and/ or provide mentoring assistance to company managers.

In supporting networks, public authorities may have some involvement in the networks but not in the investee companies

**8. Key advantages of scheme**

Amongst the key attributes of Business Angel investments are:

- Angel investors are more strongly geared towards risk than traditional commercial lenders – they seek investments with high risk/ reward ratios and are therefore more likely to invest in innovative sectors such as high-tech industry or biotechnology, where access to finance problems are traditionally more acute
- They supplement formal venture capital schemes thereby contributing to the Commission's general objective of increasing the supply of risk capital within Europe

- Angel investors are experienced business people in their own right – they often fulfil a mentoring and advisory role thereby facilitating knowledge transfer and new wealth creation
- Some angel investors seek to achieve social as well as financial objectives from their investments. The concept of angel investors 'giving-back' to the Community has in recent years been strongly championed in the States (e.g. through favourable fiscal treatment). The phenomenon is also relatively common in Europe, albeit less well developed.
- For public authorities, business angel schemes can increase the supply of risk capital and advice at little cost to public funds

**9. Competition Issues**

Angel investors do not receive public funding. The public sector role is confined to encouraging the development of networks of angel investors and matching potential angel investors with suitable companies. Competition issues therefore apply to the support to the network of investors..

## LOAN SCHEMES TEMPLATE

**1. Outline description of scheme**

Provision of loan finance to SMEs.

**2. Sources of finance for scheme (Community, national, private)**

Typical sources of loan finance might include:

- Equity capital from Regional fund and private sources (for fund set-up)
- Loan capital from financial institutions

**3. Private capital return**

Preference is often given to the return of loan capital, but normally private equity capital will be *pari passu* with public equity capital. Loan capital may be counter-guaranteed by the European Investment Fund (EIF) in areas qualifying for Objective area status.

**4. Target groups**

If a loan scheme is eligible for Structural Fund assistance under Objective area status, SME beneficiaries must be located within the Objective area. SME beneficiaries have a degree of flexibility as to how they meet the eligibility criteria – for example, they might have their main office based in the local area or the majority of their employees based in the area

**5. Overall targets (for current period)**

For some types of loan schemes, such as interest rate rebate schemes, the rebate is conditional upon beneficiary companies achieving pre-determined quantified targets. The onus is on the SME beneficiary to meet these targets before becoming eligible for the rebate. These might include:

- Number of jobs created/ jobs saved
- Level of new investment

Fund managers administering interest rate subsidy schemes supported by the Structural Funds will also have to meet certain targets. These might typically include;

- Number of companies assisted
- Number of jobs created/ jobs saved

**6. Terms of assistance (typical amount, time, terms of financing)**

The typical amount of loan financing varies greatly according to business need and the size of the loan fund. Loan funds may operate several different funds each targeted at firms with different types of financing requirements e.g. small firms loans scheme, loan schemes targeted at larger, expanding firms etc. Anything below €10,000 will usually fall under the micro-credits category, addressed in a separate template. The typical timeframe for SME loans also varies considerably but is usually spread over a minimum of three years and a maximum of twenty five years.

The terms of financing also vary – however, one commonality is that the terms are usually preferential compared with loans obtained on a commercial basis. Loan funds with a Structural Funds component fall into two main categories; *interest rate subsidy schemes*, where SME beneficiaries receive a direct discount off the interest rate – programming managers then have to meet quantified targets in terms of employment creation, firms assisted, firm growth and investment levels etc. and *interest rate rebate* schemes where SME beneficiaries themselves receive a rebate of up to a third dependent on the attainment of certain targets, primarily jobs creation and new investment oriented.

| 7. Management arrangements | |
|---|---|
| Rule 8 of the structural fund regulations for 2000-06 applies to the management of loan funds (see appendix B). [9] Loan funds are required to be managed by independent professional fund managers and must be set up as an independent legal entity governed by agreements between shareholders or as a separate block of finance within an existing financial institution. Before a loan fund can be approved, a business plan must be submitted by the co-financiers or sponsors of the fund specifying the loan fund's target market, eligibility criteria, terms and conditions of financing, operational budget, ownership and co-financing partners. The justification for the use of Structural Funds and how the Structural Fund component will be utilised must also be specified.<br><br>Loan fund managers actively monitor their investments – they also determine the fund's approach to risk management, which will vary depending on the objectives of the fund and its key stakeholders. | |
| **8. Key advantages of scheme** | |
| Amongst the key attributes of loan schemes include:<br>• The ability to recycle funding after loans have been repaid<br>• Major source of capital for SMEs seeking developmental finance<br>• Some loan fund schemes can offer loans on an unsecured basis, thereby facilitating SME access to finance<br>• Medium risk investment for public authorities which may offer good leverage to other sources of capital with the prospects of all or some of the original investment being available for re-use. | |
| **9. Competition Issues** | |
| Loan schemes, as with all other types of financial engineering schemes, will need to comply with competition policy requirements in respect of state aid. | |
| **Is the scheme located in an Objective area?** | Please tick as appropriate |
| Yes, Obj 1 area (Treaty art. 87,3,a) | √ (e.g.) |
| Yes, Obj 2 area (Treaty art. 87,3,c) | |
| No, not located in an Obj area (Treaty art 87,1) | |
| **Does the scheme involve state aid?** | Yes /No (If yes, fill in response below) |
| **If the scheme does constitute a state aid, how does it comply with the rules on state aid?** | Please tick as appropriate |
| Compatible (with state aid rules) | √ (e.g.) |
| De minimis rules (state aid under €100,000) | |

[9] Commission Regulation (EC) No 1685/2000 of 28 July 2000 laying down detailed rules for the implementation of Council Regulation (EC)No 1260/1999 as regards eligibility of expenditure of operations co-financed by the Structural Funds

**MICRO FINANCE TEMPLATE**

**1. Outline description of scheme**

Provision of micro finance to SMEs, micro firms and individual entrepreneurs. Micro-credit schemes are loans for small amounts of capital which fall below the size threshold of normal bank loans (usually less than 10,000 euros).

**2. Sources of finance for scheme (Community, national, private)**

Typical sources of loan finance might include:

- Equity capital from European Regional funds
- Micro credit finance from financial institutions
- The EIF has also recently introduced a guarantee scheme for micro credits which refunds costs of file analysis (200€ per file) and counter-guarantees the main guarantor to an extend of 75%.

**3. Private capital return**

Preference is often given to the return of loan capital, but normally private equity capital will be *pari passu* with public equity capital. Loan capital may be counter-guaranteed by the European Investment Fund (EIF) in areas qualifying for Objective area status.

**4. Target groups**

Micro credit schemes target particular types of SMEs, usually micro-firms with less than 5 employees and the self-employed. Micro credit schemes also seek to provide access to capital to individuals which for a variety of reasons, have traditionally been financially and / or socially excluded – examples of the types of disadvantaged social groups micro credit schemes might target include those with a poor credit history, the long-term unemployed, those lacking conventional qualifications/ education, young unemployed people, women entrepreneurs, entrepreneurs from ethnic minorities, the disabled etc.

If a micro credit fund receives Structural Fund assistance under Objective area status, SME beneficiaries must be located within the Objective area. SME beneficiaries have a degree of flexibility as to how they meet the eligibility criteria – for example, they might have their main office based in the local area or the majority of their employees based in the area

**5. Overall targets (for current period)**

For some types of micro credit schemes, such as interest rate rebate schemes, the rebate is conditional upon beneficiary companies achieving pre-determined quantified targets. These might include:

- Number of jobs created/ jobs saved

Fund managers administering micro credit schemes where there is a Structural Funds supported interest rate subsidy will also have to meet certain targets. These might typically include;

- Number of companies assisted
- Number of jobs created/ jobs saved

**6. Terms of assistance (typical amount, time, terms of financing)**

The typical amount of loan financing varies will generally be below €10,000. The typical timeframe for the repayment of micro credit loans varies considerably but is usually between 1 and 10 years. The average repayment period for micro loans tends to be shorter than that for larger loans.

The terms of financing also vary – one commonality is that the terms are usually preferential compared with loans obtained on a commercial basis. Micro loan funds with a Structural Funds component fall into two main categories; *interest rate subsidy schemes*, where SME beneficiaries receive a direct discount off the interest rate – programming managers then have to meet quantified targets in terms of employment creation, firms assisted, firm growth and investment levels etc. and *interest rate rebate* schemes where SME beneficiaries themselves receive a rebate of up to a third dependent on the attainment of certain targets, primarily jobs creation and new investment oriented.

**7. Management arrangements**

Rule 8 of the structural fund regulations for 2000-06 applies to the management of loan funds (see appendix B). [10] Many of the same principles apply to micro credit schemes. Under Structural Fund regulations, all loan funds (including micro-credit schemes) are required to be managed by independent professional fund managers and must be set up as an independent legal entity governed by agreements between shareholders or as a separate block of finance within an existing financial institution. Before a micro credits scheme can be approved, a business plan must be submitted by the co-financiers or sponsors of the fund specifying the loan fund's target market, eligibility criteria, terms and conditions of financing, operational budget, ownership and co-financing partners. The justification for the use of Structural Funds and how the Structural Fund component will be utilised must also be specified.

In terms of management strategy, micro credits are more strongly orientated towards the attainment of social rather than commercial objectives. Micro credits schemes are more likely to make loans that would not be accepted on a normal commercial basis due to the perceived higher risk profile.

In some countries, there is an added legislative complication in the operation of micro credits schemes. Given that the typical loan amount for a micro credits scheme is usually too low to be considered commercially viable (due to high transaction and processing costs), the management, administration and disbursement of micro loans is often delegated by financial institutions providing the loan finance to organisations which do not have legal status as financial institutions. In some countries, national legislation prevents non-financial institutions from disbursing loans. You will need to check the position in your country.

**8. Key advantages of scheme**

Amongst the key attributes of loan schemes include:

- The ability to recycle funding after loans have been repaid
- Meets market failure in that commercial providers are not actively engaged in providing finance below a certain minimum threshold
- Provides access to finance to those SMEs, particularly micro-firms and the self-employed, which have traditionally had difficulty raising funding – often with little or no collateral requirement
- Provides access to finance and encourages entrepreneurial activity amongst disadvantaged social groups and the financially excluded – often with little or no collateral requirement
- For public authorities, a means of developing micro businesses and reaching disadvantaged people

**9. Competition Issues**

Micro-credit schemes may constitute state aid to the company. However, under certain circumstances, state aid is permissible. In the case of micro-credits, the amount of state aid involved by definition will be under €100,000 over a three year period and should therefore fall within the scope of the *de minimis* rules.

[10] Commission Regulation (EC) No 1685/2000 of 28 July 2000 laying down detailed rules for the implementation of Council Regulation (EC)No 1260/1999 as regards eligibility of expenditure of operations co-financed by the Structural Funds

## GUARANTEES TEMPLATE

**1. Outline description of scheme**

Provision of loan and equity guarantees to SMEs in order to facilitate access to loan (or less commonly equity) finance. Guarantee societies and mutual guarantee societies issue guarantees in return for a fee to cover both the risk and administrative and processing costs. Many guarantee schemes in areas qualifying for Objective area status are counter-guaranteed by EIF instruments such as the SME Guarantee Facility, which covers 50% of the losses incurred by guarantee funds. In return, guarantee societies are expected to increase their risk profile by supporting higher risk SME investments with the objective of fostering "growth and employment".

**2. Sources of finance for scheme (Community, national, private)**

Typical sources of finance might be:

- Equity capital from Community Structural Funds – under the current regulations, the Structural Funds may co-finance the capital of guarantee funds
- Equity capital from national and regional public sector sources
- Private equity capital
- Loans from private sources

**3. Private capital return**

Preference is often given to the return of loan capital, but normally private equity capital will be *pari passu* with public equity capital

**4. Target groups**

Target groups will be confined to SMEs in the area covered by the guarantee fund. Guarantees are a particularly appropriate instrument for SMEs that have experienced difficulties getting access to finance via normal commercial routes e.g. due to lack of collateral, trading record etc.

**5. Overall targets**

Key indicators used by guarantee funds might include:

- Numbers of companies assisted
- Numbers of guarantees issued and total guarantee commitments
- Total value of loans leveraged
- Public funds returned for reuse

**6. Terms of assistance (typical amount, time, terms of financing)**

Guarantees usually last for the duration of the loan term, which varies according to the nature of the loan scheme operated by the financial institution administering the loans. Typically, guarantees are issued for between 40 and 80% of the total loan size. In return for the guarantee, SMEs pay a fee to cover both the guarantor’s risk and administrative and processing costs. This normally amounts to between 1 and 2% of the total transaction size, sometimes graded by the guarantee institution according to the degree of risk.

The guarantee reduces the risk exposure of the lending institution - SMEs seeking loans backed by a guarantee may therefore obtain financing at preferential rates to reflect the reduced risk.

| 7. Management Arrangements | |
|---|---|
| Rule 9 of the structural fund regulations for 2000-06 applies to the management of guarantee funds (see appendix B).[11] The funds may be publicly-supported mutual funds subscribed by SMEs, commercially-run funds with private-sector partners, or wholly publicly-financed funds. Management costs may not exceed 2% of the paid-up capital on a yearly average for the duration of the assistance unless, after a competitive tender, a higher percentage proves necessary. Guarantee funds must be set up as an independent legal entity governed by agreements between shareholders or as a separate block of finance within an existing financial institution. Before a guarantee fund can be approved, a business plan must be submitted by the co-financiers or sponsors of the fund specifying the target guarantee portfolio, eligibility criteria, terms and conditions of financing, operational budget, ownership and co-financing partners.<br><br>Funding from the Structural Funds and national/ regional sources may be available to provide support to guarantee funds in eligible Objective areas. In addition to pursuing purely commercial objectives, guarantee funds may also pursue socio-economic objectives such as new job creation or facilitating access to finance amongst disadvantaged groups etc. The guarantee fund's attitude to risk and willingness to lend to higher-risk SMEs will therefore vary depending on the objectives of key stakeholders. | |
| **8. Key advantages of scheme** | |
| Key attributes of guarantee schemes are summarised below:<br>• The ability to achieve a high leverage ratio in terms of public / private sector funding (typically 10 times)<br>• Facilitates access to loan finance on improved financial terms for SMEs which otherwise could not easily obtain access to finance (poor credit history, little or no collateral, lack of trading record)<br>• Principle of risk sharing between guarantee society and lending institution reduces the lender's risk and leverages private sector lending. It also reduces the lender's capital requirements under the Basle rules, freeing up resources.<br>• For Public Authorities, guarantee societies help to leverage private sector finance for SME promotion and wider regional development.<br>• Rigorous screening procedures and detailed knowledge of the business sectors in which clients operate reduces risk of SME default<br>• Guarantee societies provide local input and tailored business advisory support | |
| **9. Competition Issues** | |
| Guarantee schemes, as with all other schemes, will need to comply with competition policy requirements in respect of state aid. | |
| **Is the scheme located in an Objective area?** | Please tick as appropriate |
| Yes, Obj 1 area (Treaty art. 87,3,a) | √ (e.g.) |
| Yes, Obj 2 area (Treaty art. 87,3,c) | |
| No, not located in an Obj area (Treaty art 87,1) | |
| **Does the scheme involve state aid?** | Yes /No (If yes, fill in response below) |
| **If the scheme does constitute a state aid, how does it comply with the rules on state aid?** | Please tick as appropriate |

[11] Rule 9, Commission Regulation (EC) No 1685/2000 of 28 July 2000 laying down detailed rules for the implementation of Council Regulation (EC) No 1260/1999 as regards eligibility of expenditure of operations co-financed by the Structural Funds

| | |
|---|---|
| Compatible (with state aid rules on guarantee schemes) | |
| De minimis rules (state aid under €100,000) | √ (e.g.) |

## The following is the text of Rules 8 and 9 of COMMISSION REGULATION (EC) No 1685/2000 of 28 July 2000 laying down detailed rules for the implementation of Council Regulation (EC) No 1260/1999 as regards eligibility of expenditure of operations co-financed by the Structural Funds.

Rule No 8:venture capital and loan funds

1.GENERAL RULE

The Structural Funds may co-finance the capital of venture capital and/or loan funds or of venture capital holding funds (hereinafter 'funds ') under the conditions set out in point

2.For the purposes of this Rules, 'Venture capital funds and loan funds 'means investment vehicles established specifically to provide equity or other forms of risk capital, including loans, to small and medium-sized enterprises as defined in Commission Recommendation 96/ 280/EC[12].'Venture capital holding funds 'means funds set up to invest in several venture capital and loan funds. The Structural Funds' participation in funds may be accompanied by co-investments or guarantees from other Community financing instruments.

2.CONDITIONS

2.1.A prudent business plan shall be submitted by the co-financiers or sponsors of the fund specifying, inter alia, the targeted market, the criteria, terms and conditions of financing, the operational budget of the fund, the ownership and co-financing partners, the professionalism, competence and independence of the management, the fund's by-laws, the justification and intended utilisation of the Structural Funds' contribution, the investment exit policy, and the winding-up provisions of the fund, including the reutilisation of returns attributable to the contribution from the Structural Funds. The business plan shall be carefully appraised and its implementation monitored by or under the responsibility of the managing authority.

2.2.The fund shall be set up as an independent legal entity governed by agreements between the shareholders or as a separate block of finance within an existing financial institution. In the latter case the fund shall be subject to a separate implementation agreement, stipulating in particular the keeping of separate accounts distinguishing the new resources invested in the fund (including those contributed by the Structural Funds)from those initially available in the institution. All participants in the fund shall make their contributions in cash.

2.3.The Commission cannot become a partner or shareholder in the fund.

2.4.The contribution from the Structural Funds shall be subject to the limits laid down in Article 29(3) and (4)of the General Regulation.

2.5.Funds may invest only in SMEs at their establishment, early stages (including seed capital)or expansion and only in activities which the fund managers judge potentially economically viable. The assessment of the viability should take into account all sources of income of the enterprises in question. Funds shall not invest in firms in difficulty within the meaning of the Community Guidelines on State aid for rescuing and restructuring firms in difficulty[13] .

2.6.Precautions should be taken to minimise distortion of competition in the venture capital or lending market. In particular returns from equity investments and loans (less pro-rata share of the management

[12] OJ L 107,30.4.1996,p.4.

[13] OJ C 288,9.10.1999,p.2.

costs) may be preferentially allocated to the private sector shareholders up to the level of remuneration laid down in the shareholder agreement, and after that, they shall be allocated proportionally between all shareholders and the Structural Funds. Returns to the fund attributable to the Structural Funds' contributions shall be reused for SME development activities in the same eligible area.

2.7.Management costs may not exceed 5 %of the paid-up capital on a yearly average for the duration of the assistance unless, after a competitive tender, a higher percentage proves necessary.

2.8.At the time of the closure of the operation, the eligible expenditure of the fund (the final beneficiary) shall be the capital of the fund that has been invested in or loaned out to SMEs ,including the management costs incurred.

2.9.Contributions to funds from the Structural Funds and other public sources, as well as the investments made by funds in individual SMEs, are subject to the rules on State aid.

3.RECOMMENDATIONS

3.1.The Commission recommends the standards of good practice set out in points 3.2 to 3.6 for funds to which the Structural Funds contribute. The Commission will regard compliance with these recommendations as a positive element when it examines the fund's compatibility with State aid rules. The recommendations are not binding for the
purposes of the eligibility of expenditure.

3.2.The financial contribution of the private sector should be substantial, and above 30 %.

3.3.Funds should be large enough and cover a wide enough target population to ensure that their operations are potentially economically viable, with a time scale for investments compatible with the period of the Structural Funds' participation, and focusing on areas of market deficiency.

3.4.The timing of payments of capital into the fund should be the same for the Structural Funds and the shareholders, and pro rata to the stakes subscribed.

3.5.Funds should be managed by independent professional teams with sufficient business experience to demonstrate the necessary capability and credibility to manage a venture capital fund. Management teams should be chosen on the basis of a competitive selection process, taking into account the level of fees envisaged.

3.6.Funds should not normally acquire majority stakes in firms and should pursue the objective of realising all investments within the life of the fund.

Rule No 9:guarantee funds

1.GENERAL RULE

The Structural Funds may co-finance the capital of guarantee funds under the conditions set out in point 2.For the purposes of this Rule,' Guarantee funds 'mean financing instruments that guarantee venture capital and loan funds within the meaning of Rule No 8 and other SME risk financing schemes (including loans)against losses arising from their investments in small and medium-sized enterprises as defined in recommendation 96/280/EC.The funds may be publicly-supported mutual funds subscribed by SMEs, commercially-run funds with private-sector partners, or wholly publicly-financed funds. The Structural Funds' participation in funds may be accompanied by part-guarantees provided by other Community financing instruments.

2.CONDITIONS

2.1.A prudent business plan shall be submitted by the co-financiers or sponsors of the fund in the same way as for venture capital funds (Rule No 8),mutatis mutandis ,and specifying the target guarantee

portfolio. The business plan shall be carefully appraised and its implementation monitored by or under the responsibility of the managing authority.

2.2.The fund shall be set up as an independent legal entity governed by agreements between the shareholders or as a separate block of finance within an existing financial institution. In the latter case the ‘fund ’shall be subject to a separate implementation agreement, stipulating in particular the keeping of separate accounts distinguishing the new resources invested in the fund (including those contributed by the Structural Funds)from those initially available in the institution.

2.3.The Commission cannot become a partner or shareholder in the fund.

2.4.Funds may only guarantee investments in activities that are judged potentially economically viable. Funds shall not provide guarantees for firms in difficulty within the meaning of the Community guidelines on State aid for rescuing and restructuring firms in difficulty.

2.5.Any part of the Structural Funds' contribution left over after the guarantees have been honoured shall be reused for SME development activities in the same eligible area.

2.6.Management costs may not exceed 2 %of the paid-up capital on a yearly average for the duration of the assistance unless, after a competitive tender, a higher percentage proves necessary.

2.7.At the time of the closure of the operation, the eligible expenditure of the fund (the final beneficiary)shall be the amount of the paid-up capital of the fund necessary ,on the basis of an independent audit, to cover the guarantees provided including the management costs incurred.

2.8.Contributions to guarantee funds from the Structural Funds and other public sources, as well as the guarantees provided by such funds to individual SMEs are subject to the rules on State aid.

The following is an extract from Commission Regulation (EC) No 69/2001 in respect of small amounts of aid to enterprises

*Article 1* – **Scope**

This Regulation applies to aid granted to enterprises in all sectors, with the exception of:
(a) the transport sector and the activities linked to the production, processing or marketing of products listed in Annex I to the Treaty;

(b) aid to export-related activities, namely aid directly linked to the quantities exported, to the establishment and operation of a distribution network or to other current expenditure linked to the export activity;

(c) aid contingent upon the use of domestic over imported goods

*Article 2* - **De minimis aid**

1. Aid measures shall be deemed not to meet all the criteria of Article 87(1) of the Treaty and shall therefore not fall under the notification requirement of Article 88(3) of the Treaty, if they fulfil the conditions laid down in paragraphs 2 and 3.

2. The total de minimis aid granted to any one enterprise shall not exceed EUR 100000 over any period of three years. This ceiling shall apply irrespective of the form of the aid or the objective pursued.

3. The ceiling in paragraph 2 shall be expressed as a cash grant. All figures used shall be gross, that is, before any deduction for direct taxation. Where aid is awarded in a form other than a grant, the aid amount shall be the gross grant equivalent of the aid. Aid payable in several instalments shall be discounted to its value at the moment of its being granted. The interest rate to be used for discounting purposes and to calculate the aid amount in a soft loan shall be the reference rate applicable at the time of grant.

Article 3 - **Cumulation and monitoring**

1. Where a Member State grants de minimis aid to an enterprise, it shall inform the enterprise about the de minimis character of the aid and obtain from the enterprise concerned full information about other de minimis aid received during the previous three years.
The Member State may only grant the new de minimis aid after having checked that this will not raise the total amount of de minimis aid received during the relevant period of three years to a level above the ceiling set out in Article 2(2).
2. Where a Member State has set up a central register of de minimis aid containing complete information on all de minimis aid granted by any authority within that Member State, the requirement in the first subparagraph of paragraph 1 no longer applies from the moment the register covers a period of three years.

3. Member States shall record and compile all the information regarding the application of this Regulation. Such records shall contain all information necessary to demonstrate that the conditions of this Regulation have been respected. Records regarding an individual de minimis aid shall be maintained for 10 years from the date on which it was granted and regarding a de minimis aid scheme, for 10 years from the date on which the last individual aid was granted under such scheme. On written request the Member State concerned shall provide the Commission, within a period of 20 working days, or such longer period as may be fixed in the request, with all the information that the Commission considers necessary for assessing whether the conditions of this Regulation have been complied with, in particular the total amount of de minimis aid received by any enterprise.

We show below useful sources of further information;

**Information covering most types of schemes**

*European Commission DG Regio site - This site provides the latest information on the European Union's action in support of regional development*

*http://europa.eu.int/comm/regional_policy/index_en.htm*

*European Commission's Access to Finance Website – contains information and good practices on access to finance for smaller enterprises and at an earlier stage, and finance for expanding and hi-tech firms*

http://europa.eu.int/comm/enterprise/enterprise_policy/best-directory/en/finance/index.htm

**Information covering specific types of schemes**

*European Venture Capital Association*
www.evca.com

*European Business Angel network*
www.eban.org

*European Mutual Guarantees Association*
http://www.aecm.be, Tél/fax: +32 2 640 51 77

**Competition policy issues**

*DG Competition website (communication on risk capital):*
http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#D

*The Commission's most recent guidelines on the rules on state aid and risk capital were published in June 2001. The text is available from* http://europa.eu.int/cgi-bin/eur-lex/udl.pl?REQUEST=Seek-Deliver&COLLECTION=oj&SERVICE=eurlex&LANGUAGE=en&DOCID=2001c235p00030011&ext=.pdf

**Relevant organisations**

*The European Investment Fund is the European Union's specialised financial institution providing venture capital and guarantee instruments for the creation, growth and development of Small and Medium-sized Enterprises (SMEs).*

www.eif.org

***EURADA***, *the association of regional development agencies is a non profit-making organisation aiming to promote regional economic development through dialogue with the European Commission services, interchange of good practice among members*

www.eurada.org

The following table sets out case studies undertaken by CSES during the course of the preparation of the Guide to SME Risk Financing. In the main Guide, we refer to a number of best practice examples from the case studies. The full case study write-ups in template format are available online from the DG REGIO website.*[note : these will be available with the final version]*

| Case Study | Type of Instruments | Name of Scheme | Website Address of Institution | Case Study Write-Up |
|---|---|---|---|---|
| 1 | Venture Capital, Loans, Micro Loans | Merseyside Special Investment Fund | www.msif.co.uk | DG REGIO website (links to be added later) |
| 2 | Seed and Venture Capital | Enterprise Ireland | www.enterprise-ireland.ie | DG REGIO website |
| 3 | Equity and Loans | Enterprise Ireland | www.enterprise-ireland.ie | DG REGIO website |
| 4 | Guarantees | Finnvera | www.finnvera.fi | DG REGIO website |
| 5 | Loans | Finnvera | www.finnvera.fi | DG REGIO website |
| 6 | Guarantees | Finance Wales | www.financewales.co.uk/ | DG REGIO website |
| 7 | Loans | Bank für Sozialwirtschaft AG (Germany) | www.sozialbank.de | DG REGIO website |
| 8 | Guarantees | Portuguese Mutual Guarantee System (SPGM) | www.spgm.pt | DG REGIO website |
| 9 | Loans | Andalucia Interest Rate Subsidies | www.central.ifa.es | DG REGIO website |
| 10 | Loans | Andalucia Loan Scheme for Entrepreneurs | www.central.ifa.es | DG REGIO website |
| 11 | Guarantees | Eurofidi | www.eurocons.it | DG REGIO website |
| 12 | Micro-credits and seed capital | BRUSOC micro-credits and seed capital fund | www.srib.be | DG REGIO website |
| 13 | | | | DG REGIO website |
| 14 | | | | DG REGIO website |

| Publication Date | Publication Title |
|---|---|
| 1994 | Utilisation of the Structural Funds by SMEs (DG Regional Policy) |
| 1994 | Guide to Financial Engineering techniques in the context of Regional Policy (DG Regional Policy) |
| 1995 | SME Financing in Assisted Regions (DG Regional Policy) |
| 1998 | Evaluation of Financial Engineering Measures (DG Regional Policy) |
| 1998 | Guidelines on National Regional Aids OJ C74 of 10/3/1998 (DG Competition) |
| 1999 | Thematic Evaluation of Structural Fund Impacts on SMEs (DG Regional Policy) |
| 1999 | Risk Capital – a key to job creation in the European Union (DG Economic and Financial Affairs) |
| 1999 | Risk Capital Action Plan (RCAP) (DG Economic and Financial Affairs) |
| 1999 | Vademecum – Community Rules on State Aid,01.06.99 (DG Competition) |
| 1999 | Structural Fund Regulations 2000-06 COUNCIL REGULATION (EC) No 1260/1999 of 21 June 1999 laying down general provisions on the Structural Funds (DG Regional Policy) |
| 1999 | Standard notification for regional aid schemes (Nov 1999) (DG Competition) |
| 2000 | Reform of the Structural Funds – a comparative analysis (DG Regional Policy) |
| 2000 | Progress Report on the Risk Capital Action Plan (RCAP) – Oct 2000 (DG Economic and Financial Affairs) |
| 2000 | Cost of Capital to European Firms (DG Regional Policy) |
|  | Article 87 of EC treaty – sets out EU state aid policy & sets out procedural rules in state aid cases, i.e. rules on notification, monitoring of aid, reporting requirements, complaints, publication of decisions |
| 2001 | Global Entrepreneurship Monitor (GEM) - section on Venture Capital and international cross-comparison of penetration rates (The Kaufman Centre for Entrepreneurship/ Ernst & Young) |
| 2001 | Ninth Survey on State Aid in the European Union COM (2001) 403(01) (DG Competition) |
| 2001 | Commission Communication on State Aid and Risk Capital (2001/C 235/03) (DG Competition) |
| 2001 | Commission Staff Working Paper – Enterprises' Access to Finance (SEC2001)1667 – 19.10.01 |
| 2001 | Mutual Guarantees – Financial Engineering Techniques Available to SMEs – AECM (European Mutual Guarantees Association) |
|  | Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (DG Competition) |
|  | Le Financement des enterprises – typologie des instruments, implications au niveau regional – EURADE (European Regional Development Association) |