Innova-FI
Interreg Europe

# What are Financial Instruments?


European Union
European Regional Development Fund

# What are the **FINANCIAL INSTRUMENTS** under the ESI Funds

**Financial instruments (FIs)** co-funded by the European Structural Investment Funds (ESIF) are a sustainable and efficient way to invest in growth and development in EU regions and cities. They can support a broad range of development objectives to the benefit of a wide range of final recipients (FRs) with the potential for EU funds to lever in additional public and private contributions and/or to be reused for further investments.

## THE 5 EUROPEAN STRUCTURAL AND INVESTMENT FUNDS (ESIF)

- Cohesion Fund
- European Social Fund (ESF)
- European Regional Development Fund (ERDF)
- European Agricultural Fund for Rural Development (EARDF)
- European Maritime and Fisheries Fund (EMFF)

The 5 European Structural and Investment Funds may be used to support FIs under one or more programmes, including when organised through funds of funds, in order to contribute to the achievement of specific objectives set out under a priority.

When using ESI Funds, Managing Authorities (MAs) may implement FIs (or Prizes, Repayable Assistance or Grants). The choice of FI and of financial products must be determined in the ex-ante assessment.

FIs under the European Structural and Investment Funds are EU measures of financial support provided on a complementary basis from the budget in order to address one or more specific policy objectives of the EU. Such instruments may take the form of equity or quasi-equity investments, loans or guarantees, or other risk sharing instruments, and may, where appropriate, be combined with grants.

The choice of the **financial products** will depend on the **market failures, suboptimal investment situations and investment needs** to be addressed as well as the acceptable level of risk, reward and ownership. MAs can tailor financial products according to their needs and capabilities or structure the FI based on terms and conditions provided by the Commission.

# FINANCIAL INSTRUMENTS
in pills

FIs can support projects by providing four main financial products:

## LOAN

**"Agreement which obliges the lender to make available to the borrower an agreed sum of money for an agreed period of time and under which the borrower is obliged to repay that amount within the agreed time*".**
Under a FI, a loan can help where banks are unwilling to lend on terms acceptable to the borrower. They can offer lower interest rates, longer repayment periods or have lower collateral requirements.

## GUARANTEE

**"Written commitment to assume responsibility for all or part of a third party's debt or obligation or for the successful performance by that third party of its obligations if an event occurs which triggers such guarantee, such as a loan default*".**
Guarantees normally cover financial operations such as loans.

## EQUITY

**"Provision of capital to a firm, invested directly or indirectly in return for total or partial ownership of that firm and where the equity investor may assume some management control of the firm and may share the firm's profits*".**
The financial return depends on the growth and profitability of the business. It is earned through dividends and on the sale of the shares to another investor ('exit'), or through an initial public offering (IPO).

## QUASI-EQUITY

**"A type of financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity. Quasi-equity investments can be structured as debt, typically unsecured and subordinated and in some cases convertible into equity, or as preferred equity*".**
The risk-return profile typically falls between debt and equity in a company's capital structure.

* European Commission (2015). Guidance for Member States on FIs – Glossary.

# LOAN

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

## How does it work?


## NOTES

1. In addition to disbursing loans through FIs (in an implementation structure with a Fund of Funds (FoF) or without), MAs may undertake implementation tasks directly (see CPR, Art. 38(4)(c)).
2. Co-investment may come from the same FIs or a third party investor, contributing either to the fund or to individual projects.
3. Resources returned from repaid loans, which are attributable to the support from ESI Funds, i.e. excluding national co-financing, have to be re-used for purposes defined in Articles 44 and 45 of the CPR.

# TECHNICAL FEATURES

The involvement of **ESI Funds** results in loans that are offered at a lower than market interest rates, with longer repayment periods, the possibility of grace periods, when loans do not need to be repaid in the first years or with **reduced collateral requirements**; these are called **soft loans**.

In general, for commercial loans, the **interest** charged on the loan is the market rate plus a **risk premium** that reflects the likelihood of a lender getting their money back. The risk premium includes **credit risk** which varies with the borrower's credit history and expected cash flow.

One way to decrease the risk premium is through **collateral**, where the borrower offers assets such as property, receivables, or investments as security which become the property of the lender if the borrower **defaults** (does not repay the loan). Risk completely ceases only on the date the loan is fully repaid, the maturity date. Therefore, the later the **maturity date**, the higher the risk premium. Individual **repayments** must cover the interest due, but the sooner the principal of the loan is repaid then the lower the total payments will be.

## PROS

**1.** Not particularly difficult to administer (so there are limited management costs/ fees).
**2.** A defined repayment schedule makes budgeting easier.
**3.** The lending mechanism is well understood, reducing the need for capacity building and the risk of misunderstandings.
**4.** Loans preserve the equity of the FRs as there is no claim on the ownership of the enterprise.

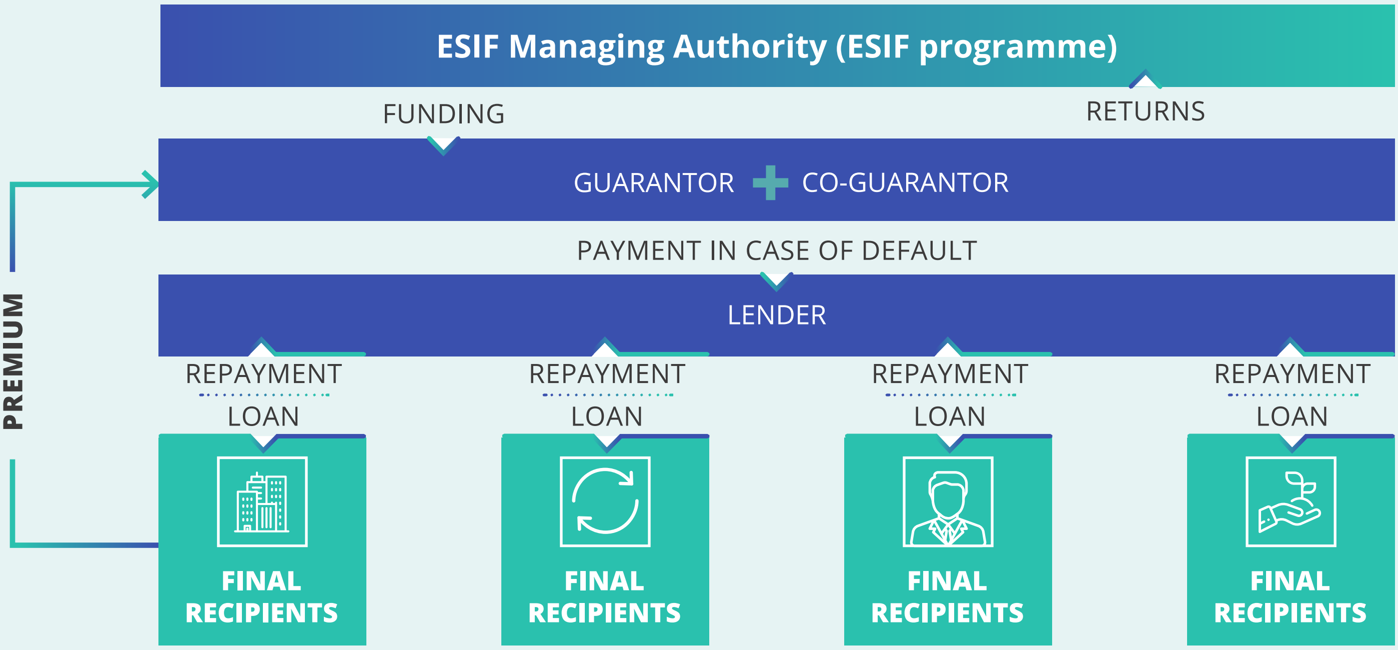
## CONS

**1.** Funded products such as loans require more initial resources than unfunded products such as guarantees.
**2.** It is sometimes difficult to establish the probability of default, especially with a lack of history of FRs.
**3.**The advantage for the FRs is almost entirely financial. There are limited additional benefits as know-how is not transferred.

# GUARANTEE

**"Written commitment to assume responsibility for all or part of a third party's debt or obligation or for the successful performance by that third party of its obligations if an event occurs which triggers such guarantee, such as a loan default*"**

## How does it work?




## NOTES

1. In addition to issuing guarantees through a body implementing FI who acts as the guarantor (in an implementation structure with a FoF or without) MAs may undertake implementation directly (see CPR, Art. 38(4)(c)).

2. ESIF programme resources could also be used for counter-guarantees for a commercial guarantor who guarantees the loans given to FRs by a commercial lender.

3. Resources returned from guarantee fees and released uncalled guarantees, which are attributable to the support from ESI Funds, i.e. excluding national co-financing, have to be reused for purposes defined in Articles 44 and 45 of the CPR.

# TECHNICAL FEATURES

Key elements in defining a **guarantee instrument** are:

- **Portfolio volume**: the aggregate amount of the underlying transaction, such as loans to be disbursed by the lender which are covered by the guarantee.

- **Guarantee Rate**: the maximum portion of the value of each loan covered by the guarantee.

- **Guarantee Cap Rate**: the maximum portion of the total portfolio covered by the guarantee. In other words, the guarantee will cover losses at the guarantee rate up to the maximum determined by the guarantee cap rate applied to the total portfolio.

- **Capped amount**: the maximum liability under the capped guarantee. It is calculated as the product of the i) total portfolio volume, ii) the guarantee rate and (iii) the guarantee cap rate. In other words, the capped guarantee will cover losses at the guarantee rate up to the maximum determined by the guarantee cap rate applied to the total portfolio volume. This amount plus expected management costs and fees related to the instrument will be set aside from the Operational Programme resources.

## PROS

**1.** Guarantees can preserve the equity of FRs as there is normally no claim on the ownership of the enterprise.
**2.** Potential benefits for FRs could include *inter alia*, lower or no guarantee fees, lower or no collateral requirements as well as lower risk premiums.
**3.** Since programme contributions cover only certain parts of loans (appropriate multiplier ratio), there is a high leverage effect.
**4.** The investment risk for third party lenders is reduced (because they only bear part of the risk of default).
**5.** Unfunded products such as guarantees require less initial support than funded products such as loans.

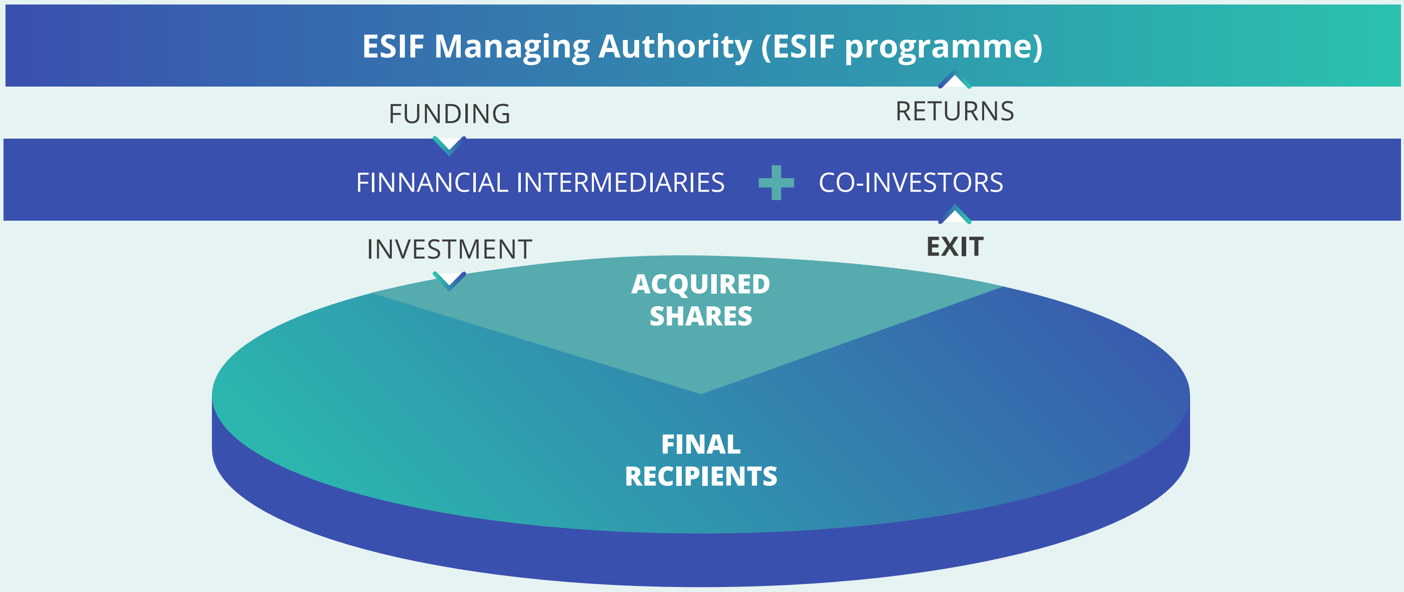
## CONS

**1.** The guarantee represents a risk reserve for the lender and does not provide liquidity. It can however, in some cases, provide capital relief to the lender.
**2.** Estimating the appropriate cap, or maximum limit, can be challenging.
**3.** There is no transfer of business expertise to FRs.

# EQUITY

**“Provision of capital to a firm, invested directly or indirectly in return for total or partial ownership of that firm and where the equity investor may assume some management control of the firm and may share the firm’s profits*”.**

## How does it work?




## TECHNICAL FEATURES

In equity investments the **exit** means the liquidation of holdings including a trade sale, sale by public offering (including IPO3), write-off, repayment of preference shares or loans, sale to another venture capitalist or sale to a financial institution. There is full insolvency **risk** for the invested capital in the target companies. Thus, a high risk is borne by the FI. However, this can be mitigated by portfolio investing and by having private sector co-investors.

### PROS

**1.** There are higher potential returns compared to pure debt instruments.
**2.** Stimulates investment by local private equity industry also in riskier areas not previously serviced.
**3.** The need for equity investment might prompt changes in regulatory framework to encourage a private equity market.
**4.** The company can benefit from investor’s management expertise.
**5.** Public investors can influence the configuration and mission of a company.

### CONS

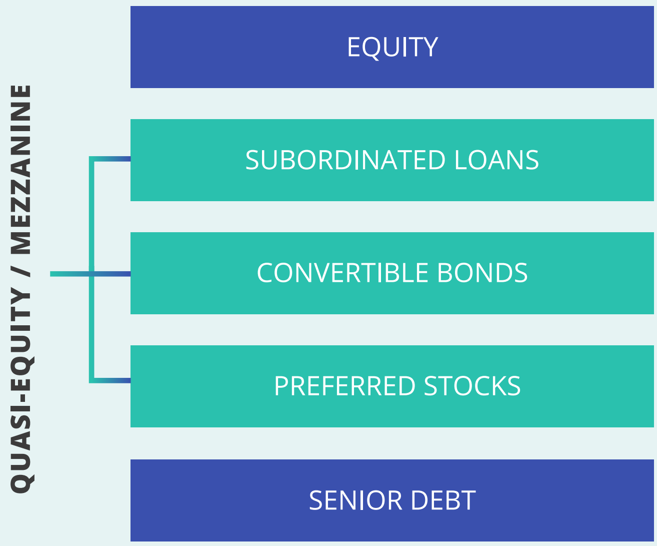
**1.** There is insolvency risk for all the invested capital.
**2.** Time-consuming and cost-intensive investment.
**3.** These investments are more difficult to administer than normal loans (high set-up and operational costs).
**4.** Short-term financing is not possible, since returns are feasible only in the long term.
**5.** Establishing the process for the investment can be challenging.
**6.** Compared to debt instruments, equity can be less atractive to FRs due to the obligation to yield control.

## QUASI-EQUITY

**"A type of financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity. Quasi-equity investments can be structured as debt, typically unsecured and subordinated and in some cases convertible into equity, or as preferred equity*".**

## How does it work?

### SUBCATEGORIES AND TYPES OF INVESTMENT




## NOTES

1. **Subordinated loans** have a lower repayment priority than normal (senior) loans. In the event of default, all other lenders are repaid before the holders of subordinated loans. Since the interest payments as well as the capital repayments are subordinated, the risk of loss in the event of default is substantially higher than for senior loans. In addition, generally, there is no collateral (security) required so interest rates are higher to cover the higher risks.

2. **Convertible bonds** are debt where the initial investment is structured as a debt claim, earning interest. At the discretion of the investor, the debt can be converted into equity at a predetermined conversion rate. A convertible bond is essentially a bond combined with a share option where the holder may exchange the bond for a predetermined number of shares at a predetermined price. Because convertibles can be changed into shares they have lower interest rates.

3. **Preferred stocks** are stocks that entitle the holder to a fixed-rate dividend, paid before any dividend is distributed to holders of ordinary shares. Holders of preferred stock also rank higher than ordinary shareholders in receiving proceeds from the liquidation of assets if a company is wound up.

# TECHNICAL FEATURES

The different forms of quasi-equity (also known as mezzanine capital or mezzanine finance) are classified as closer to equity or debt capital according to the level of ownership acquired and the exposure to loss in the event of insolvency. The risk profile will also change with the duration of capital commitment and the remuneration conditions.
In general, quasi-equity investments are more difficult to administer than classic debt instruments (loans and guarantees).

## PROS

**1.** For co-investors, there are higher returns compared to pure debt instruments.
**2.** Addresses specific risk capacity constraints in a particular market segment.
**3.** Stimulates investment by local private equity industry, also in riskier areas not previously serviced.
**4.** Might prompt changes in the regulatory framework to encourage a private equity market.

## CONS

**1.** These investments are more difficult to administer than normal loans (high set-up and operational costs), more time-consuming and cost more.
**2.** Short-term financing is not possible, since returns are feasible only in the long term.
**3.** Any ancillary services such as management expertise would be an expense for the company.
**4.** There are typically a low number of investors and FRs, while the investment amounts are high.
**5.** Compared to debt instruments they may be less attractive to FRs as they may involve loss of control when bonds are converted into equity.

## **OPERATIONAL** INSIGHTS

## **PORTFOLIO** CONSIDERATION

The ex-ante assessment will identify the most appropriate financial products to address the market gaps. This will also consider the **leverage effect** and **reinvestment** (revolving money). **Portfolio effects** should also be considered: overall risk can be reduced through appropriate diversification of FIs and the investments to be supported by them. In terms of cash flow, while **loans** are normally repaid providing steady cash flow, **guarantees** do not require immediate funding but may be called on later in the life of the fund. **Equity** is a longer term investment normally with minimal dividends in the early life of a company. Any pay-off from an '**exit**' is very difficult to determine at the time of investment and estimates will be **volatile** during the life of the fund. **Quasi-equity** returns will depend on the individual investment, which can have a high interest rate (for a subordinated loan), low interest rate (for a convertible bond) or no interest rate (for a silent partnership).

## **LEGAL** BASIS

Regulations for the 2014-2020 programming period reinforced the role of FIs, providing comprehensive provisions regarding the requirements and options for their implementation. This factsheet is concerned in particular by the following provisions:

**LEGAL BASIS**

Articles 2(11), 37-46, TITLE IV, REGULATION (EU) No 1303/2013 of 17 December 2013

Article 15, REGULATION (EU) No 1304/2013 of 17 December 2013

Article 45(5), REGULATION (EU) No 1305/2013 of 17 December 2013

Article 69(2), REGULATION (EU) No 508/2014 of 15 May 2014

Articles 4-13, Section II, COMMISSION DELEGATED REGULATION (EU) No 480/2014

Articles 6-8, Annex II, III, IV, COMMISSION IMPLEMENTING REGULATION (EU) No 964/2014

This document has been based on the fi-compass publication 'Financial Instrument products' and the META publication "What are the Financial Instruments under ESI Funds". The views expressed herein can in no way be taken to reflect the official opinion of Innova-FI consortium. Sole responsibility for the views, interpretations or conclusions contained in this document lies with the authors. No representation or warranty express or implied are given and no liability or responsibility is or will be accepted by Innova-FI in relation to the accuracy or completeness of the information contained in this document and any such liability or responsibility is expressly excluded. This document is provided for information only. Innova-FI will not give any undertaking to provide any additional information on this document or correct any inaccuracies contained therein.

www.interregeurope.eu/**innova-fi/**
alexandre.almeida@ani.pt
innova-fi
@Innova_FI
@Financial.Instruments.for.Innovation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