advancing with ESIF financial instruments

Financial Instrument products

Loans, guarantees, equity and quasi-equity

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Introduction

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.

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

This short reference guide is addressed to MAs, Financial Intermediaries (F.Ints), FRs and other stakeholders. It illustrates the key features and differences of the main **financial products** which may be offered by FIs, namely **loans, guarantees, equity and quasi-equity**. Each of these topics will be covered in the factsheet using the following order of contents:

FIs can support projects by providing **four** main financial products:

LOAN	GUARANTEE
"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.	***"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	**QUASI-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).	***"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 Financial Instruments – Glossary.	

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.

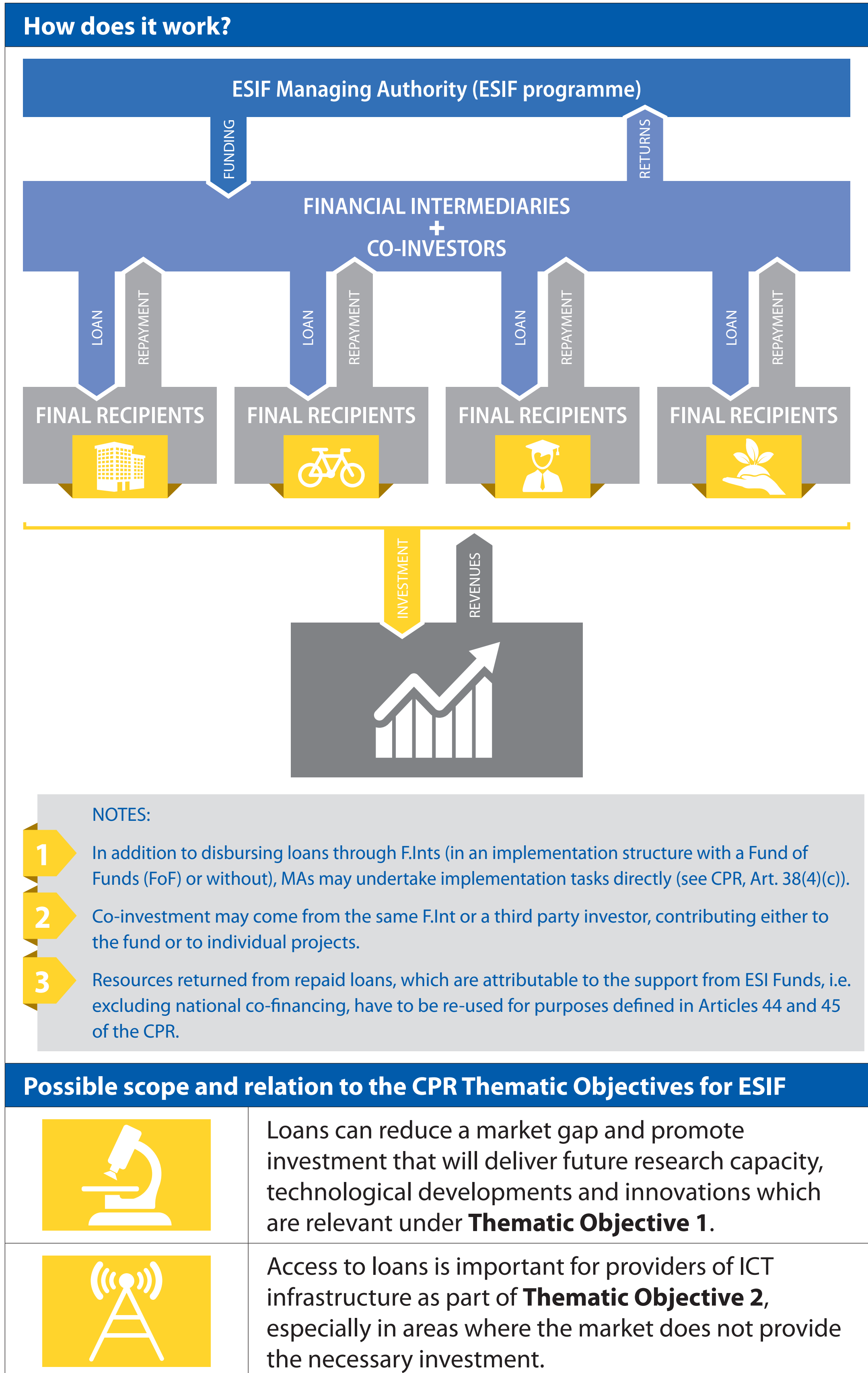
MAs can tailor financial products according to their needs and capabilities or structure the FI based on terms and conditions provided by the Commission for **'off-the-shelf'** instruments.

Off-the-shelf instruments

In accordance with Art. 38(3)(a) of the CPR (Common Provisions Regulation (EU) No 1303/2013 of the European Parliament and the Council of 17 December 2013), the MA can provide financial contributions to financial instruments complying with the standard terms and conditions for off-the-shelf FIs. The Commission has defined the following 'model' templates in Regulation (EU) No 964/2014 of the European Parliament and the Council of 11 September 2014:

1. ***Loan fund for SMEs based on a portfolio risk-sharing loan model (Risk Sharing Loan - RSL)***
   This is set up with contributions from the ESIF programme and additional resources of the F.Int to finance a portfolio of newly originated loans. The ESIF programme contribution and the additional resources provided by the F.Int bear, at any time, the losses and benefits in proportion to their contributions (pro-rata).
2. ***Guarantee fund for SMEs (Capped Guarantee Portfolio)***
   This provides credit risk protection in the form of a first loss portfolio capped guarantee which reduces the barriers that SMEs face in accessing finance. It leverages EU funds to support SME financing.
3. ***Loan fund for energy efficiency and renewable energy in the residential building sector (Renovation Loan)***
   The loan supports renovation works that implement energy efficiency or renewable energy measures, with a particular focus on multi-apartment residential buildings.

1 Loan



NOTES:

1. In addition to disbursing loans through F.Ints (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 F.Int 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.

Possible scope and relation to the CPR Thematic Objectives for ESIF

Loans can reduce a market gap and promote investment that will deliver future research capacity, technological developments and innovations which are relevant under **Thematic Objective 1**.

Access to loans is important for providers of ICT infrastructure as part of **Thematic Objective 2**, especially in areas where the market does not provide the necessary investment.

	Loans are often the most important external source of financing to help an undertaking to grow. Therefore loans are particularly suitable for **Thematic Objective 3**.
	Investments in energy efficiency are in many cases low risk and long-term, therefore loans are often very suitable for **Thematic Objective 4**. Supported measures may include partial refurbishment and deep renovation especially in the context of urban development.
	Environmental infrastructure under **Thematic Objective 6** can require significant funding, best supported by loans. As an example, investments in wastewater treatment may be partially supported by long-term loans.
	Under **Thematic Objective 7**, long-term loans could fund investment in urban transport infrastructure and rolling stock promoting sustainable transport.
	In order to support self-employment and small business creation, microcredit can be used in the framework of **Thematic Objective 8**.
	Microfinance can support minorities and marginalised communities with developing economic activities, thus promoting active inclusion under **Thematic Objective 9**.
	Student loans are particularly suitable given the flexibility and efficiency of the instrument. Loans can therefore encourage further education under **Thematic Objective 10**.

Subcategories and types of investment

Risk sharing loans are financed by both the ESIF programmes and additional resources provided by one or more F.Ints. Thus the same F.Int may be a fund manager and a co-investor. The losses, recoveries and benefits are borne and shared by the ESIF programme contribution and the additional resources provided by F.Ints in agreed proportion.
Very small loans (**microcredit**) are available for FRs who do not have access to credit, typically because they lack collateral and a credit history. These ***microcredits*** are normally less than EUR 25 000 and can finance micro enterprises in farming, commerce, handcraft, food, etc.

The **leverage** effect for loans depends on the resources co-invested in the fund in addition to ESI Funds.
For example, Estonia's project "Renovation of apartment buildings" had EUR 18 million in contributions from ERDF and EUR 49 million from public/private co-investors, resulting in a leverage effect of 3.8.
Hungarian loans implemented under "Combined Micro Credit and Grant schemes" with EUR 172 million from ERDF had a leverage effect of 1.3.
It is important to distinguish the leverage effect from the revolving effect when borrowers repay the loans and these funds can be reinvested in new projects.

Technical features

The involvement of ESI Funds results in loans that are offered at **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.

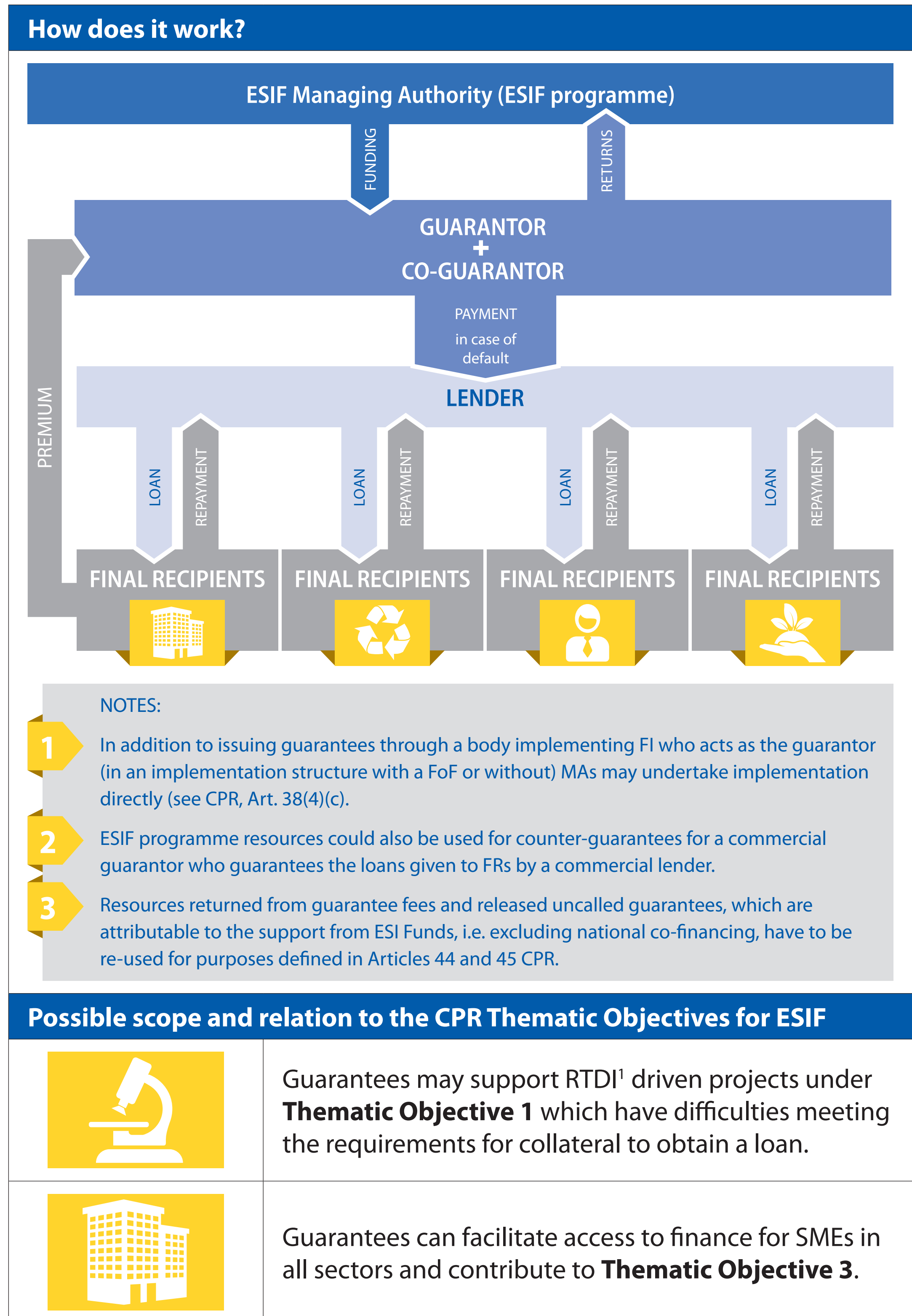
PROS	CONS
1. Not particularly difficult to administer (so there are limited management costs/fees). 2. A defined repayment schedule makes budgeting easier. 3. The lending mechanism is well understood, reducing the need for capacity building and the risk of misunderstandings. 4. Loans preserve the equity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

Example: Mecklenburg-Vorpommern

Mecklenburg-Vorpommern, in the North German Plain, is the least densely populated of all the German federal states. In 2013, the 1.6 million inhabitants of Mecklenburg-Vorpommern had a GDP of EUR 37.1 billion. The main enterprises are in the health care sector, followed by motor vehicles and manufacturing. The most important industrial sector in the state is the food industry which generates more than a third of manufacturing turnover. Because of its coastal location, Mecklenburg-Vorpommern has a significant maritime economy, with fishing and fish-farming, shipbuilding, maritime transport and port services.

In the 2007-2013 programming period Mecklenburg-Vorpommern established three loan funds: 1) for SMEs unable to obtain credit from the private market; 2) for all enterprises to finance investments under the German regional aid framework; and 3) to provide credit for private enterprises and local public authorities in order to invest in energy efficiency and renewable energy projects. Grants and loans were used in combination to address the specific needs of the targeted FRs.
Given the experiences of 2007–2013 and persisting market gap, a fund for financing SMEs is to be established in the 2014-2020 period.

2 Guarantee



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 re-used for purposes defined in Articles 44 and 45 CPR.

Possible scope and relation to the CPR Thematic Objectives for ESIF

Guarantees may support RTDI[1] driven projects under **Thematic Objective 1** which have difficulties meeting the requirements for collateral to obtain a loan.

Guarantees can facilitate access to finance for SMEs in all sectors and contribute to **Thematic Objective 3**.

1 RTDI - Research, Technology Development and Innovation

	This instrument, under **Thematic Objective 4**, can be used to facilitate investments in small scale renewables through better interest rates on their debts and hence providing access to funding at an acceptable cost.
	Under **Thematic Objective 6** a guarantee for a commercial loan could boost investments in the areas of bio-economy, resource efficiency or green infrastructures.
	Young entrepreneurs that lack the necessary financial backing may be supported through guarantees, promoting employment and labour mobility under **Thematic Objective 8**.
	Under **Thematic Objective 9**, guarantees may support individuals involved in creating new ventures for social purposes, who lack the collateral to obtain the necessary finance.

Subcategories and types of investment

The guarantor issues a **direct guarantee** for an agreed amount of debt to cover the losses of the lender in the event that the FR does not repay the debt. Guarantees may be capped only on a loan-by-loan basis to ensure that the lender bears some risk[2] (e.g. a **guarantee rate** of 70% would mean that 70% of the loss incurred due to a loan default will be covered by the guarantor). The guarantees may also be capped at the level of the loan portfolio (e.g. a **cap** of 20% at the portfolio level would mean that losses incurred due to default of individual loans may be covered until their aggregate value reaches 20% of the total loan portfolio value) therefore limiting the total exposure to losses.

A **first loss default/portfolio guarantee** is a guarantee where first the guarantor covers the losses of a loan portfolio until the cap is reached. Therefore the lender is exposed to losses greater than the capped amount of the guarantee, rather than both lender and guarantor sharing the risks of every default in proportion.

An **uncapped guarantee** is a guarantee where no cap at portfolio level is foreseen. According to capital adequacy requirements in force, this guarantee can reduce the capital required for the lending bank.

A **capped guarantee** would indemnify the lender up to a pre-defined percentage or amount of the loan and for the portfolio in default.

Counter guarantees allow a guarantor to seek reimbursement if they have to pay a claim under a guarantee they issued for a loan in default.

2 *This is also required by the State aid legal framework (where applicable)*

The **multiplier** is the ratio between the amount of programme resources set aside to cover expected and unexpected losses from new loans to be covered by the guarantees and the total amount of new loans disbursed to FRs. The multiplier shall be established on the basis of a prudent ex-ante risk assessment for the specific guarantee product taking into account the specific market conditions, the investment strategy of the financial instrument and the principles of economy and efficiency, amongst others.

For example, a multiplier of 4 means the fund can provide 4 times that amount in loans.
Bulgaria's First Loss Portfolio Guarantee had a multiplier of 5. Similarly, Rural Credit Guarantee Fund of Romania resulted in programme multiplier of 3.6. The leverage effect, which takes into account the ESI Fund contribution only for these two cases was higher at 5.9 and 4.6 respectively.
The **revolving** effect of guarantees depends on the individual contract. For normal loan guarantees, repayments of the loan then release that proportion of the guarantee and free up this amount for reinvestment.

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 OP resources.

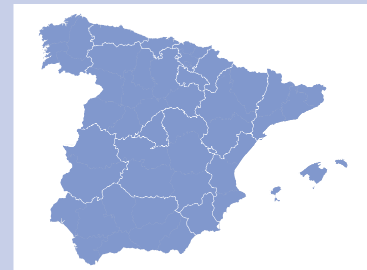
Other important elements for the definition of a guarantee are:

- ***Eligibility criteria***: conditions which regulate the access to the guarantee regarding three layers: FR, F.Int and the relevant underlying transactions. A breach of any of the eligibility criteria will result in an exclusion of the underlying transaction from the portfolio.
- ***Timing***: termination of the guarantee.
- ***Payment claim***: conditions under which payment demands are valid (e.g. losses incurred by a lender in respect to defaulted loans).
- ***Loss recoveries***: the F.Int should take recovery action in relation to each defaulted loan.
- ***Responsibilities for managing the repayments due and collateral of defaulting borrowers***: what happens to funds recovered after a complete or partial default has been accepted.

PROS	CONS
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.	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.

Example: Spain

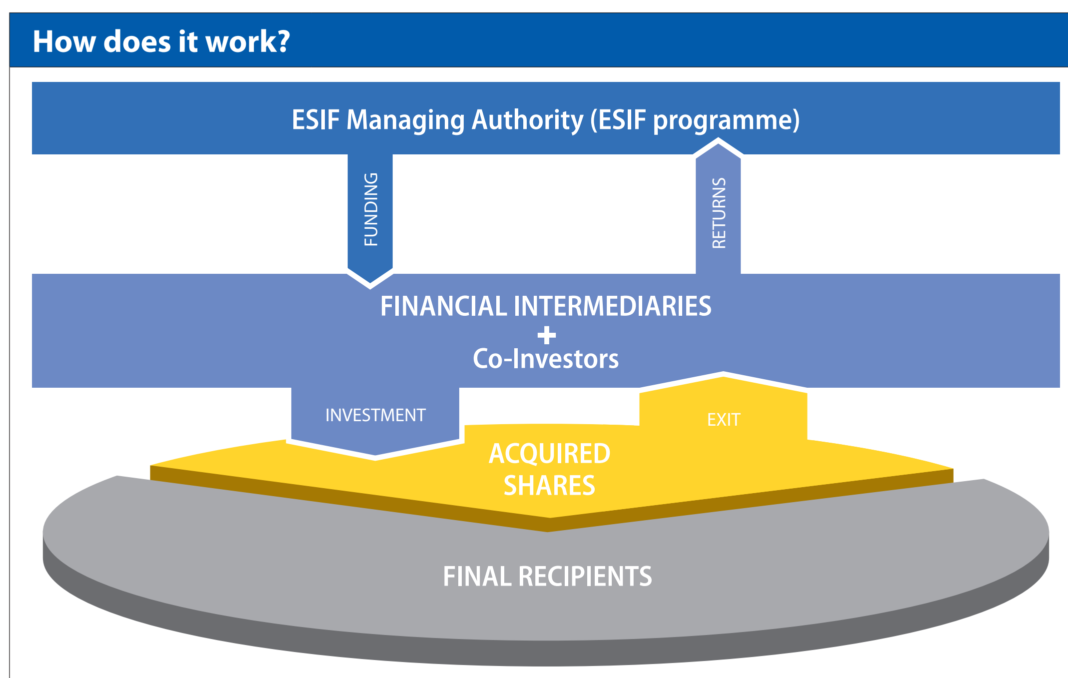
Spain's business structure is highly fragmented with many small enterprises, to the extent that 8 out of 10 companies have 1 or 2 employees. While most small enterprises are in the services sector and particularly in trade, the bulk of large enterprises are concentrated in the industrial sector, with a strong international presence in sectors such as infrastructure development, renewable energy, tourism, banking, insurance, textiles, healthcare and aeronautics.



Regional authorities and the central government have a tradition of using FIs, which are mostly managed by the regional development agencies. For example, in the programming period 2007-2013, JEREMIE Barcelona supported more than 1 800 small enterprises through guarantees.

3 Equity

How does it work?



Possible scope and relation to the CPR Thematic Objectives for ESIF

	Equity can support undertakings to cover expenses from preliminary activities such as product research and development (R&D) until a product or service can start generating revenues under **Thematic Objective 1**.
	Enhancing access to and the use and quality of ICT, as under **Thematic Objective 2**, can benefit from establishing public-private partnerships for local broadband networks.
	Equity financing suits the development requirements of many SMEs, from innovative to traditional, in all their phases under **Thematic Objective 3**.
	New and growing green economy enterprises in energy efficiency, renewable energy, environmental protection and the promotion of sustainable urban development under **Thematic Objective 4** are likely to require equity financing.
	Public contribution in the form of equity financing in revenue generating transport infrastructure projects can stimulate private equity investors and lead to a better alignment of interest between public and private sides in the area of **Thematic Objective 7**.
	Under **Thematic Objective 9**, seed equity can support social enterprises, helping to deliver high quality services of general interest.

Subcategories and types of investment

The types of equity investment normally depend on the stage of a company's development (new vs. mature) and on the investment model (co-investor in the fund portfolio or in individual investments, on a deal-by-deal basis).
Investments are often described by the relevant phase, starting with **Pre-seed**, then **Early stage** which includes **Seed** and **Start-up**, followed by **Growth** and **Expansion**. Investment in **newly established enterprises can** finance the study and development of a concept or prototype. Given the unproven business models of new enterprises, these investments are often needed to pursue strategic developments, complementary technology or new opportunities for the firm. Targeted enterprises are generally **high tech** (biotech, ICT, hi-tech energy, nanotechnology, applied mechanics, robotics, etc.) or pursuing innovative products or services with expensive **R&D** projects. **Mature companies** with proven business models may need equity investment to fund new projects, including the penetration of new markets**.**
In relation to the investment model, a typical 'deal-by-deal' investor is a **Business Angel.** This is normally an individual with business experience, who invests their personal assets and provides management experience at the very early stage of a company. **Venture Capital** is similar, investing their own capital and providing business and management assistance.
The **rationale** behind more risky investments is the expectation of higher than average returns. These investments can be time-consuming and cost-intensive (due diligence is carried out for several potential business plans before investment). Typically there are few target firms and large amounts in each transaction.

A German Technology Start-up Fund in Saxony had a leverage effect of 3 for the ERDF.
Funds can **revolve** once the investment has been sold, which implies this will typically occur later in the lifetime of the fund than for loans or guarantees.

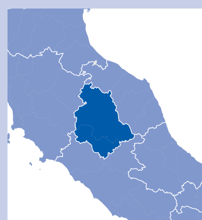
Technical features

In equity investments the **exit** means the liquidation of holdings including a trade sale, sale by public offering (including IPO[3]), 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.

3 Initial Public Offering

PROS	CONS
1. There are higher potential returns compared to pure debt instruments. 2. There is an active role in project management and access to share-holder information for the investor. 3. Stimulates investment by local private equity industry also in riskier areas not previously serviced. 4. The need for equity investment might prompt changes in regulatory framework to encourage a private equity market. 5. The company can benefit from investor's management expertise. 6. Public investors can influence the configuration and mission of a company.	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), more time-consuming and cost-intensive. 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 attractive to FRs due to the obligation to yield control.

Example: Umbria



Umbria is a region in central Italy with strengths such as well-qualified human capital, important universities and innovative services but also weaknesses such as a low level of private research and development (R&D) investment. The region has a combination of large enterprises and clusters of SMEs. Industrial specialisation includes steel and machinery around Terni; textiles, leather and clothing in Perugia; and agri-food in the Tiber area. Tourism also plays an important role.

The region hosts four poles of excellence operating in energy; genomics, genetics and biology; advanced mechanics and mechatronics; advanced materials, micro and nano-technologies. These clusters form a wide network of small and large enterprises which collaborate with the main public research bodies in Umbria. ***The poles of excellence can potentially generate high tech new enterprises if adequately supported by private investment****. Positive results have been achieved in the 2007-2013 programming period by allocating EUR13.2 million to an equity FI supporting SMEs. Management is assigned to the in-house body of the Region, 'GEPAFIN', which supports the investment projects of SMEs with financial assistance and management consulting. Building on this successful experience, in the 2014-2020 programming period, a venture capital investment is going to be set up with 50% public investment. The venture capital will target innovative start-ups.*

4 Quasi-Equity

Subcategories and types of investment

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.

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.

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. ***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

In general quasi-equity investments are more difficult to administer than classic debt instruments (loans and guarantees).

PROS	CONS
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.	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.

5 Synopsis

Pros and Cons for MAs

Loans	Guarantees	Equity	Quasi-Equity
• Address specific risk capacity constraints in a given market segment • Large scale instrument: could address a relatively high number of FRs • Limited management costs • Provide a defined repayment schedule • Mechanism is generally well understood by all parties involved • Since loans usually are repaid continuously, the money can quickly be reinvested in other projects	• High leverage effect • Addresses specific risk capacity constraints in a given market segment • Can form part of a broader strategy to increase lending to risky projects • Disbursement only in the event of default • Unfunded products such as guarantees require less initial resources than funded products such as loans • In comparison with the provision of loans with the same financial obligation, the management costs are lower • Large scale instrument: could address a relatively high number of FRs	• High level of returns are possible • Stimulates investment by local private equity industry also in riskier areas not previously serviced • Influence on the policy of the FR through the investment strategy • Could attract external investors • The need for equity investment might prompt changes in regulatory framework to encourage a private equity market	• Addresses specific liquidity and risk capacity constraints in a given market segment • Compared to normal loans, higher level of returns • Stimulates investment by local private equity industry also in riskier areas not previously serviced • Quasi-equity might prompt changes in the regulatory framework to encourage a private equity market

Loans	Guarantees	Equity	Quasi-Equity
• Expected returns are lower than for other FIs (equity in particular) • Funded products such as loans require more initial resources than unfunded products such as guarantees • In comparison with guarantees for the same financial obligation, both the investment risk and the management costs are higher • It is sometimes difficult to establish the probability of default, especially with a lack of FR history • F.Int counterparty risk needs to be carefully assessed	• The guarantee only represents a risk reserve for the lender and does not provide liquidity • Revolving effect is slower than for loans as money set aside for guarantees cannot be reused until repayment is ensured • Estimating the appropriate cap, or maximum limit, can be challenging	• Time-consuming and cost-intensive investment • Short-term financing is not possible • Full insolvency risk • High set-up and operational costs • Typically low number of investors and FRs and high investment amounts • Some regions/areas lack critical mass/ good quality deal-flow, experienced venture capitalists, and exit opportunities • Lack of sufficient know-how and infrastructure to exploit R&D results • Assessment of venture capital and private equity proposals is essential • Can only address a few selected FRs • Fundraising of private resources can be challenging, particularly for first-time venture capitalists • Slow revolving effect, as money cannot be reused until exits have been completed	• Time-consuming and cost-intensive investment • Short-term financing is not possible • Full insolvency risk • High set-up and operational costs • Assessment of quasi-equity providers' proposals is essential • Can only address a few selected FRs • Fund-raising of private resources can be challenging

Pros and Cons for F.Ints and other co-investors

	Loans	Guarantees	Equity	Quasi-equity
Pros	• Opportunity to provide new loans with reduced capital requirements and reach new client/ borrower • Attractiveness due to the universality of potential FRs	• Reduces investment risk for third party lenders • Management costs are lower • New loans with reduced risk for lenders • Recycling of funds for use by more FRs	• Active role in project management and access to shareholder information • Managers/owners are motivated to invest wisely	• Normal loan, higher level of returns
Cons	• Expected return of individual investments lower than for other FIs (equities in particular)	• Possible additional income from fees • Complex administration for the recovery of assets in the event of default	• Full insolvency risk when co-investing • Establishing the price for the investment can be challenging	• Full insolvency risk when co-investing • Establishing the price for the investment can be challenging

Pros and Cons for FRs

	Loans	Guarantees	Equity	Quasi-equity
	• Increase debt-to-equity ratios, enhancing returns to FRs • Equity is preserved as no claim on the ownership of the enterprise • Very limited know-how transfer to FR	• Reduces the risk premium • Potential benefits for FRs could include *inter alia* lower or no guarantee fees and lower collateral requirements • Increase debt-to-equity ratios, enhancing returns to FRs • Equity is preserved as no claim on the ownership of the enterprise	• No collateral to be provided • Provision of management expertise to FRs • Can access a wider network through involvement of venture capital investor	• Benefit of increased capitalisation with limited debt exposure and property risk
	• Interest is payable, regardless of results • Security can be required, up to the value of the loan itself	• Very limited know-how transfer to FR	• FRs can be less attracted by equity due to the obligation to transfer/yield control • Strong financial discipline required • Sharing the profits (on realising the investment)	• FRs can be less attracted by equity due to the obligation to transfer/yield control when the convertible bonds are translated into equity • Any ancillary services such as management expertise would be an expense for the company

6 Operational Insights

6.1 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).

6.2 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

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