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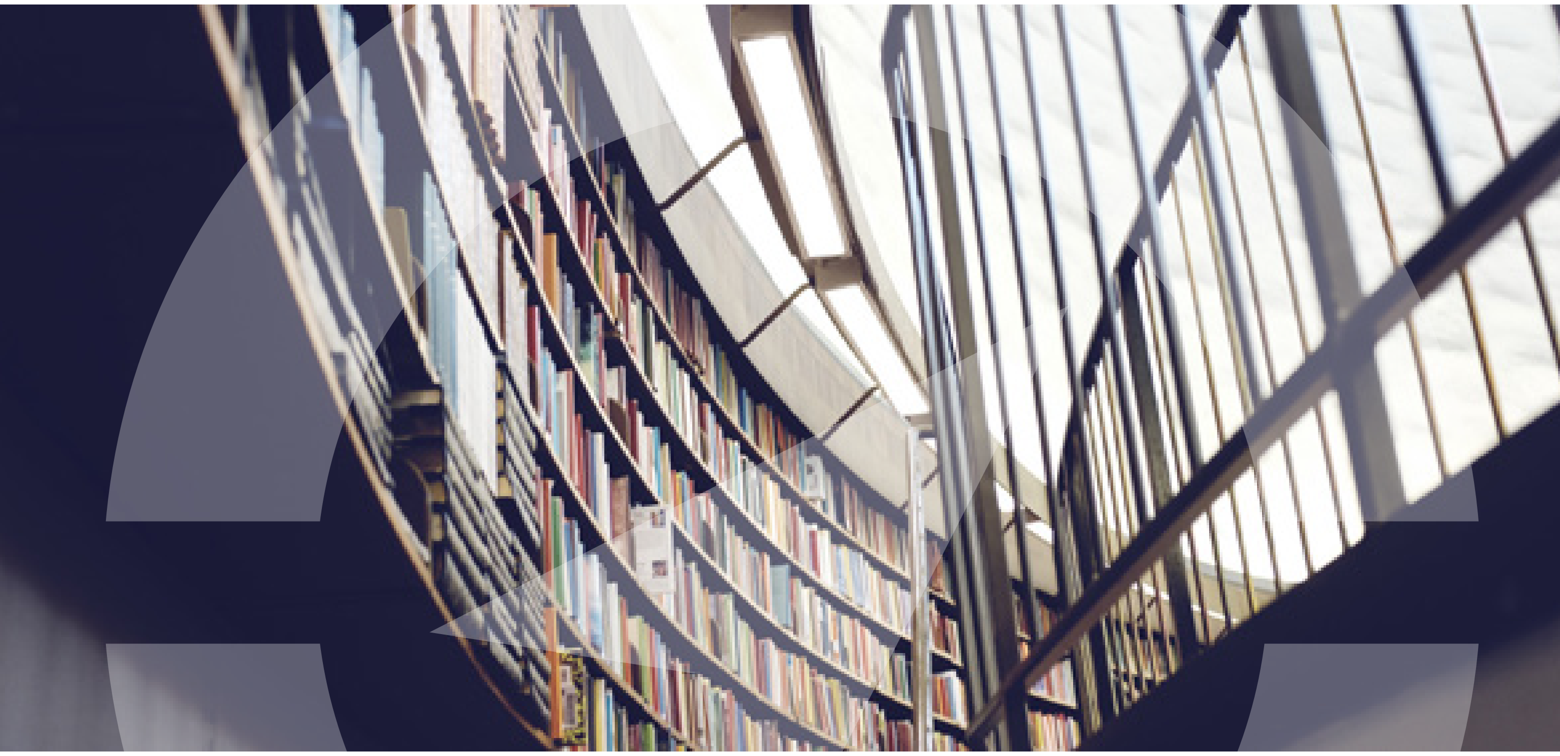
advancing with ESIF financial instruments



Introducing financial instruments for the European Social Fund

European Commission

European Investment Bank
The EU bank

DISCLAIMER

TABLE OF CONTENTS

Introduction

Scope and purpose of this handbook

This handbook gives an **overview** of the scope for financial instruments to promote inclusion, sustainable jobs and better education.

It helps managing authorities and European Social Fund (ESF) stakeholders to understand the potential offered by financial instruments to leverage and increase the effectiveness and efficiency of ESF programmes to achieve specific objectives and investment priorities.

Further, this reference guide also **targets** financial intermediaries both:

- traditional, such as banks and credit or capital institutions and;
- non-bank, such as NGOs and foundations, equity fund providers, specialised microfinance and community development financial institutions, as well as government bodies and institutions.

The handbook shows **what** a financial instrument is and the difference to other policy tools. It describes **why** financial instruments are relevant for the ESF and what they can be directed towards. It also provides a preliminary description of **how** and **who** can implement financial instruments, as well as **what** the main financial products are.

More information including EC guidance and fi-compass products is available on
www.fi-compass.eu

Structure of the handbook

What is a financial instrument? Main differences and advantages in relation to other forms of support. Main components and features in relation to the ESF ecosystem.	**Chapter 1**
Why are financial instruments relevant for ESF? Financial instruments on the wider prospective of social investment impact. The relevance and applicability in relation to thematic objectives 8, 9 and 10.	**Chapter 2**
Who is the financial instrument for? The target categories of financial instruments when working for ESF.	**Chapter 3**
How to manage and implement financial instruments? Key steps in the life cycle, governance and implementation options, and EaSI.	**Chapter 4**
Who implements financial instruments? The different types of financial intermediaries.	**Chapter 5**
What are the main financial products? Loans, guarantees, equity and quasi-equity and the main characteristics of microfinance.	**Chapter 6**

1. WHAT IS A FINANCIAL INSTRUMENT?

KEY MESSAGE

This chapter describes the basics and main features of financial instruments:

- a definition of financial instruments with the revolving and leverage effects;
- the life cycle and main financial products;
- financial instruments in relation to ESF: the key actors.

1.1 Definition and advantages of financial instruments

Financial instruments co-funded by the ESF were first introduced under Cohesion Policy in the 2000-2006 programming period. They are a sustainable and efficient way to invest in the growth and development of both individuals and enterprises. The EC glossary[1] definition is:

"Union measures of financial support provided on a complementary basis from the budget to address one or more specific policy objectives of the Union. 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".

Financial instruments have two major advantages:

LEVERAGE: they can attract additional resources, both public and private. Thus, leverage "is the sum of the amount of ESIF funding and of the additional public and private resources raised divided by the nominal amount of the ESI Funds contribution[2]".

REVOLVING: it is the capacity of the financial instrument to generate additional flows of money – either through repayments or through the realisation of investments – with the objective of further reutilisation. This revolving nature allows public authorities to benefit from increased resources.

1 Guidance for Member States on Financial Instruments – Glossary, https://www.fi-compass.eu/publication/ec-regulatory-guidance-guidance-member-states-financial-instruments-glossary

2 *Ibidem*, p.4.

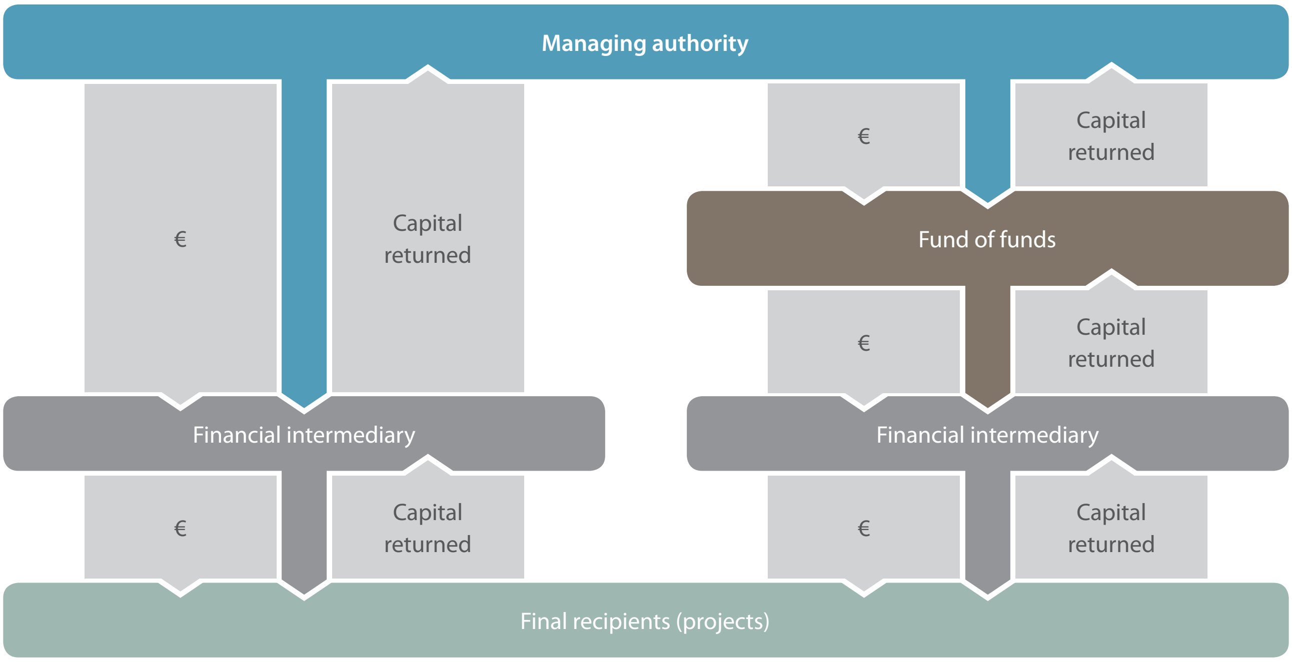
Contrary to grants, financial instruments have lower fundraising costs and can encourage greater entrepreneurial flexibility. Moreover, financial instruments are expected to generate leverage effects so that more resources are available to produce a greater impact on the local society and economy.

Other than providing financial support in a period of financial constraint by mitigating social and economic exclusion, financial instruments may also be more tailored to the needs of final recipients. Moreover, by requiring revenue generation, final recipients are more responsible in their use of financial resources provided by the ESF.

Major advantages of financial instruments are[3]:

- Leverage of resources and increase in the impact of ESF programmes;
- Efficiency and effectiveness due to the revolving funds, which stay in the programme area to be used for similar objectives;
- Increased quality of projects as the investment must generate revenue;
- Access to a wider spectrum of financial tools for policy delivery and to private sector expertise;
- Private sector support and financing for public policy objectives.

Figure 1.1: The revolving nature of the financial instrument



Source: EC (2014), '*Ex ante assessment guidance*'

Of course, for much social intervention grants are still necessary and financial instruments are complementary tools. Furthermore, the proper use of financial instruments requires a considerable rethink of the role of public budgets, the optimum legal framework and qualified expertise for proper assessments. There is a risk that opportunities are lost due to poor financial instrument design, leading to little usage or limited impact.[4]

3 EC (2014), *'Financial instruments in ESIF programme 2014-2020 – A short reference guide for managing authorities'*.

4 Committee of the Regions (2015), '*Financial instruments in support of territorial development*'.

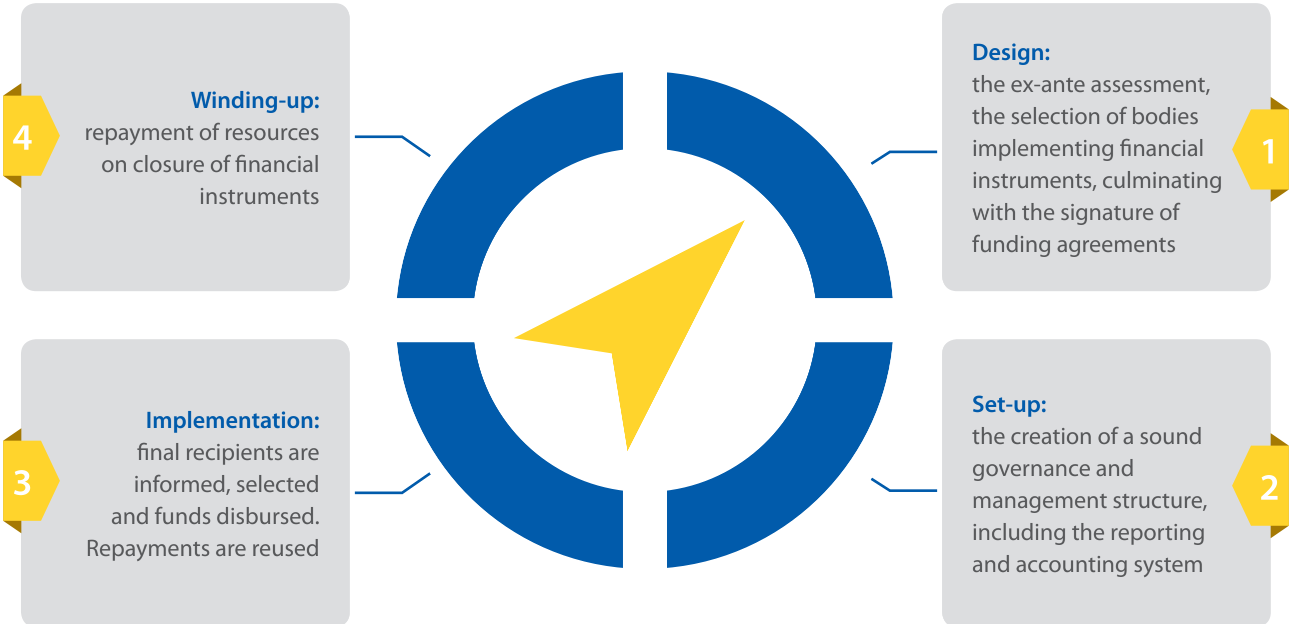
When managing authorities decide to adopt policies addressing social needs through financial instruments, they should consider:

- The complexity of the **social investment ecosystem** which can be minimised by understanding the system and by efficiently shaping financial products to address the specific needs of final recipients;
- The **financial instrument's life cycle** and related support to ensure a comprehensive and efficient strategy addressing the market gaps and encouraging national, regional and/or private co-investors to contribute funding and expertise;
- Stimulating local capabilities to ensure continued development of the local economy.

1.2 Key features of financial instruments

This section briefly introduces some of the main aspects of the financial instruments, concerning the life cycle and the financial products, which will be then analysed in detail in Chapter 4 and 6 respectively. The financial instruments have their own specific **life cycle**, as displayed in the figure below. Each phase is crucial and interconnected with adjacent phases, so they should be considered simultaneously when designing the financial instruments, rather than separately and in sequence[5].

Figure 1.2: Financial instrument life cycle



The life cycle remains the same for all types of financial instruments and related financial products. The choice of financial instrument will depend on the market failures, suboptimal investment situations and investment needs as well as the acceptable level of risk, reward and ownership. Management costs, fees and legal conditions also vary with each financial instrument. Managing authorities must therefore tailor financial products according to final recipients' needs and take into account the capabilities and structure of financial intermediaries.

The ex-ante assessment should identify the most appropriate financial products to address the market gaps. A managing authority with existing investments, or one implementing several financial instruments, should consider

5 *'Appendix 1: financial instruments guide: setting up and implementing financial instruments'* in EC (2013), *'Strategic UDF investing and project structuring'.*

the portfolio effects of individual financial instruments. Overall risk can be reduced with a spread of investments including different financial products, final recipients, terms and conditions.

The main **financial products** offered by financial instruments are loans, guarantees, equity and quasi-equity[6].

LOAN	GUARANTEE
"An 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".	*"A 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".*
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".	*"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".*

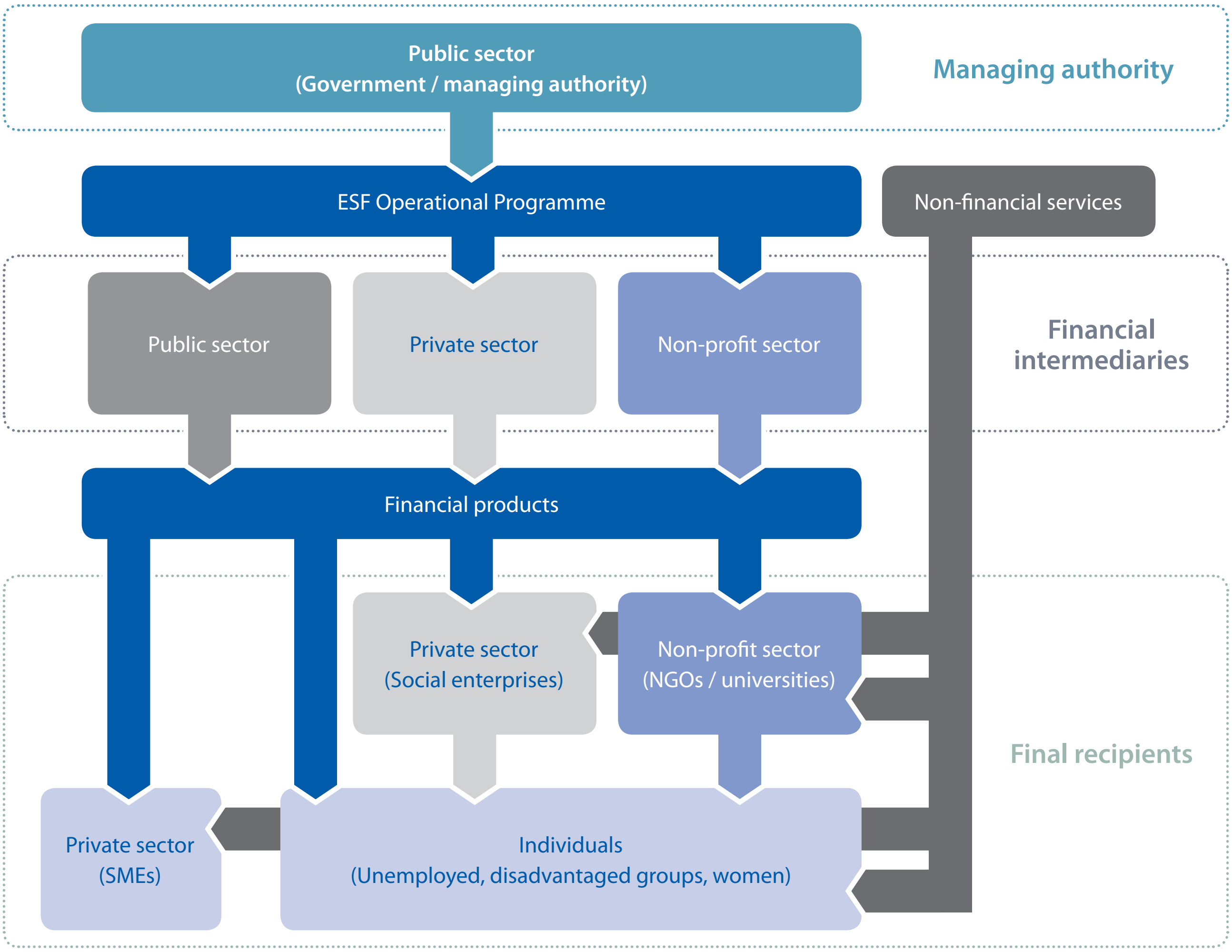
1.3 The specificity of ESF financial instruments

In the ESF context, financial instruments can be viewed as the provision of finance to an organisation, enterprise or individual with the expectation of both social and financial returns[7]. This ecosystem involves a wide range of actors, final recipients, investors and financial intermediaries as well as policy makers.

6 Definitions according to European Commission (2015), *'Guidance for Member States on financial instruments – Glossary'.*

7 OECD (2015), *'Social impact investment – Building the evidence base'.*

Figure 1.3: The main actors involved in financial instruments



The investment ecosystem includes[8]:

- **The public sector** (national, regional, and local governments), which develops and designs programmes and strategies to address social needs, while promoting an entrepreneurial environment and favouring links between other key local stakeholders. Financial instruments co-financed under the ESF can play an important role in supporting public policies to combat social exclusion, reducing gaps in public resources and generating savings. Public institutions are therefore crucial in the design of ESF programmes and in implementing financial instruments, especially with the provision of non-financial services, when addressing ESF investment priorities. The public sector can also act as financial intermediary (for example, government agencies providing finance).
- **The private sector** (entrepreneurs, banks, investors, small and medium-sized companies – SMEs), can also play a significant role in supporting social policies and programmes. SMEs can be either final recipients, or a vehicle to address individual social needs, such as a social enterprise. Banks and investors may use social investments to acquire new customers and suppliers, as well as to explore innovative services and new products.
- **The non-profit sector** (NGOs, universities, foundations) acts as pioneer and advisor in social investment. It can provide direct and financial support for programmes addressing social needs. It can have close contact with the target groups, as well as valuable hands-on experience and knowledge of social issues. Moreover, it can contribute with innovative pilot projects and schemes as well as by disseminating best practices.

8 ILO (2006), *'Stimulating youth entrepreneurship: barriers and incentives to enterprise start-ups by young people'*.

2. WHY USE FINANCIAL INSTRUMENTS IN ESF PROGRAMMES?

KEY MESSAGE

This section describes the main reasons justifying the use of the financial instruments in ESF programmes by:

- providing an overview of the advantages of using financial instruments;
- describing the main characteristics of social impact investment and how these can fit the ESF;
- providing information on how financial instruments can match ESF thematic objectives.

2.1 Financial instrument value added

It is important to understand how financial instruments can fit in the framework of ESF programmes and add value. This is a technical, but also a prospective issue. Traditionally 'social' and 'financial' dimensions are perceived as conflicting if not opposing. Investments in social capital are expected to have negative financial returns while investments creating financial value would not take into consideration the social dimension[9]. This 'trade off' is well known and seen by those who work in ESF programmes. It is difficult to apply a 'rate of financial return' or 'net present value' when dealing, for example, with the inclusion of migrants in a depressed urban context.

There is an increasing need to improve the efficiency and effectiveness of public policies since challenges are even more demanding and, at the same time, public budgets are under pressure. Microenterprises have considerably more problems accessing finance than other enterprises. Obtaining finance appears to be more difficult for vulnerable groups such as ethnic minorities or female entrepreneurs. Finally, the financial crisis harmed poorly educated persons more than the well-educated and also threatened the governments' capacity to invest in education and skills enhancement.

Financial instruments may represent an opportunity for public actors to increase the available resources and their capacity to address new social challenges, since they are:

- revolving, i.e. with repaid funds being used again;
- suitable for financially viable projects, i.e. those which generate income or savings to repay the support;
- designed to attract co-investment, including private investment, to increase the available funds;
- also able to support supply-side development, by contributing to market development.

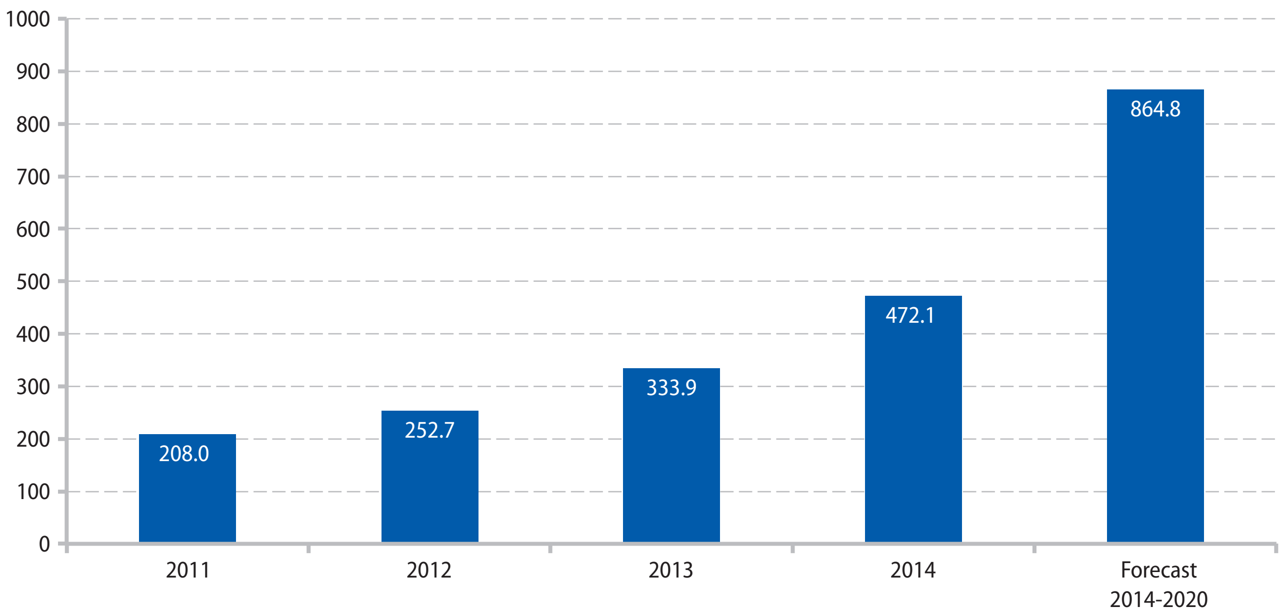
9 Jed Emerson (2000), '*The Nature of Returns: A Social Capital Markets Inquiry into Elements of Investment and The Blended Value Proposition*', Social Enterprise Series1, No. 17 Harvard Business School.

For social policy, financial instruments can impact beyond the financial aspect. They can:

- provide 'financial citizenship' to disadvantaged people. Typical ESF target groups often acquire financial services through an informal relationship, which might be inefficient and even dangerous. Financial instruments instead (e.g. microfinance) can bring 'financial citizenship' to these people;
- encourage self-sufficiency and entrepreneurship. Financial instruments give their 'clients' capital to get plans off the ground and produce revenue. They should continue to produce revenue after the loans have been repaid;
- improve living conditions. Microfinance can give unprivileged people capital stability, including financial security in the face of sudden monetary problems, combatting poverty and fostering social change;
- empower social services. Financial instruments can support services in key sectors such as health, employment, education, housing and family services. According to the OECD, "*integration practices are gathering momentum*" since financial instruments provide additional resources and also foster "*solutions to the specific challenges of working in complex governance settings*"[10].

These general and social advantages are not completely new. However, only 53 financial instruments, almost all supporting SMEs[11], were implemented by ESF programmes in the 2007-2013 programming period across 7 Member States. Furthermore, the majority of Member States did not use financial instruments to deliver ESF interventions. This modest take up indicated that ESF stakeholders lack experience in using these instruments. But apart from the technical competence, there is also a difficulty in seeing financial instruments in the framework of social investment. However, the provision of financial instruments in the 2014-2020 programming period is encouraging, with a doubling of resources delivered through financial instruments under the ESF programmes.

Figure 2.1: Cumulative ESF Operational Programme amounts paid to financial instruments (EUR million)



Source: DG Employment, Social Affairs and Inclusion (2015)

10 OECD (2015), '*Social impact investment – Building the evidence base*', p.22.

11 fi-compass, (2015), *'The European Social Fund – Financial Instruments'*

2.2 Social impact investment

It is useful also to understand the potential use of financial instruments in a different way. This new prospective can be offered by the paradigm of "**social impact investment**" which has become increasingly important in recent decades. It has been codified and defined internationally and supported by an increasing number of national governments, the European Union (EU) and international organisations.

Social impact investment has been developed in different national and international contexts (e.g. OECD, G8, G20) as "*the provision of finance to organisations addressing social needs with the explicit expectation of a measurable social, as well as financial return*"[12].

2.1 MORE INFO

The social impact investment paradigm and its main elements

In the last decade, social impact investment catalysed a convergence of opinion in public and private sectors. More than 1 200 asset managers dealing with EUR 41 trillion have subscribed to the UN "principle for socially responsible investment". A growing ecosystem related to social impact investment is emerging, with a range of private intermediaries and investors committed to addressing social needs including Venture Philanthropy, Community Debt Financing, Community Development Equity, Social Venture Capital, Socially Responsible Investment Funds and Traditional Capital Institutions. In 2014, the 125 leading impact investors were forecast to increase their investment by nearly 20%. In this scenario, foundations, social enterprises, NGOs, philanthropic associations and non-profit associations become more aware of the potential and increasingly play a crucial role.

The main elements of social impact investment are:

- **Social needs**. The social impact investment primary objective and starting point is to tackle social needs which range from ageing to disability, from health to children and families, affordable housing, unemployment, etc.;
- **Demand**. Service delivery organisations play a decisive role in addressing social needs. They include community organisations, charities, non-profit organisations, social enterprise, and social impact-driven businesses. Individuals, disadvantaged or not, can be seen as 'potential' beneficiaries;
- **Supply**. Social impact investors vary, in addition to government and public institutions there are foundations, high net worth individuals, philanthropists, banks and other financial institutions;
- **Intermediaries**. Commercial banks, investment banks, independent financial advisors, brokers and dealers play a pivotal role in developing social impact investment;
- **Enabling environment**. This includes social systems, tax and regulation.

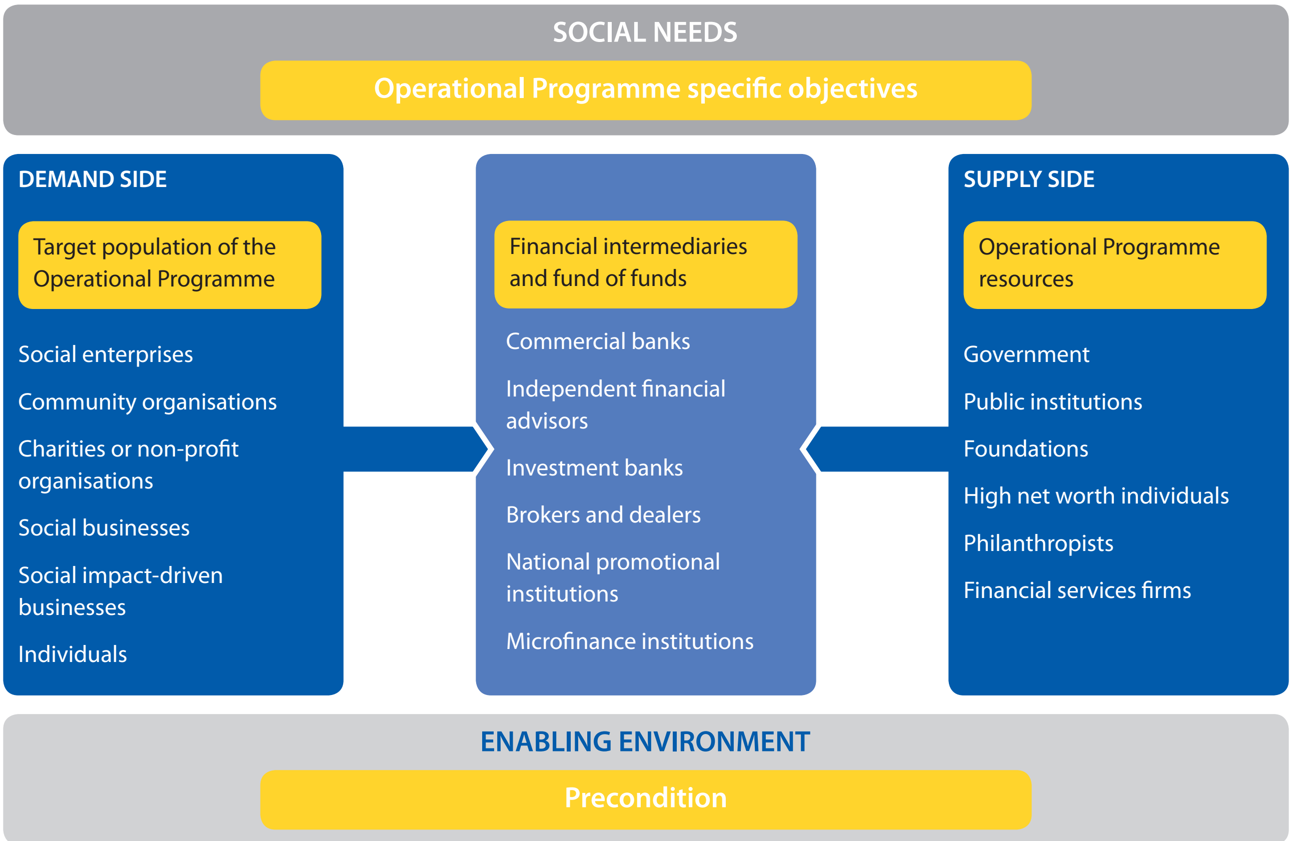
12 *Ibidem*, p.10.

Social impact investment is easily adaptable to ESF programmes and can use financial instruments to deliver ESF policy actions:

- **The needs** of social impact investment are similar to those in the programme strategy, the priority axis and the thematic and specific objectives;
- Programme resources become part of the **supply side**. The **demand** comes from target final recipients described in the programme actions;
- **Enabling conditions** are, in the language of Cohesion Policy, the key elements in the ex-ante conditionality. These include administrative capability, administrative burdens and sector planning;
- **Financial intermediaries** can implement the financial instruments.

Figure 2.2 provides an idea of how a social impact investment scheme can be easily applied to the ESF programme logic to understand and verify **needs** linked to the specific objective. The **social capital demand** from final recipients can be addressed by leveraging public and private resources (**supply side**). Furthermore, the managing authority can also verify whether a financial instrument can be implemented.

Figure 2.2: Social impact investment framework and the ESF Operational Programme



Source: re-elaboration from OECD (2015), '*Social impact investment – Building the evidence base*'

2.2 REGULATION

The ex-ante assessment CPR Art. 37 and social impact investment

An ex-ante assessment is required to analyse and map market failures and suboptimal investment situations, to identify gaps (supply side and demand side). The ex-ante assessment also takes into consideration lessons learnt to identify challenges or obstacles. The social impact investment can be a base on which to develop the more complex and sophisticated ex-ante assessment. The ex-ante assessment verifies the adequacy of a financial instrument to address the market failure or suboptimal investment situation and highlights contributions the financial instrument could make to the achievement of ESF objectives. There is more information in the following chapters and on the *fi-compass* website, manual section: https://www.fi-compass.eu/resources/product/64

Social impact investments can have a range of social and financial return expectations and impact measurement.

2.3 MORE INFO

The four characteristics of impact assessment[13]

- ***Intentionality*** – The intent of the investor to generate social and/or environmental impact;
- ***Investment with return expectations*** – Impact investments are expected to return all the money invested or lent and, if relevant, to generate a financial return;
- ***Range of return expectations and asset classes*** – Impact investments generate returns that range from below market (sometimes called concessionary) to a risk-adjusted market rate;
- ***Impact measurement*** – A hallmark of impact investing is a commitment of the investor to measure and report the social and environmental performance and the progress of underlying investments.

13 For more information see http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html

These characteristics are very useful to establish financial instruments with ESF support which can generate both financial and social returns:

Social impact investment characteristics	Application to ESF context
Intentionality	The aims of the financial instruments clearly embody the strategy of the programme. In other words, the financial instruments are coherent and consistent with the specific priority axis and specific objective of the programme generating the "intended social" result.
Investment with expected returns	Capital is repaid. If this is not feasible, grants, repayable grants, or non-financial assistance may be more appropriate.
Range of return expectations and asset classes	Investment supported by financial instruments should generate returns, but since they typically involve non-bankable targets, these may be achieved only by adopting below market and/or risk-adjusted rates. Furthermore, financial instruments can be combined with other forms of support such as grants and non-financial services to support final recipients.
Impact measurement	Financial instruments are monitored beyond the classic output and financial indicators, as results and impacts need to be considered. Furthermore, indicators need to be related to the specific investment priority.

2.4 MORE INFO

The Social Return on Investment (SROI)[14]

Social Return on Investment (SROI) is a framework for measuring and accounting for the value created or destroyed by social investment and its impact on the socio-economic context. It measures social, environmental and economic outcomes and uses monetary values to represent them. This guides and influences investment decisions, and seeks to reduce inequality and improve wellbeing. SROI is therefore more about value, rather than money. It measures the value of the benefits relative to the costs of achieving those benefits:

$$\text{SROI} = \frac{\text{Net present value of benefits}}{\text{Net present value of investment}}$$

SROI can be:

- **Evaluative**, being conducted retrospectively and based on existing outcomes;
- **Forecast**, predicting the social value created if activities meet their targets.

14 This box is based on The SROI Network (2012), '*A guide to Social Return on Investment*'

SROI is based on seven principles[15]:

- **Involve stakeholders**. Once identified, they should be consulted throughout the analysis. So the value and the way it is measured, is informed by those affected by or who affect the investment;
- **Understand what changes**, and evaluate this through evidence, recognising positive and negative changes as well as those intended and unintended;
- **Value the things that matter**. Financial proxies can help evaluate outcomes. Since many outcomes are not traded in markets their value is not recognised. Financial proxies should be used to give a voice to people excluded from markets but who are affected by social investments;
- **Only include what is material**. Information and evidence in the accounts should give a true and fair picture, so stakeholders can draw reasonable conclusions about impact. This requires an assessment of whether a different investment decision would be made if particular information were excluded;
- **Do not over-claim**. Reference to trends and benchmarks helps assess the change caused by the investment, as opposed to other factors, and should take account of what would have happened anyway. The contribution of other people or organisations should match the outcomes;
- **Be transparent**. This includes explaining and documenting each decision relating to stakeholders, outcomes, indicators and benchmarks; the sources and methods of information collection; the different scenarios considered and communication of the results to stakeholders;
- **Verify the result**. SROI inevitably involves subjectivity, so appropriate independent assurance helps stakeholders assess whether or not the analysis is reasonable.

2.3 How financial instruments can match ESF thematic objectives

Social impact investment helps frame financial instruments in the ESF programme. The next step is to see how financial instruments can match ESF thematic objectives (TOs)[16]:

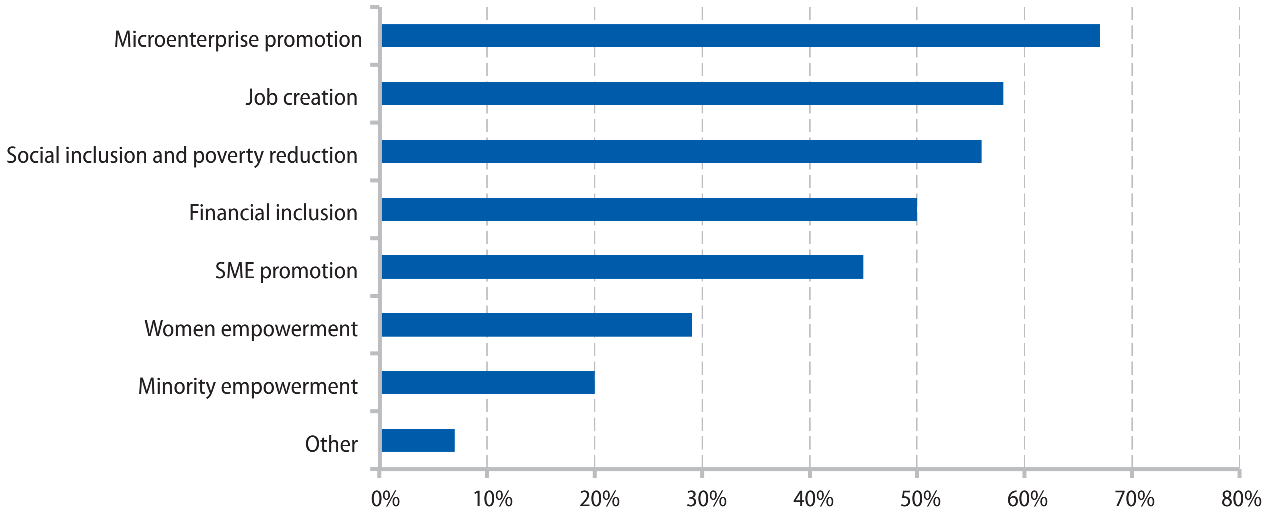
	TO 8 - Promoting sustainable and quality employment and supporting labour mobility
	TO 9 - Promoting social inclusion, combating poverty and any discrimination
	TO 10 - Investing in education, training and vocational training for skills and lifelong learning

15 The SROI Network (2012), *'The seven principles of SROI'*.

16 EC (2013), *'Regulation (EU) No 1304/2013 of the European Parliament and of the Council of 17 December 2013 on the European Social Fund and repealing Council Regulation (EC) No 1081/2006'.*

How can financial instruments help meet these thematic objectives? Some data can help in answering this question. The figure below regarding the use of microfinance instruments[17] offers a first indication of financial instruments addressing social purposes. Financial instruments in microfinance have been mostly used for SME promotion, especially microenterprises, followed by instruments to promote job creation. Social inclusion and poverty reduction represent the third main mission of microfinance.

Figure 2.3: Main missions of microfinance in Europe (2012)

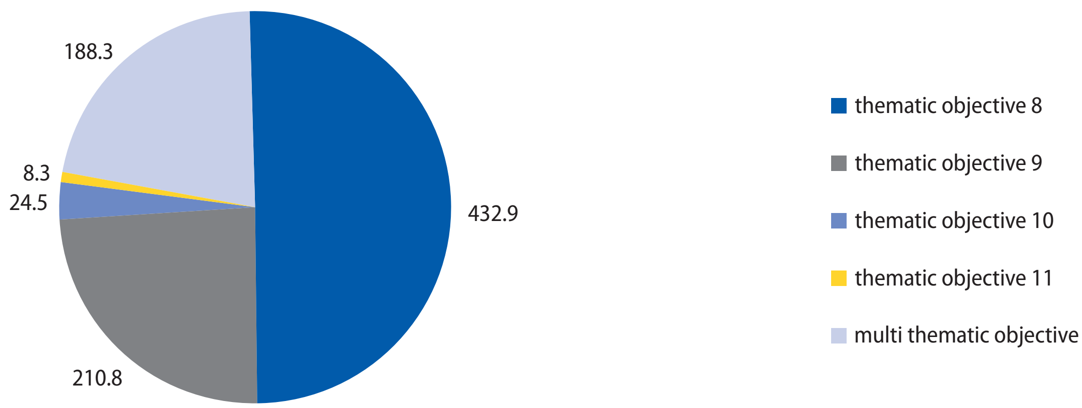


Source: European Microfinance Network (2014), '*Overview of the microcredit sector in the European Union*'

The use of financial instruments for education and training is more limited. Training is often included in financial products to promote job creation and for SME start ups. Specific financial instruments for goals addressing thematic objective 10 appear less common, as these activities are normally additional non financial services accompanying the financial products.

These tendencies are confirmed for the 2014-2020 programming period (Figure 2.4), with half the resources allocated to thematic objective 9 (employability and business creation), and only a small part for thematic objective 10 (education).

Figure 2.4: Planned ESF Operational Programme allocations to financial instruments by thematic objective, provisonal data (EUR million)



Source: elaboration by DG Employment, Social Affairs and Inclusion based on ESF programmes

17 ENM (2014), '*Overview of the Microcredit Sector in the European Union*'.

However, there is an important element to note. An intervention may address a specific thematic objective, but it could impact others. For example, supporting disabled persons establishing a business or becoming self employed is not only a way of reducing unemployment but also develops people's creativity and innovative potential by making them feel trusted and useful. Well designed, inclusive entrepreneurship policies foster economic and social inclusion too. As an example, financial instruments under thematic objective 8 also contribute to social inclusion and poverty reduction, which are the main objectives of thematic objective 9. When designing financial instruments it is therefore important to put them in the broad strategic context of the ESF programme, being aware of the positive spillover effects for other thematic objectives.

The following sections describe the potential key advantages of using financial instruments, the logic of a financial instrument in terms of social impact investment, and how a financial instrument can contribute to the investment priorities under each thematic objective.

2.5 MORE INFO

Methodology and sources of information for investment priority assessment

An important aspect to understand is which investment priorities in the ESF programme can benefit most from financial instruments. This strengthens coherence in the programme between the needs assessment, the thematic objective, and implementation of the financial instrument.

There is a section for each thematic objective, with tables assessing the potential relevance of financial instruments for individual investment priorities in the 2014-2020 programming period. This multi-criteria analysis considers:

- past experience (2007-2013 programming period) in the EU, based on studies and reports from European institutions including: EC (2012), '*The Network for Better Future of Social Economy (NBFSE) – Strand financial instruments and mechanisms of funds' allocation to social economy*'; EC (2014), '*Implementation of the European Progress Microfinance Facility – 2013*'; EMN (2014), '*Overview of the microcredit sector in the European Union*'; EC (2015), '*A map of social enterprises and their eco-systems in Europe – Country Reports*'; COR (2015), '*Financial instruments in support of territorial development*'; EC (2015), '*Social investment in Europe – A study of national policies*';
- past experience in non-EU OECD countries, based on studies and reports including: OECD (2013), '*Innovative financing and delivery mechanisms for tackling long-term unemployment*'; OECD (2013), '*Job creation through the social economy and social entrepreneurship*'; OECD (2014), '*New investment approaches for addressing social and economic challenges*'; OECD (2015), '*Social impact investment – Building the evidence base*';
- interviews with managing authorities on their actual or potential use of financial instruments by investment priority.

The potential relevance can be low (★), medium (★★) or high (★★★).

2.3.1 Financial instruments for promoting employment and supporting labour mobility (TO 8)

Financial instruments seem particularly appropriate for creating jobs. In the 2007-2013 programming period, most of the 53 financial instruments implemented across 7 Member States addressed SMEs. In particular, financial instruments contributed to self-employment through entrepreneurship and business creation, including innovative microenterprises. This is confirmed by a report on the microfinance sector from European Microfinance Network, the most widespread mission of financial instruments is microenterprise promotion followed by job creation (see Figure 2.3 in the previous section). Entrepreneurship and self-employment help people find jobs, especially for specific target groups (unemployed, migrants, women, people over 50, and young people) who have a hard time finding a job, but who could run an entrepreneurial activity.

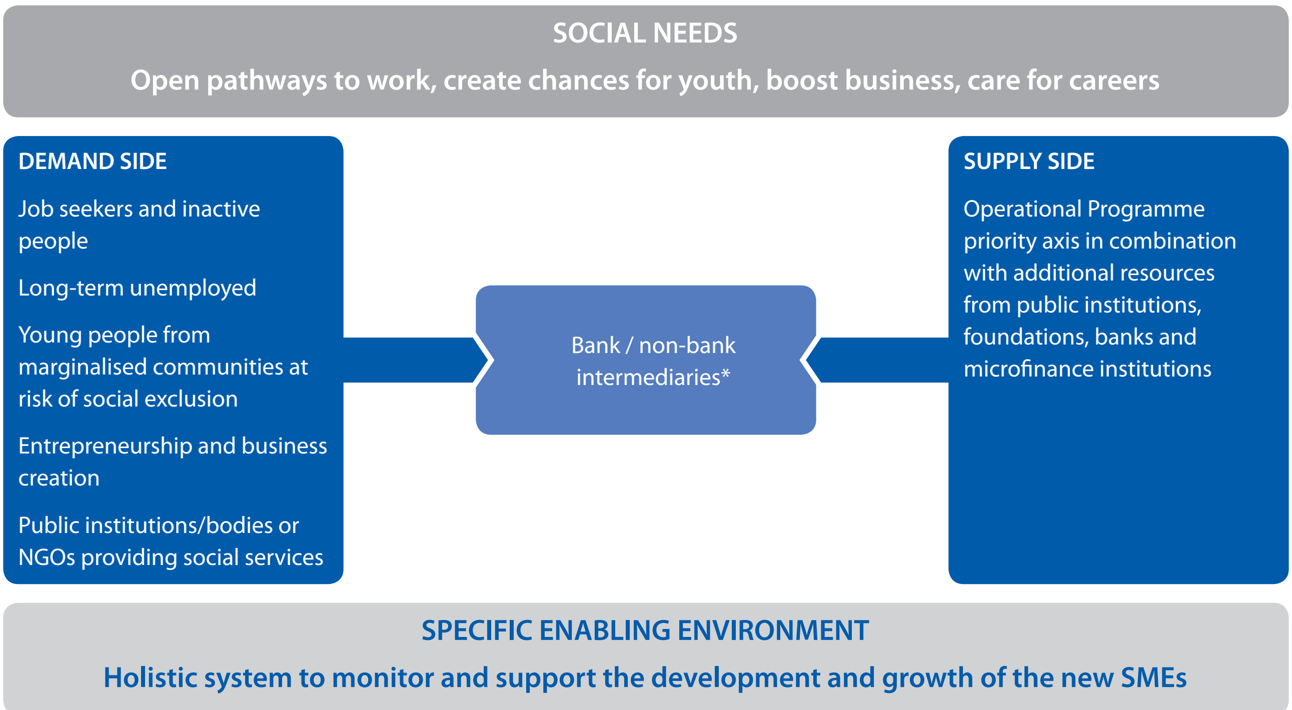
KEY ADVANTAGES

Thematic Objective 8

Promoting employment and supporting labour mobility

- Economic returns in addition to social value especially when initiatives are tailored to creation of SMEs.
- Direct and tangible spillovers in the local economic context with reduced unemployment rate.
- When financial instruments are tailored to business creation, with financial returns, there may be more co-investment.
- Financial instruments can cover the gap incurred by entrepreneurs in the social economy in some countries where there is insufficient institutional support from the government.

Figure 2.5: The logic of financial instruments under TO 8



*See Chapter 5 and table 5.2 and 5.3 for detail on bank and non-bank intermediaries.

2.6 EXAMPLE

Support for Self-Employment and Business Start-Ups, Latvia

This intervention targets working age people, including the unemployed, wishing to start a business or become self-employed, by providing loans and grants. It also provides additional services through consultation and training. The government decided to launch the Start Programme in 2009 to provide entrepreneurs and SMEs with start-up finance. The Mortgage and Land Bank of Latvia has specialist consultants and 32 branches or sub-branches covering the whole of Latvia. Customers (start-ups and newly established companies) are invited to interviews, which analyse their theoretical and practical knowledge to subsequently offer training. The programme provides loans of up to EUR 77 000 (LVL 54 000) for investment and working capital, for up to eight years. Additional support in the form of training is also provided.

In particular, past experience proved the suitability of:

- loans, which are appropriate to support start-ups favouring self-employment and small business creation. Longer repayment periods coupled with lower interest rates and lower collateral requirements reduce the risk of failure and encourage entrepreneurs to start new businesses;
- guarantees can support young entrepreneurs that lack the necessary financial backing and collateral, promoting employment and labour mobility, by providing credit risk protection. They can also attract additional funds for business creation and expansion.

TO 8 INVESTMENT PRIORITY	POTENTIAL RELEVANCE
Access to employment for job-seekers and inactive people, including the long-term unemployed and people far from the labour market, also through local employment initiatives and support for labour mobility	★★★
Sustainable integration into the labour market of young people, in particular those not in employment, education or training, including young people at risk of social exclusion and from marginalised communities, including through the implementation of the Youth Guarantee	★★★
Self-employment, entrepreneurship and business creation including innovative micro, small and medium-sized enterprises	★★★
Equality between men and women in all areas, including access to employment, career progression, reconciliation of work and private life and promotion of equal pay for equal work	★★
Adaptation of workers, enterprises and entrepreneurs to change	★★
Active and healthy ageing	★
Modernisation of labour market institutions, such as public and private employment services, and improving the matching of labour market needs, including through actions that enhance transnational labour mobility as well as through mobility schemes and better cooperation between institutions and stakeholders	★

Note: ★★★=High; ★★=Medium; ★=Low. See Box 2.5 for more detail.

A major lesson from the past is to make financial instruments more effective under thematic objective 8. Many employment problems are complex and require multiple interventions by a range of stakeholders to provide solutions that fit around final recipients in a flexible way. Unemployed people may in fact also require support to increase their human capital and ability to work, such as training. Support for business creation should include enterprises being accompanied and monitored after the start-up phase to ensure their sustainability. Such support should avoid SMEs becoming dependant on these services[18] and, above all, financial instruments accompanied by additional business services should not distort local markets especially when they target innovative start-ups.

2.7 EXAMPLE

The Radom Entrepreneurship Centre, Poland

This intervention supports a social NGO assisting people wanting to start a business through preferential loans offered by the ESF operational programme (interest 4% p.a., maturity 60 months, for up to EUR 12 000, grace period up to 12 months, no fees or commission). Additionally, the NGO offers training services (accounting, banking, business law, marketing and social security) and consulting to the disadvantaged and unemployed on how to start and run a business. This model, promoted by an NGO as a financial intermediary, has been pursued in other Polish regions.

2.3.2 Financial instruments for promoting social inclusion and combating poverty (TO 9)

After employment and business creation, financial instruments and microfinance in particular, are used to address social inclusion and combat poverty in specific disadvantaged groups. Financial instruments designed to address thematic objective 8 also often generate positive spillover in poverty reduction. Social exclusion is a complex, multi-dimensional, multi-layered and dynamic process in which some individuals are prevented from participating fully by virtue of their poverty, lack of basic competence and lifelong learning opportunities, or as a result of discrimination. They have little access to decision-making processes, education and job opportunities as well as social and community networks and activities and are thus less able to take control over decisions that affect their daily lives[19].

KEY ADVANTAGES

Thematic Objective 9

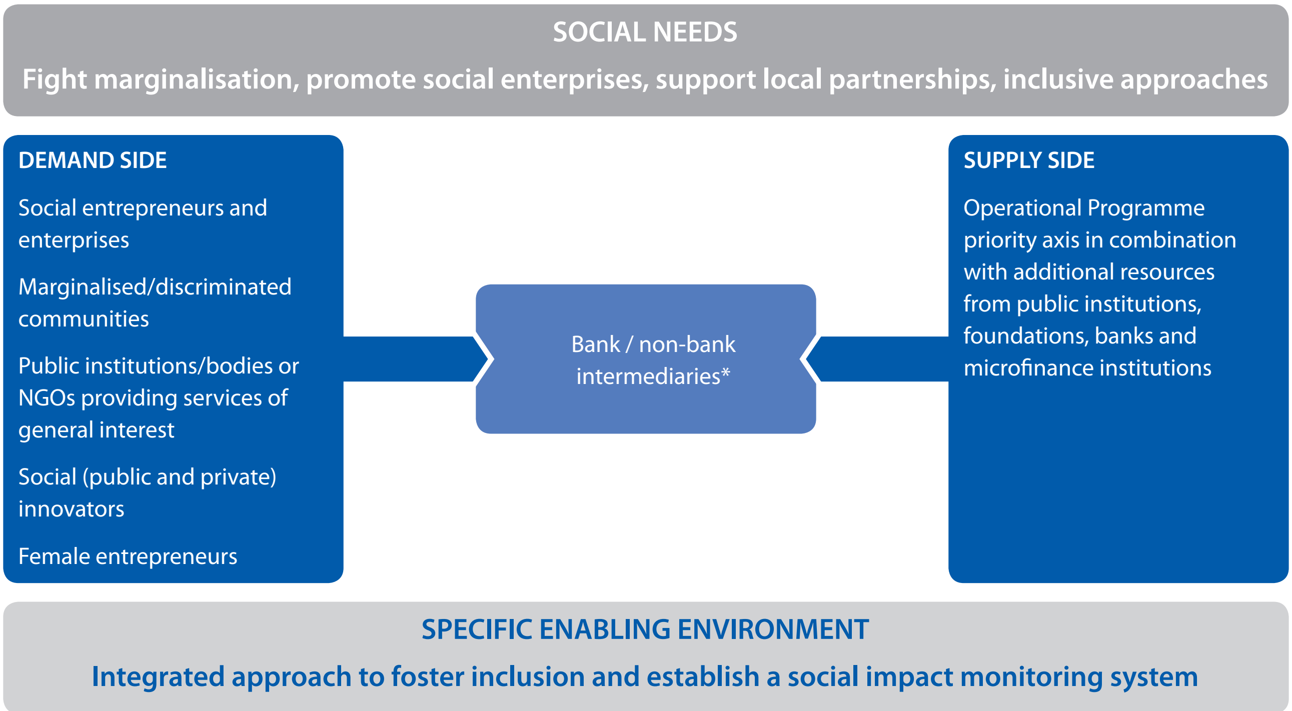
Promoting social inclusion and combating poverty

- Activation of local financial intermediaries to match needs of social inclusion.
- Financial instruments can integrate institutional support for social inclusion which is low in most member states.
- Financial instruments are an important additional instrument for combating poverty in times of persistent financial and economic crisis.
- Providing financial instruments to disadvantaged groups reduces public spending for social services.
  Added value in terms of making the borrowers more responsible.

18 OECD (2013) *'Innovative financing and delivery mechanisms for getting the unemployed into work'*.

19 Eurostat (2010), *'Combating poverty and social exclusion. A statistical portrait of the European Union 2010'"*.

Figure 2.6: The logic of financial instruments under TO 9



*See Chapter 5 and table 5.2 and 5.3 for detail on bank and non-bank intermediaries.

TO 9 INVESTMENT PRIORITY	POTENTIAL RELEVANCE
Active inclusion, including with a view to promoting equal opportunities and active participation, and improving employability	★★★
Socio-economic integration of marginalised communities such as the Roma	★★
Combating all forms of discrimination and promoting equal opportunities	★★
Enhancing access to affordable, sustainable and high-quality services, including health care and social services of general interest	★★
Promoting social entrepreneurship and vocational integration in social enterprises and the social and solidarity economy in order to facilitate access to employment	★★★
Community-led local development strategies	★★

Note: ★★★=High; ★★=Medium; ★=Low. See Box 2.5 for more detail.

The different financial products can have different roles:

- Loans are appropriate for minorities and marginalised communities, developing economic activity and new job opportunities which promotes active inclusion. Longer repayment periods coupled with lower interest rates and collateral requirements increase access to credit for such groups and social inclusion;
- Guarantees may support individuals who lack collateral in creating new ventures for social purposes. They can also attract additional funds for business creation and expansion;

- Equity can support social enterprises, helping to deliver high quality services of general interest for disadvantaged people. The types of equity depend on the stage of the company's development (new or mature) and on the investment model (co-investor in the fund portfolio or individual investments, on a deal-by-deal basis).

To make financial instruments more effective under thematic objective 9, as for thematic objective 8, additional services may be required. This could be done by integrating financial instruments with other measures under the ESF programmes. When financial instruments concern disadvantaged people the absence of collateral or additional financial guarantees may lead to information asymmetries raising credit risk, so social needs may be overestimated or underestimated. In addition the social impact of financial instruments under this thematic objective may be more difficult to assess in quantitative terms. Stronger monitoring and a proper system of indicators improve the effectiveness of financial instruments.

2.8 EXAMPLE

Finlombarda supporting social enterprises, Italy

Managed by Finlombarda, the ESF JEREMIE Holding Fund in Lombardy supports cooperatives and social enterprises, improving social inclusion.

Four commercial banks were selected by Finlombarda and share 50% of the risk on loans of up to EUR 4 000 per person. The final recipient is typically a member of a cooperative or social enterprise that supports the disadvantaged. The members had to invest the loan in the capital of their social cooperative, where they also work. This reinforced the capital structure and empowered cooperative members.

Finlombarda assisted in the 8 000 transactions with individuals (60% women, 45% people with disabilities) from 550 social cooperatives (31% of the total in the Lombardy Region) which increased their social capital by EUR 32 million.

2.3.3 Financial instruments for investing in education, skills and lifelong learning (TO 10)

Among the three thematic objectives, investing in education represents the most challenging use of financial instruments, due to the wider time gap between the investment and the benefits. Moreover, the mismatch between the timing of the costs and benefits of education is especially salient for young borrowers. The default rate drops sharply with age[20]. Young people have less access to finance because they are likely to have lower personal savings and less collateral, less credit history, and less past business experience. However, financial instruments for thematic objective 10 can also be tailored to address employability indirectly (since investment in education increases job opportunities). These initiatives can develop entrepreneurial mindsets and skills to make young people aware of self-employment as a career option and equip them with the entrepreneurial knowledge, technical skills and competencies required to establish and run a successful business.

20 Dynarski and Kreisman (2013), '*Loans for education opportunity: making borrowing work for today's students*'.

KEY ADVANTAGES

Thematic Objective 10

Investing in education, skills and lifelong learning

- Economic returns in addition to social value especially when initiatives are tailored to creation of SMEs.
- Increased amounts available for students with a reduced cost of financing education.
- Since returns on investing in education affects qualifications, then financial instruments may encourage people – especially from social-economical disadvantaged backgrounds – to keep on studying.
- Investing in education raises the potential for finding better job positions.

Figure 2.7: The logic of financial instruments under TO 10

SOCIAL NEEDS

Improve access to learning, promote better/high qualified jobs, increase the quality of training

DEMAND SIDE

Students

Workers seeking higher qualifications

Public institutions/bodies or NGOs providing vocational training

Public and private institutions involved in primary and secondary education

Universities or High Research Centers

Bank / non-bank intermediaries*

SUPPLY SIDE

Operational Programme priority axis in combination with additional resources from public institutions, foundations, banks and microfinance institutions

SPECIFIC ENABLING ENVIRONMENT

Comprehensive support framework (i.e. combined incentives) linking education system to labour market

*See Chapter 5 and table 5.2 and 5.3 for detail on bank and non-bank intermediaries.

TO 10 INVESTMENT PRIORITY	POTENTIAL RELEVANCE
Reducing and preventing early school-leaving and promoting equal access to good quality early-childhood, primary and secondary education including formal, non-formal and informal learning pathways for reintegrating into education and training	★
Improving the quality and efficiency of, and access to, tertiary and equivalent education with a view to increasing participation and attainment levels, especially for disadvantaged groups	★★
Enhancing equal access to lifelong learning for all age groups in formal, non-formal and informal settings, upgrading the knowledge, skills and competence of the workforce, and promoting flexible learning pathways including through career guidance and validation of acquired competence	★★
Improving the labour market relevance of education and training systems, facilitating the transition from education to work, strengthening vocational education and training systems and their quality, including through mechanisms for skills anticipation, adaptation of curricula and the establishment and development of work-based learning systems, including dual learning systems and apprenticeship schemes	★
Reducing and preventing early school-leaving and promoting equal access to good quality early-childhood, primary and secondary education including formal, non-formal and informal learning pathways for reintegration into education and training	★

Note: ★★★=High; ★★=Medium; ★=Low. See Box 2.5 for more detail.

However, even if there is no extensive experience, including in the OECD, some financial products already have a long tradition. In particular, student loans are appropriate given their flexibility and efficiency. Loans can therefore encourage further education and increase human capital. Longer repayment periods coupled with lower interest rates and collateral requirements are particularly suitable for young people who invest in education to increase their employability.

3. WHO ARE THE FINANCIAL INSTRUMENTS FOR?

KEY MESSAGE

The main characteristics of the final recipients are described through:

- an overview of financial exclusion with the characteristics and needs of final recipients;
- describing the main barriers that prevent ESF targeted groups from financial inclusion and how the ESF can mitigate them using financial instruments.

3.1 Main characteristics of the ESF target groups

Financial instruments under the ESF are tailored to financially excluded final recipients with high social vulnerability.

Financial exclusion refers *"to a process whereby people encounter difficulties accessing and/or using financial services and products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life in the society which they belong"*[21].

21 EC (2008), *'Financial services provision and prevention of financial exclusion'*, p.9.

Financial exclusion can be related to[22]:

Transaction banking	Savings
Exclusion from receiving regular electronic payments such as wages, pensions or social assistance; converting cheques or vouchers into cash; storing money safely; paying for goods and services other than with cash; paying bills electronically; making remittances.	It is often a consequence of social problems and lack of money (low income and profit), lack of habit, or an unwillingness to deal with banks because of negative past experience.
Credit	**Insurance**
Exclusion from access to goods or services requiring resources beyond the immediate budget.	It is sometimes mandatory for specific goods (motor vehicles) or economic activities (self-employed trades or professions).

Primary target groups for ESF financial instruments are:

Women	Migrants
• To improve their skills and enhance their intra-marital position; • Financial instruments can give them better job opportunities and sustain their entrepreneurial initiatives; • Sustaining the inclusion of women in the workplace generates positive spillovers beyond the local economic context; • Financial instruments contribute to gender equality and social inclusion.	• Providing financial instruments to migrants can be a powerful tool to favour social inclusion and increase their chances of finding a job; • Job inclusion for migrants can contribute to local economic wealth by increasing the active population and production opportunities as well as reducing welfare dependency; • Favouring social inclusion of migrants can diminish social tension and increase the number of active young people in countries affected by ageing problems and constrained by public spending on pensions; • Migrant attitude to financial inclusion, including their demand for financial services, is an evolving process related to migration phases, each of which presents different financial needs[23].

22 World Bank (2005), *'Indicators of Financial Access – Household – Level Surveys',* and EC (2008), *'Financial services provision and prevention of financial exclusion'.*

23 EC (2008), *'Financial services provision and prevention of financial exclusion',* p.9.

Unemployed	Students
• Supporting finance for job creation can generate positive spillovers by reducing unemployment and household poverty; • Increasing employment also generates positive local economic spillovers in terms of growth and productive activities; • Sustaining employment opportunities is critical for reducing welfare dependency and for providing the contributions needed to pay for a person's own future pension and care, as well as contributions for current public social spending.	• Supporting local education increases local human capital; • High-quality human capital makes the economy more attractive for further investment and also offers well-educated people new and better job opportunities; • Education goals can also be addressed by providing financial support to local schools, universities and research centres reducing emigration among young people with the consequent reduction in local human capital.
Disadvantaged people	**Social enterprises**
• Financial instruments for people with disabilities, ex-convicts, and recovering alcoholics or drug addicts can be a powerful tool for social inclusion and increase their chances of finding a job; • Inclusion of people also has positive spillovers on the local welfare system (reducing costs for providing assistance); • Financial instruments can improve accessibility to services such as social protection, poverty reduction programmes, disability-related assistance, public housing and health-care.	• Providing financial support to social enterprises is a way to sustain initiatives as well as to indirectly help disadvantaged groups targeted by social enterprise activities with both social and economic outcomes; • Supporting social enterprises reduces the need for public resources addressing social inclusion; • The social economy is a growing sector in Europe and social enterprises can play a crucial and increasing role in economic growth.

3.2 Barriers to financial inclusion

Barriers to finance for final recipients fall, according to the OECD[24], into four main areas:

Market barriers	Institutional barriers
• Derive from information asymmetries between lenders and borrowers, especially when financial intermediaries have insufficient information to judge the viability of business proposals; • Market barriers can be higher for new enterprises and start-ups, but can also affect disadvantaged individuals and under-represented groups without sufficient collateral; • In principle, financial intermediaries could apply higher interest rates to compensate for the higher risk-profile of activities undertaken by disadvantaged individuals; • Borrowers might also be induced into repayment using their household budget, increasing the chances of ill health and reducing their ability to work, which would also result in higher chances of loan defaults.	• Institutional barriers limit financial lending in particular for enterprises; • In some European countries, lack of legislation about new sources of finance for social enterprises can generate uncertainty about their proper use; • Policy makers have only recently started to legislate for new channels of finance such as crowdfunding and peer-to-peer lending; • Information and awareness-raising initiatives are key elements to overcome these barriers.
Skills barriers	**Cultural barriers**
• Many loan applications are rejected because the information submitted is incomplete or wrong; • Skills barriers can also involve business planning, business management and financial literacy (many people from disadvantaged and under-represented groups have never submitted an application loan); • Members of some target social groups (such as low-educated or migrants) may also lack a good grasp of business finance concepts that are key to understanding the risks and opportunities associated with a business; • The applicant's lack of awareness of their own legal status, financial condition, requirements or financial possibilities for their enterprise.	• Normally, bank loan officers are trained to deal with an entrepreneur working full-time; the same applies to full-time workers under a job contract. Entrepreneurs who manage different businesses at the same time or individuals working part-time may have limited access to credit because they fall outside this type of client; • There can be cultural barriers where migrants and ethnic minorities may face language and social barriers to building a close and confident relationship with financial intermediaries; • Some groups may be unwilling to share full information on personal revenues and indebtedness with loan officers, who are perceived as outsiders; • Women and youths may not approach banks because they think they are unlikely to obtain a loan, these are "discouraged borrowers". This is especially true when they have experienced prolonged periods of labour market inactivity.

While barriers can negatively affect the achievement of goals in all three thematic objectives, not all final recipients are constrained by the same barriers. The following table summarises impacts of barriers for the main final recipients. It also displays the different contribution of each ESF thematic objective to target groups to show interactions between final recipients, barriers and thematic objectives.

24 OECD (2014), p.10, '*Policy brief on access to business start-up finance for inclusive entrepreneurship*'.

Apart from market barriers whose high impact is transversal to all target groups, other barriers impact differently on final recipients:

- cultural and skills barriers mostly affect individuals and institutional barriers mainly impact enterprises;
- skills barriers mostly affect migrants that work in countries with different legal and human capital requirements and standards;
- unemployed, especially those affected by long-run inactivity, could have low quality education and, if not young, can face more difficulties in upgrading their skills; students may need to improve their education to find better jobs;
- institutional barriers negatively affect access to finance for social enterprises, through a lack of legislation or a complicated legal system.

Table 3.1: Impact of barriers on final recipients and contribution of ESF thematic objectives to each target group

Financial Recipients	Barriers				ESF Thematic Objectives		
	Market	Cultural	Skills	Institutional	8	9	10
Women	★★	★★	★★	★	★★	★★★	★★
Migrants	★★★	★★★	★★★	★★	★★	★★★	★★
Unemployed	★★★	★★	★★★	★★	★★★	★★	★★
Students	★★	★★	★★★	★	★★	★	★★★
Disadvantaged people	★★★	★★	★★★	★★	★★	★★★	★
Social enterprises	★★★	★	★	★★★	★★★	★★★	★

Impact: ★★★=High; ★★=Medium; ★=Low.

4. HOW TO MANAGE FINANCIAL INSTRUMENTS?

KEY MESSAGE

This section highlights:

- the main activities of each of four phases in the life cycle of financial instruments;
- governance options for implementation;
- the main characteristics of the third axis – Microfinance and Social Entrepreneurship – of the Employment and Social Innovation (EaSI) programme.

4.1 The main phases of the life cycle of financial instruments

As anticipated in Chapter 1, the life cycle of the financial instruments has four interlinked phases of design, set-up, implementation and winding-up.

4.1.1 Design

This phase helps define the choice of financial instrument and the implementation arrangements. It includes five main activities.

Reference to financial instruments in the Operational Programme	Ex-ante assessment	Selection of the implementation options	Selection of the body implementing the financial instrument	Defining and signing the funding agreement

Once the managing authority has made **reference to financial instruments in the ESF programme** and specified the delivery of the actions to implement them, it organises the **ex-ante assessment.** This provides evidence based decision making in the design and implementation of financial instruments taking account of, *inter alia*, State aid issues. Once completed, the ex-ante assessment must be submitted to the monitoring committee for information and a summary of findings and conclusions published within three months of finalisation. The third activity relates to the **selection of implementation options**, in choosing the governance structure (see section 4.2) for the financial instrument. The managing authority may decide to implement the financial instrument through a financial intermediary or in two stages through a fund of funds as well as financial intermediaries. Once the implementation option has been chosen, managing authorities should **select the body implementing the financial instrument**. Financial intermediaries or the fund of funds must be selected by the managing authority in accordance with applicable law, including on public procurement, and taking into account economic and financial viability, capacity to implement the financial instrument, effective and efficient internal control and accounting systems, robust methodology for selecting final recipients and the ability to raise additional financial resources. The last step is related to the **drafting and signature of the funding agreement**, which represents the legal commitment between the managing authority and the fund of funds or between the managing authority and financial intermediary or, where applicable, between the fund of funds and the financial intermediary.

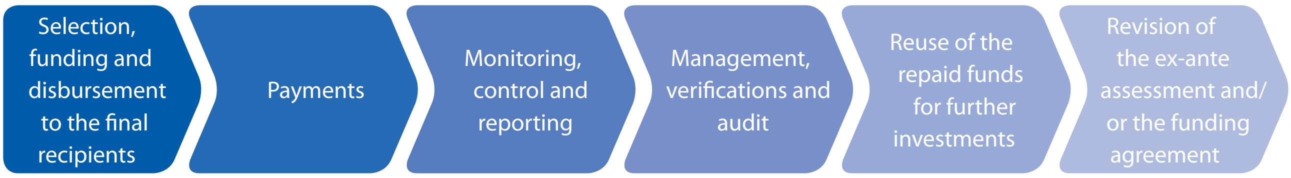
4.1.2 Set-up

This phase aims to create a sound governance and management structure, as well as reporting and accounting systems, in order to safeguard and accelerate the implementation phase. It includes four main activities.

The first step is to make the **governance structure** operational and activate the decision-making process according to the roles and responsibilities of the different parties established in the funding agreement. Next is to **open fiduciary accounts.** In order to ensure proper accounting and an audit trail, the fund of funds or financial intermediary either opens a separate account for the financial instrument, or fiduciary accounts in their name on behalf of the managing authority. Alternatively, it can also set up the financial instrument as a separate block of finance with a clear accounting distinction. Rules for payments to the financial instrument and for treasury management are established under the funding agreement. Next is to establish the **documentation, management and control systems,** detailed in the funding agreement. Finally the financial intermediary **sets up the operational structure** and develops the capabilities needed to ensure efficient channelling and adequate promotion of the financial instrument.

4.1.3 Implementation

Once the governance architecture has been established, the next phase is the implementation of the financial instrument. The implementation phase includes six main steps.



The first step regards the **selection, funding and disbursement to the final recipients.** First of all**, final recipients** need to be informed of the availability of the products offered as well as the requirements for accessing them. Eligibility, risk and the returns of potential investments need to be assessed, together with their capacity to deliver positive impacts in line with the investment strategy and business plan.

Financial intermediaries and final recipients enter into a contract governing the obligations of the parties including, for example, terms and conditions of the transaction, availability of documents proving the investments and specific separate accounting. Once the contract has been signed and documents providing eligibility provided, disbursement can take place.

The next step concerns the **payments**. For payment flows *from managing authority to financial intermediary,* the financial intermediary (or any fund of funds) prepares the request for each payment by the managing authority as specified in the funding agreement, declaring the resources disbursed and specifying the management costs and fees. *From managing authority to certifying authority***,** the managing authority verifies the information from the financial intermediary and transfers the information to the certifying authority (if the managing authority is not carrying out the certifying authority functions). *From certifying authority/managing authority to the European Commission*, the certifying authority (or managing authority embedding the functions) submits the application for interim payment of at most 25% total amount of programme contributions committed to the European Commission.

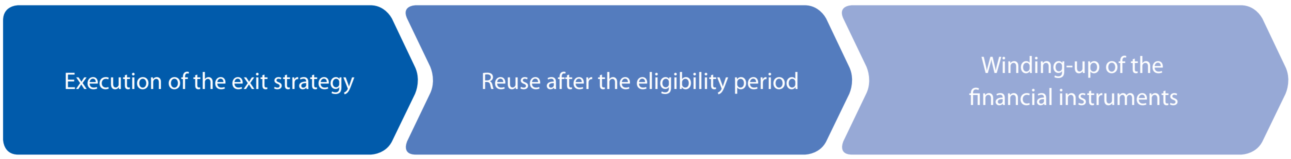
The third step relates to **monitoring, control and reporting** activities as established in the funding agreement. The *financial intermediary* reports regularly to the managing authority - or fund of funds, and this to the managing authority - the support paid to final recipients, management costs and fees, the value of investments, the results of internal controls and monitoring, as well as information on output and result indicators directly from the final recipient. The *managing authority reports to the monitoring committee and the European Commission* by verifying the information from the financial intermediary or fund of funds and preparing a report on the implementation of financial instruments to be annexed to the Annual Implementation Report.

The fourth step regards **management verifications and audit** activities. The managing authority carries out management verifications throughout the programming period as well as during the set-up and implementation phases. These activities are also a basis for approval from the certifying authority for payment applications to the European Commission. The financial intermediary and the fund of funds carry out performance and monitoring checks including *inter alia* performance and monitoring visits. The audit authority could carry out an audit on the managing authority, fund of funds and financial intermediary. Any control at the level of final recipients could take place only if there are inaccurate or unavailable supporting documents at the level of the managing authority, fund of funds and financial intermediary.

The last two steps regard the **reuse of repaid funds for further investments within the eligibility period** – revolving resources are part of the value added by the financial instruments and the long-term sustainability of the ESF support – and the **revision of the ex-ante assessment and/or the funding agreement** in case of changes in the economic situation, market, or legislation.

4.1.4 Winding-up

The winding-up phase concludes the life cycle of the financial instrument and is usually defined in the design and/or set-up phase. The exit strategy must be included in the funding agreement as part of the investment strategy. Winding-up includes three main activities.



Execution of the exit strategy refers to the recovery of resources invested in final recipients (which might entail sales of investments) and needs to be planned and carefully implemented. Resources paid back before the end of the eligibility period include capital repayments with gains and other earnings or yields, such as interest, guarantee fees, dividends or any other income generated by the instrument, which are attributable to support from the ESF. These can be **reused after the eligibility period** for:

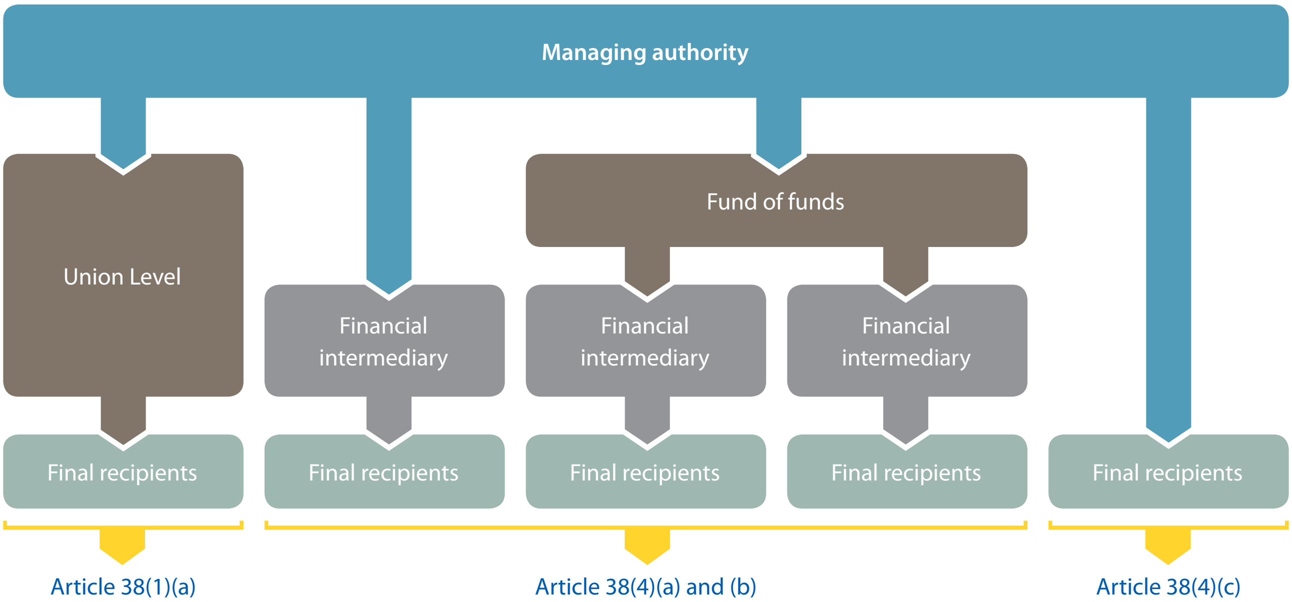
- further investments through the same or other financial instruments, in accordance with the specific objectives set out under a priority;
- preferential remuneration of private investors, or public investors operating under the market economy principle, who provide additional resources to the financial instrument or who co-invest at the level of final recipients;
- reimbursement of financial instrument management costs and fees.

Financial instruments can continue to work after the exit of resources attributable to the ESF. On the other hand, a financial instrument can complete its life cycle and be liquidated (**winding-up**). As part of the liquidation of financial instruments, accounts should be settled and shareholders paid out their share of the initial investment plus any surplus on realised investments.

4.2 The different implementation options

There are different options for implementation arrangements according to Art. 38 of Regulation 1303/2013 (CPR). Each of these involves roles and responsibilities being assigned to different bodies. The structures, as shown in figure 4.1, vary from financial instruments set up at EU level, managed directly or indirectly by the European Commission, to financial instruments set up at national, regional, transnational or cross-border level, such as the managing authority, any fund of funds and financial intermediary[25] interacting together.

Figure 4.1: Implementation options under the CPR



The managing authority may:

- contribute European Structural and Investment Funds (ESIF) resources to EU level financial instruments under Art. 38(1)(a);
- invest in the capital of an existing or a newly created legal entity under Art. 38(4)(a);
- entrust implementation tasks to another entity under Art. 38(4)(b);
- or undertake implementation tasks directly under Art. 38(4)(c) for loans and guarantees only.

25 Body that implements the financial instrument (CPR Art. 38(7)(b)).

Depending on the implementation structure, the managing authority may decide to implement the financial instrument through a financial intermediary or in two stages through a fund of funds.

4.1 REGULATION

IMPLEMENTATION OPTION	HIGHLIGHTS
Art. 38(1)(a): financial instruments are set up at Union level and managed directly or indirectly by the Commission	• The financial instruments exist, saving time and resources needed for creating one and avoids duplication of effort; • Economies of scale with a critical mass (especially relevant when the target market is small); • Reduces risk for the managing authority by relying on a tested vehicle and reduces burdens for managing the financial instrument; • No need for on-the-spot verifications by the managing authority or audits of the operations by the audit authority.
Art. 38(4)(a): managing authority invests in the capital of existing or newly crated legal entity to implement financial instrument	• A new legal entity avoids potential conflicts of interest with existing business objectives (since the entity is independent and focused on financial instrument implementation alone); • For existing legal entities there is relatively quick implementation and no set-up cost; • This option can be also implemented by using a fund of funds.
Art. 38(4)(b): managing authority entrusts implementation tasks to another entity	• Entrusting provides the managing authority with a robust structure which is well equipped and experienced in professionally managing funds and investments; • It builds on the know-how and expertise that public and private bodies have of the local financial and legal environment; • This option can be also implemented using a fund of funds.
Art. 38(4)(c): managing authority directly implements the financial instrument (valid only for loans and guarantees)	• Simplified procedures allowing for non-grant funding from ESIF without setting up a dedicated financial instrument which can be complex and time-consuming; • Leaner implementation structure, avoiding additional layers of monitoring and reporting; • Leveraging of managing authority in-house expertise; • No funding agreement, only a strategy document is required; • Relatively quick implementation, assuming that the managing authority has experience with this type of instrument.

4.3 The EaSI programme's third axis: Microfinance and Social Entrepreneurship (MF/SE)

The Employment and Social Innovation (EaSI) programme is an EU level financial instrument managed directly by the European Commission to support employment, social policy and labour mobility across Member States[26]. At the heart of EaSI is the concept of social innovation and its special focus on youth.

The EaSI programme, set to run from 1st January 2014 to 31st December 2020, brings together three programmes managed separately in 2007-2013, which now form the three axes of EaSI. These are:

- **PROGRESS** (Programme for Employment and Social Solidarity), which supported the development and coordination of EU policy for employment, social inclusion, social protection, working conditions, anti-discrimination and gender equality;
- **EURES** (European Employment Services), a cooperation network between the European Commission and the Public Employment Services of the Member States that encourages mobility of workers;
- **Microfinance and Social Entrepreneurship** (MF/SE) which aims to increase the availability of microcredit to individuals for setting up or developing a small business.

EaSI objectives are therefore strictly interconnected with ESF goals, especially employment and social inclusion, and the programme offers additional financing instruments to meet social needs. EaSI aims to:

- Strengthen ownership of EU objectives and coordination of action at Union and national levels for employment, social affairs and inclusion;
- Support the development of social protection systems and labour market policies by promoting good governance, mutual learning and social innovation;
- Modernise and ensure effective application of EU legislation;
- Promote geographical mobility and boost employment opportunities by developing an open labour market;
- Increase the availability and accessibility of microfinance for vulnerable groups and microenterprises, and increase access to finance for social enterprises.

26 EC (2013), *'EaSI – New EU umbrella programme for employment and social policy'.*

4.2 MORE INFO

PREVIOUS RESULTS OF THE PROGRESS MICROFINANCE FACILITY

The European Progress Microfinance Facility (EPMF), launched in 2010 and running alongside the new MF/SE Programme till 2016, aims to increase the availability of microcredit – loans up to EUR 25 000 – for setting up or developing a small business. Progress Microfinance does not directly finance entrepreneurs, but enables selected microcredit providers in the EU to increase lending, by:

- issuing guarantees, sharing the potential risk of loss;
- providing funding to increase microcredit lending.

EPMF is a EUR 180 million investment fund supplemented by EUR 25 million for guarantees, which aims to disburse 46 000 microcredits totalling EUR 500 million by 2020. By September 2015, EUR 375 million microcredits were disbursed across 22 EU countries and supporting 35 000 micro-beneficiaries and preserving 50 000 jobs. Break-down data shows that 61% of recipients were unemployed, 16% in youth or senior age brackets, 75% were start-ups and 37% were female entrepreneurs (Source: European Investment Fund 2015).

EaSI's third axis - MF/SE - aims to increase the availability of microcredit to individuals who want to set up or develop small businesses. Another aim is to support social enterprise development. Among the three EaSI axes, the MF/SE initiative can better match ESF goals and, in particular, the use of financial products to address individual and microenterprise social needs. Moreover, it does not function as a stand-alone instrument, but together with the ESF and the European Globalisation Adjustment Fund (EGF) forms a coherent set of EU programmes to promote employment, social protection and social inclusion.

The MF/SE objectives are:

- Increase access to, and the availability of, microfinance for vulnerable individuals or groups who want to set up or develop businesses and microenterprises;
- Build up the institutional capacity of microcredit providers;
- Support the development of social enterprises, in particular by facilitating access to finance.

In pursuing its objectives, the MF/SE initiative pays particular attention to:

- vulnerable groups, such as young people;
- promoting gender equality;
- combating discrimination based on sex, racial or ethnic origin, religion or belief, disability or sexual orientation.

The MF/SE initiative includes new elements[27] particularly appropriate for the ESF framework:

- Increase **access to microfinance** by extending funding to microcredit providers to improve access to microfinance, particularly for people facing difficulties accessing the credit market. These include people who have lost or are at risk of losing their jobs, have difficulty in entering or re-entering the labour market, are at risk of social exclusion, or are socially excluded, and those who have difficulty accessing the conventional credit market and who wish to start up or develop their own microenterprises;
- Funding **for capacity-building in microfinance institutions**, such as support for a microfinance institution needing an IT system to deal with growing demand, or having to hire additional loan officers to better meet the needs of the target group;
- **Development of new financial instruments for social entrepreneurship**, by making hybrid financing available for social enterprises in the form of a combination of equity, loans, guarantees and grants.

MF/SE offer two types of financial products tailored to public and private institutions that provide microfinance loans and/or guarantees to individuals or microenterprises:

- **Funded instruments**, which include loans and equity. The pricing of funded instruments will reflect individual transaction risks as well as the local market. Financing for micro-borrowers may include new microcredits or micro-leases up to EUR 25 000;
- **Guarantees (EaSI Guarantee Financial Instrument)**[28], which provides capped guarantees and counter-guarantees covering loan portfolios in the microfinance and social entrepreneurship sector. The instrument is specifically dedicated to financial intermediaries in order to expand their range of final recipients and increase the availability and accessibility of microfinance for vulnerable groups, microenterprises and social enterprises.

27 EC (2015), '*Work programme funding priorities for 2015 – European Union for employment and social innovation (EaSI)*'.

28 EC and EIF (2015), '*Annex II to the Open Call for Expression of Interest to select Financial Intermediaries under EaSI – Capped Guarantee under the European Programme for Employment and Social Innovation ("EaSI") Indicative Term Sheet for the EaSI Microfinance Guarantee*'

The following table illustrates the main features of the MF/SE financial products:

MF/SE Financial products		Main features
Funded financial instruments	Senior loans	Long-term financing generally for 5-7 years, depending on the debt servicing capacity
	Subordinated loans	Financing subordinated to senior creditors, typically enhancing the final recipient's capital structure
	Risk-sharing loans	Senior loans combined with risk participation in microcredits
	Equity participations	Investments through ordinary or preferred shares, typically with an investment horizon of 6-8 years
EaSI Guarantee Financial Instrument		Guarantee characteristics: • Guarantee rate up to 80% of each underlying microcredit/guarantee; • Guarantee for up to 6 years, so covering defaults within 6 years of the loan starting. However, the maturity may be longer than 6 years; • Cap rate up to 30% based on expected cumulative losses for the entire portfolio; • Other than a potential commitment fee, no guarantee fee is charged to the financial intermediary. Microcredit characteristics: • Costs are related to the set-up or development of a microenterprise (investment and working capital), including loans to the self-employed; • Minimum maturity of three months; • Maximum amount of EUR 25 000. Final recipient characteristics: • Vulnerable persons who have lost or are at risk of losing their job, have difficulty in entering or re-entering the labour market, are at risk of social exclusion, are socially excluded or are disadvantaged with regard to access to the conventional credit market and who wish to start up or develop their own microenterprises including self-employment; • Microenterprises in both start-up and development phases, especially microenterprises which employ vulnerable persons.

Organisations that can apply for MF/SE initiatives are:

- EU Member States;
- European Economic Area (EEA) countries, in accordance with the EEA Agreement, and the European Free Trade Association (EFTA) Member States;
- EU candidate countries and potential candidate countries, in line with the framework agreements concluded with them on their participation in EU programmes;
- Public and private bodies established at national, regional or local level and providing microfinance for persons and microenterprises and/or financing for social enterprises in the above countries.

4.3 MORE INFO

MF/SE synergies with the ESF

ESF initiatives can be enhanced by MF/SE financial instruments through:

- New job opportunities for unemployed people and non-bankable individuals;
- New financial instruments for financial intermediaries providing microfinance and local and non-bank intermediaries addressing social needs;
- New financial instruments for social enterprises.

MF/SE initiatives are therefore particularly appropriate for thematic objective 8 and thematic objective 9.

5. WHO IMPLEMENTS FINANCIAL INSTRUMENTS?

KEY MESSAGE

This section describes the main features of financial intermediaries by:

- distinguishing between bank and non-bank intermediaries and between multi-markets and local intermediaries;
- assessing how they can contribute to the social impact investment;
- advising on choosing the most appropriate financial intermediaries.

5.1 The main features of financial intermediaries

Financial intermediaries play a crucial role in the social impact investment ecosystem, by providing links between investors and final recipients, as well as by proposing innovative solutions and offering advice and non-financial support which can help to lower costs and reduce risk.

In the ESF framework, financial intermediaries operating for social goals have a dual mission[29] of social responsibility (offering services to those excluded from the formal banking sector) and being financially-driven and sustainable. Such a trade-off can influence the choice of financial instruments, how they are structured and organised and which stakeholders should be involved. For instance, non-profit financial organisations may be particularly vigilant for their social mission, while commercial banks and private investors may be more interested in financial returns.

Financial intermediaries that operate in the financial ecosystem differ in legal status, size, governance structure and mission. Three main distinctions should be considered:

- The ability to collect **deposits** distinguishes banks from non-banks;
- **Proximity** to the local socio-economic context distinguishes multi-market from local intermediaries;
- Their **mission**, which is investing sustainably or not.

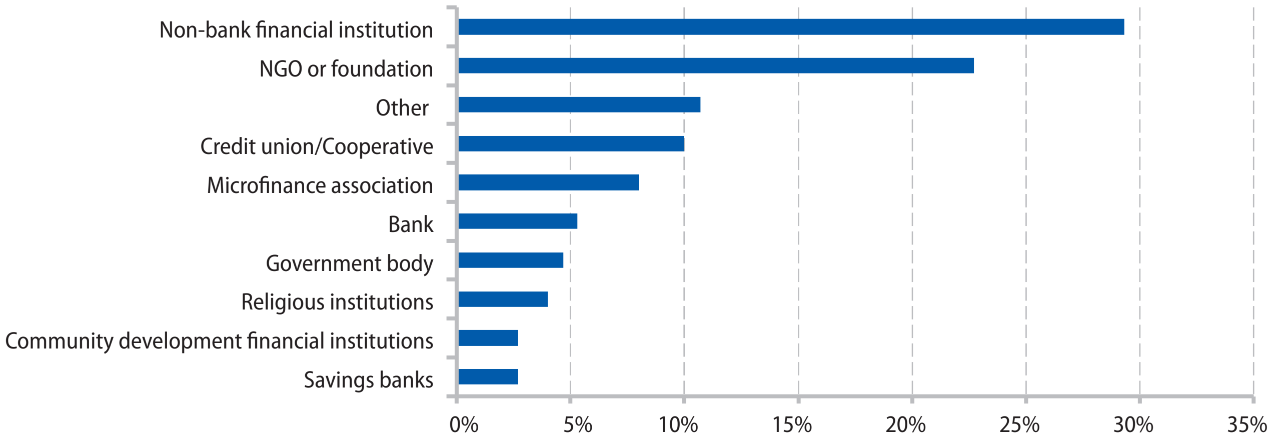
29 CERISE (2006), *'Handbook for the analysis of the governance of microfinance institutions'.*

5.1.1 Bank *vs* non-bank intermediaries

Banks normally do not provide finance to non-bankable or socially excluded targets as part of their usual commercial activities. These financial intermediaries include commercial banks, credit unions, cooperative banks and savings banks.

Non-banks operate more in markets with low financial service penetration and limited public or third party support. Non-banks may not only aim at developing commercial activities but also at providing finance to socially excluded targets. These intermediaries include NGOs or foundations, specialised microfinance intermediaries (non-bank financial institutions) government bodies or agencies, and community development financial institutions.

Figure 5.1: Distribution of microfinance intermediaries by institutional type



Source: European Microfinance Network (2014), '*Overview of the microcredit sector in the European Union 2012-2013*'.

According to the survey on microfinance provided by European Microfinance Network[30], non-banks represent the bulk of financial intermediaries with NGOs and non-bank financial institutions providing more than 50% of microfinance. Among banks, credit unions and cooperative banks support social investment more than commercial banks.

30 European Microfinance Network (2014), '*Overview of the microcredit sector in the European Union 2012-2013*'.

Table 5.1: The main characteristics of financial intermediaries[31]

Financial Intermediaries		Ownership	Client type	Products	Sustainability and independence
Bank financial intermediaries	*Commercial banks*	Private shareholders	Commercial micro, SME, and large enterprise clients, urban, fewer poor clients	Credit, savings, payments, sometimes insurance	High; initial support required, then independent
	Credit unions/ coop. banks	Owned by members	A range of clients, depending on members	Basic savings and credit, although savings led	Medium to high depending on capacity of management and governing body
	Savings banks	Shareholders government and/or private	Broad target group: poor and non-poor; generally rural	Primarily savings; wide distribution network leveraged for payment services	Medium to high
Non-bank financial intermediaries	*NGOs or foundations*	No owners, strong ownership characteristics among founders and board	Poor, "unbanked" clients; for multipurpose NGOs, various target clients and beneficiaries	Traditionally credit led; multipurpose NGOs generally add financial services to other activities	Low to medium (high costs and lack of separation of activities can delay or prevent sustainability of financial activities)
	Social equity fund providers	Funded by a group of social venture capitalists or impact investors	Social enterprises; start-ups	Equity, mezzanine capital	Medium

31 Table is based on World Bank (2013), '*The new microfinance handbook*', pp. 173-174.

Financial Intermediaries		Ownership	Client type	Products	Sustainability and indepen-dence
Non-bank financial intermediaries	*Specialised microfinance intermediaries*	Mix of public and private shareholders; sometimes other financial institutions or other companies	Clients vary depending on type of product (for example, credit or insurance)	Credit only, leasing, insurance; normally not able to take deposits	Medium to high; initial support may be required depending on target market
	Government bodies or agencies	Shareholders, generally government, some private	General population; government sometimes mandates poor or rural focus	Varied; some offer a full variety of financial services, others focus on agricultural lending	Varied; medium (benefits from public subsidies in certain cases due to rural distribution network)
	Community development financial institutions	Private shareholders	Local disadvantaged people and community business	Basic credit and savings	Varied sustainability and independence

5.1.2 Multi-market *vs* local intermediaries

Financial intermediaries that are involved in the ESF framework should recognise the value of social investments. They should understand the specific financial needs of the target groups and the area in which they operate. This aspect is particularly important for commercial and larger financial institutions which, although they have specific local units, generally operate in several markets and could be therefore more distant from the social peculiarities of a specific territory.

Local financial institutions:

- May be better able to play the role of 'community financial intermediaries', since they know the local borrowers, their customers and suppliers, and the local business and social conditions; therefore, they can rely on more face-to-face contact with both local enterprises and individuals[32];
- They may also have an advantage in processing soft information because of the physical proximity of the loan officer to the management of the institution that must approve the credits[33];
- With greater knowledge of the local social environment, personal contact with the applicant, familiarity with individual situations and possibilities, they can increase the chance of funds being repaid[34].

However, these counterparts are generally smaller intermediaries and can suffer more from problems of self-sustainability, due to a reliance on subsidies or shareholder contributions and tend to finance projects with low economic returns. Moreover, despite their knowledge of the local context and their professional lending staff, they often require technical support for institutional capacity building.

32 Berger, Molyneux and Wislon (Eds.) (2015), *'The Oxford handbook of banking – Second Edition',* p.302.

33 *Ibidem.*

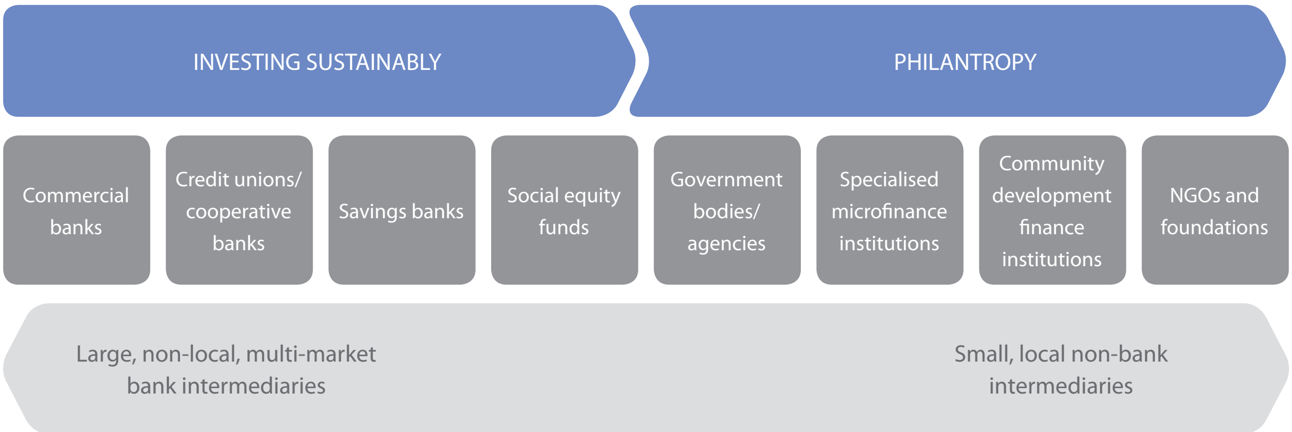
34 Better Future for the Social Economy Network (2012), *'A better future – Results of the network for better future of social economy'.*

5.2 Financial intermediaries and social impact investment

Financial intermediaries operating under the ESF framework should promote investments that generate social impact. The financial instruments should produce positive social outcomes and contribute to the social inclusion of the most disadvantaged groups. Even if tailored to entrepreneurial needs, financial instruments should be set up to promote a social mission. This does not imply, however, that investing in social goals does not generate economic and financial returns.

Supporting finance for vulnerable groups and start-ups implies that financial intermediaries accept a higher degree of risk and lower returns, so financial products may be effective only in the long-run. In this case, financial products should be shaped to maximise the leverage effect. Social investment relies on the capacity of financial intermediaries to sustain long term projects by minimising the cost of running them.

Impact investment[35]



There is a **trade-off** between financial sustainability and the social mission. Maximum investment sustainability is normally ensured by bank intermediaries and in particular large commercial banks, which can diversify their assets and deposits reducing credit and liquidity risk. Bank intermediaries can be less willing to invest in social activities associated with higher risk and lower returns. On the other hand financial intermediaries such as grant-based organisations like NGOs or foundations, provide finance only for social purposes, expecting lower or only philanthropic returns. For these financial intermediaries social mission is a priority compared to financial sustainability.

When financial intermediaries move from financial products for commercial purposes to social impact investment, two additional aspects should be taken into consideration:

35 Figure adapted from Social Impact Investment Task Force (2014) *"Impact investment: the invisible heart of markets – Harnessing the power of entrepreneurship, innovation and capital for public good"*

Adaptability of the financial products:

- Financial intermediaries should ensure a variety of financial products adapted to different social needs and the changing social environment, including medium and long-term finance for projects that may carry higher risks;
- When dealing with enterprises, adaptability implies that financial intermediaries should not limit their focus to a specific investment stage and should be ready to invest when the social enterprise is at a different stage. Adaptability implies shaping financial instruments to address the specific needs and expectations of individuals or disadvantaged groups;
- Adaptability can be transversal for financial intermediaries. Banks and large intermediaries, by operating in different markets, can have a broader and more diversified set of financial products; small and non-bank intermediaries can have a restricted number of tailored financial products.

Qualified expertise:

- Financial intermediaries dealing with social investment should be equipped with experts capable of understanding the social needs of final recipients;
- Other than financial support, when dealing with social issues, financial intermediaries should provide supplementary technical, financial and managerial advice;
- Social impact should be constantly and efficiently monitored to measure the achievement of social goals. Expertise is required to guarantee a transparent and efficient system for measuring the social impact of investments;
- Large bank intermediaries can be better equipped to provide additional services and have an operational accountability system. Small local non-bank intermediaries, instead, may be better equipped in terms of understanding local social needs.

5.3 The selection of financial intermediaries

The choice of financial intermediaries implementing financial products under the ESF framework should be based on three aspects.

1) Managing authorities should consider for each financial intermediary:

- Proximity to local market;
- Importance of the social mission to the financial intermediary;
- Financial sustainability of their investment goals;
- Capacity to implement financial instruments that generate returns;
- Capacity to adapt financial products to social investment;
- Capacity to understand social needs;
- Provision of additional non-financial services;
- Provision of additional private and public resources as well as capacity to attract private sector support (and financing) to public policy objectives.

The following table offers a synthesis of how financial intermediaries match these categories.

Table 5.2: The key characteristics of the financial intermediaries

Financial Intermediaries		Proximity to local market	Focus on social mission	Focus on investment sustainability	Adaptability of financial products for social investments	Understating of social needs	Additional non-financial services
Bank financial intermediaries	Commercial bank	★	★	★★★	★★	★	★★★
	Credit unions/ Cooperative banks	★★	★★	★★	★★	★★	★★
	Savings banks	★★	★★	★★★	★	★★	★★
Non-bank financial intermediaries	NGOs or foundations	★★★	★★★	★★★	★★★	★★★	★★
	Social equity fund providers	★★	★★★	★★★	★★	★★	★
	Specialised microfinance intermediaries	★★★	★★★	★★	★★★	★★★	★★
	Government bodies or agencies	★★	★★	★★	★★	★★	★★
	Community development financial institutions	★★	★★	★★	★★	★★	★★

Note: ★★★=High; ★★=Medium; ★=Low

2) How each financial intermediary matches thematic objective goals

- **TO 8** supports employment and labour mobility, by sustaining business creation and self-employment. Unemployed people, in particular the long-term unemployed, in addition to financial support, need non-financial services such as training to improve their capacity and advice on business creation. SMEs, which create new jobs should have a clear and efficient business strategy, so financial sustainability of their projects is of primary importance;
- **TO 9** aims at social inclusion for disadvantaged groups. For these, financial intermediaries should be more orientated towards a social mission then financial sustainability, since they are often dealing with non-bankable and poor people which generate low financial returns. Socially excluded people need financial intermediaries that are locally based and have experts that understand local social needs. For these targets specific and adaptable financial products are required;
- **TO 10** promotes education. Students who are willing to improve their human capital do not require particular characteristics from the financial intermediaries. Additional non-financial services can be offered for job orientation.

The following table displays the relation between thematic objectives and the main characteristics of the financial intermediaries. The logic behind the table is to show which financial intermediary characteristic is the most important for the thematic objective's main goals. For instance, disadvantaged groups under thematic objective 9 need financial intermediaries that are close to the local market or that are focused more on social mission than on financial sustainability. Start ups and business creation (thematic objective 8), instead, need more attention to the financial sustainability of their project rather than on social mission.

Table 5.3: The key characteristics of the financial intermediaries and the ESF thematic objectives

ESF thematic objectives	Proximity to local market	Focus on social mission	Focus on investment sustainability	Adaptability of financial products for social investments	Understating of social needs	Additional non-financial services
TO 8 – Employment and business creation	★★	★★	★★★	★★	★★	★★★
TO 9 – Social inclusion of disadvantaged groups	★★★	★★★	★	★★★	★★★	★★
TO 10 – Education	★★	★★	★	★	★	★★

Note: ★★★=High; ★★=Medium; ★=Low

3) Creating a new ad-hoc financial intermediary or choosing from existing players[36]

- An ad-hoc intermediary should be more tailored to a mission but at the expense of higher costs, especially when the financial instrument is temporary;
- If the financial intermediary is chosen from existing players, the main advantage lies in leveraging existing expertise with reduced cost;
- Established financial institutions should shift from simply selling a financial product to adjusting both products and services to final recipient needs, to improve their future cash flows and so their ability to repay the financial resources[37].

36 OECD (2014), *'Policy brief on access to business start-up finance for inclusive entrepreneurship'.*

37 COPIE (2012), *'Designing microfinance operations in the EU – A manual on how to build and implement microfinance support programmes using the ESF'.*

5.1 REGULATION

European Code of Good Conduct for Microcredit Provision

In 2011 the Commission launched the European Code of Good Conduct for Microcredit Provision[38] which provides a set of standard terms for management, governance, risk management, reporting, and consumer and investor relations. These standards are for the benefit of customers, investors, funders, owners, regulators and partner organisations. The Code of Good Conduct is primarily designed to cover non-bank microcredit providers which provide loans of up to EUR 25 000 to micro-entrepreneurs.

According to the code, microcredit providers should:

- Ensure constant and clear relations with final recipients and investors;
- Have an efficient governance structure;
- Adopt common reporting standards;
- Implement a management information system.

Moreover, the code sets a series of obligations of the microcredit financial intermediaries towards final recipients and investors, such as:

- **Financial intermediary relations with final recipients and investors:** guarantee sufficient information for final recipients; guarantee final recipient rights; avoid over-indebtedness of customers; ensure costumer care; guarantee staff and institutional behaviour; ensure final recipient data protection; guarantee investor relations;
- **Governance:** provide business plan; management and external boards;
- **Risk management:** provide a risk management framework; manage fraud and security risk; internal audit;
- **Reporting standards:** adopt common reporting standards;
- **Management information systems:** guarantee functionality and expandability.

38 EC (2011), *'European code of good conduct for microcredit provision'*.

6. WHAT ARE THE MAIN FINANCIAL PRODUCTS?

KEY MESSAGE

This section describes the main financial products of loans, guarantees, equity and quasi-equity by analysing:

- the advantages and disadvantages of each financial product;
- how they can contribute to each ESF thematic objective;
- examples in the implementation of financial products to address ESF thematic objectives.

6.1 Introduction

Traditional financing mechanisms such as grants and interest rate subsidies supported disadvantaged groups, in particular self-employment, as well as SME activity. Today these are seen as expensive policy solutions due in a time of constraints on government budgets[39]. New emerging financial instruments, in particular microfinance, can complement the role of traditional policies and support the significant entrepreneurial potential of financially disadvantaged social groups.

Financial instruments can support social projects/investments by providing the following financial products[40]:

- **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;
- **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;
- **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;
- **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 un- secured and subordinated and in some cases convertible into equity, or as preferred equity.

39 OECD (2014), '*Policy brief on access to business start-up finance for inclusive entrepreneurship*'.

40 *fi-compass* (2015), '*Financial instruments products – Loans, guarantees, equity and quasi-equity*'.

6.2 Loans

Loans represent an agreement that obliges the lender to give a sum of money (principal) to the borrower in exchange for future repayment of the principal along with interest, within an agreed time. In general, the interest charged 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. 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.

6.1 MORE INFO

Microcredit

Loans **up to EUR 25 000** are defined as **microcredits** and can be used to provide credit to:

- **Microenterprises** – businesses employing less than 10 people and with an annual turnover and an annual balance sheet of less than EUR 2 million;
- **Disadvantaged persons** – such as the unemployed, inactive people or immigrants – who wish to go into self-employment but lack access to traditional banking services.

In implementing microcredits for social purposes, the managing authority normally consider that:

- They should be implemented in a **flexible and sustainable way** to meet specific individual needs and expectations. This is particularly important in the European social investment ecosystem, which lacks a common microfinance business model. This is due to large differences across countries in terms of intermediary profile, target final recipients and regulatory frameworks. In order to create a positive impact on the social ecosystem, microcredits should be tailor-made and demand-driven, with a clear focus on the target group and business sector;
- Microcredit efficiency and effectiveness can be enhanced when **supported by non-financial services**, such as mentoring, training and counselling activities. Final recipients often need additional advice and business development services so that they can autonomously run a business and use the loans productively.

Normally microcredits have relatively higher management costs, higher risk and therefore higher interest rates. It follows that not all financial intermediaries are willing to operate in microfinance markets. Microfinance intermediaries are typically characterised by features which better meet the specific social ecosystem. Mainstream commercial lenders generally find it unprofitable and risky for their reputation to provide small loans to people on low incomes or at-risk of exclusion. In addition their standardised risk analysis may not be appropriate to deal with these customers. On the contrary, microfinance intermediaries and not-for-profit lenders have developed appropriate risk analysis including budget schemes and creditworthiness measurements[41].

41 EC (2008), *'Financial services provision and prevention of financial exclusion'*, p.119.

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). The main characteristics of these **secured loans** are:

- A contract for the return of principal plus regular payments of interest within an agreed time period;
- Risk of loss is also determined by the quality of the collateral backing the loan;
- Lower interest rates than unsecured loans;
- Higher chance of repayment.

TYPE OF FINAL RECIPIENTS	Individuals/Enterprises
THEMATIC OBJECTIVE	TO 8 – Entrepreneurship and business creation, adaptation of workers, enterprises and entrepreneurs to change, access to employment for job-seekers and inactive people. TO 9 – Promotion of social entrepreneurship, active inclusion and improving employability, integration of marginalised groups. TO 10 – Enhancing access to education and lifelong learning, improving the labour market relevance of education and training systems, facilitating the transition from education to work.

PROS	CONS
• Not particularly difficult to administer (so there are limited management costs/fees); • A defined repayment schedule makes budgeting easier; • The lending mechanism is well understood, reducing the need for capacity building and the risk of misunderstanding; • Loans preserve the equity of the final recipient as there is no claim on the ownership of the enterprise.	• Funded products such as loans require more initial resources than unfunded products such as guarantees; • It is sometimes difficult to establish the probability of default, especially with a lack of history of final recipients; • Financial intermediary counterparty risk needs to be carefully assessed as they might also go bankrupt; • The advantage for the final recipient is almost entirely financial. There are limited additional benefits as know-how is not transferred.

Unsecured loans do not require collateral. For this reason they are the only option for borrowers who do not own property or assets. The main characteristics of unsecured loans are:

- A contract for the return of principal plus regular payments of interest within an agreed time period;
- Risk of loss is determined by the certainty of cash flow from the borrower;
- Lender focuses mostly on the credit rating, history and debt ratio of the borrowers;
- Higher interest rates than secured loans.

The ESF can ensure **soft loans**, which are offered at lower than market interest rates, with longer repayment periods, or with reduced collateral requirements.

6.2 EXAMPLE

Bank Gospodarstwa Krajowego, Poland

Loans initiative implemented through a fund of funds and several financial intermediaries, with about EUR 6 million of ESF funding, and EUR 7 million total operational programme funding. The aim of the initiative is to create new capacities for social enterprise investments. Final recipients are NGOs conducting business, social cooperatives, religious organisations, as well as non-profit public and private companies all across Poland, throughout 5 macro-regions. Loans are given for 60 months with a grace period of up to six months for repayment of principal. The maximum amount is EUR 25 000, with an interest rate of 0.69%, there are no additional fees, and the *de minimis* rule applies for State aid. Applicants can use consulting services before and after obtaining the loan.

6.3 Guarantee

A guarantee supports individuals and companies entering new markets for social investments where they lack knowledge and proven techniques to manage credit risk. Guarantee schemes support access to finance by transferring or mitigating risks and therefore reducing the costs that enterprises or individuals are not able or willing to pay. They act as a type of 'insurance policy' against non-payment. The guarantor issues a guarantee for an agreed amount of debt in the event that the final recipient does not repay the lender. They are therefore particularly appropriate for unbankable individuals or enterprises with low expected financial returns.

The key features of a guarantee are:

- Mitigating losses for the lender in the event of default;
- Lowering the cost of financing, so increasing the financial sustainability of projects.

An **uncapped guarantee** for a new portfolio of loans provides protection against losses and full reimbursement of each loan in a new portfolio, within a pre-determined guarantee rate (which ensures that the bank bears some risk). This guarantee reduces the capital required for a bank.

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

All types of guarantees should specify the risk sharing formula, the timing and calculation of guarantee claim payments, responsibilities for collection against defaulting borrowers, what happens to funds recovered, maximum exposure to individual loans, guarantee approval and issuance procedures as well as the fees. Typically, the borrower pays the guarantor a premium as a fee, in addition to repaying the loan. These fees depend on the guarantee period, the risk factor, and the amount of the loan to be guaranteed. In the event of default by the borrower – and based on terms clearly defined in the contract – the guarantee fund will reimburse the lender. If there is no loan default, there is no cash outflow from the guarantee fund.

TYPE OF FINAL RECIPIENTS	Individuals/Enterprises
THEMATIC OBJECTIVE	TO 8 – SMEs/social enterprises for business/employment expansion, self-employment, people at risk of social exclusion (young people in particular, as for the Youth Guarantee). TO 9 – Social enterprises for investment projects addressing disadvantaged groups, promotion of social entrepreneurship, enhancing access to affordable and sustainable high-quality services. TO 10 – Promoting equal access to good quality education, enhancing equal access to lifelong learning for all age groups, facilitating the transition from education to work, strengthening vocational education and training systems and their quality.

PROS	CONS
• Guarantees can preserve the equity of final recipients as there is normally no claim on the ownership of the enterprise; • Potential benefits for final recipients could include *inter alia*, lower or no guarantee fees, lower or no collateral requirements as well as lower risk premiums; • Since programme contributions cover only certain parts of loans (appropriate multiplier ratio), there is a high leverage effect; • The investment risk for third party lenders is reduced (because they only bear part of the risk of default); • Unfunded products such as guarantees require less initial support than funded products such as loans.	• The guarantee represents a risk reserve for the lender and does not provide liquidity. It can however, provide capital relief for the lender; • Estimating the appropriate cap, or maximum limit, can be challenging; • There is no transfer of business expertise to final recipients.

6.3 EXAMPLE

Guarantee Fund for creation of companies initiated by women, France[42]

The 'Fonds de garantie à l'initiative des femmes (FGIF)' is part of the national Guarantee Funds scheme. This is funded through the French Ministry of Labour with support from ESF and encourages the creation, take-over and development of companies by women. The FGIF scheme is available to all women, regardless of their professional status, the company's legal form or business activity. The scheme is managed at local level but selection criteria are defined at the national level. Business proposals are appraised by business advisors and business professionals deciding whether the project will be covered. The guarantees are provided for loans of at least EUR 5 000 per company and for 2 to 7 years. The guarantee rate is 70% for loans under EUR 38 000 with guarantees capped at EUR 27 000 for loans of EUR 38 000 or more. The key element of this financial product is an individual approach with a strong and personalised selection process involving due diligence of the applicant and the business plan and meetings to coach the project initiator.

42 OECD (2014), *'The missing entrepreneurs 2014 – Policies for inclusive entrepreneurship in Euro'*, p.196.

6.4 Equity

Equity is a financial product where an investor finances an enterprise in return for a share of the ownership. Equity investors can be active – playing a hands-on role in running the business – or passive – taking little part in the management.

While loan capital requires interest payments regardless of the profitability of the business, equity capital does not. Types of equity investment are often described by the relevant development stage of an enterprise, 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 not just for financial interest, but they also pursue strategic developments and complementary technology or business fields for the enterprise. Targeted enterprises are generally high tech (such as biotech, ICT, hi-tech energy, nanotechnology, applied mechanics and robotics) or for innovative products or services with expensive R&D projects. Mature enterprises with proven business models may need equity investment to fund new projects, including the penetration of new markets.

The rationale behind more risky investments is the expectation of higher-than-average returns. These investments are sometimes called *Venture Capital*. They are time-consuming and cost-intensive (due diligence may be carried out for several potential business plans before any investment is made). Typically there are few target enterprises and large amounts in each transaction.

At the very early stage of an enterprise, a Business Angel, who is normally an individual with business experience, can invest their personal assets and provide management experience.

TYPE OF FINAL RECIPIENTS	Enterprises
THEMATIC OBJECTIVE	TO 8 – SMEs/social enterprises for business/employment expansion. TO 9 – Social enterprises for investment projects addressing disadvantaged groups.

PROS	CONS
• There are higher potential returns compared to pure debt instruments; • There is an active role in project management and access to shareholder information for the investor; • The local private equity industry and local investor activity in riskier areas can be encouraged; • The need for equity investment can prompt changes in regulatory framework to encourage a private equity market; • The company can benefit from investor's management expertise; • Public investors can influence the configuration and mission of a company.	• There is insolvency risk for all the invested capital; • Time-consuming and cost intensive investment; • These investments are more difficult to administer than normal loans (high set-up and operational costs), more time-consuming and cost-intensive; • Short-term financing is not possible, since returns are feasible only in the long term; • Establishing the process for the investment can be challenging; • Compared to debt instruments, equity can be less attractive to final recipients due to the obligation to yield control.

6.4 EXAMPLE

Midtjysk Iværksætterfond (Midtjyske Entrepreneur Fund), Denmark

The Midtjyske Entrepreneur Fund invests in knowledge-intensive and innovative businesses. In cooperation with Nupark Accelerance (an accelerator program), there are investments in enterprises, provided there is a corresponding amount from another investor. The fund manager decides on a case by case whether to use a loan or an equity investment (or a combination of the two). The decision is taken after enterprises have entered the six month accelerator program, under the supervision of the fund manager. Enterprises that complete the program can apply for financing from Midtjysk Iværksætterfond. The applicants are evaluated by an investment committee and investments are based on the results of the enterprise during the accelerator program and their future attractiveness. The fund manager selects private co-investors, who are typically Business Angels. Enterprises that receive capital are also followed closely by the fund manager who, while the growth plan is being implemented, works actively with them at least once a week.

6.5 Quasi-equity

Providing finance using quasi-equity products is valuable in supporting social enterprise development and avoiding market distortions related to grants. By filling the gap between debt and equity, these are usually structured as investments where the financial return is a percentage of future revenue streams.

This can be used when enterprises face onerous debt financing or when share capital is not possible due to their legal status.

Quasi-equity is often defined as a 'patient' capital, since it implies long-term debt or financial investment with terms and conditions that do not require immediate repayment[43]. Quasi-equity is therefore particularly appropriate for social enterprises, which often have a financial-social return gap. They provide goods and/or services to disadvantaged groups generating a high social impact, but suffer from a lack of capital and low financial returns in their projects. The advantage of quasi-equity therefore is that it creates appropriate incentives for social enterprises to operate efficiently with more result-oriented strategies.

The key features of quasi-equity are:

- Return related to the performance of the (social) enterprise;
- Investor has no immediate stake in ownership of the enterprise, but may take a seat on the board;
- No/low return if the enterprise does not meet expectations;
- The return can be capped;
- Flexibility of returns and payments, as agreed by all parties;
- Due diligence by the investor will focus on the viability of the business model, the track record of management team and the credibility of forecasts.

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 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.

43 Handford (2005), '*Guide to finance social enterprises*'.

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 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 an enterprise is wound up.

TYPE OF FINAL RECIPIENTS	Enterprises
THEMATIC OBJECTIVE	TO 8 – SMEs/social enterprises for business/employment expansion. TO 9 – Social enterprises for investment projects addressing disadvantaged groups.

PROS	CONS
• For co-investors, there are higher returns compared to pure debt instruments; • Addresses specific risk capacity constraints in a particular market segment; • Stimulates investment by local private equity industry, also in riskier areas not previously serviced; • Might prompt changes in the regulatory framework to encourage a private equity market;	• These investments are more difficult to administer than normal loans (high set-up and operational costs), more time-consuming and cost more; • Short-term financing is not possible, since returns are feasible only in the long term; • Any ancillary services such as management expertise would be an expense for the company; • There are typically a few investors and final recipients, while the investment amounts are high; • Compared to debt instruments, they may be less attractive to final recipients as they may involve loss of control when bonds are converted into equity.

6.5 EXAMPLE

Mikromezzaninfonds, Germany

The Mikromezzaninfonds (MMF) combines equity capital and loans up to EUR 50 000. The MMF aims at small and young enterprises, start-ups, enterprises that offer training positions, disadvantaged people such as women and migrants as well as social and eco-oriented enterprises. When the MMF started in July 2013, it provided EUR 35 million. EUR 21 million came from the ESF. In August 2014 the total was increased by another EUR 35 million. Between July 2013 and November 2014, 1 000 enterprises were supported with investments totalling EUR 41 million, 6 000 jobs were created and 4 300 were safeguarded. The fund offers financing anywhere in Germany for up to 10 years at a fixed rate of 8% p.a. and with a profit related component of 1.5% p.a. via the medium sized investment company network. The fund is managed by NBank, Lower Saxony's investment and development bank.

In addition, there are mixed forms of financial products, defined as **hybrid capital**, which contain elements of grants, equity and debt capital[44]. The grant character can be explained as there are no interest costs and, in certain pre-agreed scenarios, the investment is converted into a grant. Financial products with hybrid capital character include:

- A *recoverable grant,* a loan that must be paid back only if the project reaches certain previously defined milestones. If the milestones are not reached, the recoverable grant is converted into a grant. This mechanism can be used if success of the project enables the social enterprise to repay the loan to the social investor;
- A *forgivable loan*, a loan which is converted into a grant in the event of success (but it can be also partially converted in case of failure). If the social enterprise reaches the goals agreed beforehand, the loan does not have to be repaid;
- A *convertible grant*, when the social investor provides the enterprise with a grant that is converted into equity under pre-determined conditions.
- A *revenue share agreement*, when the investor finances a project and receives a share of future revenues. This risk sharing model can be used to repay the financing and gives the social enterprise financial flexibility.

44 Social Investment Task Force (2011), '*Social investment manual – An introduction for social enterprises*'.

Notes

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contact@fi-compass.eu

European Commission
Directorate-General
Employment, Social Affairs and Inclusion
B-1049 Brussels

European Investment Bank
Advisory Services
fi-compass
98-100, boulevard Konrad Adenauer
L-2950 Luxembourg