Interest of Financial Instruments for the management of public funds, opportunities and difficulties

Ricardo Pedraz González

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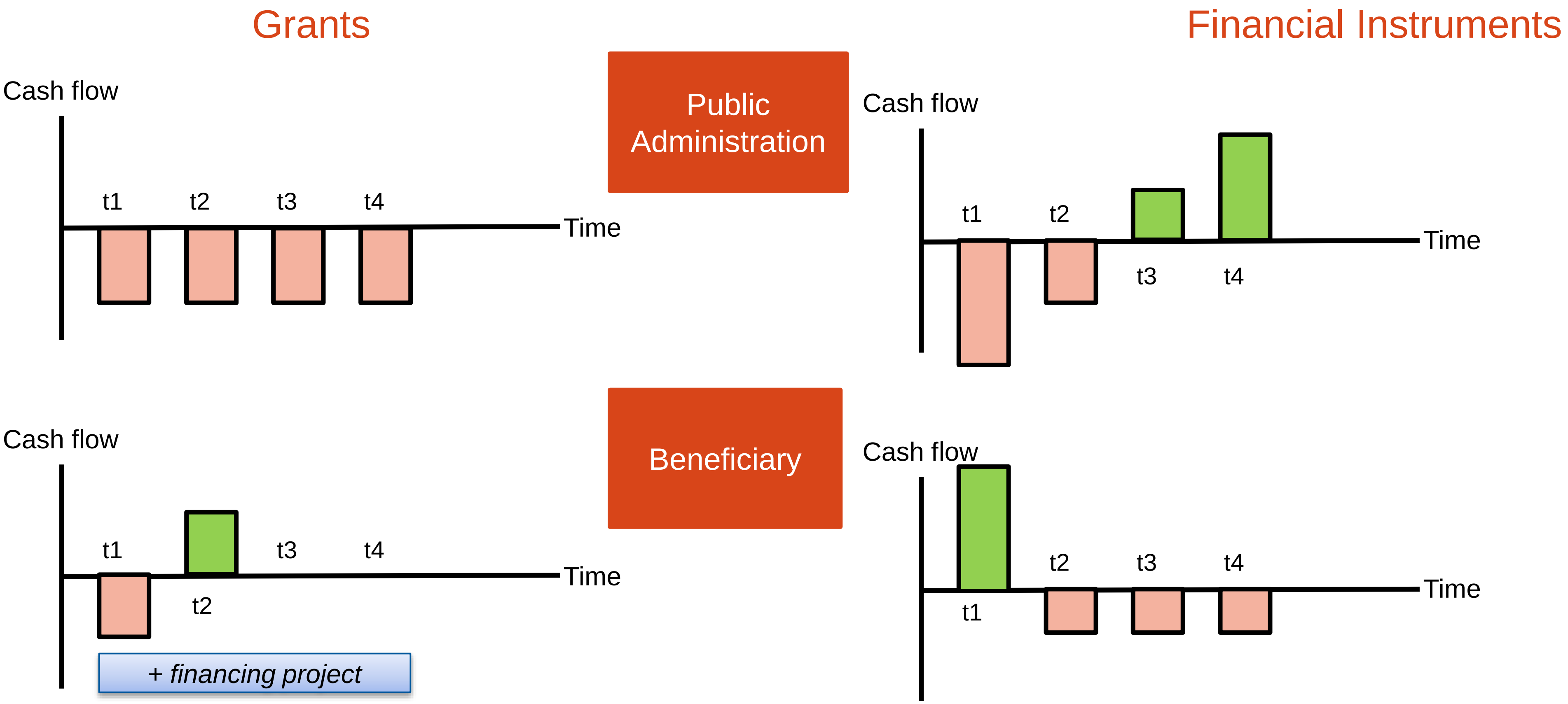
PURPOSE:

- Those working in programmes that have a private sector development component with the background on the types of financial instruments that may be relevant to be applied by your Departments/Agencies:

INDEX:

- Introduction about the differences between financial instruments and grants
- Definition of each type of financial product and financial instrument
  - Loans, Equity and Guarantees
- Risks associated to each type of financial instrument and product
  - Loans, Equity and Guarantees
- (Theoretical) Intervention logic of each financial product

Differences between Grants and Financial Instruments

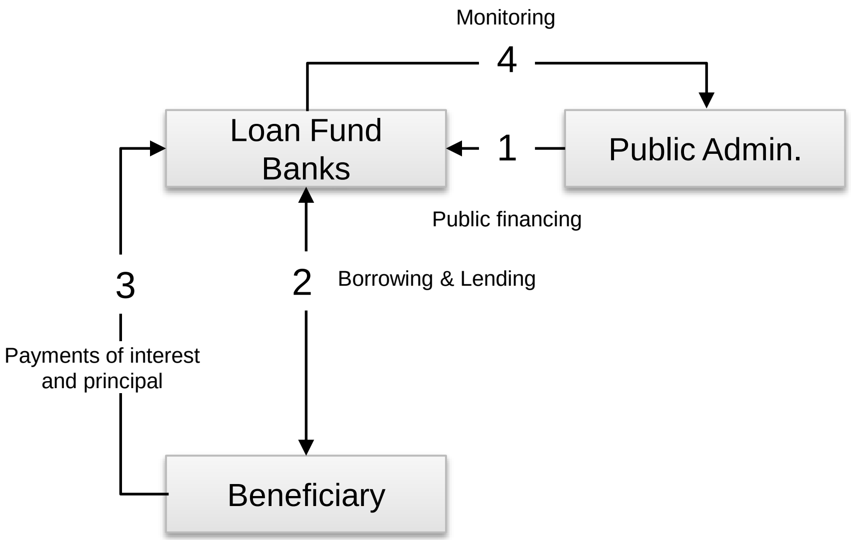


Financial Instruments: Loans

Public lending

A loan is where the Public Administration provides funding and is contractually entitled to repayment of this amount over time or at a future date. The original amount borrowed is known as the principal, whilst any additional income levied by the administration as a result of providing this funding is considered interest.

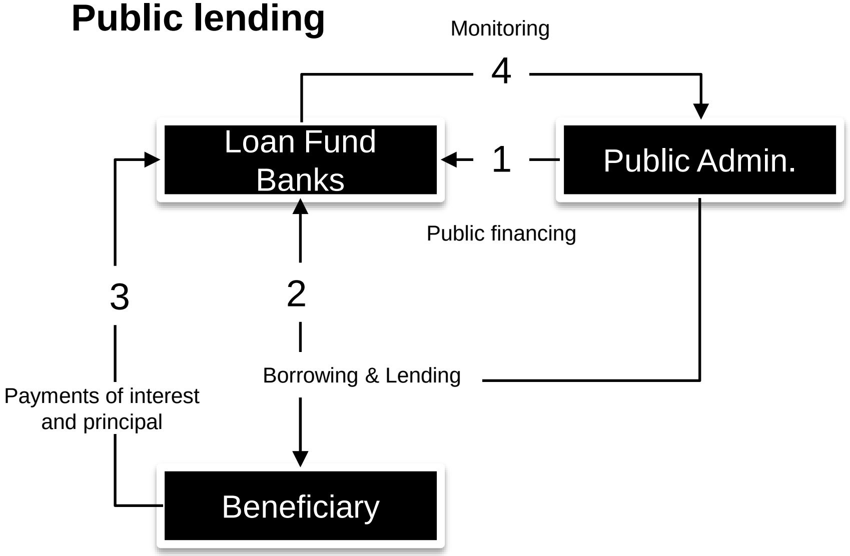
Loans can be repaid according to various repayment terms – monthly, quarterly, bi-annual or annual, or one-off bullet repayment.



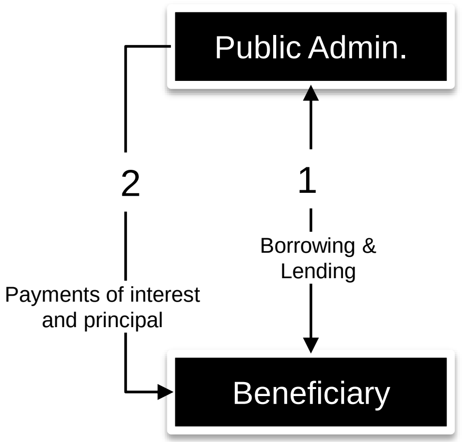
Public loan through LF or Banks

Financial Instruments: Loans

Public lending



1st lost Public loan through LF or Banks



Direct Public lending

Financial Instruments: Loans

- **Financial Risk**

The principal financial risk is the risk of default on repayments by the borrower. This is particularly relevant to programmes being approved using loan funding where the probability of repayment is low.

- **Other Risks**

Public admin has to consider various elements to protect itself from reputational risk through either who it has elected to provide lending to or how the funding has been used.

When considering charging interest we have to balance the need to ensure concessionality that will help private sector development with the need to maximize value for money for the taxpayer in achieving reasonable returns.

If there were an incorrect assumption about State Aid regulation, it would require retrospective restatement of it and would increase the risk of losing co-finance.

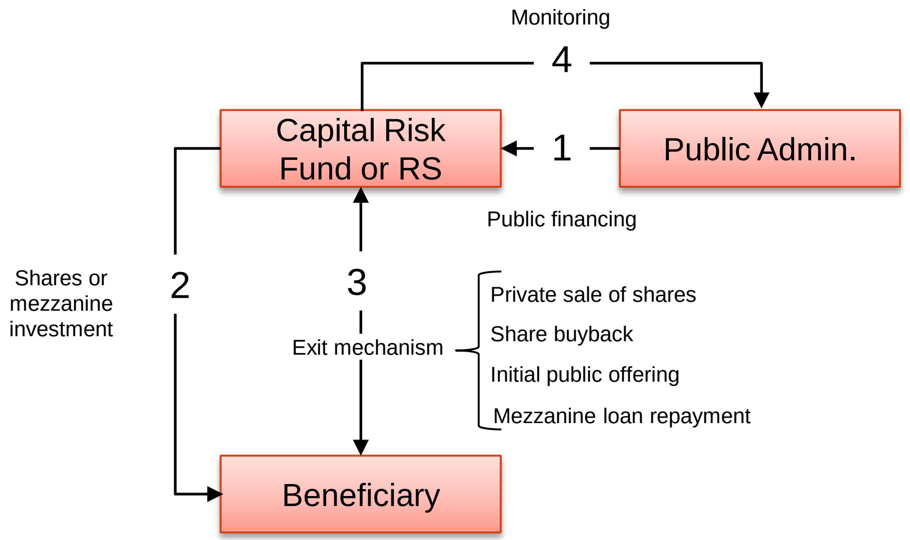
Financial Instruments: Equity

Public capital investment

Equity exists in a situation where, in exchange for providing funding, Public funding is allocated a shareholding in a for-profit making entity.

Shares normally offer associated voting rights and the rights to repayment on the breakup of the entity or to dispose of the shareholding. It is possible for there to be different types of shares and for different types of shareholdings to have different rights attached.

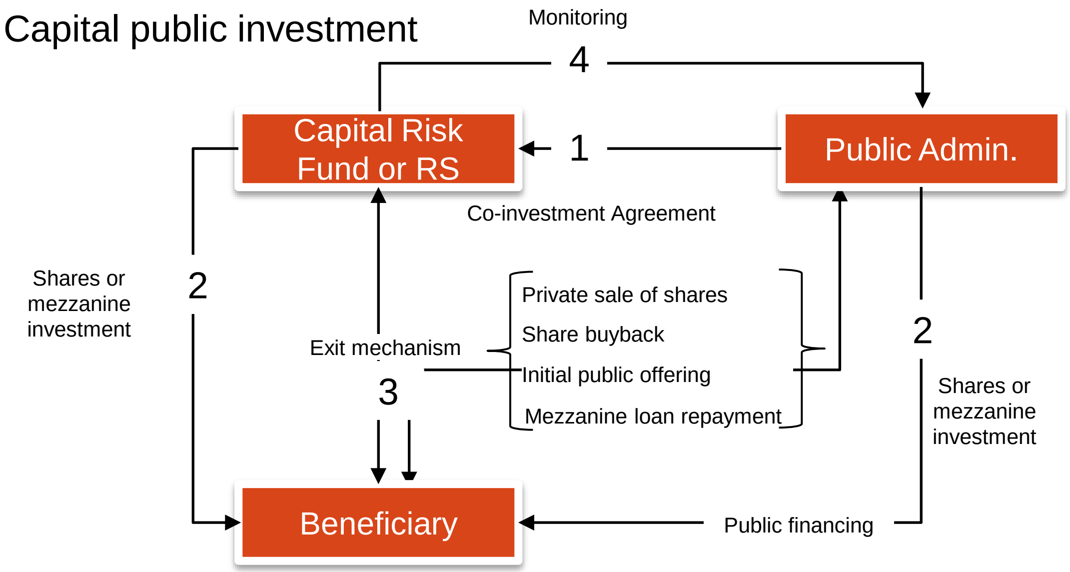
On dissolution of a company, shareholders are normally entitled to their proportion of the net assets or an entity, after deduction of protected liabilities such as secured loans.



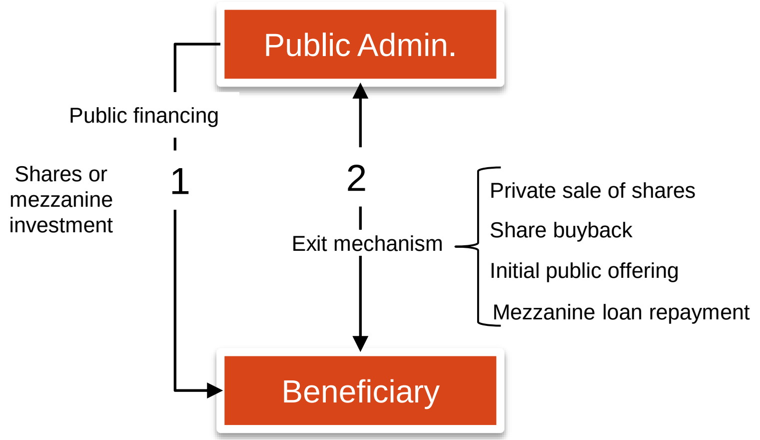
Capital investment through CRF or Risk Society

Financial Instruments: Equity

Capital public investment



Capital co-investment through CRF or Risk Society



Direct Public Investment
(not allowed through ERDF funding)

Financial Instruments: Equity

- **Equity – Financial Risks**

The main risk associated with equity is the risk of a downward revaluation and how Public admin budgets for falls in value. This is a real risk as in the majority of your proposed investments and sectors where there is not a proven history of positive returns and increases in value. (That said, past performance is not always a wholly reliable indicator of future performance.)

There is the very real risk of a lack of a secondary market and buyers to enable Public admin to have an exit route that will enable it to secure recovery of its investment funding. This also potentially poses difficulty in forming an effective basis for valuation, particularly where there are different types of equity holders. In this case, it may be appropriate to engage external financial advisors to help form a basis for valuation and to assist in the assessment of the valuation of the investment throughout the programme.

Financial Instruments: Equity

- **Equity – Other Risks**

There is an increased reputational risk associated with being a shareholder/owner of an entity. Public admin must therefore carefully consider the co-investors and the nature and scope of activities that the company can/does perform. Public Admin may have to take account of Treasury concern over jurisdiction of government owned and supported entities in the light of the government stance on tax avoidance.

Other than speculative purchases and sales on stock exchanges, which are not relevant to public policy, equity is by nature a long-term investment. This introduces governance issues as well as concern at the structure of equity vehicles. For example: Who is best placed to carry out Public Admin's voting rights and to protect Public Admin's interests? As a potential majority shareholder, should Public Admin have a direct interest? And, if so, who should act in this role?

If there were an incorrect assumption about State Aid regulation, it would require retrospective restatement of it and would increase the risk of losing co-finance.

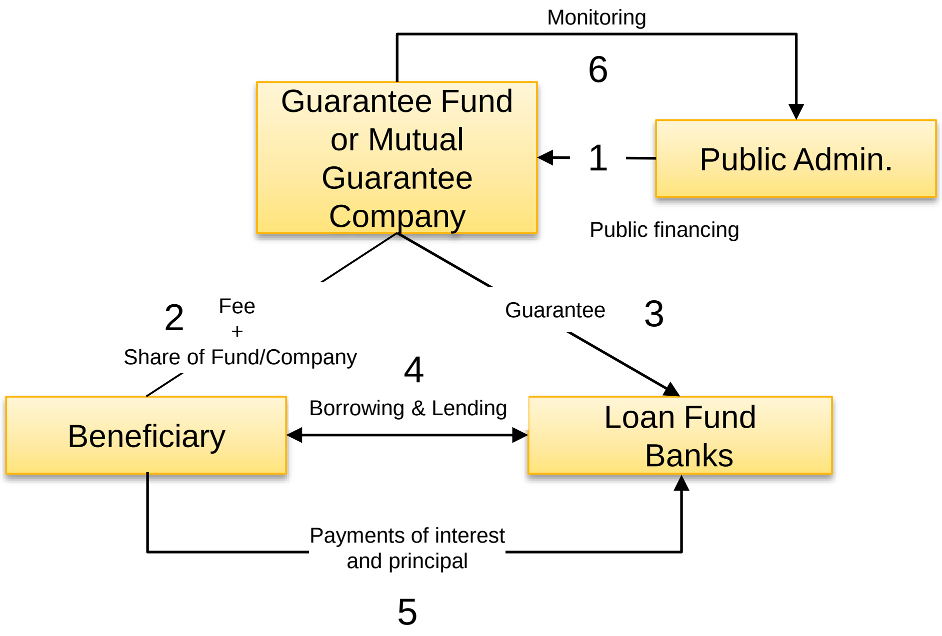
Financial Instruments: Guarantees

Public supported guarantees

A guarantee is a non-cancellable indemnity bond that is backed by an entity in order to guarantee funders that principal and interest payments will be made.

It can lower the cost of financing for issuers because the guarantee typically earns the security a higher credit rating and therefore lower interest rates.

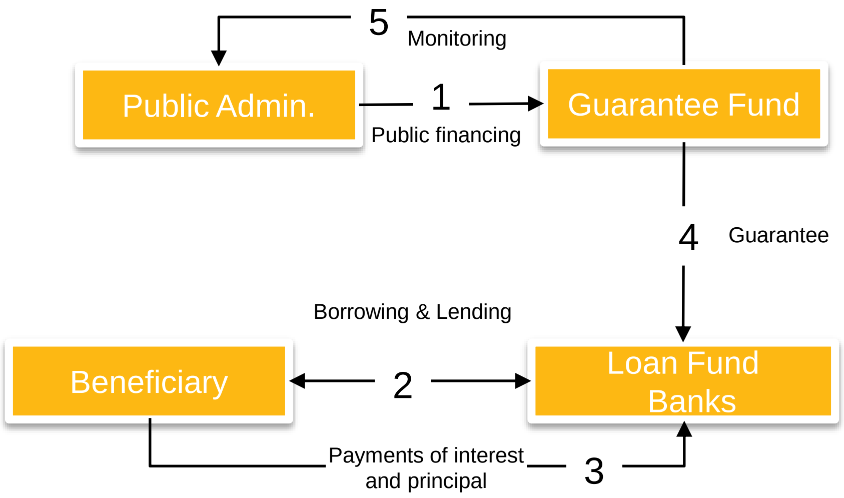
Guarantees are used to reduce the risk to loans and liabilities and typically improve the credit agency ratings of borrowers. Some type of loans for projects typically require guarantees.



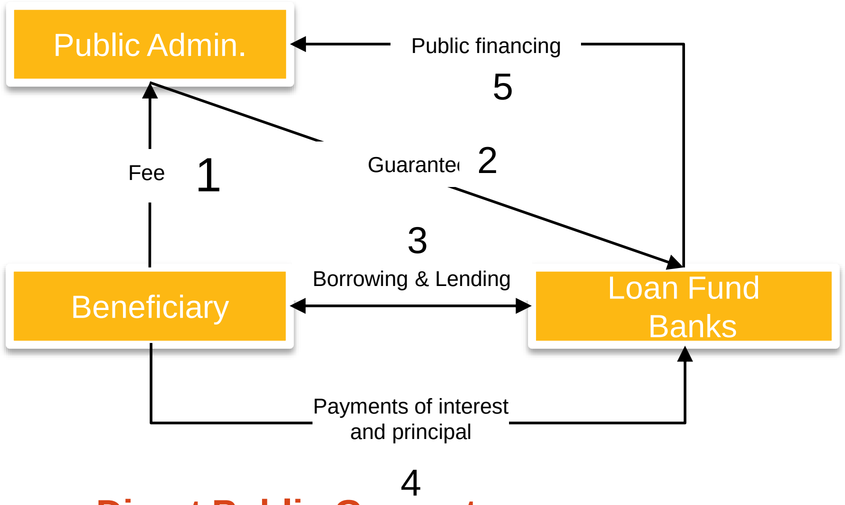
Public guarantees through GF or MGC support

Financial Instruments: Guarantees

Public supported guarantees



Capped Portfolio Public Guarantee



Direct Public Guarantee

Financial Instruments: Guarantees

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- **Other Risks**

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When considering charging fees we have to balance the need to ensure concessionality that will help private sector development with the need to maximize value for money for the taxpayer in achieving reasonable returns.

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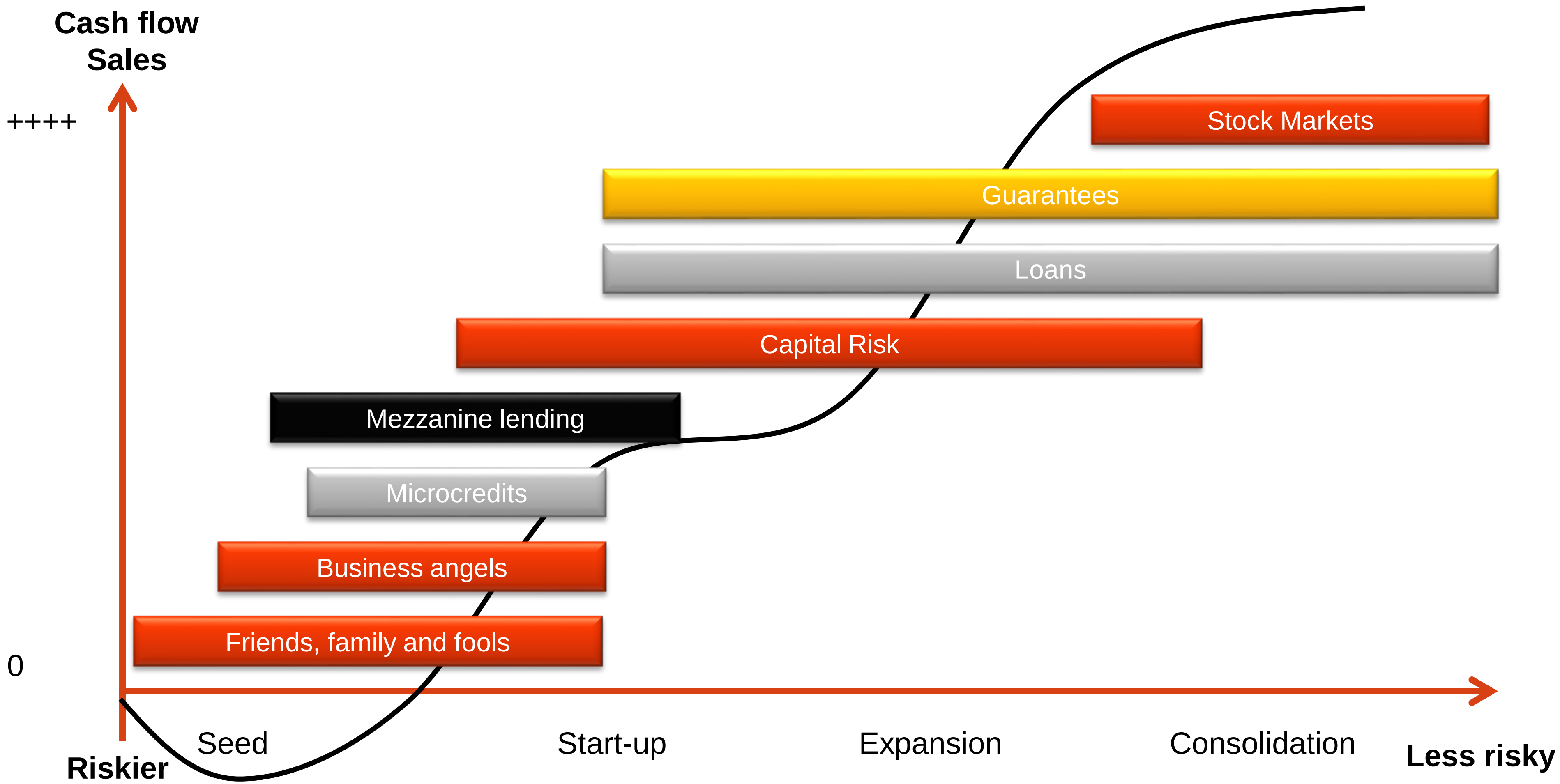
Intervention logic according to life cycle of the entity



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