



Lowlands and Uplands Scotland ERDF and ESF Programmes 2007-2013 Programme Monitoring Committee

EXCEPTIONAL PROJECT PROCEDURE – CONSIDERATION OF ERDF STRATEGIC PROJECTS SCOTTISH INVESTMENT BANK LOAN FUNDS

1. Purpose

- 1.1 To advise the Committee of the recommendation from the ERDF Priority 2 Advisory Group arising from the appraisal of the ERDF strategic project submitted under the Exceptional Project Procedure in the LUPS ERDF Programme 2007-13.

2. Background

- 2.1 The Exceptional Project Procedure for the 2007-13 Programmes was originally approved by the Programme Monitoring Committee at their meeting on 19 March 2008. Subsequent revisions to this paper were approved by Committee in November 2008 and September 2009. The basis for this decision was a clear recognition that there may be special circumstances which prevent an application being submitted within the usual application deadlines. It was felt that an exceptional procedure needed to be established for such cases, particularly where projects for reasons of economic turmoil, large scale redundancy, market exploitation or private sector co-financing may be time critical.
- 2.2 Following discussions with the IAB and the Managing Authority, a Stage 1 application was submitted on 15 February 2010 by the Investment and Entrepreneurship Policy Division of Scottish Government under ERDF P2. The application was submitted in direct response to the current economic downturn and the subsequent reduction in the availability of bank lending to SMEs. In line with the procedure, the application was assessed by the IAB and the Managing Authority. As the application addressed the appropriate criteria to be considered under the Exceptional Project Procedure the applicant was advised to submit a Stage 2 application which would be considered at the Programme Monitoring Committee meeting on 17 March 2010.
- 2.3 The Stage 2 application was submitted within the timescale set by the IAB i.e. 19 February 2010. The following request for ERDF funding was received under the Exceptional Project Procedure.
- 2.4 **Summary of ERDF Bid received under the Exceptional Project Procedure:**

Project Applicant	Project Title	Total Eligible Costs (£)	ERDF Request (£)	Intervention Rate (%)
Priority 2				
The Scottish Government	Scottish Investment Bank Loan Funds	50,000,000	20,000,000	40
Total		50,000,000	20,000,000	

- 2.5 The report of the Advisory Group is detailed below at Section 4 with project recommendation.
- 2.6 At section 5 of this paper there is a financial summary providing the financial implications in ERDF grant terms of agreeing the project recommendation.
- 2.7 Overall, and subject to this Committee agreeing to the recommendation of the Advisory Group, **£20,000,000** ERDF grant will be allocated at this time.

3. **Advisory Group Process**

- 3.1 In the normal way, the full application was subject to technical/eligibility checks by the IAB and appraisal by the Managing Authority, the IAB Programme Managers, Advisory Group members and Scottish Government policy experts. The policy experts provided input in particular into the fit with the strategic policies of the Scottish Government. External stakeholder members of the Advisory Group were appointed by the Scottish Government as the Managing Authority.
- 3.2 The respective scores of the second stage application by the 'Virtual' Advisory Group members and the IAB Programme Managers, Managing Authority and Scottish Government policy experts were collated by the IAB and the previously agreed weighting factor applied. An average overall score was then calculated and checks were undertaken to ensure that any anomalous scores were justified and did not unreasonably affect the final score and ranking. A Standing Advisory Group was convened to discuss application. This afforded the opportunity to test and validate the initial scores in an open and frank debate where Standing Advisory Group members had been selected on the basis that they had no conflict of interest in respect of the project under consideration.

4. **Advisory Group Report**

4.1 **ERDF Priority 2 Advisory Group Report**

4.1.1 The ERDF Priority 2 Advisory Group met on 24 February 2010 to discuss the strategic bid submitted under the Exceptional Project Procedure. Below is a summary of the Advisory Group discussion and overall recommendations.

4.1.2 **LUPS/ERDF/2010/3/2/0003 The Scottish Government – Scottish Investment Bank Loan Funds**

The application received a total score of 43.94 following assessment by Virtual Advisory Group members.

The Group received a presentation on the project from Ian McCall (The Scottish Government), Pat McHugh (Scottish Enterprise) and Brian McVey (Scottish Enterprise). Officials will also attend the PMC meeting to provide a presentation on the proposal.

The creation of the Scottish Investment Bank is a critical action in the Scottish Government's Economic Recovery Plan, designed to address key funding constraints arising from the effects of the economic downturn and the major changes in funding conditions that have occurred since

September 2008. Evidence from the Scottish Government's "Access to Finance" reports and elsewhere highlights a growing need to intervene in areas of the loan market where we have a significant number of growing and exporting businesses experiencing difficulties in obtaining finance.

The proposed new Loan Fund will be directed at addressing a specific market failure in the supply of growth capital for SMEs in Scotland, focussing on those companies facing the most significant financial constraints during the current economic climate: Growth Companies and Exporters.

The ERDF application proposes the establishment of a Loan Fund of £50m, reflecting the current funding and resource availability, and securing a maximum ERDF contribution of £20m for the Lowlands and Uplands Scotland Programme area (a separate application will be made for ERDF support in the HIE area). This assumes around 90 loans will be made in Lowland Scotland at £250,000-£2m (assuming an average SIB participation in loan value at £500,000, as part of a typical deal of £1m+).

This is likely to represent a relatively small proportion of the potential gap in loan finance. It is for this reason that the ambition to build on the ERDF loan fund with a substantial contribution from private-sector sources is an important aspiration in this area.

The primary drivers for the intervention are to address two important and related challenges:

- i) To increase Scotland's sustainable economic growth from its relatively low level over the last 30 years; and
- ii) To ensure those businesses most likely to emerge from the current economic situation are in the best possible shape to drive increased sustainable growth.

Consultation with key stakeholders such as banks, equity investors, business organisations and relevant experts support the proposition that the recent changes in the lending behaviours of banks have created a gap in provision (or arguably, re-created a market that was previously served by 3i and others who withdrew from that market as the banks became less cautious in their lending). As banks have over the last year or two reduced their commitment and exposure levels, these asset classes are becoming more important for a wider range of firms including those seeking to grow and export – a much broader cohort of companies than those that will seek or be able to attract external equity finance.

There is considerable evidence from press coverage and surveys conducted by business organisations, that companies have found it more difficult to raise finance for growth during the recent economic downturn. While there are signs that conditions are easing, it is clear there remain constraints, both in the supply and demand for finance.

The evidence of demand is informed by the results of four major Surveys:

- the Scottish Government's SME Access to Finance Surveys (June 2009, updated with a follow-up survey on in November),
- a specific survey was commissioned by the Scottish Government to inform the case for the SIB, carried out by IFF Research (February 2009);
- a series of interviews with SE's account managed companies on the impact of the credit crunch and the economic downturn, carried out over 2008 and 2009; and

- the Review of SDI's Internationalisation Activities (2010), including specific questions on the role of finance for exporting firms.

A critical data source is the analysis commissioned from Experian/pH Group, looking at borrowing activities by all companies across the UK, based on credit-reference data and a model for financial-health, using balance sheets lodged with Companies House. This data also informed the UK Review of SME Finance (the Rowlands Review, November 2009). All of these reports confirm the existence of significant constraints on both the demand and supply of finance. The evidence from the SIB Survey of Growth Companies and Exporters, the SDI evaluation and SE's surveys of account-managed companies, all suggests that it is the groups targeted by the SIB loan Product – growth companies and the exporters – that are most constrained.

The Fund will build on the success of the existing Scottish Enterprise equity products, which will sit alongside it as the starting resource for the Scottish Investment Bank. By helping companies to access the finance for that innovation, in a climate of depressed corporate lending volumes, the Fund will also contribute to the Priority 1 objective of improving enterprise research and innovation – key features of growing and exporting companies.

While the JEREMIE model in Scotland has not been considered appropriate (in part reflecting governance, accountability and value for money issues), the main principles behind JEREMIE will be adopted in the approach taken by the Scottish Investment Bank (SIB). In particular, the SIB will: utilise ERDF resource for SME financial instruments; leverage private sector expertise and capital; adopt private sector decision making and share commercial returns on a *pari passu* basis; adopt an evergreen outcome by recycling public sector returns for long term sustainability; and aspire to re-allocate resources to respond to future, demonstrable shifts in market failure. The SIB will provide the exit for other ERDF funded interventions, equity based, and offer a rationale for having flexibility on the use of returns attached to these vehicles that is based on the needs of the Scottish economy when the relevant returns become available.

Following the presentation and Question and Answer session Advisory Group members had a full discussion regarding the Fund. Group members agreed that this was a good application which clearly meets demand in the market place. Advisory Group members agreed that the application should be recommended for approval.

Advisory Group Recommendation: Recommended for Approval

5. Implications of Approving Advisory Group Recommendation

5.1 The implications of approving the Advisory Group recommendations are summarised in the table below:

Priority	Total Grant Allocation* (£)	Approved Grant Commitments to date** (£)	Available Allocation (£)	Value of bids recommended for approval (Exceptional projects) (£)	Remaining Balance (£)
Priority 1: Research and Innovation	82,898,704	76,148,688	6,750,016	0	6,750,106
Priority 2: Enterprise Growth	109,967,669	78,155,970	31,811,699	20,000,000	11,811,699
Priority 3: Urban Regeneration	91,357,756	62,774,964***	28,582,792	0	28,582,792
Priority 4: Rural Development	46,017,241	20,705,195	25,312,046	0	25,312,046
Priority 5: Technical Assistance	8,120,689	4,205,982	3,914,707	0	3,914,707
Total	338,362,059	241,990,799	96,371,260	20,000,000	76,371,350

*An average exchange rate of 1 EURO = £0.90 or £1 = 1.111 has been used.

**Assuming AG Recommendations in Paper 8 have been approved.

*** A figure of £35m has already been ring-fenced (although not yet formally approved by ministers) for the forthcoming JESSICA Fund and associated infrastructure projects.

6. Recommendations

6.1 The Committee is invited to:

6.1.1 consider the recommendation of the Advisory Group in respect of the Scottish Investment Bank Loan Funds at section 4.1.2, together with the presentation by the sponsor at the PMC meeting before deciding on the recommendation to be made to ministers;

6.1.2 note and agree the Advisory Group report summarised at section 4 above;

6.1.3 note the level of commitments for each Programme Priority as detailed at section 5.1 above; and

6.1.4 acknowledge the additional work carried out by the Advisory Group in appraising this project application.

Ian McCall
Scottish Government
Tel: 0300 244 1138
Email: Ian.McCall@scotland.gsi.gov.uk