Department for Agriculture, Environment and Rural Affairs

Ex Ante Review of the Potential Role of Financial Instruments within the Rural Development Programme

March 2019

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Executive Summary

Overview

- This report sets out the findings of a review into the economic value that might be available from the introduction of Financial Instruments ("**FIs**") as a means of financing Northern Ireland's Rural Development Programme ("**RDP**")
- Financial Instruments are a means for Government to provide financing support to enterprises that assist in delivering its policy objectives. However, unlike grants, FIs are designed to be recouped by Government to allow investment in other qualifying projects in the future. As such, FIs are typically provided as either:

  1) A loan to the final recipient;

  2) A guarantee over the recipient; or

  3) Equity investment in a venture established by the recipient.

- The key benefits and drawbacks of FIs are as follows:

Key Benefits of FIs	Key Drawbacks of FIs
• Efficiency and effectiveness gains due to revolving nature of funds - they stay in the programme area for future use for similar objectives • Potential to leverage private sector support (and financing) to deliver public policy objectives • Better quality of projects as recipients are incentivised to plan appropriately for repayment • Access to a wider spectrum of financial tools for policy delivery including greater private sector involvement and expertise. • Allow a move away from "grant dependency" culture	• Less attractive to recipient due to requirement to repay loan / return equity investment • Potential for displacement of private financing market • There is a need to ensure State Aid legislation is adhered to in the delivery of FIs • Additional administrative burden on Managing Authorities (in this case DAERA) and requirement to acquire specific skills to manage investment

- The EU Common Provisions Legislation permits the European Structural Investment Funds to be utilised in the form of FIs but sets out guidelines on how this approach should be considered – including undertaking an Ex Ante Assessment. Whilst it is expected UK will have exited the EU prior to the implementation of any future FIs, it is likely that the concept of FIs will also be considered as part of any future Northern Ireland rural development policy to be supported through the NI Block Grant. Therefore, the existing guidance that has been published by the EU for the ESIF FI programme has been used as a reference point for this analysis.

Key Findings

- The analysis has found that, in general, an FI Programme to support rural development policy in Northern has the potential to add value to the NI taxpayer. This value will be derived through the provision of more accessible finance to small to medium rural businesses with the potential to assist in the economic and social development of rural communities in Northern Ireland.
- The value to farmers and primary producers as a specific sector was considered in detail within the appraisal. However, the stakeholder consultation indicated that the need for enhanced access to finance was currently low amongst farm businesses. The key exception to this is new entrants to farming (i.e. individuals seeking to move from another background into farming through acquisition of a farm) but the size of this group is not sufficient to justify a separate category of beneficiary so these individuals can be grouped with other small rural businesses for the purposes of any future programme.
- It is important that any future programme does not cause displacement within either the commercial financing market or other public interventions. A key issue in relation to the latter is that Invest NI already provide loan and equity support to all SMEs within NI through its Access to Finance Programme. However, a market gap has been identified with regard to the provision of loan finance to both:
  1) Rural start-ups / small businesses; and
  2) Social enterprises focussed on rural development.
- The analysis and consultation undertaken for this report has identified value in establishing a loan-fund to support the NI RDP from which qualifying businesses can borrow to invest in qualifying projects. The qualifying criteria for both borrowers and projects should be based on both socio-economic objectives (the current LEADER programme provides the basis for the objectives necessary to meet the need identified through the stakeholder consultation) as well as commercial objectives to ensure the return of the capital for recycling for the benefit of future borrowers
- To maximise the value that this loan fund can deliver to the NI RDP:
  - A suitably experienced entrusted financial intermediary should be appointed to deliver and manage the investment into rural businesses in accordance with parameters set by DAERA;
  - Additional private finance should be leveraged through this appointed financial intermediary to ensure maximum value to the NI taxpayer. Preferably match funding (this should be determined through a competitive procurement process but it is recommended the appetite is tested through a market sounding exercise beforehand).
- It is estimated based on this review that a potential market gap of between **£4m** and **£36m** exists. However, the initial fund should be considered a pilot fund (in line with the approach being taken in DEFRA). An initial fund of **£20m** is proposed based in this initial analysis.
- To reduce administrative costs and timescales for setting up an FI Programme, DAERA should build on existing governance frameworks where possible. Invest NI would seem best placed to implement the fund

as it has the necessary skills and expertise to deliver the procurement of a financial intermediary and is in the process of designing the future of its Access to Finance programme.

- Therefore, the next step should be a dialogue between DAERA and Invest NI in terms of a collaborative approach to implementation of the fund. If Invest NI cannot provide input into this process, DAERA will need to consider other options for establishing a team to deliver the requirements.

Remaining Uncertainties

- It should be recognised that there are number of other areas of uncertainty regarding the governance and legislative environment that will need to be clarified prior to the introduction of the proposed FI support programme. The key outstanding items are as follows:
    - **NI Executive Input**: The body that will have ultimate legislative responsibility for any FI programme still needs to be determined in the absence of an Executive in NI.
    - **Programme for Government**: The priorities of rural businesses within any future Programme for Government, when agreed, will have a bearing as to the allocation of funding to this fund in any future RDP.
    - **Future format of RDP**: As UK is due to leave the EU prior to 2020, the future format of the RDP will need to be determined and consideration given to how an FI Programme can be included within this programme.
    - **Funding available through the RDP**: The level of funding that DAERA will have to allocate towards a rural business FI programme beyond 2020 in the absence of the EAFRD contributions will need to be determined.
    - **Relevance of EU regulations**: If the UK is to exit the EU, the legislative structure that will govern the implementation of the programme will need to be confirmed. This will include the applicability of EU legislation on State Aid for example.
- Given the level of uncertainty regarding the future of the programme at present it is not possible to stipulate a specific timescale on the implementation on an FI Programme. Therefore, the position will need to be monitored and the analysis updated when new information comes to light on the above issues.

Recommendations for Next Steps

- This report provides an initial consideration of the need for an FI programme and a possible approach to addressing the market gap in the provision of finance to rural enterprises. However, until clarity is available on each of the above issues, it will not be possible to set specific targets and guidelines for the implementation of an FI programme.
- Therefore, the proposed next steps for implementation of the programme to consider when clarity is available are set out below.

1) **Establish Source of Funding**: The availability of EAFRD funding towards the proposed FI Programme is the first issue to address. If the UK is to exit the EU and this funding is not available, the objectives and requirements of the UK government regarding the implementation of an FI programme will need to be confirmed;

2) **Engage with Invest NI**: As stated above, the potential for achieving economies of scale through combining the DAERA funding with DfE funding implemented through Invest NI on a collaborative basis should be explored. This would address one of the NIAO's issues raised in its review over Invest NI's Access to Finance Programme that economies of scale should be maximised.

3) **Develop draft investment strategy**. When clarity on the key areas of uncertainty is available, the investment strategy raised above should be developed in more detail. This will need to include the following

    a) **Market sounding exercise:** Engagement with potential financial intermediaries to establish the likely appetite to engage as a fund-manager, the potential target SMEs, the potential for private finance leverage and fund specification / value / operational limitations.

    b) **Engage with the LAGs:** The beneficiaries under the current LEADER programme grants will be key targets under the proposed Rural Business FI Programme. The Local Action Groups that are dealing with these enterprises on a daily basis are well placed to advise of the specific needs from these bodies and how an investment strategy can target the areas of greatest need.

    c) **Review findings from the Rural Business Investment Scheme:** The objectives of this scheme will be aligned closely to the objectives of any further Rural Business FI scheme. Therefore, the findings regarding demand and benefits achieved through this grant provision should be considered before the implementation of a loan fund.

4) **Identify the specific requirements for introducing the FI formally into the RDP**: When the future RDP format is established the precise strategic fit of any FI Programme will need to be considered;

5) **Agree the governance structures**: Identify the preferred option, including decisions on key bodies such as the representatives of DAERA on Fund Boards (their roles and responsibilities) and partnerships with business development suppliers;

6) **Agree the use of Grant Fund to support programme**: Whilst grant funding will not be provided through the fund, it will be important to ensure business planning support is available to prospective borrowers to ensure investor readiness. Therefore, there will be a need to continue with the LEADER programme (or an equivalent programme under any new RDP regime following Brexit) to provide this support.

7) **Engage Legal Advice**: Legal advice will be required to assist with the detailed State Aid issues (if relevant) as well as the procurement of fund managers.

8) **Design of application process and procedures** need to be decided and if there is a need to provide wrap around support with a grant/skills provision alongside the FI. Aspects such as making obtaining a loan easier and moving away from bureaucracy of grants should be important considerations.

9) **Establish monitoring and evaluation procedures:** Commercial as well as economic development performance indicators covering investment activity, outputs, results and impacts will need to be implemented in addition to the social benefits sought by DAERA.

- It is important to note that the DEFRA is facing similar issues to DAERA in the implementation of the English Rural Business FI Programme through the RDP England regarding future uncertainty (although the lack of a functioning Executive is not an issue faced by DEFRA). DEFRA have indicated it expects the implementation of this programme to take two years. It is recommended that DAERA monitor the progress of DEFRA in this implementation process and take cognisance of any decisions taken with regard to the future of European funding.

1. Introduction

1.1. Purpose of Report

- This report sets out the findings from a review into the potential value that might be available to the Department for Agriculture, Environment and Rural Affairs (“**DAERA**”) from the introduction of Financial Instruments to support Northern Ireland rural development policy delivered through the EU funded Rural Development Programme (“**RDP**”).

1.2. Background

- The Europe 2020 Strategy sets out the European Union's current plans for ensuring smart, sustainable and inclusive growth of the Union and reducing regional disparities. In order to assist in delivering this strategy during the 2014 to 2020 programming period, five European Structural and Investment Funds ("**ESIF**s") have been established:

1) European Regional Development Fund
2) European Social Fund
3) The Cohesion Fund
4) European Agricultural Fund for Rural Development
5) European Maritime and Fisheries Fund

- The ESIFs provide funding to member states to enable the achievement of the key strategies set out within Europe 2020. The use of these funds is governed by a single set of rules in order to ensure that the funding is used in line with the strategy and to ensure the consistent implementation across the EU member states. These rules covering all 5 EU structural and investment funds are set out in the Common Provisions Regulation ("**CPR**").
- The CPR sets out the procedures around which member states can apply for funding towards the delivery of policies and projects within their jurisdictions. Whilst the majority of the funds available to member states are likely to be provided directly through capital grants, the CPR also allows the funding to be provided by way of Financial Instruments ("**FIs**"). FIs offer potential benefits in the use of funding in that they allow capital funding to be recycled for use on multiple projects.
- However, in order to be permitted to allocate funding on this basis the CPR sets out strict criteria that must be achieved before FIs can be utilised. These rules include the development of an Ex-Ante Assessment which considers in detail the potential benefits and risks of FI provision to ensure that value can be achieved through this form of intervention.

- DAERA is the Managing Authority ("**MA**") responsible for the implementation of the Northern Ireland RDP to which funding from the fourth ESIF listed above, the European Agricultural Fund for Rural Development ("**EAFRD**"), is expected to contribute. The DAERA RDP, as approved by the European Commission on 25th August 2015, has identified a number of priorities for the use of EAFRD funding. However, it has not yet introduced the use of FIs for this funding and it states:
- "The use of financial instruments was assessed at an early stage in programme development. This initial investigation identified areas of the Programme where it may be beneficial to offer Financial Instruments as an alternative to, or in addition to, grant funding. Further work is needed to establish which of the potential options would be appropriate. As such, it is not intended to introduce Financial Instruments at the beginning of the programme period, but the option will be kept under review and it may be appropriate to introduce Financial Instruments at a later stage through the modification process."
- Since the completion of the RDP DAERA have engaged the Strategic Investment Board to undertake the envisaged analysis into the potential benefits and appropriate investment strategy of an FI Programme and have established a Project Board to guide this process. This report represents the output from this engagement.

1.3. Scope of Review and Use of EC Guidance

- Needless to say, the UK's departure from the EU creates a number of uncertainties for DAERA regarding the future of the RDP and the value, source and mechanism of the funding that will be available to deliver DAERA's policy objectives. As explained later in this report, it is unlikely that an FI programme will be implemented prior to the end of the current RDP in 2020 by which time the UK is expected to have departed from the EU. As such, it is expected that the EAFRD will not be the funding source for any future FI and so the legislation governing its use may not apply to DAERA. However, given the UK Government has moved to using forms of FI interventions in other areas, it is expected that the concept of FIs will also be considered as part of any future Northern Ireland rural development policy to be supported through the NI Block Grant. The existing guidance that has been published by the EU for the ESIF FI programme[1] has been used as a reference point for this analysis. The principals of this guidance is expected to reflect any specific guidance issued by the UK Government on the implementation of an FI programme.
- The CPR legislation on the use of the ESIF funding[2] issued by the European Commission ("EC") indicates that the primary reason that an Ex-Ante Assessment must be undertaken for FI use and not for grant use is the need to assess the risk of displacing the financing market within the specific region under review. Therefore, overarching objective of this report is identify areas of **market failure in the provision of finance to agricultural and rural projects and the value of public intervention through an FI.**

[1] Financial Instruments in ESIF programmes 2014-2020
[2] Guidance for Member States on Article 37(2) CPR– Ex-ante assessment – Feb 2015

- The table below sets out the seven stages that EC guidance indicates should be considered as part of the Ex-Ante guidance. As stated above, this guidance has been used as a reference point for the purposes of this report so the sections that each stage is addressed is set out below also.

• Step	• Stage of EU Guidance on Ex-Ante Appraisal	• Section of Report in which issues is Addressed
• 1	• Analysis of market failures, suboptimal investment situations and investment needs;	2 and 3
• 2	• Assessment of the added value of the FI;	2 and 3
• 3	• Estimate of additional public and private resources to be potentially raised by the FI;	4
• 4	• Assessment of lessons learned from similar instruments and ex-ante assessments carried out in the past;	5
• 5	• Proposed investment strategy;	6
• 6 & 7	• Specification of expected results and establishing provisions allowing the Ex ante assessment to be reviewed and updated • (As a number of uncertainties remain regarding the implementation of FIs, these issues will be covered as part of the next steps for the programme)	7

2. Rationale for Using FIs within the RDP

2.1. Definition

- Prior to considering the potential use of FIs by DAERA, it is important to clarify what they are and how they differ in comparison to the current form of funding that is delivered through the RDP. The term "Financial Instrument" has a broad meaning within the financial industry. The term is generally considered to mean a tradeable financial asset – i.e. a transferable contract that gives rise to an obligation for one entity to pay the counterparty. This covers a range of such contracts that are traded by banks and the capital markets.
- The CPR does not set out a specific definition of the term financial instrument. However, they are generally considered to be means for providing support for investments designed to be recouped by the MA. This will typically be through the provision of either

  4) a direct loan to the final recipient;

  5) guarantees over the liabilities of the recipient; or

  6) equity investment in a venture established by the recipient.
- Essentially they are a means for providing access to capital for businesses and projects that will assist in meeting the objectives of the ESIFs.

2.2. Strategic Rationale for Using FIs

- A number of EU policy frameworks set out a desire for increased use of financial instruments as methods for financing its strategic objectives. The primary reason for this is to ensure public funds can be used as efficiently as possible. This is also reflected within UK policy for example, the recent introduction of Financial Transactions Capital ("**FTC**") being made available to the NI Executive in addition to the NI Block grant.
- In the current budget-constrained climate, FIs enable Governments to use public funding as enabling capital to allow private enterprises to assist in achieving socio-economic objectives of government. Moreover, as the objective is to return this capital to Government it represents an opportunity to use public funding more efficiently than if it were delivered as a direct grant.

2.3. Forms of FI

- The CPR legislation stipulates that ESIF programme support delivered through FIs will take the form of loans, guarantees or equity/venture capital. The implications of each are set out below:

- Table 2.1: Overview of different types of FI

Form of FI	Key Aspects
Loan	• Can only be implemented where evidence is available that banks will not lend under EU State Aid rules. • Governed by a loan facility agreement which will set out the terms on which the loan will be provided and how it will be repaid. • Monies from the EAFRD are transferred directly to the rural business for investment in the activity / project following review and approval by DAERA that the envisaged outcomes are aligned with the thematic objectives of the RDP. • The loan must be repaid and repayment can be either in equal instalments over the loan term (annuity), all principal repaid at maturity (Bullet) or at irregular intervals over the life of the loan (all set out within the loan facility agreement). • Interest payable on the outstanding balance and covenants will typically be stipulated in the facility agreement which will result in sanctions if debt service payments are missed e.g. the transfer of ownership of the security to the lender.
Guarantee	• Governed by a guarantee agreement which will set out (a) the liability that has been guaranteed by the ESIF funds (b) the term of the guarantee and (c) the conditions under which the guarantee will be released or will be called upon. • Depending on the creditor whose investment is being guaranteed, there may be a requirement to place the guaranteed funds in an escrow account (a separate account from which the monies can be drawn only under the conditions set out within the guarantee agreement). Alternatively, the creditor may accept a letter of credit from DAERA meaning funds need not be placed into escrow but must be available from DAERA if necessary. • A typical structure may be one in which DAERA guarantees the repayment of loans drawn by a rural business from a local bank. In this case, DAERA are required to meet the debt service payments if the borrower cannot do so. Typically the guarantor (DAERA) will not provide a guarantee over the full credit balance, for example, the value of the guarantee may only be 70% to 80% of the amount borrowed. This ensures that an incentive exists on both (1) the private lender to ensure their due diligence and risk assessment is accurate, and (2) the borrower to ensure their focus is on meeting the debt service obligations.

Form of FI	Key Aspects
Equity	• The vehicle for equity investment from DAERA will typically be an acquisition of share capital in an incorporated entity (e.g. a limited company) undertaking an eligible project / activity. In this case the aims of the limited company's investment will be governed by the memorandum and articles of association of the entity. However, for small entities it is common for investors to set a shareholders agreement in place to govern the terms of the investment. It is likely this will be required for any investment by DAERA of EAFRD funds. • Returns on the investment are made through the dividends paid out of the company's profits. Equity investment typically has no formal term but the shareholders agreement may stipulate some conditions to assist DAERA to exit the investment when its objective has been achieved. • Equity investment transfers an element of control in the entity as key decisions must be taken by shareholders. In addition, representation on the company's board of directors is a common stipulation with equity investments such as this and this may be an option DAERA can consider in certain circumstances.

- It is important to note that the FIs proposed for use within the ESIFs and governed by the CPR are to represent an alternative means for using the grant assistance already allocated to the relevant programmes. Therefore, the loans / equity capital provided through the EAFRD are not repaid to the EC but rather remain available for the MA to reinvest.
- As such, the FIs provided through the ESIF do not contribute to the UK public debt. This is different to other forms of investment such as the European Fund for Strategic Investment (known as Juncker's Investment Plan) which aims to aims to use separate finance from the European Investment Bank ("**EIB**") to address market failures and mobilise private investment. If the NI Executive were to borrow additional funds beyond the current allocation from the ESIFs from the EIB (or any other external source), this would contribute to the UK debt position and the payments to the NI Executive from HM Treasury may be reduced as a result.

2.4. Key Benefits

- Ultimately, FIs represent access to capital for enterprises to invest in projects that can achieve social policy objectives that would not otherwise not be delivered. However, grant funding provides the same monies into the system and these do not need to be paid back. Therefore, it is important to set out the rationale for using FIs rather than grant funding to achieve the same objectives.

- The EC FI Guidance for the current programme lists six key benefits that are linked to the implementation of FIs. Each are listed below along with a description as to how each can provide assist DAERA meet its responsibilities for rural development in Northern Ireland:
- Table 2.2: Key Benefits of FIs

• FI Benefit	• What Does this Mean for Rural Development in NI
Leverage resources and increased impact of ESIF programmes	An important objective of the FIs is to lever in additional private sector finance as investment capital. It is envisaged that the structures through which FIs must be invested will attract a greater level of private investment than might be the case under a grant funding model. For example, a structure in which DAERA takes an equity stake in a rural development project will ensure public involvement in the project for a longer term. This sharing of risk between public and private sectors can create the potential for much larger scale investments than might otherwise be the case.
Efficiency and effectiveness gains due to revolving nature of funds, which stay in the programme area for future use for similar objectives	Investment of capital through FI's will ensure that capital will remain available to meet DAERA objectives for the long-term[3]. This is not the case with grant funding models in which an investment is used for a one-off purpose that may only have a short-term benefit. This is because FIs should only be invested in viable (albeit risky) projects. Meaning the investment will return to DAERA for reinvestment in other projects long after the current ESIF programme has expired.
Better quality of projects as investment must be repaid	The necessity for DAERA to invest only in financially viable projects ensures a level of scrutiny and project planning is undertaken prior to investment focussing on the commercial viability of the project that might not be the case for grant funded models.[4] This will often be enhanced by the involvement of private funders who typically engage expert project appraisers for more significant investments. This scrutiny can ensure that weaknesses in projects can be identified by DAERA early and addressed before the activity commences and capital is lost due to poor planning.

[3] Theoretically, the capital will never leave the system and may even grow assuming it is always repaid. However, in reality, given the risky nature of the projects in which it will be invested, it is likely the value will fall over the longer term as some investments will fail or wind down.

[4] Whilst grant funded projects are expected to go through a rigorous business plan process, this focuses primarily on the Value for Money of the investment to the public purse rather than on projects ability to service its debt / equity investment in accordance with the financing agreements.

• FI Benefit	• What Does this Mean for Rural Development in NI
Access to a wider spectrum of financial tools for policy delivery & private sector involvement and expertise	As mentioned above, FIs have the potential to finance much larger scale projects. This can provide access to both a wider and higher quality pool of private sector expertise, both in terms of the management of capital investment as well as monitoring its performance. This can create benefits in terms of the levels of expertise and experience that can be drawn upon to achieve DAERA's objectives as well as in terms of decreasing and sharing project risk among a wider set of stakeholders.
Move away from "grant dependency" culture	Grant funding has been the primary method of intervention to support capital investment provided by DAERA to date. It is possible that, through FIs, agri-food businesses, farms, forest holdings and rural businesses could start to rely less on grant aid and start to recognise the benefits of using public sector finance as well as its expertise to share in the risks and develop projects on a long-term whole-life basis to achieve shared objectives and benefits.
Attract private sector support (and financing) to public policy objectives	The FIs represent an opportunity for DAERA to involve private sector financiers to buy-in to the socio-economic objectives and priorities of DAERA. Clearly this will not be the case for some categories of project that are solely social in their objectives. However, for the economically viable projects through which DAERA are seeking to develop economically sustainable farms, agri-food businesses and rural communities, the use of FIs can attract "partners" to provide support in achieving these objectives. The FIs provide a mechanism in which the objectives of both private investors and DAERA are aligned. This has the potential to provide significant support to ensuring DAERA meets its targets.

2.5. Key risks / constraints

- There are a number of drawbacks to using the FIs as opposed to capital grant funding. The extent to which these risks and constraints apply will depend heavily on the form of investment and the project activity the investment is financing. The key risks / constraints are as follows:

- Table 2.3: Direct Consultee List

• FI Drawback	• What Does this Mean for Rural Development in NI
• Requirement for Borrower to repay loan / return equity investment	• Under the current grant aid model, there is no requirement to pay the monies back to DAERA, other than through clawback. Therefore, the requirement to do so and pay interest and a return to DAERA through the FI model will undoubtedly place increasing pressure on the profitability of the recipient of the finance when compared to grant aid funding.
• EAFRD Allocation to RDP	• The FI programme is currently applicable only to the portion of the RDP funded by the EAFRD. Therefore, projects that are to be predominantly funded from National sources will be constrained (this will not be a constraint if the UK government decide to implement its own FI Programme independent of EU funding post-Brexit).
• Potential displacement of financing market	• As stated above, the primary rationale for undertaking an ex-ante assessment is to ensure that there is a need for government intervention. If finance from government acts in competition with private investors, there is a risk that the appropriate pricing of risk is distorted which will ultimately lead to less capital being available across the market as a whole.
• State Aid implications	• The implementation of FIs must be undertaken in adherence to strict State Aid regulations. Therefore, the MA must be fully aware of these rules prior to considering the use of FIs. State Aid rules are designed to ensure that market competition is not distorted by public intervention and that one private entity is not advantaged over another. Therefore, the terms of the FIs used by DAERA must be commensurate to the terms reasonably available within the financing market for a similar situation. • The extent to which State Aid legislation will apply to DAERA after Brexit will depend on the terms of any trade agreement between the UK and the EU. However, it is envisaged legalisation with similar aims and principles regarding ensuring fair competition will replace it.

• FI Drawback	• What Does this Mean for Rural Development in NI
• Additional administrative burden on MA and requirement to acquire specific skills in DAERA to manage investment	Unlike grant aid, the use of FIs obligates the MA to ensure its investment is closely monitored throughout the investment tenor to ensure that no breach of the terms within the financing agreements, guarantees or equity agreements is, or is likely to occur. The MA needs to ensure it has the appropriate expertise available to undertake this investment monitoring. These complexities of delivery and potential lack of existing models and expertise can mean that the set-up costs of FIs can be greater than the grant-aid models.

- This section demonstrates that FIs will derive the benefits only in certain specific circumstances i.e. those projects that can be demonstrated to:

a) Be revenue generating and commercially viable (meaning the investment can be repaid);

b) Be unable to obtain capital investment from other (private) sources – i.e. a market failure exists; and

c) Have the potential to meet the socio-economic objectives of DAERA.

- It is important that the Ex Ante Assessment develops these criteria to specifically focus on the priority areas which are deemed suitable for FIs in the agri-food, forestry and rural sectors in Northern Ireland.

2.6. Potential Application of FIs within the RDP

- As discussed above, FIs will only derive benefits when utilised on certain specific types of investment. Primarily these must be financially viable projects for which funding options from the existing banking sector or capital markets have been exhausted. The RDP measures to which such projects / activities are most likely to relate are the following:
- **M04** - Investments in physical assets
- **M07** - Basic services and village renewal in rural areas
- **M08** - Investments in forest area development and improvement of the viability of forests
- **M19** – Support for LEADER local development (CLLD – community-led local development)
- An overview of the potential benefits of FIs for each of the above measures is set out below:

- Table 2.4: Potential Application of FIs to Key Measures

Measure	Key Elements that Align with FI Benefits	Example FI Implementation

M04 - Investments in physical assets	• Section 8.2.3.2 of the RDP States:
	  ○ "The success of the farm modernisation programme in the 2007-2013 RDP demonstrated a willingness of farmers to invest in the development of their business. However, the ability of farm businesses to invest has been restricted, in some cases, by the availability of match funding."
	  ○ "If Northern Ireland is to develop a more successful and competitive agri-food processing sector, increased innovation to move from low-tech production and a movement from local markets to high value added activities to increase export is required"
	• "'Going for Growth' in May 2013 - the report sets a series of growth targets for the industry with a focus on accelerating exports and stimulating entrepreneurship and innovation."
	• The capital element of the Farm Business Improvement Scheme and the Agri-Food Processing Investment Scheme are key vehicles (discussed further below)
		• Loan to develop new farm buildings to improve resource and production efficiency.
		• Loan repaid through increased income / savings generated by farmer from greater efficiency.

• Measure	• Key Elements that Align with FI Benefits	• Example FI Implementation
M07 - Basic services and village renewal in rural areas	• "There is a need to develop and improve Northern Ireland's rural heritage and to use the natural and built environment as the basis for sustainable economic growth" • "there are opportunities to develop cultural and outdoor recreational tourism" • Examples of the type of project that could be funded to improve infrastructure include construction and modernisation of tourism information centres, visitor information and guidance, signposting of touristic sites, and the development and conservation of cultural and natural heritage	• Joint venture Company established with FI share capital to develop and run a visitor information centre in a rural village. Local representatives and DAERA form the board. • Return on investment gained through the commercial operations or the visitor centre.
M08 - Investments in forest area development and improvement of the viability of forests	• The RDP recognises the following in relation to this measure: • "There is a need to integrate afforestation with agricultural practice. • There is a need to use innovative methods to improve utilisation of fragmented woodland. • There is a need to improve access to forest land to improve economic performance.	• Loan for the development of technologies to sustainably harvest willow timber for use in biomass energy facilities. • Loan to be repaid from income generated from timber sales.
M19 - Support for LEADER local development	• This measure focuses on ensuring that projects identified, sourced and progressed by local communities as opposed to central government can be provided with support from the ESIF funds and the programme is not solely central government led.	• Development of a village shop for an area that does not currently have access to such a facility.

• Measure	• Key Elements that Align with FI Benefits	• Example FI Implementation
	• By its nature, no specific projects are set out within the RDP but the concept of providing capital to locally generated, rural projects has the potential to create a wide range of commercially and economically viable ventures that would suit the FI funding model.	• These can often be set up by local village residents and run as a social enterprise. FI capital could be used as equity investment in this social enterprise.

2.7. Analysis on the Potential Value of FIs

Desk-based analysis of key information sources / reports available to demonstrate that the need for capital investment in rural areas exceeds the supply in Northern Ireland was undertaken prior to a more detailed consultation with potential Stakeholders. A summary of the key points from this desk based research is as follows:

Table 2.5: Desk Based Research over FIs

Report / Survey Undertaken	**Findings**	**Conclusions to be drawn for NIRDP**
An assessment of the degree to which rural businesses access national mainstream employer skills and government business support programmes: **Evidence report 2013 (DEFRA)**	This survey defines "rural" business as those "Rural respondents that were located in any of the following locations: hamlet and isolated dwelling (sparse and less sparse), village (sparse and less sparse), town and fringe (sparse). The report found that rural and urban businesses are equally likely to report having attempted to obtain finance. However, the survey found the proportion of businesses that obtained all they needed from first source by rural/urban location was as follows: **Rural: 50.9%** **Urban: 75.7%**	There is a potential "financing gap" between urban and rural businesses in relation to the access to finance. Rural businesses are significantly less likely to secure the finance they require for investment than urban based businesses.

Report / Survey Undertaken	Findings	Conclusions to be drawn for NIRDP
SME Journey Towards Raising Finance 2014 Survey **(British Business Bank)**	This report found: • There was a greater demand for finance by SMEs in 2014 compared to 2012 (mainly relating to 0-9 employees SMEs) – 18% as opposed to 15% two years earlier • Main source of finance is loans/ overdraft and capital asset finance • Main reason for failing to access finance remains cash flow/ working capital/ fixed assets	There is a growing need for finance from SMEs in the UK and there are large proportion that cannot access sufficient finance for their needs
Small Business Finance Markets 2015/16 **(British Business Bank)**	Northern Ireland has the lowest of each of the following in each of the UK: • Share of births of new enterprises per person (2014) • Share of total GVA (2013) • Share of population (2014) • Share of business population (2015) "Access to finance can be an enabler for increasing productivity"	NI is underperforming the rest of the UK with regard to the development of new businesses and start-ups. These types of businesses can drive GVA within a region and access to finance is key for this.
Improving access to finance for small and medium-sized enterprises: **Department for Business, Innovation & Skills and HM Treasury**	There are 2 million SMEs in England and annually 20% seek finance of which 40% are unsuccessful	Access to finance is an inhibitor of growth for SMEs
UK business; activity, size and location: 2016 (**Office of National Statistics**)	There are 2.55 million businesses registered for VAT and/or Pay As You Earn (PAYE) in the UK in March 2016 The percentage of VAT and/or PAYE based businesses in NI as a percentage of the whole of the UK is an	Whilst the size of the rural community in NI is considerably smaller than that of England (and this needs to be taken into consideration when

Report / Survey Undertaken	**Findings**	**Conclusions to be drawn for NIRDP**
	average of 2.7% over last three years (therefore, there are c70,000 businesses in NI)	benchmarking findings) there is still a considerable number of businesses that potentially require access to finance in NI.
Ex Ante Assessment for ERDF Programme (**Invest NI**)	Northern Ireland economy is dominated by SMEs (98.2% of companies) and of that 89% are micro enterprises. Access to finance is a major constraint to their growth, both from a perception issue and in reality. 91% of Northern Ireland SMEs expect it to be difficult to access finance, the highest of any UK region.	Access to finance from SMEs is an issue that has been recognised in NI previously.

2.8. Conclusion

- The analysis in this Section demonstrates that there are potential benefits available in re-allocating a portion of DAERA's EU RDP funding from a grant based model to an FI model. This use of FIs represents an opportunity to:
- Leverage resources and increase the impact of funding programmes (whether through the EU or UK);
- Achieve efficiency and effectiveness gains due to revolving nature of funds, which stay in the programme area for future use for similar objectives;
- Deliver better quality of projects as investment must be repaid;
- Provide access to a wider spectrum of financial tools for policy delivery & private sector involvement and expertise;
- Move away from a "grant dependency" culture;
- Attract private sector support (and financing) to public policy objectives.
- However, this value will depend on the likely demand from farms and rural businesses for finance within NI as well as the potential costs involved in setting up the infrastructure, resources and administrative systems necessary to manage this form of investment.
- This has been explored in more detail as part of the Stakeholder Consultations discussed in Section 3 below.

3. Stakeholder Consultations

3.1. Overview of Approach to Stakeholder Consultations

- This sections provides the analysis required to address the first stages that EC guidance indicates should be considered as part of the Ex-Ante review process being:

1) Analysis of market failures, suboptimal investment situations and investment needs; and
2) Assessment of the added value of the FI.

- The primary source of information that has been used to consider this has been consultation with parties who represent the stakeholders in the introduction of FIs into the NI RDP. This process was undertaken from March 2017 and September 2017 and this section presents the findings from the consultations.
- The overarching purpose of the Stakeholder Consultation process is to answer the key question:
- "Is there a case for using Financial Instruments to support the rural economy in Northern Ireland?"
- To answer this question, the consultations focussed on three key principals
    1) What is the existing Demand from viable Farmers and Rural Businesses for finance investment in their enterprises?
    2) Does a Financing Gap exist? i.e. are these viable enterprises unable to access appropriate finance?; and
    3) If a public intervention were to be introduced using an FI what form would add most value?
- The information required to address the points above has been gathered through two different means:

1) Direct Consultation with Stakeholder Representatives:

- A detailed questionnaire was developed setting out the information required for the purposes of the Ex Ante Assessment (a copy is provided at Appendix 1). A list of appropriate Stakeholders were identified and agreed within the Project Board. This list consisted of 21 separate groups / organisations deemed qualified to represent the views of rural businesses, farms and financiers. The list of consultee were as follows:

- Table 3.1: Direct Consultee List

Consultee Category	Organisations Consulted
Internal DAERA represtatives	Statistics and Analytical Services Branch
	Economics Branch
	LEADER Programme
	Food business incubation centre
	Forest Service
Farms / Rural Business Representatives	Ulster Farmers Union
	Rural Development Council
Existing Government Backed Loan / Equity Investment Schemes (Non-DAERA)	FTC Infrastructure Fund
	Invest NI
	Ulster Community Investment Trust (UCIT)
	NI Small Business loan fund
	NI Growth Loan Fund
Banks	Ulster Bank (Agriculture team)
	Danske (Agriculture team)
	Bank of Ireland (Agriculture banking)
	Bank of Ireland (Business Acquisition)
	First Trust - Agri Loan Team
LEADER Local Action Groups / Local Councils	Mid Ulster District Council
	Fermanagh and Omagh District Council
	Causeway Coast & Glens Local Action Group
Other revelant Consultees	University of Strathclyde - European Policies Research Centre

- The questionnaire was issued to senior representatives from each of the above organisations and individual consultations were held with each individual (a mixture of face-to-face and telephone interviews where appropriate with a number of follow-up meetings where further information was deemed necessary).

2) Farm Survey:

- DAERA undertook a survey of farm businesses in Northern Ireland over June and July 2017. The survey was voluntary and was completed by the registered respondents whose details were held by DAERA on Citizen Space. A questionnaire was compiled by DAERA and issued via email to a stratified random sample of 5,000 farms that were selected from 16,804 farm businesses for whom DAERA holds email addresses. A total of 360 responses were received of which 357 were considered valid for the purpose of this report. The results from this survey were compiled by DAERA and a summary of the results presented in Section 2.6 below (with the detailed results presented in Appendix 2).

- The overarching targets for the consultations were ultimately enterprises operating in rural areas. For the purposes of the Ex Ante Assessment the project Board has determined that the definition of "Rural businesses" is deemed to cover enterprises that are either:

a) Farms and Primary Producers:

b) **Forestry Business**: Commercial enterprises operating in the forestry sector; and

c) **Other Rural Businesses**: Enterprises operating in settlements with populations below 5,000 as well as open countryside (this could be both commercial businesses and social enterprises)

- As the consultation has revealed that very different funding environments exists for each of these groups of businesses, this report presents the responses from each group separately.

3.2. Farms and Primary Producers

3.2.1. Overview of Existing Funding Environment for Farms

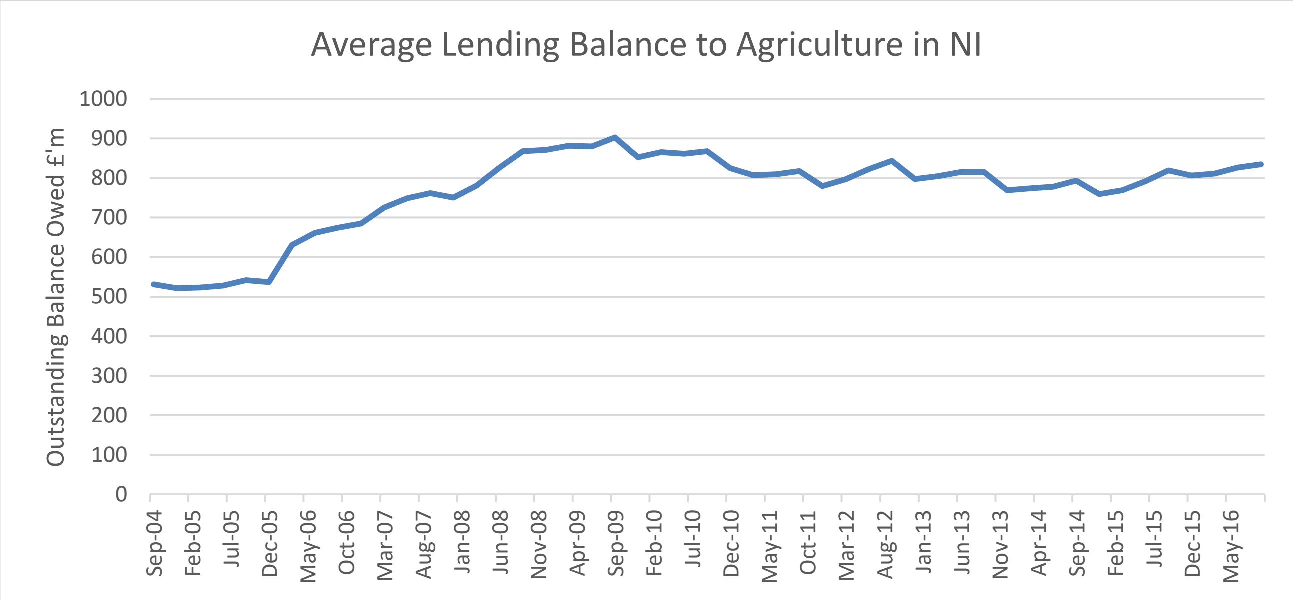
- The consultations held with representatives of the agriculture sector in Northern Ireland as well as the banks and financiers involved in lending to farmers and primary producers revealed a number of key features that dictate the financing environment in which farmers and primary producers currently operate. These features are as follows:
- Farming is an important driver of the NI economy:
  - In NI, the Agriculture sector contributes double the GVA compared to the UK as a whole on a pro-rata basis[5] (1.2% in NI and 0.6% in UK)
  - The number of farms per hectare of land in NI is over double that in the UK as a whole (18.1 per 1000ha in NI compared to 8.8 in UK)
- **Farmers hold high value collateral**: Farmers typically own substantial land on a freehold basis in NI. This land has a value on the open market and so can be used as collateral against which to secure debt funding. This is a key requirement of banks and senior debt providers who are typically the most risk averse lenders but provide the least expensive form of debt;
- **Long-term businesses**: Farms in NI tend to be held in families for generations meaning banks typically have longer term relationships with farm businesses in comparison to other sectors. This provides a greater level confidence as to the future ability of the business to meet its debt service obligations which increases the banks' appetite to lend. In addition, farmers in NI tend to be very reluctant to enter into debt obligations as they are keen to avoid passing this burden onto future generations. This means that famers typically take debt very seriously and will only lend capital when they have a high confidence on future income available to meet the debt requirements. Again this increases the appetite to lend from banks.
- **EU Subsidies**: Whilst farming is a commodity business and the margins are low and can vary over short time periods, the EU subsidies are available to farmers such as the Basic Payment Scheme, provide a guaranteed income and so reduce the risk of default in the view of lenders.
- As a result of the above, the financing investment into farm business is predominantly through **local banks**. Four banks in particular hold the vast majority of the market share in Northern Ireland being Danske (formerly Northern), Bank of Ireland, Ulster Bank and First Trust.

3.2.2. Historic Demand for Finance from NI Farms

- The aggregate amount of bank debt outstanding to agricultural businesses in NI over the last 12 years is illustrated below:

[5] Source: DAERA Statistical Review of NI Agriculture 2016

- Figure 3.1: Historic Lending to Agriculture in NI (BBA)



- The graph demonstrates that lending grew sharply from 2005 up to the start of the global financial crisis in 2008/09 during which the total outstanding debt to farmers rose from c£550m to over £900m in the space of four years. In 2009 the availability of new lending fell and so the outstanding balances have steadily decreased on average to 2015.
- This analysis indicates that the global financial crisis resulted in a reduction in the level of debt being drawn by famers. This reduction had an impact on the financing environment within the agriculture sector (both demand side and supply side) as described below.

3.2.3. Farming: Demand Side Issues

- The feedback from the consultations have highlighted that there has been a significant increase in the level of scrutiny by banks on financing requests from farmers since the global financial crisis in 2008-2010 The criteria used by banks for lending decisions (for capital infrastructure development) has changed as follows:

1) **Increased focus on Cover Ratios as opposed to Collateral**: Previously the value lent by banks would have focused largely on the value of the collateral against which the loans were secured. Now there is far greater focus on future performance of farms and the source of forecast revenue streams and cash-flow available to debt service ("**CFADS**"). This can be difficult for some farmers to predict and so there has been a rise in the need for professional accountancy advice in forecasting future financial performance (which has increased costs to farmers);

2) **Reduced gearing levels**: Since the global financial crisis, banks are seeking to reduce risk by increasing the proportion of a project that must be funded either by the farm itself or through sub-ordinated financing. Where previously farmers may agree 70% to 80% of the capital requirement, this has reduced to 50% to 60% in the current market. Therefore, an increased investment contribution is required from the farmers' reserves or from another external funding source.

3) **Reduced focus on relationship**: Historically, farmers could draw loans from banks only by approaching their local bank manager with whom they would have had a relationship. However, the centralisation of banks services mean that farmers no longer typically have a direct relationship with the individual bankers. This means that farmers cannot draw loans without evidence of the ability to perform through:

    a. **A detailed business plan** – which often requires professional assistance to prepare as discussed above; and

    b. **Evidence of a track record**: Historic financial data on the farms previous performance (typically 3 years).

- In summary, the process for securing long-term loans is more onerous and the probability of success is lower than before the financial crisis.

- However, the consultation revealed that there are four categories of farmers that have particular challenges in accessing finance as a result of this increased level of scrutiny. These are:

1) **New entrants**: This is typically individuals seeking to move into farming by taking over or acquiring farm businesses from retiring farmers (rather than starting a new farm business from scratch which is extremely rare in NI). New farmers who do not yet have any track record of farming and so cannot provide the necessary level of confidence to banks as to their ability to perform. One of the banks consulted highlighted that it is very difficult for banks to fund young farmers to get into farming because acquisition price is currently so high in NI and the typical land rental period or conacre so short (typically 10 months) that it is difficult to achieve a financial return through this approach.

- It was acknowledged however that young farmers understand business plans and are generally more content to adapt to the greater demands on online application forms etc than older experienced farmers.

- A general theme amongst consultees is that a scheme whereby the FIs could support loans provided to young farmers would be in strong demand amongst new entrants.

2) **Farmers lacking business skills**: Those without the skills to prepare a business plan or the funding to engage appropriate professional advice have significant difficulty in securing finance. This indicates that if an FI Programme is to be implemented, some form of support in preparing financial forecasts and business plans will be necessary if this category of farmer is to secure the finance.

3) **Farmers seeking working capital**: An issue raised by a number of consultees was inflexibility of loan products. Farming is a cyclical business and farmers are keen to reduce debt when possible. However, penalties for early repayment[6] mean this is not an attractive proposal financially. Therefore, farmers are forced to consider expensive overdraft facilities for working capital purposes.

4) **Diversification**: There is less interest from banks in supporting farmers to diversify away from their core business since the global financial crisis. Popular sectors for diversification raised throughout the consultation process were renewable energy / anaerobic digestion plants, engineering and other leisure businesses.

- Other key points emerging from the consultation with the farmer representatives include:
- **The majority of bank lending to farmers is typically through short-term or unstructured debt:** Many farmers use overdrafts or asset finance arrangements (whereby a finance lease is secured over the specific equipment provided) to finance their capital expenditure. This is more expensive than secured debt. In addition, the fall in the level of bank debt available to farmers has led to an increase in other forms of external private finance. The most popular with provided to farmers include:
  - **Credit Unions**: Entered the market relatively recently but only for small loan sizes (typically a maximum of £20k to £30k);
  - **Merchant finance** - (animal feed or other suppliers). Suppliers will provide unsecured loans to ensure that their products can be sold. However, ultimately the banks fund the merchants so from an industry perspective banks still need to consider the risks that the suppliers are taking and this will impact on the terms available to farmers.
  - **Peer-to-Peer / Crowd funding / mezzanine finance**. There are an increasing number of alternative lenders within the current market that provide loans with c10-11% interest rate and require significantly less due diligence and covenants. However, these options are typically only used because the borrower is under pressure and has exhausted bank facilities. The price of these loans then put the borrower under more pressure so both UFU and the banking markets are not keen on farmers using this method.
- **If an FI were to be introduced, a Loan would be the preferred option**: The key features of such a loan sought by the consultees include:
  - Less onerous in terms of application than grant financing (although consultees generally recognised the need for business plans and that Government needs to ensure a market failure exists);

[6] Famers volatile income streams may mean that farmers can save on interest costs by repaying the loan early but this can result in an early repayment charge / redemption fee under terms of many types of commercial loan products

- More flexible than existing loan structures – i.e. ability to repay early when produce margins are greater and delay repayment when margins are falling rather than incurring early repayment penalties.
- Repaid over a longer term than is currently available (UFU cited a 40 year period which may not be achievable but longer than the maximum 7-10 years that the current commercial banks tend to offer for example).

- **There is little appetite for equity investment:** Equity investment is rarely sought by farmers for development as they are typically very reluctant to give away any share of their farms as these are generational holdings. The only instances cited by consultees when equity investment / venture capital involvement has been sought by farmers is in the development of renewable energy facilities (typically anaerobic digestion plants). Therefore, equity investment is not considered relevant in the financing of farms.
- The Ulster Farmers Union ("UFU") confirmed that one of its central objectives at present is to encourage farmers to think more carefully about future financial sustainability. The requirements for business plans from banks is a positive step in the mind of UFU as it encourages the development of a clear business strategy.
- DAERA consultees also indicated that farmers are being encouraged to consider their financing needs through a number of different schemes such as the **Farm Business Improvement Scheme** (a DAERA intervention) and the **Agri-Food Loan Scheme** (an Invest NI intervention) - both of which are discussed in Section 3.2.5 below).

3.2.4. Farming: Supply Side Issues

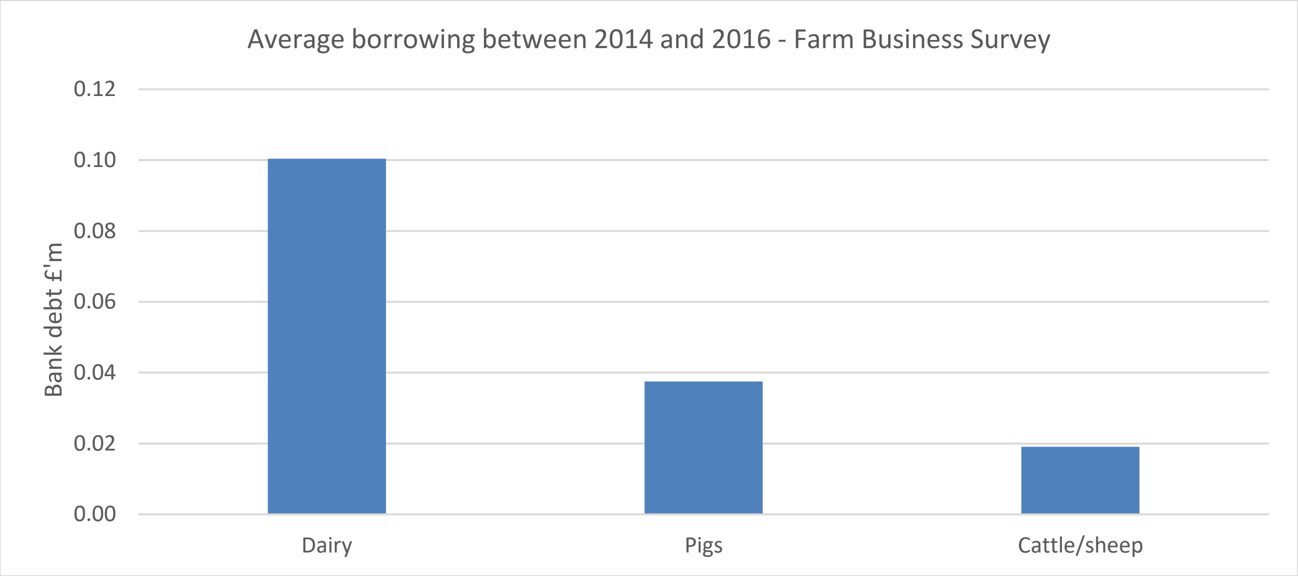
- In general, the consultations held with the bank representatives indicated that the farming sector is viewed very favourably by the banks in NI. Each one of the consultees was a specialist in lending to the agriculture sector and each of the banks had specialist agricultural teams. The consultees generally indicated the market for lending to farmers was very competitive which has resulted in favourable terms being offered to farmers.
- The key reasons for this have already been highlighted in Section 3.2.3 above, being:
- Availability of security meaning risk of loss is reduced:
- Farming being a long-term, resilient sector meaning long term future relationships are available; and
- Farmers tending to take responsibility of debt very seriously resulting in low levels of default.

- However, the banks consulted did confirm that a business plan was now an important document prior to lending as their credit committees' decisions on lending now depended heavily on stress tests and analysis of key ratios.
- The bank consultations revealed that the appetite and analysis of risks differ depending on the type of farm seeking the loan. A summary of the main issues that banks considered when lending is set out below:
- Table 2.1: Key Issues Raised by Banks by Farm Type

• Farm Type	• Key Issues considered by Banks
• Dairy	• Lower capital requirement (compared to pig / poultry) and high level of security and usually generates good profits although there can be difficult periods of low prices • Banks generally have confidence over the long term margins • Direct payments under the Basic Payment Scheme ("**BPS**") account for a much smaller proportion of gross output of the dairy farm business compared to beef and sheep.
• Pig / Poultry	• High capital requirement and low levels of security but a high margin (for poultry). Less appetite from banks to lend than dairy but more than for beef/sheep (excluding Moy Park). • Typically the largest borrowers due to the high capital requirement (hen-houses etc) • Moy Park's particular dominance and their requirements in the poultry sector has resulted in an improvement in business / financial planning. Moy Park require poultry farmers to adhere to strict KPIs as part of their contracts. This has assisted in the financing of development in this sector.
• Beef / sheep	• Low income sector and are typically dependent on direct payments under the BPS for profitability. • Banks would not lend to this sector were in not for the subsidies received meaning that Brexit represents a significant risk. • This sector tends to have very low levels of debt and have the most difficulty is securing finance.

- The breakdown of lending per farm type compiled from the results of the Farm Business Survey in 2015/16 supports this position as shown[7]:

- Figure 3.2: Average Borrowing by Farm Type



- In summary, the finance provided by banks to the dairy sector is the highest by some margin. This is because farmers in dairy sector typically have access to greater land available as security compared to the other sectors which reduces the risk of default to lenders (and hence the appetite to lend). Therefore, borrowing within the dairy sector tends to be significantly more prevalent.
- In general, the banks were supportive of the FI proposal and all those consulted indicated their organisation would be interested in acting as a financial intermediary if required.
- The banks cited the current FBIS approach as a similar consideration to the FI proposals in that the funding would support their own investment and offer an opportunity to reduce the risk to the banks. However, FBIS is a grant as opposed to a loan and there was general agreement that there would be less appetite amongst farmers for a loan which has to be repaid.

[7] Poultry industry was not included in the FBS

- Typically, (in the current low interest rate environment) the repayment timescale is the most relevant issue to borrowers. The longer the loan tenor, the more affordable the debt service payments. Whilst terms differed between funders, the typical approach to lending depended on the purpose of the loan. An overview of the loans provided for specific purposes as revealed through the consultation process is shown below:

- Table 2.2: Breakdown of Loan Types

Purpose of Finance	Typical of Loan provided
Day-day working capital	Overdraft – repayable on demand
Acquisition of plant / Machinery	Asset finance loan – repayable over c5 years
Development of buildings / infrastructure	Term loan repayable over 10-15 years
Land acquisition	Mortgage / debenture repayable over 25 years

- The maximum repayment period any of the banks consulted could currently accept is 25 years.
- The two primary reasons cited by the banks consulted for declining loans to farmers were:
  1) **Confidence in the management personnel**: This can come down to either the training of the farmer or the track record of the farm business leading to banks uncertainty in the ability of management to manage the loan appropriately. Ultimately, this evidence comes from the track-record of the business as well as the robustness of the future business plan;
  2) **Existing debt levels**: As shown above, there was a significant increase in the amount of debt drawn by farmers between 2005 and 2008. This has led to the debt leverage within some farm businesses becoming too high i.e. too much existing debt on their books for banks to feel comfortable about lending more.
- This can lead to farm businesses becoming very sensitive to small changes in economic conditions. For example if a dairy farmer is leveraged to 80%-90%, a very small reduction in milk prices could lead to them defaulting on their existing loans due to a fall in revenue meaning the lender has the right to claim the assets on which the loans are secured.

3.2.5. Existing Interventions into Financing Farm Investment

- Two key government interventions currently exist for farmers and primary producers regarding the provision of capital for investment in their businesses in Northern Ireland which are relevant to the consideration of FIs:

1) Farm Business Investment Scheme (FBIS)

- All the banks interviewed confirmed they were supportive of the FBIS programme, largely because it provides the banks with detailed cashflow forecasts which they can effectively use for their credit paper. The 40% of FBIS grant is paid and makes the decision easy for the bank for the remaining 60%. The forecasts help with loans other than those related to the FBIS also.
- However, it is important to note that the FBIS is a grant scheme and so the appetite from farmers is likely to be significantly greater than a loan product which must be repaid to DAERA. This point was raised by the banks consulted as well as the other consultees within DAERA.

2) The Agri-Food Loan Scheme

- This is an existing scheme that was established by the Department for the Economy (DfE) and implemented through Invest NI. It was implemented in 2013 to encourage the poultry broiler sector (as the initial target for scheme) to expand to take advantage of the decision by UK retailers to source meat products from the UK.
- The key features of the scheme are as follows:
    - Government provides up to 40 percent of the overall finance requirements (50% for new entrants to the sector; can be 30% for existing growers, or established farmers) as a loan on commercial interest rate terms. The remaining 60% is provided by the bank who also arranges the loan on behalf of Invest NI. The Government loan is subordinated (meaning the bank is repaid first if the borrower is in financial distress) and most of the interest on the Government tranche of the loan is rolled up.
    - The initial budget allocation was £10m. However, only £447,000 had been issued by 2016[8].
- There has been a very low uptake of the scheme to date. This is partly because the business plans produced for the scheme were deemed by the banks to be sufficiently robust that they were often content to lend the full amount.
- This confirms the findings arising from the consultations with the funders of the agriculture sector that there is a strong appetite from funders to lend to farmers and primary producers in the current market. The main reason borrowers cannot access loans is that they do not have an adequate business plan. The introduction of FIs will not solve this issue although it shows the potential value in providing wider support services to farm businesses to unlock greater capital investment.

[8] Data derived from the FBIS business case which was completed in the summer of 2016

3.2.6. Future Uncertainties - Brexit

- The consultations have revealed the importance of direct payments under the BPS to the appetite of banks to lend to farmers, especially to the sheep / beef farmers.
- Key points to note regarding future uncertainty raised during the consultations are as follows:
- One of the banks consulted confirmed that the presence of the BPS is the only reason why they can lend to beef/sheep farmers as the future ability of farmers to meet debt service obligations would be significantly reduced without this income.
- Another bank representative indicated they typically reduce the forecast income by c30% when using debt service cover ratios to size a potential loan to address the potential risk of falling prices;
- Whilst banks recognised that there has been little impact of this to date, as Brexit draws closer farmers and their representatives have a concern that the levels of uncertainty will restrict the availability of finance.
- Whilst the individual bankers consulted all expressed a personal view that the UK Government will introduce a scheme to replace the CAP, from an institutional perspective this remains a risk.
- The view of the UFU is that there is going to be a stronger need than ever for finance support in the aftermath of Brexit. UFU can see a need (and are supportive of) a strong government back loan product. However, its representative would like to see something similar to the Agricultural mortgage corporation in GB as these are loans lent over 40 years.
- On the basis of the above, the availability of FIs to replace the potential withdrawal of the appetite from banks to lend to the agriculture sector could become important post-Brexit.

3.2.7. Farm Business Survey

- Overview
- The RDP Management Branch within DAERA prepared and issued an online survey in June 2017 via email to a stratified random sample of 5,000 farms that were selected from 16,804 farm businesses for whom DAERA holds email addresses.
- The purpose of the survey was to establish an understanding of farmers' experiences in accessing commercial finance such as bank loans, hire purchase agreements from machinery dealers, and credit accounts from agricultural merchants. The questionnaire issued with the survey sought information on commercial finance products currently available to their business, their experiences in accessing them and gaps that they thought existed in the market.

- The survey was voluntary and was completed by the respondents on Citizen Space. A total of 360 responses were received by deadline of which **357** were valid. The response rate to the survey was 7.1% and overall the survey represents the experience of 1.5% of Northern Ireland's 24,528 farm businesses. DAERA consider this to represent a reasonable sample of farm businesses in Northern Ireland.
- An overview of the respondents to the survey by farm size and type is shown below:

- Table 2.3: Farm Survey Respondents

		Farm Size				
		Very Small	Small	Medium	Large	Total
		%	%	%	%	%
Farm TYPE	CEREALS	1.7%	0.4%	0.2%	0.1%	2.4%
	GENERAL CROPPING	3.0%	0.5%	0.3%	0.6%	4.4%
	HORTICULTURE	0.6%	0.5%	0.3%	0.9%	2.3%
	PIGS	0.2%	0.3%	0.4%	0.7%	1.5%
	POULTRY	1.5%	1.7%	0.8%	0.6%	4.7%
	DAIRY	1.7%	4.4%	3.7%	6.3%	16.1%
	CATTLE & SHEEP: LFA	35.6%	3.5%	1.8%	1.2%	42.2%
	CATTLE & SHEEP: LOWLAND	16.4%	2.2%	0.9%	0.7%	20.2%
	MIXED	2.4%	1.0%	0.6%	1.0%	5.1%
	OTHER TYPES	0.6%	0.2%	0.1%	0.1%	0.9%
	Total	63.8%	14.7%	9.2%	12.3%	100.0%

- Key Results
- The detailed results of the survey compiled by DAERA is presented in Appendix 2. The key findings from these results are summarised as follows:
- Almost a third of respondents (**28.6%** on a weighted basis) confirmed that there had been a change in the person or persons who have responsibility for making financial decisions for the farm business within the last five years. This indicates a high rate of change for financiers in regards to the individuals in whom they need to have confidence in running the businesses.
- Over half of respondents confirmed that they sought some form of external finance for their business over the last five years. More importantly **40%** of respondents indicated they intended to seek some form of external finance in the next five years compared to **28%** that do not. This confirms there is high demand for finance from farmers in NI. The farm type with the greatest demand is poultry (**84%**). This is understandable due to the high capital infrastructure requirements of this sector.

- Overdraft facilities are the most popular type of finance sought most by farmers (**32.6%** of all the finance sought). This confirms the findings from the direct consultations highlighted above. However, medium / long term bank loans (tenors over 3 years) are the second most popular at **28.8%.** In addition, a high proportion of applications are successful at **77.4%**. This indicates that problems accessing to capital is limited only to a small proportion of farm businesses.
- The most common reason for seeking finance in the past for the purchase of machinery (**63.4%)** for which hire-purchase loans will be available.
- Day-to-day working capital (**45.2%)** was the second most popular whereas only a quarter of the finance sought was for construction of new farm buildings / land purchase or improvement in the past. However, this was reversed for future intentions where **c40%** of respondents indicated they intended to use external finance for capital investment.
- There was a clear distinction in relation to the satisfaction in accessing finance reported by the medium to large farms compared to the small / very small farms. A clear conclusion is that larger farmers have better access to finance than the smaller operators.
- Only **30%** of respondents that intend to seek finance in the future are confident of successfully accessing the required amount and type. Again, the larger the farm, the greater confidence of accessing finance. This demonstrates the concerns regarding uncertainty in the financing markets amongst smaller farmers in the future.
- The greatest barrier to growth reported by respondents is low margins on products leading to low profitability. **82.7%** of respondents ranked this reason in the top three potential barriers. Over **50%** ranked either Brexit or increasing agricultural policy uncertainty in the top 3 reasons which again indicates that farmers are concerned about the future.
- The key statistic is that only **21.5%** of respondents ranked lack of finance within the top 3 barriers to future growth of their businesses. This confirms that access to finance is not seen as a significant problem by farmers in NI and supports the views arising from the direct consultations that financiers have a strong appetite to invest in agricultural businesses.

3.2.8. Conclusion on Farms and Primary Producers

- The main conclusion drawn from both the direct consultations and the farm survey is that there is little evidence that the demand for finance from the majority of farm businesses for viable business propositions exceeds the available supply in the current financing market. This demonstrated by:
- The strong appetite of banks to lend to farmers meaning that there is limited market failure and a weak rationale for intervention from DAERA;

- The high level of alternative grant financing available to the sector means that debt based instruments are less attractive; and
- The availability of the current agri-food loan scheme from Invest NI represents a form of FI that is already provided to certain farmers. The poor uptake of this scheme does not support the need for a similar scheme aimed at farmers from DAERA.
- In general the consultations revealed that if banks were unwilling to provide loans to farm businesses, it is because the proposals represent a significant risk of default. The provision of an FI for these projects will not address this risk.
- However, there are categories of farm businesses that represent exceptions to the above general principal. These are:

1) **New entrants to the farming sector**: Individuals without the track record and existing security to ensure confidence in an investor that a return on their investment is available. These circumstances represent a potential market failure as this investment may add value in terms of rural development but is not supported by the private sector.
2) **Post-Brexit Borrowers:** Given the current reliance on grants and subsidies within agricultural businesses at present, the political and policy uncertainty caused largely by Brexit means that both the availability of grants and subsidies as well as the appetite of funders will fall in the future. At that time it is likely that the greater numbers of farmers that require finance will be unable to access it.

- There is not yet enough evidence that Brexit will impact on the financing market for farmers to the extent feared and so the provision of an FI within the current RDP cannot be justified at the present time. Furthermore, the development process for new agricultural policies post Brexit will take into account the financial impact on farm businesses.
- Also, the number of new entrants to the farming market is not at significant enough a level to justify the establishment of a specific FI loan fund to new-entrant farmers only. Therefore, it is recommended that new entrant farm businesses are treated no differently to the wider definition of rural businesses if an FI is to be established. This is explored further in Section 3.3 below.

3.3. Rural Businesses

3.3.1. Subject of Review

- The definition of a Rural Business for the purposes of this Section is an enterprise that operates in a settlement with a populations below 5,000 as well as open countryside. This covers a wide range of organisations and includes both commercial businesses as well as social / not-for-profit enterprises. The key criteria for eligibility for an FI programme for the purposes of this consultation is ultimately **rural enterprises that that can add an economic benefit to the rural economy and assist in meeting DAERA's policy objectives**.

3.3.2. Target Enterprise Size

- The latest data available data on company size in NI indicates that **98.2%** of all companies are classed as Small or Medium Enterprises ("SMEs")[9]. Given the majority of larger companies with NI are based in urban settings, the proportion is considered to be even higher for rural businesses.
- The Ex Ante Assessment for the purposes of the ERDF (European Regional Development Fund) FIs undertaken by Invest NI in 2014 demonstrated that SMEs in NI have the greatest difficulty in accessing finance of all regions in the UK. This is due largely to a less developed market for finance outside of bank financing (which is an issue Invest NI as the local development agency is seeking to address).
- The feedback from consultations with representatives of the DAERA Food and Farming Policy team confirmed that the few food producers classified in the "large" company category in NI have access to grant support from the Department for the Economy ("**DfE**") through Invest NI, as these enterprises are seen as essential to driving exports from NI. The consultation indicated that this grant finance was necessary because the large businesses are considered "mobile" meaning that they can relocate to any jurisdiction the directors choose based on the tax advantages or the grant availability. This means there is significant competition from other jurisdictions for these companies to move and if NI wishes to retain the economic benefits they generate, then it is necessary to offer grant supportto prevent. SMEs are typically less mobile than large companies and so cannot relocate as easily.
- A consistent theme coming out of the consultations was that the large companies operating in rural areas would not benefit from FIs as there is little evidence of an inability to access finance if required and there are grants available from other public sources.
- On this basis, this Ex Ante Assessment has focussed on the Rural SMEs within NI.

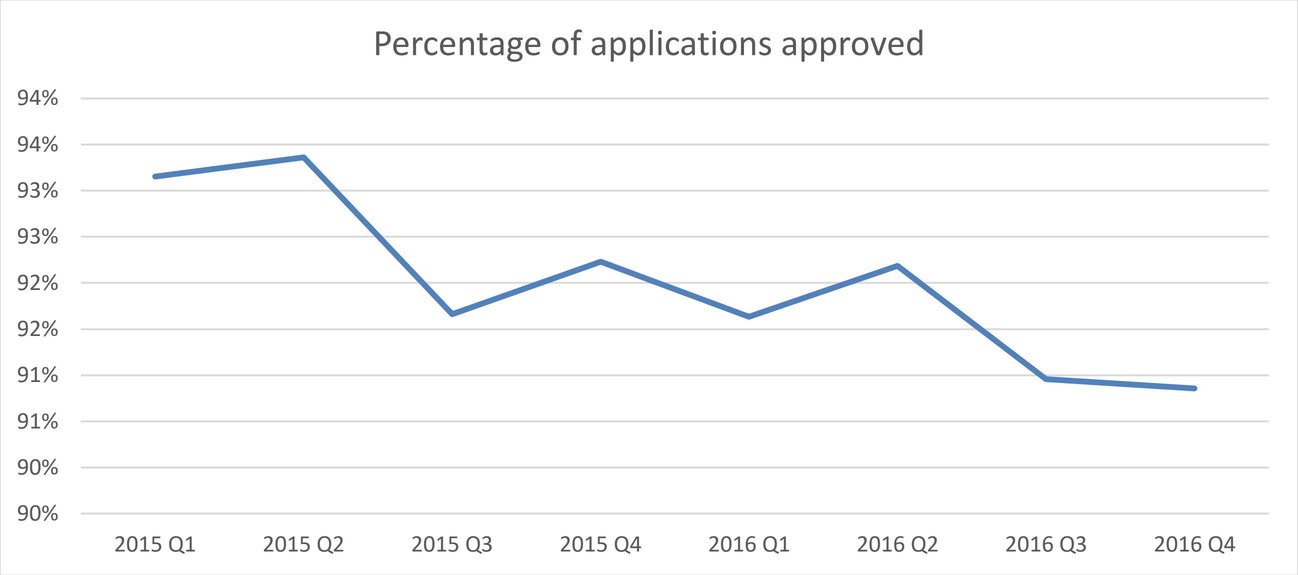
[9] Department for Business, Innovation and Skills: SME Journey Towards Raising External Finance October 2013

3.3.3. Current Funding Environment for Rural SMEs

- Data published by the British Banking Association ("**BBA**") indicates that the proportion of loan applications from SMEs that are approved is typically over 90%. The latest BBA data underpinning this statistic is below:
- Table 3.1 Overview of SME Lending in NI

Quarter	Percentage of SME loans approved in NI	Total Value of SME Loans in NI (£'m)
2015 Q1	93.2%	462
2015 Q2	93.4%	410
2015 Q3	91.7%	350
2015 Q4	92.2%	440
2016 Q1	91.6%	508
2016 Q2	92.2%	418
2016 Q3	91.0%	391
2016 Q4	90.9%	329

- The trend in application approvals is illustrated in the chart below:
- Figure 3.3 Trend of SME Loan Application Approvals in NI



- Whilst the data shows the trend is falling, the average proportion of loans approved over the last 24 months is still **92.0%**. However, consultations with representatives of rural businesses as well as alternative lenders have indicated that this does not show the full picture.

- The data presented above represents only the loans for which a formal application has been made to the bank in question. Typically, the prospective borrower will discuss a loan with their branch manager prior to making the application. At this meeting the manager will confirm whether the loan is likely to be approved. If the borrower does not make an application following this discussion, it is not recorded within the BBA data.

- In fact, the consultations have revealed that mainstream banks are typically **not** the primary source of funding for rural businesses unless they can demonstrate a strong track record of at least three years. Start-up rural businesses will not have the evidence to support bank finance and so significant structured finance is not an option for new businesses. This is the case for both urban and rural based businesses.

- The consultations with representatives of rural businesses have revealed that the main areas in which financing gaps exist within rural businesses are with:

1) Social / community enterprises; and
2) Growing / start-up firms

- There is a demand for loan finance in relation to both these groups to assist in developing the businesses (capital development as well as revenue costs for marketing, administration etc). In Northern Ireland, the main sources of finance for each of these groups at present are described below:

1) Social / Community Enterprises

- **Ulster Community Investment Trust**: This is the primary source of loan funding for social enterprises in Northern Ireland (another potential source is the Charity Bank which provides much less funding in NI). UCIT has committed in excess of £50 million to over 360 organisations in Northern Ireland since 2001. The capital it lends was originally provided by the Local Enterprise Development Unit ("**LEDU**" - the predecessor to Invest NI) and the International Fund for Ireland ("IFI") along with a £6.6m loan book from IFI, DfI and DAERA.
- The Rural Development Council ("**RDC**") confirmed through consultation that UCIT play a significant role in the provision of finance to social enterprises but the demand is too great for one organisation and there is a need for other financiers in the market at present.
- **Public grant finance**: Social enterprises are typically funded to a large extent by public sources – usually a combination of grants from public bodies as well as private donations. However, grant finance from public bodies is falling across all sectors at present with the reduction in government budgets.
- Consultees all confirmed that there is a recognition amongst social enterprises that alternative forms of finance need to become available to order to ensure financial sustainability.

2) Commercial SMEs:

- **Grant funding through LEADER** Programme[10]: Grant funding through the RDP is available through the LEADER Programme in NI which focuses on Priority 6 of the current RDP (Promoting social inclusion, poverty reduction and economic development in rural areas,). Ten Local Action Groups ("**LAGs**") exist to manage funding allocated to this programme within the RDP (a total of **€80m**). This has allocated **£27m** for the Rural Business Investment Scheme which provides grant support for the creation and development of micro and small enterprises (including farm diversification and private tourism businesses) in rural areas. Further details of this scheme are provided in Appendix 3.
- **Family members:** Consultees all confirmed that family and friends are the primary source of start-up capital for SMEs. They can often provide any match funding required for grant income also.
- **Various Invest NI Backed Schemes** – Invest NI have recognised there is financing gap for SMEs and have established a continuum of support through the "Access to Finance" initiative. This provides start-ups and growing companies with finance to enable growth. A number of these initiatives use Financial Instruments available through the ERDF and include the Small Business Loan Fund (managed by UCIT), the Growth loan Fund (manged by Whiterock Capital) and a number of other equity based funds.

[10] It should be noted that the LEADER Programme is also available to support social enterprises seeking to develop rural communities

- From the above list it is Invest NI that provide the greatest funding support for rural SMEs to access finance at present. However, as discussed below, the objectives of the Invest NI funds can differ from the objectives of DAERA.

3.3.4. Overview of Demand from Rural Businesses

- The extent of demand for finance from rural businesses is difficult to measure on an objective basis. It has not been possible to undertake a survey as was completed for the farm businesses as DAERA do not have access to a database of business contact details. However, those consultees representing rural businesses (particularly the LAGs, the RDC and UCIT) were all keen to point out how their experiences with rural based businesses demonstrated strong levels of entrepreneurship.
- Typically the population of rural towns have less opportunities for economic development. They differ from urban populations in NI because:

1) Foreign Direct Investment (FDI) is considerably rarer in rural areas than in cities such as Belfast and Derry~Londonderry; and
2) There is a lower level of public sector employment in rural areas;
3) There tends to be poorer infrastructure available to support business growth (e.g. broadband access etc).

- Therefore, there is a culture of businesses recognising they have to help themselves and far less of a dependency on grant culture than would be the case in the farming sector. The most common types of rural businesses in NI raised by consultees during interviews were in the following sectors:
- Tourism
- Engineering
- Manufacturing
- Construction
- Agricultural diversification (farms being used for other enterprises other than primary food production)
- Consultees indicated that the most common reasons for rural businesses to draw loans were as follows:

1) Upgrade / develop accommodation or infrastructure;
2) Acquisition of new equipment / machinery;
3) Working capital: to ensure that adequate cashflow was available to fund ongoing cost of sales as well as marketing and admin costs; and
4) Bridging finance: Any grants that might be available are paid retrospectively, so finance is required to deliver the capital development for which the grant is being paid.

- Specific examples cited in consultations supporting the potential for the rural community to develop sustainable business include the following:
- **Mid-Ulster Council**: There are currently c600 different SME companies' employing c8000 people. The area could arguably be described as a world leader in construction materials handling with the presence of Powerscreen ensuring numerous successful SMEs through the supply chain;
- **Draperstown**: This area was cited as an example of an area in which the population demonstrated particular entrepreneurship. Examples include:
  - Fourds Ltd- a Draperstown engineering business which launched an innovative window blind system with assistance from Invest Northern Ireland
  - Peace Tech - the founder of which is from Draperstown and which was named among the top 25 of the UK's most influential entrepreneurs in 2017[11];
- **Causeway Coast and Glens**: The most prevalent form of diversification from farm-based businesses is into engineering businesses. Primarily new machinery and enhancing their production line. There are many successful examples of this approach.
- The LAG representatives were also keen to point out that the GVA created by rural businesses was delivered despite the poorer infrastructure (broadband, roads, telecoms etc) available compared to urban areas. Therefore, greater investment in rural business could generate a significant economic return.
- The LAGs consulted confirmed that a high demand for finance existed. They hold a regular workshop for rural businesses interested in applying for grant funding through the LEADER programme (this is mandatory if the application is to be considered). This is always well attended (one LAG consultee confirmed that at the last workshop 77 individuals attended).
- This would seem to indicate that the demand for finance amongst rural businesses is not being met by the supply.

3.3.5. Rural Businesses: Supply Side Issues

- An overview of the four main sources of finance available to rural SMEs (other than the UCIT as described above) and the extent to which the consultations revealed a financing gap are described below:

[11] https://www.belfasttelegraph.co.uk/business/news/derry-businessman-henry-josephgrant-recognised-in-top-25-of-the-uks-most-influential-entrepreneurs-35493596.html

3.3.5.1. Commercial Banking Market

- As stated in Section 2 above, the consultees representing the banks were typically agricultural finance specialists. Each confirmed that there was no specific focus within their organisations on rural businesses. Whilst each also confirmed that the banks they represented would support rural businesses, this was always qualified by the necessity for applicants to provide the necessary information to provide confidence to their credit committees that they can meet the debt service obligations.
- Key points arising from the consultations with other representatives were as follows:
- Rural SMEs, particularly new start-up or early stage enterprises, face the same issues as highlighted for new-entrant farmers discussed in Section 3.2 above. In order to secure senior debt finance, it is necessary to demonstrate a strong track-record of at least three years performance.
- The capital protection requirements of banks meant that small rural businesses rarely received approvals from banks for long-term loan applications.
- Loans to SMEs represent too great a risk of default. The provision against loss within the Small Business Loan Fund is current **8%** per annum. This is too high a default rate for a senior lender to sustain and maintain the profitability required by shareholders.
- In reality, rural SMEs are rarely considered “investor-ready”. As with farm businesses, one of the key barriers to entry is that businesses lack the skills and financial knowledge to develop business plans. Consultees indicated that this has put many businesses off pursuing investment to develop business plans.
- In summary, the commercial banks cannot provide the level of financing required by rural business to grow. Therefore, if the socio-economic benefits from growing these enterprises are to be secured, public finance will be required. At present that is provided mainly through Invest NI.

3.3.5.2. Invest NI

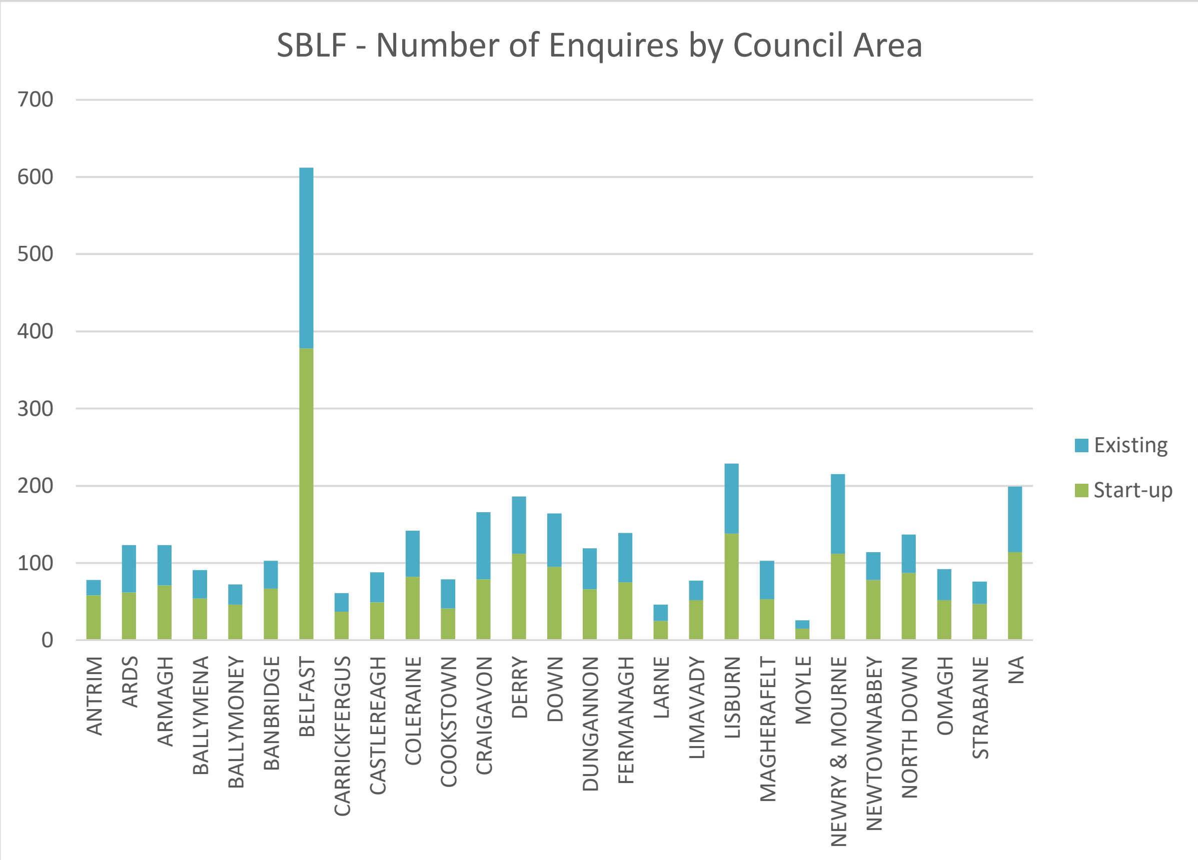
- As NI’s primary economic development agency, Invest NI provide a range of financing support for SMEs through an “Access to Finance” initiative. This is a range of different funds that aim to provide different levels of support to businesses depending on their stage of development.
- However, Invest NI is an agency of DfE and so the objectives that it seeks to achieve do not always reflect those policies that DAERA needs to implement. For example:
- The Invest NI funds are focused on economic development through export growth as this is the primary objective of DfE and the ERDF. The primary objective of DAERA and the EAFRD is ultimately the development of the rural economy. Therefore, the necessity to export goods and services from NI to other jurisdictions, whilst beneficial, is not the primary policy objective of DAERA.

- A number of the Invest NI funds are focussed on equity investment rather than lending. The consultations have demonstrated no specific demand for equity funding and this form of financing was not sought by any of the consultees. Typically rural businesses have a similar mentality as described above for farm business. They tend to be family-based businesses that do not wish to give away any stake to external funders. Therefore, equity is not considered a suitable investment means for a rural-based FI programme. However, this is a key form of investment encouraged by Invest NI at the start-up stage within its Access to Finance Programme.
- The focus on economic development through private commercial growth means that the Invest NI funds do not typically invest in social enterprises / not-for-profit organisations. These organisations have a significant role to play within the development of rural areas but cannot avail of these investment funds.
- Nevertheless, the data collected by the Invest NI funds provides a useful indication of the level of demand that is not currently being met by the supply. The NI Small Business Loan Fund ("**SBLF**") and the Growth Loan Fund ("**GLF**") are good examples of the type of funds that provide loans for SMEs (with the SBLF providing smaller loans to small / start-up businesses with the GLF focused on larger / medium sized businesses).
- The background to these funds and the data relevant to the extent of loans they are providing across NI are discussed below.

- NI Small Business Loan Fund
- The SBLF was first established in April 2013 with the aim of ensuring that businesses are not held back because they cannot access finance. It provides loans to individuals, private companies and social enterprises in the SME and micro enterprise size range that are in the start-up and growth phases of development. The fund has lent over £6m to over 300 firms during its first 4.5 years of existence.
- The fund provides a maximum loan amount of £15k to start-up enterprises, with potential for follow-on lending up to a maximum of £50k. However, existing businesses can apply for loans of up to £50k. The loans are typically unsecured but personal guarantees may be sought by UCIT (the fund manager) and applicants need to clearly demonstrate their ability to service the loan repayments prior to a loan being provided.
- Finance can be provided for:
- **Working Capital**: money required to meet the day to day costs of running the business
- **Development Finance**: money required to expand the business, for example marketing
- **Commercial Premises** – (deposit, costs of moving, improvement)
- **Plant and Machinery** – (deposit, tooling, installation, training)

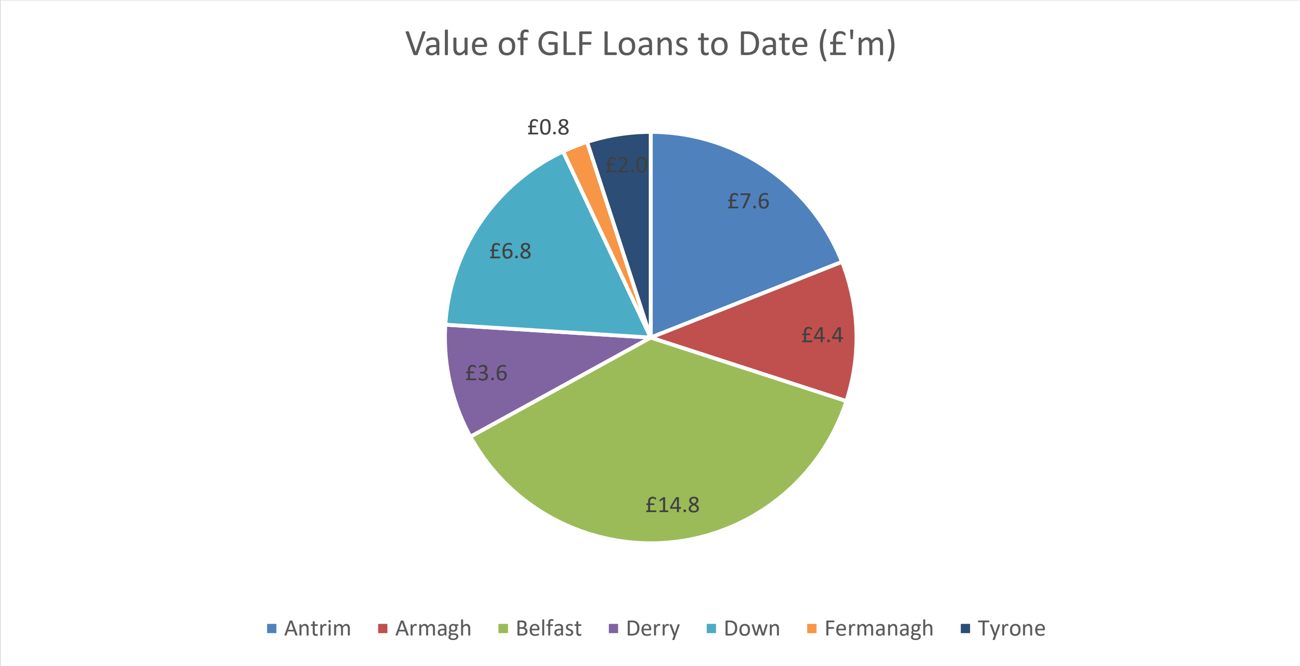
- **Intangible Assets** – (patent costs, IT software and licences)
- **Gaps in funding working capital** where commercial funding sources (e.g. overdrafts and invoice finance) cannot provide the full requirement
- Increasing sales, new contracts
- Stock Purchases
- International Trade
- However, the rules governing the funds stipulated by Invest NI <u>explicitly exclude</u> any loans from being provided to primary producers within the agriculture sector.
- The chart below shows the distribution of enquiries made to the SBLF by Council Area:

- Figure 3.4: Distribution of SBLF Enquiries by Council Area

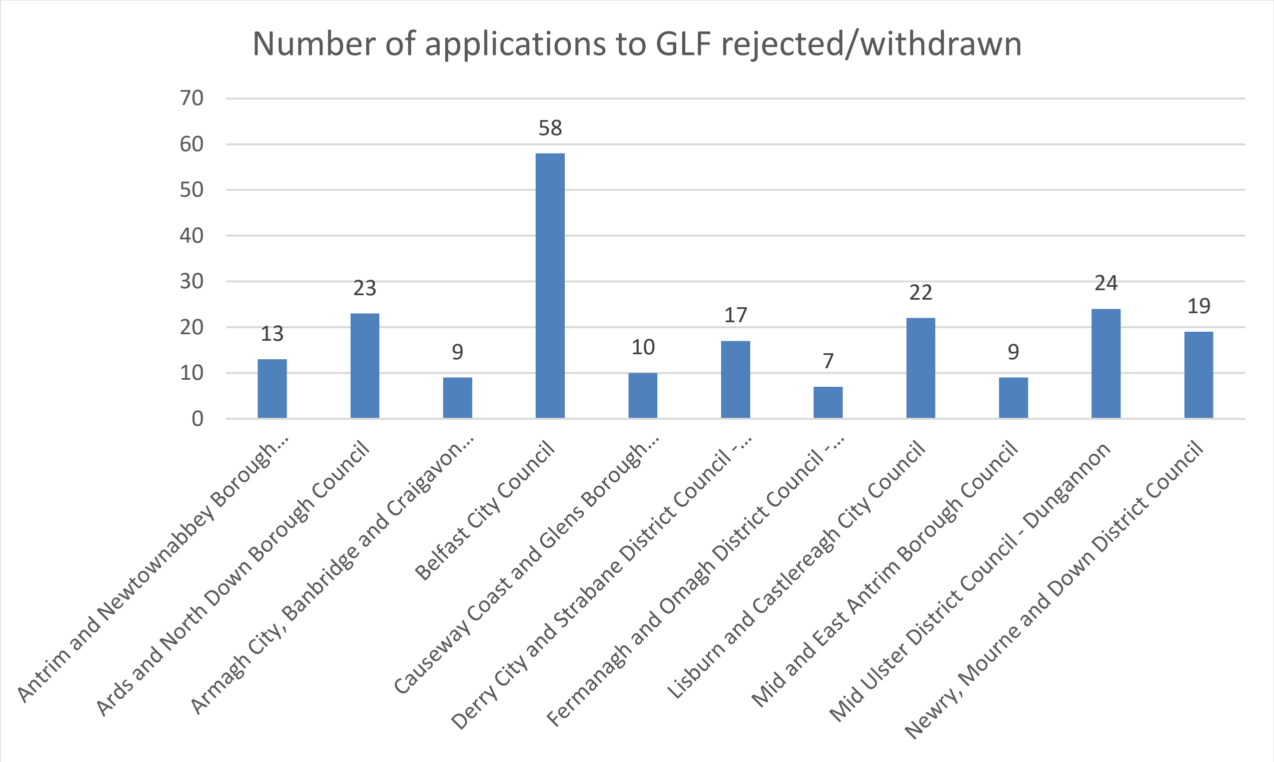


- The SBLF representative confirmed that the majority of the demand for the SBLF loans came from urban areas within NI (as demonstrated in the chart above with the Belfast area being considerably the highest source of enquiries). However, this was due largely to the marketing networks for the fund being more accessible within urban locations. Some of the most successful firms that the SBLF have supported have been based in rural areas. One particular example is Brocagh Precision Engineering ("**BPE**") which is used by SBLF as a case study to demonstrate the benefits it can provide. BPE is based in a rural area near Coalisland and the SBLF finance allowed the investment in new machinery and working capital to develop new products for the construction and demolition sector which resulted in export orders and plans for new staff.
- The SBLF is not targeted specifically at rural areas and the view of the SBLF representative was that if a fund existed that was marketed specifically toward rural businesses, the demand from this sector would be greater.

- Growth Loan Fund
- GLF was established in 2012 and provides unsecured loans of between £50,000 and £500,000 SMEs in NI. It is managed by Whiterock Capital Partners and is run on a fully commercial basis. A total of £50m finance has been provided to GLF by Invest NI (£25m - partly through the ERDF as an FI) and £25m by private sector investors in Whiterock. Loans are made only to businesses that can demonstrate export potential and GLF is targeting businesses mainly in the manufacturing, engineering or tradable services sectors.
- To date GLF has provided loans to over 130 companies in NI and have lent over £40m in loans since it became operational 5 years ago. The proportion of the £40m lent by GLF by the location of the SMEs that have drawn the loans is shown below:
- Figure 3.5: Breakdown of GLF Lending by Area



- The chart shows that whilst the highest proportion of the loans lent are in Belfast, there have been loans lent in all counties. However, more important for the purposes of establishing the demand for FIs from rural business is the extent of loan applications that have been rejected because they do not meet Invest NI's export requirements.
- GLF confirmed that a total **288 applications** for loans had been rejected since it became operational and the majority of these rejections were due to the applications failing to demonstrate the necessary export potential. These are examples of borrowers that have the potential to meet DAERA's policy objectives if they are based in rural areas.
- Details regarding the location of the SMEs whose applications were rejected /withdrawn have been collected by GLF for 211 of these (73%) and are shown below:
- Figure 3.6: Breakdown of Rejected GLF Loans by Area



- The chart shows that applications for loan finance have been rejected/withdrawn for SMEs within all 11 of the NI local council areas.
- It should be recognised that a proportion of the declined projects are likely to have been declined because they are not viable (and so FIs would not be an appropriate replacement to the GLF). However, this demonstrates the potential demand from SMEs that could be eligible for FIs through the RDP.
- This conclusion was supported by the GLF consultee who indicated that there would be significant demand from rural businesses that do not meet the exporting criteria for the GLF but would qualify for a "rural specific" fund.
- This example as well as the data from the SBLF clearly demonstrates there is latent demand for finance amongst rural SMEs in NI.

3.3.5.3. LEADER Programme

- The grants available under the LEADER Programme schemes (such as the Rural Business Investment Scheme discussed above) are utilised by rural businesses. However, LAG based consultees indicated that there are five key issues that reduce demand:

1) **Eligibility of Investment Uses**: There are only certain categories of costs that can be supported by the public grant so a large number of applications are ineligible (see Appendix 3 for the list of ineligible costs within the Rural Business Investment Scheme ;

2) **The requirement for a competitive procurement process**: The terms of the grant require applicants to ensure they have delivered competition in the contracting / acquisition so need to develop a tender specification and issue to multiple bidders to demonstrate value for money. This is an onerous process and puts a large number of potential applicants off;

3) **Match funding**: As discussed above, the requirement to match the grant with external investment can prove very difficult as, even with the reduced risk, banks will need the following to release any funds:

    a. a detailed business plan

    b. 3 prior years financial statements to demonstrate the track record

- Again, these requirements are considered onerous by a large number of potential applicants.

4) **Complicated application process**: Consultees overwhelmingly indicated that the onerous application process was a key restriction on the demand for the grants. They confirmed that local councils are not permitted to provide advice to applicants in completing the forms to avoid any perception of a conflict of interest. Therefore, they have to engage an accountant to assist with the application which is expenditure that they may not get back if the application is unsuccessful.

5) **Requirement to demonstrate job creation rather than profitability**: The supply of finance is reduced by the requirement to demonstrate job creation (consultees indicated that scoring of a project is all about the number of jobs being created). This can be very costly for a business when it may not make sense to employ a staff member immediately.

- Each of the above issues is relevant to a greater extent to social enterprises and community groups also. The LAG consultees all indicated that applications were lower than they would like. Ultimately, whilst the programme is providing assistance and meeting some needs, the process is considered too complicated for many potential applicants.

3.3.5.4. Other Government Backed loans

- The other primary government-backed loan scheme that is supporting the Invest NI Access to Finance funds in addition to the ERDF FIs is the Financial Transactions Capital ("**FTC**"). The features of FTC are as follows:
- FTC is a form of capital financing that was introduced by the UK Government in 2012/13 in order to encourage private investment and stimulate the economy.
- It is administered by DoF and its key feature is that it can only be deployed by the public sector as a loan to, or equity investment in, a private sector entity. Therefore, it must be repaid to DoF under the conditions of a loan / equity agreement.

- The NI Executive is granted an annual allowance of FTC by HM Treasury which is in addition to the NI Block Grant. Therefore, whilst it is provided over and above the Capital DEL budget available to sponsoring departments it has its own ring-fenced budget and so any loan will be subject to the application process managed by DoF and will depend on other priorities and commitments for FTC in NI.
- £100m of FTC has been allocated to a new fund entitled the Northern Ireland Investment Fund as part of Budget of 2016-17. This Fund has been established provide loan, equity or 'mezzanine' finance to viable local private sector projects in the following sectors:
    - Urban regeneration
    - Energy and energy efficiency
    - Telecoms
    - Social housing
- On the basis of the above, the FTC Infrastructure Fund will add little value to objective of rural economic development and so the risk of displacement of this fund with a Rural FI Programme is low. However, this concept is very similar in nature to the FI Programme (i.e. the provision of loan finance rather than grants to achieve policy objectives). Therefore, it represents a relevant precedent in delivering the concept of FIs.

3.3.6. Conclusion on Rural Businesses

- The extent of market failure amongst non-farm based rural businesses is very different to the farms assessed in Section 3.2. Whilst grants and subsidies are available for non-farm businesses operating in the rural economy, they do not exist to the same extent as those operating in the agricultural sector with access to the SFP. The key conclusions from the above analysis are:
- **A demonstrable need for finance exists within the rural SME Market**: Consultations have identified a strong demand for FIs from both commercial SMEs/micro businesses as well as social enterprises.
- **A clear market failure exists in meeting this need**: There is a gap in finance both from the banking sector and Invest NI in relation to support specifically for rural businesses. This market failure is being partially addressed through the LEADER Programme but this grant funding is adding less value that it could be through an FI scheme as (1) the application process is complicated and (2) this funding is not being recycled for future use.
- **Demand exists for government-backed Loan Finance**: Consultees all confirmed that the key focus of rural business is the annual affordability of the debt. Therefore, the key attributes to any FI loan product are:
    - Reduced interest costs for Social Enterprises who are not as constrained by State Aid legislation.
    - Greater tenor of loan to ensure affordability for commercial SMEs as State Aid rules will restrict

- Flexibility - with the ability to repay earlier if cashflows allow
- Available for working capital and bridging loans.

3.4. Forestry

- The consultations have revealed that Forestry as a sector in itself is not appropriate for consideration of FIs. The primary reasons for this are:
    - The capital requirements for forests is largely in the land. The planting costs are ultimately not significant and so financing is typically not required to a large extent. Most of the RDP grant beneficiaries in the forestry sector are already land owners so do not need this capital. The RDP typically provides grants to ensure that this land is retained as forests.
    - The return on timber production is achieved over 30- 40 years. There are few investors in the private sector that are content to tie their investment up for this length of time. Whilst there has been a growth in demand for short-rotation timber for wood-fired renewable energy plants, the difficulty for growers of short-rotation trees (such as willow) it is competing with wood processing plants i.e. the sawdust and chips are the key value. Willow is the lower end of the value market.
    - The only commercial value comes from holding significant areas of land. In this regard, growers would be competing with Coilte in RoI
- However, there is currently a drive by government to encourage the commercialisation of forests. In particular investment into Forestry based the leisure / tourism ventures are growing at present for example:
    - **Glamping:** Luxury camping facilities are becoming more and more popular in NI.
    - **Mountain biking**: The businesses supporting this growing activity include bike rental and associated equipment sales etc The forestry division in DAERA engage with the local council to provide a licence to use the mountain bike trails and associated commercial development.
    - **B&Bs:** Accommodation for tourists seeking to visit forest areas
    - **Renewable Energy**: There has been a recent growth in demand for short-rotation timber for wood-fired renewable energy plants such as willow. However, there is strong competition from Coilte and the waste-wood market in this industry.
- Ultimately, all the these ventures would fall under the category "rural businesses" and so the findings presented in Section 4 above apply to the forest based enterprises. There is little justification for a separate Forestry based FI fund.

3.5. Summary of Conclusions Drawn from Stakeholder Consultations

- The key findings arising from the direct stakeholder consultations and the farm survey is as follows:

1) There is little evidence of an immediate need for an FI intervention to support farm businesses in NI. A strong appetite from commercial banks in NI to support this sector currently exists due to the nature of the borrowers as well as a number of other public interventions. The Farm Business Survey indicated that a low number of farmers saw access to finance as a barrier to future growth of their businesses. Therefore, the demand for an FI product is expected to be low from farmers in the current market.

2) It is recognised that this position may change as the UK withdraws from the EU and the policy environment regarding subsidies, future grant provision and the NI RDP become less certain. As such it is important that the position is monitored as the process of Brexit proceeds.

3) New entrants into farming is the only category for which the introduction of an FI loan product is envisaged to add material value. However, the numbers of such new entrants expected into farming is not envisaged to be sufficient to justify a specific intervention aimed specifically at this group. Therefore, new farmers should be considered as a rural business for the purpose of any FI Programme.

4) There is clear evidence of a need to support rural SME businesses – both commercial businesses and social enterprises. The demand for finance from this group currently exceeds the supply of finance which is predominantly from the funds managed by UCIT. Therefore, evidence of a financing gap exists which could be addressed through an FI intervention. Whilst Invest NI provides a range of support to young and growing businesses, there is deemed to be a gap for rural businesses that are not specifically targeting NI exports. The target for the FIs provided as part of the RDP should be into productivity improvements rather than exports.

5) There is no evidence of a significant financing gap in the forestry sector and so there is no justification for a specific fund targeting forestry businesses. The forestry based businesses that require finance will fall under the category of rural businesses and should qualify for any general FI intervention that is established.

6) The consultations indicate that a loan fund which aims to leverage additional private investment (and is managed along with this private investment by an experienced financier) is likely to represent the greatest value for money. There are a number of precedent examples for this form of investment including:

    - The Growth Loan Fund (supported by Invest NI)
    - The Infrastructure Investment Fund (Supported by DoF)
    - The agri-food loan scheme (supported by Invest NI)

- The investment strategy for such a loan fund is considered in detail in Section 6 below.

4. Assessment of the Market Gap Value

4.1. Overview

Section 3 has demonstrated that there is a general demand for a Rural Business FI Programme. However, the consultation process is not sufficient, in itself, to provide an accurate estimate of the extent of finance that will be required to cover the costs of all viable rural projects that cannot be delivered because of access finance i.e. the **"**Market-Gap**"**. As such, further analysis has been undertaken to provide a broad estimate as to the potential value of this Market Gap. This analysis is based on both:

1) **Statistical Analysis**: Collation of the evidence on the likely number of rural SMEs in NI that require finance for viable projects but cannot access it due to the appetite of funders for risk; and
2) **Benchmarking**: The size of the funding made available to businesses under similar schemes and the eventual uptake of this finance.

4.2. Statistical analysis

A detailed analysis of the key factors in determining the potential Market Gap (for example the total size of the market and the potential demand from the rural community in NI) has been undertaken.

The table below shows the approach that has been taken to estimating a market-gap from the available information on the number of SMEs operating in rural areas that would seek finance in the form of an FI:

Table 4.1: Quantitative Estimate of Financing Gap

Calculation Component	Data	Source of Information
Estimate of the number of SMEs in NI:		
Total number of businesses in NI either registered for VAT or PAYE (i.e. operating)	84,305	2016 ONS Data - see attached
Proportion of businesses as SMEs	99.30%	FSB website
Total estimated SMEs in NI	**83,715**	
Estimate of the number of these SMEs that operate from rural areas:		
Proportion of SMEs in rural areas	77%	NI Assembly Paper "Rural Development issues and challenges in Northern Ireland
Total number of SMEs in Rural areas in NI	**64,460**	
Estimate of the number of these rural SMEs that require finance		
Total proportion of SMEs either currently seeking or intending to seek finance (Q2 2017)	21%	Page 286 of SME Finance Monitor Q2 2017
Total number of SMEs in Rural areas in NI seeking or intending to seek finance	**13,537**	
Estimate of the number of these rural SMEs requiring finance that cannot access it		

Calculation Component	Data	Source of Information
Proportion of SMEs seeking finance but unable to access any finance	13% to 27%	Longitudinal Small Business Survey 2016: SME employers – cross-sectional report
Number of SMEs that cannot access finance in NI rural areas	**1,760 to 3,655**	
Estimate of the number of these projects that are commercially viable (FIs should only be provided to projects that are viable and meet the long term policy objectives of the RDP)		
Proportion of SMEs that cant access finance but have a "viable" project	10% to 20%	This is the lower end of the range used by EIB to considered the finance gap within their Doc: Using Financial Instruments for SMEs in England in the 2014-2020 Programming Period A study in support of the ex-ante assessment for the deployment of EU resources
Number of SMEs that cannot access finance in NI rural areas but have a viable project	**176 to 731**	
Final estimate of the total value of the gap in the rural market – i.e. the funding required by rural SMEs in NI for viable projects that cannot access the finance		
Value of finance typically sought by SMEs in rural areas	£25,000 to £50,000	Based on the Small Business Survey 2016 - see link
Estimated value of financing gap for viable projects from rural SMEs in NI	**4,399,425 to 36,549,073**	

In summary, the total value of the funding required by rural SMEs in NI for viable projects that cannot be provided through commercial means is estimated to be between **£4.4m and £36.5m.**

4.3. Benchmarking with other Similar Programmes

- It is also useful to consider precedent projects in the estimation of the potential size of the Market Gap. Whilst there has been no FIs introduced specifically for businesses in NI previously, there are other schemes which can provide a relevant benchmark being:

- **Invest NI Loan Funds**: Specifically the Growth Loan Fund and the Small Business Loan Fund:
- **DEFRA FI Proposal**: Whilst the DEFRA scheme has not yet been implemented, this provides a good benchmark for a rural loan scheme in the current market on the assumption that a similar demand per SME will apply to England as it will to NI.
- **The Rural Business Investment Scheme**: As discussed above, this is a grant scheme targeting rural enterprises through the LEADER programme currently being rolled out by DAERA.
- Each of these benchmarks is discussed below:

- Invest NI Loan Funds:
- The SBLF was originally established as a £5m loan fund to be invested over a period of 5 years – with a maximum loan of only £50k. However, this target was achieved within four years due to high demand. The GLF was established as a £50m loan fund and provided loans between £50k and £500k. It is also expected to be fully utilised by its expiry date.
- The consultation with both funds indicated that a prudent estimate would be that 40 to 50% of the applicants would qualify for a rural loan fund (in reality this is likely to be greater). Therefore, a market gap of between £25m and £30m could be justified. In any case this falls within the range calculated using the statistical analysis above and so no extension to this range is necessary.

- DEFRA FI Market Gap Analysis

The DEFRA Ex Ante report estimates the value of the market gap for rural businesses (including farm and forestry holdings) at between £62m to £125m. Given the number of rural SMEs in NI is estimated to be approximately 13% of those in England, this would indicate a market financing gap at between **£8m and £16m**. This also falls into the range estimated through the statistical analysis and so there is no further extension of this range as a result of the benchmarking to DEFRA views.

<u>Rural Business Investment Scheme</u>

Whilst this is a grant scheme it seeks to target a similar group of potential beneficiaries as an FI Programme. This scheme is still being rolled out and so demand is not yet fully known for the scheme. However, the total market gap identified for this scheme was £27m. Again, this falls within the scheme range estimated above.

4.4. Conclusion on Market Gap

The analysis of the potential size of the Market Gap using the statistical data available at present has indicated that the potential value of viable rural projects in Northern Ireland that will fail to access finance due to a low risk appetite from existing financiers is in the range of **£4.4m to £36.5m**.

Benchmarking this against other similar loan schemes being delivered by Invest NI has supported this range and so it is deemed to be the most accurate available.

However, it is important to note that the value of any FI programme does not necessarily have to meet the full size of the Market Gap as other factors need to be taken into consideration. These are discussed in Sections 5 and 6 below.

5. Lessons learned from previous Programmes and Constraints in Implementation

5.1. Overview

- FIs have been in existence since the 2007-2013 ESIF programme. Therefore, there are have been many lessons learned from the provision of these programmes over the last decade and the EC Guidance specifically requires that these are considered prior to the implementation of another programme. Therefore, this section sets out the key learning points from the programmes that are most relevant to the establishment of a rural business FI Programme in NI. These are considered to be:

1) The Ex-Ante Assessment of the proposed FI Programme for the RDP England undertaken on behalf of DEFRA.
2) The interim evaluation of Invest NI Fund of Funds (by Invest NI in 2014).
3) The NIAO Report on the Invest NI Access to Finance Programme (September 2017).

- The primary purpose of the review of the above appraisals is to assist in defining an investment strategy for the Rural Business FI Programme. A key determinant of the terms on which support can be provided to beneficiaries of an FI Programme is the current State Aid legislation. Therefore, this is also discussed separately in this section below.

5.2. Lessons noted by DEFRA Ex Ante Assessment

- The Department for the Environment, Food and Rural Affairs ("**DEFRA**") within the Westminster government has recently completed an ex-ante assessment for the introduction of a Rural FI programme. The conclusions from this report reflect the findings gathered from the NI Stakeholder Consultations reported above i.e. that there is a need to establish a fund to support Rural SMEs in England.

The key lessons that have been learned from previous similar programmes in England that are highlighted within this report and are relevant to the DAERA programme are as follows:

1) **It is important to set up the FIs as early as possible in the programming period**: The DEFRA review highlighted an issue encountered in previous programmes whereby FIs set up late in the programming period cannot be invested in time for the end of the programme. It can take several months/years for the market to become fully aware of the availability of an FI programme. Therefore, if budgetary time limits are stipulated regarding the timescales over which a scheme can be available this lead-in time needs to be taken into consideration.

2) **Build on existing institutional frameworks where possible**: Setting up new teams and governance arrangements can be costly and time consuming. If existing frameworks are available to the MA they should be utilised as far as possible to reduce administrative costs and timescales. In Northern Ireland, Invest NI

has already established a number of loan based schemes. As such, it has the skills and expertise in house to lead the procurement of fund managers and the monitoring / management of funds and is best-placed in NI for this activity.

3) **It is important to ensure a local presence is available for partnership through FIs**. This means that it is not sufficient for FI administration to be based in urban areas – the borrowers need to have access to individuals that can arrange FIs within their local areas. This is particularly important for rural funds in which a strong alliance with LAGs and banks can help ensure product design is optimal and help with information dissemination also.

4) **It is important not to overestimate the level of funding gap that can be addressed by FIs**: The DEFRA ex-ante assessment has recommended using a pilot programme to test the demand for the product before rolling the concept out more fully in the future if successful.

5) **Structure of the financial instrument must be attractive to the financing market**: It is imperative to undertake market testing before engaging a financial intermediary to assist in delivering the investment to beneficiaries. This will provide clarity on the level of private finance than might be leveraged from the proposal and the optimum loan terms for which a demand would exist from the market.

6) **It is important to align funds with existing local business support networks**: The NI fund will need to have a strong alliance with the mechanisms currently in place to deliver the LEADER programme. This includes close liaison with the LAGs and local councils in implementation.

7) **It is important to minimise the administrative burden on beneficiaries**: Details of business plans and proposals will ultimately be necessary if the proposals of perspective borrowers are to be assessed prior to lending. However, cognisance needs to be taken that an onerous administration process will reduce uptake of the loan. This is an important reason for the market gap at present (especially with smaller businesses and social enterprises). Therefore, it is important not to repeat this mistake and to ensure prospective borrowers have access to wrap-around business support as part of any programme.

5.3. Recommendations from the Interim Evaluation of Invest NI Fund of Funds

- The evaluation of the Invest NI Fund of Funds delivering the Access to Capital programme[12] made a total of 15 recommendations. The most relevant to the DAERA objectives are as follows:

[12] Entitled Interim evaluation of Invest NI Fund of Funds by Urbis Regeneration (June 2014)

- Invest NI should liaise with the DfE to ensure that research on the requirement for capital considers the potential market failure in social enterprise support and the availability of community development finance[13].
- Invest NI should introduce and monitor new reporting measures at fund level which encourage collaboration between fund managers to develop the deal flow chain between the seed, early and development stages of funding.
- If practically possible Invest NI should seek approval to establish a flexible risk capital pot of between £5-£10m that could be allocated rapidly to an individual fund in response to market signals. This would reduce the time associated with securing separate approvals to extend a fund.

5.4. NIAO Review of Invest NI Access to Finance

- In September 2017 the Northern Ireland Audit Office published its findings from a review over the Invest NI Access to finance fund. The key findings and recommendations from this report that are relevant for consideration by DAERA in relation to the rural business FI programme are as follows:
- The report recognises that access to finance has been crucial to the development of SME growth in NI since the contraction of the banking market in 2009 caused by the global economic crisis. However, the information currently available in NI does not enable an accurate measurement of the current funding gap and the programme is at too early a stage to confirm whether value for money will be secured.
- However, one flaw noted by the report was that the small size of some funds has created economy of scale issues with regard to the fees paid to fund managers which contributed to the relatively high fee levels for some of the smaller funds.
- It is important that Invest NI works to reduce fund manager costs where possible. Invest NI should be able to clearly demonstrate the steps which it has taken to minimise fee levels.
- The report recommends that Invest NI should identify the extent of the funding shortfall which is likely to arise following the future loss of EU funding and quantify the level of additional baseline expenditure which will be required to deliver its operations.
- NIAO recognise that the selection of fund managers is critical to the success of the programme. Invest NI must ensure that all appointment competitions rigorously test the ability of bidders to provide a high quality service. Invest NI must also ensure that its oversight of fund managers is capable of promptly identifying issues such as breaches of contract and potential conflicts of interest and of gathering sufficient evidence to take action to tackle poor fund manager performance.

[13] This category being one of five categories mentioned within the report (the other four are not highlighted as they are less relevant to DAERA's objectives

- However, the report confirms that co-investment arrangements with private funders offer a number of advantages to the taxpayer, including the equal sharing of investment risk and returns, a focus on investments led by the private sector and lower fund management fees. The report recommends that Invest NI seek to maximise the level of co-investment activity within its Access to Finance Strategy and assess the scope for delivering future planned funds through co-investment arrangements**.**

5.5. State Aid

- All public authorities within the EU have an obligation to adhere to EC legalisation on State Aid at present. This legislation exists to avoid public authorities granting an advantage through state resources to organisations that could potentially distort competition and trade in the EU. Whilst the specific regulations governing State Aid in the EU may not apply to the UK by the time the FI is being implemented, it is envisaged that UK specific regulation will take its place in order to avoid displacement or the provision of unfair advantages on certain companies. Therefore, it is important that cognisance of the current state aid legislation is taken when considering the investment strategy for any DAERA managed FI programme.
- Ultimately State Aid rules will dictate the terms under which public monies can be provided to private enterprises via a loan or grant. The key considerations to note in the consideration of a loan fund to support rural SMEs are as follows:
- **State Aid applies to Economic Undertakings**: State Aid can be defined as any subsidy provided by a public authority to an enterprise engaged in an economic activity, which that same enterprise could not obtain on the open market. By this definition, if a borrower is deemed to be an "economic undertaking", loan from DAERA provided to finance that undertaking which has more favourable terms that might be available on the open financing market will be considered State Aid and so may be in breach of the Commission regulations.
- **State Aid Rules apply to social enterprises also**: State Aid rules apply to enterprises that are deemed to be Economic Undertakings. The determination as to whether an enterprise represents an economic undertaking through the "Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union". Section 2.1 Paragraph 9 of this guidance states that "the application of the State aid rules does not depend on whether the entity is set up to generate profits. Non-profit entities can also offer goods and services on a market." Therefore, whilst more favourable terms might be available for Social Enterprises, the fact that they are non-for-profit does not mean State Aid rules do not apply.

- **There are circumstances where an enterprise will be exempt from State Aid Rules**: The rules around State Aid are complex and under certain conditions State Aid provided by a public authority is allowable by the Commission. The General Block Exemption Regulation ("**GBER**") sets out the conditions which, if fulfilled, exempt the Authority from having to seek Commission approval for the grant. Therefore, even if a loan from DAERA did qualify as State Aid, it may be possible for DAERA to provide this loan on more favourable terms and still comply within the Commission rules. The applicability of the GBER will depend on the specifics of the project into which the investment is to be provided. For example Article 14 of the GBER exempts Regional Investment Aid and Article 56 exempts Aid for Local Infrastructure.
- **De minimis Regulation will be important for DAERA Programme**: Article 3 of Commission regulation 1407/2013 (external to the GBER) stipulates that State Aid is exempt from the Commission notification requirement if the total subsidies provided to a single undertaking do not exceed **€200,000** over any period of three fiscal years. The applicability of the de minimis regulation will depend heavily on the interest rate available for a similar project in the open financing market as well as the prevailing exchange rate at the time of the loan.
- By way of an example of the de minimis rule application - since the loans provided by the SBLF are below £50,000, they all fall below the de minimis threshold and so state aid rarely applies to this fund.

5.6. Conclusion

- This section has highlighted some of the key findings and lessons learnt from reviews of programmes with similar objectives to DAERA regarding the provision of capital to support SMEs. These findings, lessons and guidance have been incorporated into the consideration of the investment strategy outlined in Section 6 below:

6. Proposed Investment Strategy

6.1. Overview

- The Sections above have demonstrated that value could be added to the NI economy through the implementation of an FI Programme for rural businesses as well as the scale of the market gap that such an intervention could address.
- This section represents a first step towards considering an investment strategy for the implementation of this Programme. There are a number of external factors on which clarity will be required before an FI Programme can be implemented. However, this section seeks to consider the options that might be available to DAERA and the approach that has been adopted within NI to date so that when clarity on the overarching strategy of the Department is available (and a budget has been agreed), these options can be considered in more detail.

6.2. Strategic Objectives

- It is important that the implementation of any FI is done so with clear reference to the strategic policy objectives of DAERA. Currently these objectives and the plans for meeting these objectives are set out in detail within the RDP. Whilst the format of the RDP may change following Brexit, it has been assumed that the priorities of the DAERA relating to rural development will remain broadly consistent.
- Whilst the RDP sets out DAERA's socio-economic objectives, the nature of an FI Programme is such that commercial objectives must also be established to ensure the return of the capital is achieved. The enterprises that can assist in achieving the objectives of the RDP can be both commercial businesses (whose primary objective is to grow revenue and profits for the owners / shareholders) as well as social / not-for-profit enterprises.
- The two key criteria that enterprises must demonstrate if an FI is to add value to the DAERA RDP are:

a) The purpose of the loan must align to the socio-economic objectives of the RDP

b) The enterprise must have a revenue stream through which it can meet the debt service requirements of the FI.

- Each of these points is discussed below:

- Socio-Economic Objectives:
- As discussed above, the RDP measure which aligns most closely to the SME Rural Business sector for which a market gap has been identified is Measure 19 – Support for LEADER local development (community-led local development).

- This measure is entirely funded from grant income within the latest version of the RDP. The current budget for the LEADER programme within the 2014-2020 RDP is **€80m**. The following four objectives that have been established within the RDP for the LEADER Programme represent appropriate criteria for potential applicants to an FI Programme to be asked to demonstrate to ensure the key areas of need are being addressed.

1) **To increase economic activity and employment rates within the wider rural economy** through encouraging and supporting the creation and development of micro and smaller enterprises including on-farm diversification into non-agricultural activities and tourism.
2) **To maintain and improve the living conditions and general well-being** of rural dwellers through the provision of more, better and sustainable basic services
3) **To regenerate villages and their surrounding areas** by improving their economic prospects, their appearance and the quality of life of village dwellers.
4) Projects which **tackle rural poverty and social isolation**, and which link into other Government and EU Strategies on poverty and isolation where this is possible.

- It should be noted that there may be other criteria that will apply to a future FI depending on the requirements of the future RDP. Therefore, this list is not expected to be exhaustive.

- Commercial Objectives:
- The primary benefit of FIs that has been identified within the sections above is that they represent an opportunity for public investment to recycled following successful achievement of its objectives. The DEFRA Ex-Ante Assessment noted that the fundamental financial objective of a rural FI should be to:
- Provide finance to SMEs with projects which are able to provide a commercial return but who are unable to secure funding due to a range of market failures.
- Build an extensive legacy fund from making successful investments which will generate returns for reinvestment in the rural economy
- In order for these objectives to be achieved the investment must be repaid by the beneficiary. This requires the implementation of procedures for monitoring the financial performance of the investee to ensure risk of non-repayment is mitigated and the payments are received in line with the loan agreements. This will include the setting of financial terms commensurate to the risk of the investment. The terms that DAERA will need to consider as part of an FI include:
- **Interest rate** associated with the loans (the greater the level of risk, the higher the interest rate);
- **The tenor of the loan**: This should take into consideration the revenue being generated by the investment as well as the useful life of the assets that have been acquired / developed

- **The repayment method**: Should the loan be repaid via an annuity or full repayment on maturity
- **Security**: Whilst the nature of the rural businesses that are being targeted by the FIs is likely to mean that little security value will be available, some form of security will be necessary to ensure an incentive to repay the debt exists. This may be a floating charge over the assets of the borrower.
- **Performance measures and covenants** for lower than expected performance: These covenants might include:
    - Cashflow available for Debt Service ("CFADS") to debt service cover ratios; and/or
    - Ratio of the outstanding loan to security value
- Ensuring the correct balance between risk mitigation and achieving the social objectives is a complex process and DAERA do not currently possess the necessary skills and experience for accurate measurement in-house at present. Therefore, additional support will be necessary to ensure the above issues can be appropriately considered for the purposes of any future FI Programme.
- The options available to DAERA for securing this support are considered below.

6.3. Long List of Implementation Options

- The EU FI Compass guidance indicates that DAERA as the Managing Authority for the EAFRD in NI has the choice of five different options for the implementation of FIs as stipulated within the CPR regulations. Whilst strict adherence to this EC guidance may not be necessary given the current Brexit negotiations, these options are useful as a long-list of options for implementation and are summarised below:
- Table 6.1: EC Guidance Implementation Options

•	• Implementation option	• Form of FI	• Summary of Implementation Mechanism
• 1	• Implementation under shared management through an entrusted entity	Loan, guarantee or Equity	Under this option DAERA would set the parameters for the investment but would entrust the identification of suitable beneficiaries as well as the implementation and the management of the investment to a financial intermediary / fund manager. This financial intermediary should be an appropriate financial institution as stipulated under Article 38 of the CPR if the funds are to be provided by the EAFRD. Ultimately this involves establishing a "fund" for investment and management by a third party in accordance with the specific rules identified by DAERA.

•	• Implementation option	• Form of FI	• Summary of Implementation Mechanism
• 2	Implementation under shared management through investment in capital of existing or newly created legal entity	Equity	Under this option, MAs acquire share capital in investment vehicles which have or will be set up with the objective of supporting investment activities and final recipients consistent with the investment priorities. Therefore, the MA will have an element of control in the business in accordance with the memorandum and articles of the business. This option relates mainly to equity investment which the stakeholder consultation has determined is not appropriate in this instance. Therefore, this is not considered as a shortlisted option.
• 3	Implementation under shared management of loans or guarantees directly (or through an intermediate body)	Loan or Guarantee	Under this option, DAERA would identify the specific beneficiaries that will meet the economic investment directly and issue and manage the loan / guarantees delivered through the FI Programme. Ultimately this is similar to the implementation of a grant-based programme with the exception that additional resources will be required with DAERA to manage interest / principal payment receipts and monitor the financial performance of investments.
• 4	Contribution of ESIF programmes' allocation to EU level instrument (all except 'SME initiative')	Loan, guarantee or Equity	This would involve DAERA allocating part of its EAFRD contribution to an EU level financial instrument which will then be managed by the EC. It is unclear at this stage whether there are any EU level financial instruments that would specifically align to the priorities within DAERA's current RDP. However, this option will not be possible if the UK exits the EU. Given this is anticipated to occur in 2019, this is not considered a viable option.
• 5	Contribution of ESIF programmes' allocation to EU level instrument ('SME initiative' only)	• Loan, guarantee or Equity	• This option is similar to (4) above but focused specifically on Small and Medium Enterprises (**SME**s). • As above, given the UK is expected to exit the EU by 2019 this is not considered a viable option.

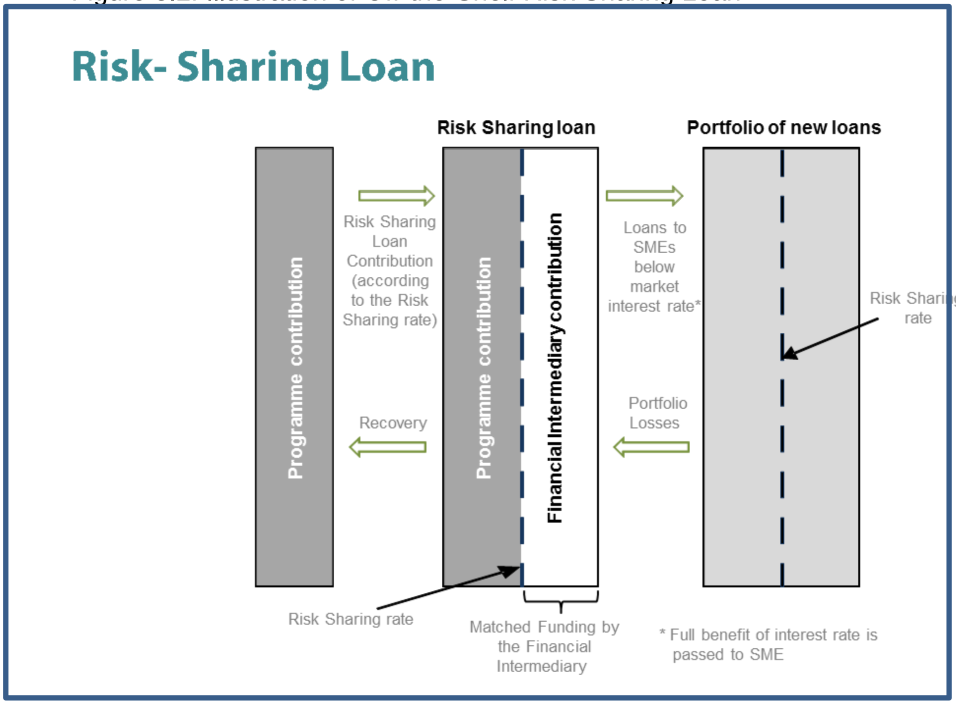
- On the basis of the above, only Option 1 or Option 3 are considered viable[14]. The advantages and disadvantages of each option are considered below.

6.4. Overview of Shortlisted Options

- Option 1: Implementation through an Entrusted Entity
- It is worth noting that the EC has established a set of "off-the-shelf" financial instruments for use by MAs in the implementation of FIs under Option 1. The aim of these documents is to provide standardised terms and conditions for the engagement of a financial intermediary, which are compatible with ESI Funds regulation and State Aid rules and seek to combine public and private resources.
- One in particular, the "Risk Sharing Loan" is specifically aimed at SMEs in order to provide easier access to finance by providing a financial intermediary with a funding contribution and credit risk sharing and thereby offering SMEs more funds at preferential conditions in terms of interest rate reduction and if relevant collateral reduction. Key features of this off-the-shelf agreement are:
- 25% of funding to be provided by a financial intermediary that will manage the loan – the remaining 75% of financing requirement can be provided as a loan (at preferential rate and conditions) through the EAFRD.
- Loans of up to €1m and for a maturity period between 1 and 10 years.
- An illustration of the mechanism through which the loans will be issued is shown below:

[14] It should be noted that this assumes the provision of ESIF funding will not be available after Brexit. If a financial arrangement is agreed between the UK and the EU whereby this funding is still available, the above option consideration should be revised.

- Figure 3.2: Illustration of Off-the-Shelf Risk Sharing Loan



The approach the DfE utilise for the delivery of the Access to Finance programme through Invest NI reflects this approach for the two loan funds (although it does not utilise the Off-the-Shelf instruments which have been introduced since the implementation of the Access to Finance Programme). Whilst not entirely utilising EU funded FIs, the financial intermediaries are procured using the expertise and knowledge within Invest NI to ensure that the objectives of the specific intervention are met.

The financial intermediaries for each of the funds that have been established through this process for the Access to Finance Programme are as follows:

- Table 6.2: Invest NI Access to Capital Intervention Funds

Fund	Size of Fund	Support Product	Financial Intermediary / Fund Manager
NI Small Business Loan Fund	£5m	Loan	Ulster Community Investment
Techstart NI	£29m (ERDF FI)	Equity	Pentech Ventures LLP
Growth Loan Fund	£50m	Loan	Whiterock Capital Partners
Co-Fund NI II (ERDF)	£50m	Equity	Clarendon Fund Managers
Development Funds NI	£60m (ERDF FI)	Equity	Kernel Capital and Crescent Capital

This demonstrates that Option 1 is already a tried and tested approach within NI at present although this is solely with the objective of economic development through Invest NI.

- Option 3: Implementation into Beneficiaries Directly
- The Department of Finance have issued guidance on the provision of loan finance by public sector bodies within a document developed in June 2008 and updated in April 2012 entitled "Managing Public Money Northern Ireland". This document is based on similar guidance issued by HM Treasury which was revised in July 2013.
- This guidance sets out the key principles for departments in managing the provision of loan finance. In particular, Annex 5.5 (Departmental Lending) sets out the principles for the provision of loans by government departments - referred to as voted loans. These principles have been developed for loans made under the National Loan Fund, which provides local authorities with capital finance when required, but apply to the provision of all loans.
- A summary of the key principles from this guidance are as follows:
- **Legislation:** The lender must have the appropriate statutory authority in place prior to the loan being made.
- **Approval Process (Credit Committee):** The lender must ensure that the conditions for their loans are satisfied and that repayments of interest and principal are received on time.

- **Interest Rate:** The public sector should not lend at a loss. Therefore, interest must be sufficient to cover at least the cost of the borrowing, on the same terms and for the same period. This ensures that lending is unsubsidised and reduces the risk of breaching State Aid rules.
- **Loan Duration**: The length and type of loan should be matched to the type of asset being acquired and the expected payback period.
- **Recovery of Loan Principle**: Loans should only be made where there is a reasonable expectation that they will be serviced and repaid on the due dates. Lending departments should consider whether to take security in order to fully protect their position. In addition, penalty interest should be charged if a payment of interest or principal repayment is not received on time.
- **State Aid**: To ensure consistency with the requirements of EU State Aids, loans to commercial organisations in NI should be on commercial terms. Guidance from DFP as to the appropriate de minimis levels applicable will be required.
- **Insurance**: The Borrower should demonstrate the assets have been appropriately insured.
- **Early Repayment**: If a Borrower wishes to repay their loan early, the terms of the loan agreement must stipulate payment by the Borrower of all principal and interest due.
- Other issues on which the guidance is silent but will need to be considered if DAERA opt for direct implementation of any FI loans are:
- **Repayment of Principal**: Should the repayment of the principal loan be amortised over the duration of the loan (as in a typical mortgage) or paid in instalments or a lump-sum on expiry of the loan (a bullet payment).
- **Management of Default**: Consideration needs to be given to a solution to the situation where a borrower ceases to trade. In this situation the ability for DARD to take a mortgage charge / debenture over the assets of the business needs to be considered. As such, the value of the assets should be a factor in determining the loan amount.
- **Monitoring of Loan Performance**: DARD should establish a function to monitor the financial performance of the borrower to ensure the debt is not at risk of default. This should include regular submission of financial results from the borrower and mechanisms in place to seek repayment of the loan if the financial position deteriorates. This role could be undertaken largely by the financial intermediary if DARD decide to use this route.
- It is also important to note that, if DAERA were to provide loans directly to rural businesses on the above basis it is necessary to ensure the vires exists to do so. This will necessitate the use of legislation which specifically permits the issuing of loans, guarantees or the investment of equity for the purpose of achieving DAERA's statutory objectives.

- The national subordinate legislation that has been enacted through the NI Assembly structures, which gives DAERA the power to administer the RDP and make payments is The Rural Development Programme Regulations (Northern Ireland) 2015. The powers to provide loans or equity investments is not specifically stated within this legislation and DAERA representatives have confirmed that when this legislation was adopted the provision of such powers was not contemplated.
- However, it is possible that the current legislation might cover such a scenario. For example, if the legal interpretation of the phrase "may pay financial assistance" extends to the provision of financial instruments this will be permissible. Therefore, legal advice will be required if this option is to be implemented.

6.5. Leverage of Private Funding

- Potential financial intermediaries that could provide match funding for the project include:
- the EIB,
- commercial banks,
- mezzanine lenders,
- "third-sector" lenders or
- Institutional investors.
- Each of the potential funders that were consulted as part of the stakeholder consultations (including the main NI based banks and the financial intermediaries managing the Invest NI loan funds) expressed a potential interest in providing match funding.
- Ultimately the financial intermediary will have to be formally procured through an appropriate competitive process (with which the Central Procurement Directorate can assist DAERA if necessary). However, it is recommended that a market sounding exercise is undertaken prior to this process to establish the appetite for match funding.
- The "Off-the Shelf" agreements that have been developed by the EC stipulate a 25% investment from a private source with the remaining 75% being provided from public sources. However, the GLF achieved 50% private leverage (i.e. £25m of the original £50m capital was provided from private sources). Given the GLF is a more relevant precedent, it is suggested that a 50% leverage should be the target for any future FI Programme.

6.6. Preferred Implementation Option

- The analysis presented in the section above demonstrates that Option 1 (Implementation through an entrusted financial intermediary) is likely to be the preferable solution on the following basis:

    - Whilst DAERA have the necessary resources in place to implement and monitor grant provision (to ensure the conditions of the grant are implemented), a very different set of skills is required to establish a credit function capable of managing outstanding loans as required under Option 3. Consultation with DAERA representatives has revealed that the capacity and resources within DAERA is not available at present.
    - A key benefit of FIs is the ability to leverage private investment to support the public intervention. The ability to leverage private investment is restricted under Option 3 but can be stipulated within the procurement process for a financial intermediary under Option 1.
    - There is doubt over the vires of DAERA to lend directly under Option 3; and
    - Option 1 has been tried and tested through Invest NI and value-for-money has been confirmed through the monitoring process.
- Given the impending Brexit it is assumed that DAERA will be unable to utilise the "Off-the-Shelf" documentation. However, as Invest NI has significant experience in the procurement of financial intermediaries, it is suggested that liaison with Invest NI will be necessary as part of any implementation.
- The most appropriate approach for identifying an appropriate financial intermediary to establish the Rural Business fund will be dictated to an extent by the size and nature of the fund that is to be established and the approach to match funding that should be adopted. These issues are discussed in the sections that follow.

6.7. Scale of FI Investment

- The analysis on the size of the market gap within Section 4 indicates that demand for a rural business loan fund could range from between £4.4m and £36.5m.
- A key lesson learnt from previous FI implementations listed in Section 5 above that it is important not to overestimate demand, as this could tie up important capital for DAERA. As this is the first fund that DAERA will have sought to introduce, it will be important to adopt a conservative approach in the sizing of the fund due to uncertainties in forecasting future market trends due to a range of factors which include:
- Rates of economic growth and the impact of these on SME demand for finance.
- The situation in the Eurozone and any impact on demand within the EU as a result of the Brexit negotiations or implementation.
- changes in financial markets/ more onerous capital requirements/ structural changes in banks/ levels of bank lending
- the impact of current supply side interventions on the economy – will more credit be available in the short term

- the scale and scope of bank funding available and any restrictions which may apply;
- rural policy has traditionally been delivered through a grant regime. It will therefore require a hearts and minds exercise to change to a more commercial approach. This will require sufficient investment in awareness raising and as such it may take time to achieve major changes in attitudes and beliefs and thereby uptake of funds
- confidence levels of rural SME, their business skills, capacities and growth aspirations can be impacted by any of the above.
- However, it is also important to recognise that economies of scale can be achieved through the implementation of a larger fund. The establishment of funds require commitment to fixed implementation costs and overheads that are not based on the fund size. Therefore, a greater value can be achieved through the economy of scale principal. The smaller the size of the fund, the greater the proportion of fixed costs) including management fees) as highlighted by the NIAO report over Invest NI's Access to Finance Programme.
- The funding allocated to the Rural Investment Scheme is £27m. However, as this is a grant scheme it should be expected that the demand will be greater than for a loan scheme. Nevertheless, the results of this scheme will provide a useful indicator as to the potential demand for the rural FI fund in the next programme.
- Taking the above considerations of risk versus economy of scale into consideration, it is envisaged that a fund size of approximately **£20m** would be an appropriate scale of fund. This would require £10m of investment from the RDP and £10m match funding from an appropriate financial intermediary. The current funding available for the LEADER programme is €80m (which equates to c£70m). Therefore, this level of investment represents replacing approximately 14% of the funding allocated towards the LEADER programme.
- However, prior to formally allocating any capital it is recommended that a more focused market sounding exercise is undertaken with potential financial intermediaries to establish issues such as the appetite for match funding and their views on the likely demand and timescales for investment

6.8. Product Scope / Target Investment

- There are two specific categories of enterprise for which the greatest need has been identified through the stakeholder consultations and which are not targeted specifically by Invest NI through the Access to Finance Programme. Therefore, a "market gap" is deemed to exist for a Rural Business FI for these two categories.
- The two categories are set out in the table below along with an overview as to the target beneficiaries that are deemed appropriate for each category:

- Table 6.2: Overview of Proposed Product Scope and Target

Type of Loan	Overview of Product to meet Need	Loan Size
Start-Up / Small Business Loans	• The target for these loans should be start-up businesses in rural areas as these are the enterprises which have the greatest difficulty accessing finance through grants. Primarily because they are often missed from the marketing networks and lack the funding to engage professionals to prepare the business plans that are necessary to apply to this funding. • These type of firms are also missed largely from the Invest NI target as they are not specifically focused on exporting / job creation. However, it is this size of firms that often contribute most to the objectives of LEADER (see above). • Small loans also result in less displacement of other commercial entities and financial institutions. • As soon as the target firms reach a certain level and maturity, then the Invest NI Access to Finance will become more accessible. Therefore, this programme will support Invest NI's objectives rather than displace them. • This category of beneficiary is a target for the Rural Business Investment Scheme and so any FI Programme should be introduced after the completion of this scheme. • A key focus of this fund should be to provide initial working capital and cover to invest in assets to get businesses off the ground. • It is imperative that the provision of the loan fund is supported by wrap-around business support for business planning, financial forecasting etc. This is the key reason for the financing gap and so providing loans without this support will not result in any demand. Therefore, if funding is allocated through LEADER for this fund, there should be sufficient grant support to ensure business plans etc can be developed.	£10 to £100k

• Type of Loan	• Overview of Product to meet Need	• Loan Size
• Social Enterprise Loans	• The purpose of this category of FI loan should be to provide capital for social, not-for-profit enterprises to invest in assets to assist in rural development. • The market gap for social enterprises is higher than for commercial businesses because the Invest NI funds are not typically focused on this form of enterprise. However, this form of investment is a key contributor to the LEADER objectives. • Social enterprises tend to have a higher requirement for capital as the focus is the whole community rather than a single business proposition. • Social enterprises have more scope under State Aid rules for development if they are not undertaking an economic development. Therefore, larger loans can be made whilst remaining under the de minimis/ exempt thresholds. • An example of social enterprises that could benefit from this fund are local enterprise agencies seeking to develop accommodation for local businesses to provide economic growth • The three key characteristics to determine it as a Social enterprise that is eligible for investment are: 1) **Must have a social mission** or objective (and this objective must tie into the rural focused objectives of the fund 2) **Must have an asset lock** – i.e. no distribution of assets – all surpluses generated should be reinvested into the business; and 3) Must be revenue generating in order to repay loan.	• £10k-£500k •

- The demand for each of the above categories is expected to be approximately equal in terms of monetary value. Whilst the number of commercial businesses seeking a loan will be greater than the number of social enterprises, the value of loans to the latter are expected to be larger.

- Ultimately, the above approach will ensure that a focus is placed on the development of rural towns and villages and that rural businesses have similar opportunities to achieve growth as their urban based counterparts. Once the commercial rural businesses achieve an element of growth, they will have better access to the financial initiatives provided by Invest NI which will allow further growth as well as accelerated economic development for rural areas in NI.

6.9. Loan Features

- It is anticipated that the specific terms of any loans provided through this FI Programme will be influenced largely by the Financial Intermediary / Fund managers' assessment of the risk of each prospective borrower. If private finance is to be leveraged through this fund it is important that commercial terms can be applies. It is also important these are considered with reference to the relevant legislation regarding State Aid rules at the time of investment.
- However, ultimately, the loans provided through the fund must provide a benefit to the potential beneficiaries. The stakeholder consultations have indicated that the following are important issues for borrowers to ensure the demand exists:

- Pricing (i.e. interest rates, fees):
- The pricing of a loan needs to reflect the risk to the lender and so may be set on a loan by loan basis. Any rural FI must be sustainable and a key aspect is to ensure the supported businesses are able to demonstrate their ability to manage commercial funding. If the loans are to be provided at favourable rates, State Aid limitations will apply. However, if the difference between the interest paid through a similar commercial loan and the interest paid on the FI loan is less than €200k, then the de minimis exemption will apply.

- Flexibility:
- The stakeholders specifically indicated that flexibility was a key aspect that would dictate demand. Longer term loans with ability to repay early without penalty and offer repayment holidays/ interest only/ etc are important. However, it is recognised that this may impact on the pricing available to borrowers.

- Financial Covenants:
- It is anticipated that financial covenants will be incorporated within the loan terms assessing and measuring the borrower's ability to cover both operating costs and debt service cashflows as a minimum.

- Ultimately the specific terms of the loan will need to be discussed and agreed with the appointed financial intermediary if match funding is to be expected. The appointed body will not be prepared to accept a return on its own private finance that is less than the market rate for that specific risk category.
- This may require an element of subsidy / subordination from DAERA. However, this should be established further during the detailed market sounding exercise when clarity on the future of the RDP is available.

6.10. Implementation within the RDP

- One of the key lessons learnt from previous FI programmes (as highlighted in Section 5 above) is the importance of aligning the provision of funds with existing local business support networks.
- Section 8.2.10.2 of the RDP 2014-2020 (Implementation of LEADER in Northern Ireland) indicates that DAERA intend to develop a detailed Strategic Outline Business Case for LEADER which will set out the challenges for which the LEADER approach will deliver additional added value and benefit for rural areas.
- It is envisaged the outcome of this Business Case process will ensure that the Local Action Groups are provided with specific and detailed guidance from which LAGs will be asked to develop Local Development Strategies and tailored to the needs of their particular areas. This also ensures that any overlap or duplication of funding with other government funding streams will be avoided, audit and control findings and the reduction of the error rate can be taken into consideration and the RDP funds can be directed to areas of maximum benefit. The Business Case will also ensure there is coherence and complementary across all the RDP Measures and particularly in relation to M04 (Investments in Physical Assets) and M16 (Cooperation).
- It is recommended that the establishment of an FI Programme is developed considered as part of the strategic objectives of the LEADER programme to ensure that the provision of support to rural communities and businesses is aligned to existing grant schemes available to rural communities.

7. Conclusions and Next Steps

7.1. Summary of Conclusions

The key findings from this appraisal are as follows:

- The analysis has found that an FI Programme to support rural development policy in Northern has the potential to add value to the NI taxpayer. This value will be derived through the provision of more accessible finance to SMEs with the potential to assist in the economic and social development of rural communities in Northern Ireland.
- The value to farmers and primary producers as a specific sector was considered in detail within the appraisal. However, the stakeholder consultation indicated that the need for enhanced access to finance was currently low amongst farm businesses. The key exception is new entrants to farming but the size of this group is not deemed sufficient to justify a separate category of beneficiary. New farming entrants can be grouped with other rural businesses for the purposes of any future programme.
- It is important that any future programme does not cause displacement within either the commercial financing market or other public interventions. A key issue in relation to the latter is that Invest NI already provide loan and equity support to all SMEs within NI through its Access to Finance Programme. However, a market gap has been identified with regard to the provision of loan finance to both:
    1) Rural start-ups / small businesses; and
    2) Social enterprises focussed on rural development.
- A loan fund with the following characteristics is anticipated to address this market gap:
    - The criteria for borrowers from the fund should be based on both socio-economic objectives (the current LEADER programme provides the basis for the objectives necessary to meet the need identified through the stakeholder consultation) as well as commercial objectives to ensure the return of the capital for recycling for the benefit of future borrowers;
    - A suitably experienced entrusted financial intermediary should be appointed to deliver and manage the investment into rural businesses in accordance with parameters set by DAERA (based on the above objectives).
    - Additional private finance should be leveraged through this appointed financial intermediary to ensure maximum value to the NI taxpayer. Preferably match funding (this should be determined through a competitive procurement process but it is recommended the appetite is tested through a market sounding exercise beforehand).
    - It is estimated based on this review that a potential market gap of between £4m and £36m exists. However, the initial fund should be considered a pilot fund (in line with the approach being taken in DEFRA). An initial fund of £20m is proposed based in this initial analysis.
- To reduce administrative costs and timescales for setting up an FI Programme, DAERA should build on existing governance frameworks where possible. Invest NI would seem best placed to implement the fund

as it has all the necessary skills and expertise to deliver the procurement of a financial intermediary and is in the process of designing the future of its Access to Finance programme.

- Therefore, the next step should be a dialogue between DAERA and Invest NI in terms of a collaborative approach to implementation of the fund. This should be explored as soon as possible. If Invest NI cannot provide input into this process, DAERA will need to consider other options for establishing a team to deliver the requirements.

7.2. Key Uncertainties

In addition to the potential input from Invest NI into the procurement of an FI Programme, there are number of other areas uncertainty regarding the governance and legislative environment that will need to be clarified prior to the introduction of the proposed FI support programme:

- **NI Executive Input**: The body that will have ultimate legislative responsibility for any FI programme still needs to be determined in the absence of an Executive in NI.

- **Programme for Government**: The priorities of rural businesses within any future Programme for Government, when agreed, will have a bearing as to the allocation of funding to this fund in any future RDP.

- **Future format of RDP**: If the UK is to leave the EU within the next 2 years, the future format of the RDP will need to be determined and consideration given to how an FI Programme can be included within this programme will be required. Will the LEADER programme still exist for example?

- **Funding available through the RDP**: The level of funding that will DAERA have to allocate towards a rural business FI programme beyond 2020 in the absence of the EAFRD contributions will need to be determined.

- **Relevance of EU regulations**: If the UK is to exit the EU, the legislative structure that will govern the implementation of the programme will need to be confirmed. This will include the applicability of EU legislation on State Aid for example.

Given the level of uncertainty regarding the future of the programme at present it is not possible to stipulate a specific timescale on the implementation on an FI Programme. Therefore, the position will need to be monitored and the analysis within this report updated when new information comes to light on the above issues.

7.3. Recommendations on Next Steps

- This report has provided an initial consideration of the need for an FI programme and a possible approach to addressing the market gap in the provision of finance to rural enterprises. However, until clarity is available on each of the above issues, it will not be possible to set specific targets and guidelines for the implementation of an FI programme.
- Therefore, the proposed next steps for implementation of the programme to consider when clarity is available are set out below.
  - **Establish Source of Funding**: The availability of EAFRD funding towards the proposed FI Programme is the first issue to address. If the UK is to exit the EU and this funding is not available, the objectives and requirements of the UK government regarding the implementation of an FI programme will need to be confirmed;
  - **Engage with Invest NI**: As stated above, the potential for achieving economies of scale through combining the DAERA funding with DfE funding implemented through Invest NI on a collaborative basis should be explored. This would address one of the NIAO's issues raised in its review over Invest NI's Access to Finance Programme that economies of scale should be maximised.
  - **Develop draft investment strategy**. When clarity on the issues raised in Section 7.2 is available, the investment strategy raised above should be developed in more detail. This will need to include the following
    a) **Market sounding exercise:** Engagement with potential financial intermediaries to establish the likely appetite to engage as a fund-manager, the potential target SMEs, the potential for private finance leverage and fund specification / value / operational limitations.
    b) **Engage with the LAGs:** The beneficiaries under the current LEADER programme grants will be key targets under the proposed Rural Business FI Programme. The LAGs are the groups that are dealing with these enterprises on a daily basis and so are best placed to advise of the specific needs from these bodies and how an investment strategy can target the areas of greatest need.
    c) **Review findings from the Rural Business Investment Scheme:** The objectives of this scheme will be aligned closely to the objectives of any further Rural Business FI scheme. Therefore, the findings regarding demand and benefits achieved through this grant provision should be considered before the implementation of a loan fund.
  - **Identify the specific requirements for introducing the FI formally into the RDP**: When the future RDP format is established the precise strategic fit of any FI Programme will need to be considered. Any new requirements and formal changes which might be required will also have to be factored into the investment strategy;

- **Agree the governance structures**: Identify the preferred option, including decisions on key bodies such as the representatives of DAERA on Fund Boards (their roles and responsibilities) and partnerships with business development suppliers;
- **Agree the use of Grant Fund to support programme**: Whilst grant funding will not be provided through the fund, it will be important, in particular, to ensure business planning support is available to prospective borrowers to ensure investor readiness. Therefore, there will be a need to continue with the LEADER programme (or an equivalent programme under any new RDP regime following Brexit) to provide this support.
- **Engage Legal Advice**: Legal advice will be required to assist with the detailed State Aid issues (if relevant) as well as the procurement of fund managers.
- **Design of application process and procedures** need to be decided and if there is a need to provide wrap around support with a grant/skills provision alongside the FI. Aspects such as making obtaining a loan easier and moving away from bureaucracy of grants should be important considerations.
- **Establish monitoring and evaluation procedures:** Commercial as well as economic development performance indicators covering investment activity, outputs, results and impacts will need to be implemented in addition to the social benefits sought by DAERA.

DEFRA is facing similar issues to DAERA in the implementation of the English Rural Business FI Programme through the RDP England regarding future uncertainty (although the lack of a functioning Executive is not an issue faced by DEFRA). DEFRA have indicated it expects the implementation of this programme to take two years. It is recommended that DAERA monitor the progress of DEFRA in this implementation process and take cognisance of any decisions taken with regard to the future of European funding.

Glossary of Capitalised Terms

Acronym	Meaning
BPS	Basic Payment Scheme
CPR	Common Provisions Regulation
CAP	Common Agricultural Policy
DAERA	Department for Agriculture, Environment and Rural Affairs
DfE	Department for the Economy
DfI	Department for Infrastructure
EAFRD	European Agricultural Fund for Rural Development
EC	European Commission
EIB	European Investment Bank
ERDF	European Regional Development Fund
ESIF	European Structural and Investment Funds
EU	European Union
FBIS	Farm Business Investment Scheme
FDI	Foreign Direct Investment
FI	Financial Instruments
FTC	Financial Transactions Capital
GBER	General Block Exemption Regulation
GVA	Gross Value Added
IFI	International Fund for Ireland
LAG	Local Action Group
LEDU	Local Enterprise Development Unit

Acronym	Meaning
MA	Managing Authority
Project Board	DAERA Representatives appointed to guide the Review Process for this Report
RDC	Rural Development Council
RDP	Rural Development Programme
SME	Small or Medium Enterprise

Appendix 1: Questionnaire Issued to Stakeholders for Direct Consultation

[See attached]

Appendix 2: Results of Online Survey Sent to Farmers

[See attached]

Appendix 3: NIAO Report over Invest NI Access to Finance Programme

[See attached]