Financial Transactions Capital

Overview Paper

DFP

Context

In 2012-13 the UK Government introduced an additional type of capital funding in order to boost investment – so called Financial Transactions Capital (FTC). Northern Ireland has benefitted from this additional funding through allocations in recent UK Budgets and Autumn Statements. FTC can stimulate private sector investment in infrastructure projects that benefit the region, over and above the level of investment made by the Executive from its normal Capital DEL budget. It is expected that FTC will form an increasing part of the Executive's capital budget going forward.

HMT Scoring

<u>HM Treasury – Financial Transactions</u>

Financial Transactions do not strictly add to capital expenditure per se, as they are not regarded by HM Treasury as spending transactions. However for the purposes of Northern Ireland departments, FTC is treated akin to Capital DEL and has a ring-fenced budget that is controlled by HMT.

Key Requirements

The distinguishing feature of FTC is that the funds can only be deployed by the public sector as a loan to, or equity investment in, a private sector entity[1]. The entity will then use the funding to invest in related infrastructure. The investment must be consistent with and supportive of the Executive's overall strategic aims and

[1] Private sector is defined by ONS Classification guidance and is determined by where control lies, rather than by ownership or whether or not the entity is publicly financed.

objectives. FTC may be channelled through a council to the private sector if the council makes an agreement with a relevant sponsor department.

FTC is therefore very different from the normal Capital DEL funding that departments receive from the NI Block through the Budget process. Capital DEL is used directly by departments and related public bodies to purchase capital assets and deliver public infrastructure, which are then wholly owned by the public sector.

A key to the deployment of FTC is ensuring that there is a suitable 'route to market', which entails identifying:

- Those capital projects that will deliver policy and are suitable for delivery by the private sector;
- private sector entities to lend to or invest in; and
- ensuring that sponsor bodies have the requisite legal vires to enter into such transactions.

Key Flexibilities

There is considerable flexibility in terms of the repayment period and interest rates that may apply. The first tranche of FTC received in 2012 were repayable to HM Treasury at 60%.

If interest is charged on the loans issued, the NI Executive can retain the interest receipts. If the loan is used to fund 'economic activities', the loan will contain State Aid if the interest rate is less than the European Commission's reference rate (more on this below).

DFP circulated a letter to the departments in April last year, which set the general rules for the departments and also outlined a number of incentives. A copy of this letter is attached at **Appendix A.**

State Aid

EU State Aid rules are critical in the application of FTC and there have been recent changes in the way the European Commission and the European Courts interpret the State aid rules that funders need to understand. Importantly, this complex issue is for the sponsor department to address in the first instance.

In particular, following the 2010 Leipzig/Halle ruling, the EC has confirmed that the construction of any type of infrastructure that is meant to be exploited economically, is an economic activity in itself, which means that State Aid rules apply to the way in which it is funded[2].

Therefore funders must first determine whether the investment (loan or equity) will be used to fund infrastructure that will used for 'economic activities'. If so, State Aid will be present when the interest rate on the loan is less than the European Commission's reference rate or the terms of the equity funding agreement are less than a 'market economy investor' would expect.

Loans

[2] For more information see paras 34 – 40 in the EC's Notion of Aid paper (http://ec.europa.eu/competition/consultations/2014_state_aid_notion/draft_guidance_en.pdf)

When State Aid is present in a loan, the funding department and/or the sponsor body will need to calculate the amount of State Aid in the loan, using the EC's 2008 Reference Rate methodology[3]) and determine whether the loan falls within the scope of an 'exemption regulation' or must be 'notified' to the EC for individual approval. The two main exemption regulations that funders should consider are the General Block Exemption Regulation (GBER)[4] and the de minimis regulation[5]. While these regulations exempt funders from having to fully notify loans to the EC for approval, funders must adhere to the specific administrative requirements of each regulation (e.g. maximum aid amounts, aid intensities, summary information that must be provided, declarations by aid beneficiaries etc).

If the loan does not fall within the scope of an exemption regulation, it will have to be notified to the EC for approval. This notification process is a very lengthy procedure and it is could take 9 – 12 months to get a no objection decision from the EC.

Equity

If funding is to be provided in the form of an equity injection, it should either be through a notified scheme or adhere to the 'market economy investor principle' or be an investment on a "pari passu" basis with a private sector partner.

Types of Projects

[3] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:014:0006:0009:EN:PDF

[4] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:214:0003:0047:EN:PDF – Please note the current GBER expires on 30 June 2014 and will be replaced with a new GBER that will expire on 31 December 2020.

[5] http://ec.europa.eu/competition/state_aid/legislation/de_minimis_regulation_en.pdf

There are no set criteria (other than above) for what projects may be funded through FTC. To date the Executive has agreed to provide FTC for a range of projects, including:

- DETI - Agri-food Loan Scheme: This scheme bridges the shortfall in secured lending to small businesses/farmers seeking to invest on the back of a commitment by the major UK supermarkets to source more of their produce from the UK. The Agri-food loan scheme provides subordinated Executive loans of up to 40% of build costs with the banks providing the balance of funding.

- DSD – Housing schemes: Several schemes to stimulate the local housing market and housing supply. One scheme involves the purchase of vacant / repossessed homes by Housing Associations, which will then fix up and sell on the market at a discount (70% of average house price). Another scheme is to stimulate new build affordable homes and a further scheme is a new shared equity scheme which is a variation on the existing Co-ownership scheme. The shared equity scheme requires first time buyers to purchase a starter share between 60% and 75%. Participants initially pay a very low rent on the remaining share with the interest rate increasing to encourage buy out of the remaining share by year 5.

- University of Ulster Greater Belfast Development Scheme: This provides loan funding to the University of Ulster for its major relocation scheme to Belfast City Centre.

- DHSSPS – Loan Scheme to GPs and Dentists: This scheme provides loans to GPs and Dentists to improve their practices and purchase of medical and dental equipment.

Levels of Funding

The latest amounts available in each year are shown in the table below, alongside the allocations made to date to individual projects (the Executive has no budget allocations beyond 2015-16).

Financial Transactions Capital - November 2015				**£000s**
Year	**2012-13**	**2013-14**	**2014-15**	**2015-16**
Funding Available	**11,839**	**46,755**	**62,770**	**128,998**
Carryforward of unspent FTC			**5,855**	**300**
Executive Allocations				
Invest NI - Agri-Food Loan Scheme				2,000
Growth Loan Fund			6,800	5,000
Invest NI Projects				1,000
Northern Ireland Science Park			50	9,400
Dental Practices				0
GP Premises				9,000
Get Britain Building	11,839	7,200		
Affordable Home Loans		5,000	7,500	
Empty Homes Scheme		3,700	5,500	
University of Ulster		25,000	48,475	
Queen's University				14,500
Co-Ownership Housing				88,398
NI Investment Fund				-
Total Projects:	***11,839***	***40,900***	***68,325***	***129,298***
Residual Available/ Underspend	**0**	**5,855**	**300**	**0**

EYF Arrangements

Separate End of Year Flexibility (EYF) arrangements exist for limited carry forward of unspent FTC. The FTC EYF scheme allows the Northern Ireland Executive additional flexibility to carry forward unspent Financial Transactions Capital funding across each of the next two financial years. This flexibility equates to 20% carry forward of unused Financial Transactions Capital funding from 2013-14 into 2014-15 and 10% from 2014-15 into 2015-16.

Treatment of FTC in Economic Appraisal

In the preparation of Economic Appraisals that seek to utilise Financial Transaction Capital departments should bear in mind that the use of public funds, regardless of any repayment considerations, should be supported by an appropriate business case. In particular for economic appraisals that utilise FTC, each appraisal must clearly set out the alignment of the project with the Executive's priorities, the repayment profile and key risks in relation to the repayment of any loan or equity investment.

FTC represents a beneficial injection to the NI economy. It enables more projects to be undertaken than would be the case in its absence. This might suggest that FTC-funded expenditures should be included as a benefit in appraisals. However, beneficial injections can be treated as a benefit in an economic appraisal only if the injection is tied to the specific project and would be lost to Northern Ireland if that project did not proceed.

Once an overall FTC budget has been set, it has effectively become a Northern Ireland resource, which, if not committed to one project in

NI, will be committed to another. The use of FTC funding on one project means the loss of the opportunity to use it to undertake another project. It therefore has an opportunity cost in NI terms, and accordingly all expenditures funded by FTC should be included at their full cost in appraisals.

Of course, the relevant financial cash flows (including e.g. loans, capital repayments and interest charges) should all be reflected appropriately in public expenditure affordability analyses, or in any other necessary financial analyses, bearing in mind the retention of any capital repayment proportion, interest receipts and factoring in analysis on potential bad debt.

It is important that the financial analysis is calculated separately from the economic appraisal NPVs, which are designed to indicate VFM from an NI economic perspective and must be based on NI resource costs irrespective of financing.

Appendix A

Michael Brennan
Head of Central Expenditure Division

Room P6, Rathgael House
Balloo Road, Bangor BT19 7NA
Tel No: 028 91 858151
Fax No: 028 91 277678
email: mike.brennan@dfpni.gov.uk

Department of Finance and Personnel
www.dfpni.gov.uk

Copy Distribution List Below

FROM: **MICHAEL BRENNAN**

DATE: **8 APRIL 2013**

TO: **FINANCE DIRECTORS**

RING-FENCED FINANCIAL TRANSACTIONS CAPITAL FUNDING

Introduction

1. You will be aware that the Executive received significant ring-fenced financial transactions Capital DEL funding in the recent 2013 UK Budget. The purpose of this note is to invite departmental proposals in terms of utilising this funding.

Funding Available

2. Following the 2013 UK Budget allocations we are currently holding £46.8 million in 2013-14 and £59.3 million in 2014-15 in respect of financial transactions Capital DEL funding. This funding is ring-fenced by HM Treasury and can only be used for loan or equity investment. It will be important that the Executive makes best use of this funding.

Incentives for Departments

3. The key criterion in using this funding is that it must be used to provide a loan or equity investment to a private sector entity. Departments can determine whether to charge interest on any loan made and will be allowed to keep any interest receipts in this respect.

4. The ring-fenced capital funding will be repayable to HM Treasury, although not at 100%. DFP will be seeking clarification from Treasury colleagues on the percentage that must be paid back and on what timescale. To give departments an added incentive to participate departments will be allowed to keep half of the net benefit i.e. if the department recoup 100% of the loan principal and the funding is 60% repayable to HM Treasury, the departments will be required to pay back 80%, with the remaining 20% held at the 'Centre' to manage the overall position. An illustrative worked example is included at **Annex A** for information.

5. When considering options for utilising this funding, priority will be given to proposals that will free up conventional Capital DEL (or indeed Resource DEL) funding. To give departments an incentive to develop such proposals, departments will be allowed to keep 50% of any conventional Capital DEL that is freed up as a result. The remaining 50% must then be surrendered to the Executive for reallocation.

Budget Impact

6. Any repayments will be reflected in departmental baselines from 2014-15 onwards. This means that departments will carry the risk of any loan or equity investment defaulting.

Departmental Proposals

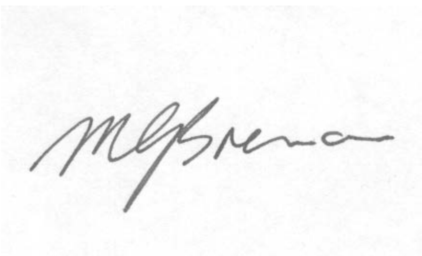
7. Departments are asked to consider carefully any proposals that they may have in this respect. Proposals may cover a funding request for either 2013-14 or 2014-15, or indeed both years. This should include consideration of any potential EU State Aid issues and whether the department has legal authority to provide loan assistance or undertake equity investment.

8. Proposals should be submitted to Peter Jakobsen (peter.jakobsen@dfpni.gov.uk) before Wednesday 1 May 2013 and copied to your Supply Officer. When submitting proposals please use the attached Pro Forma (**Annex B**), appending any other relevant information.

Next Steps

9. DFP officials will consider departmental proposals in advance of the June Monitoring round with a view to presenting recommendations to the Executive as part of that round. We will also engage with Treasury officials on the repayment schedule they expect and discuss any proposals with relevant departments.

10. If you have any questions in relation to this ring-fenced funding please contact Peter Jakobsen (68241) or Stephen Barrett (68275) in the first instance.



MICHAEL BRENNAN

Ext. 68151

Copy Distribution List:

Stephen Peover
Bill Pauley
Supply & CED Grade 5s, 7s and DPs
Principals in Finance Branches

ANNEX A

Example of Loan and Equity to Private Sector

For the purposes of this illustrative example:

- The loan is to the value of £400m;
- the loan is repayable over four years;
- the loan repayment amount to HMT is 80%; and
- the department shares half the benefit of the remaining 20%.

£ million	Year 0	Year1	Year2	Year3	Year4
Department Yellow (Net Budget)					
Original Budget	1,000	1,000	1,000	1,000	1,000
Adjustment to Budget for Loan to Private Sector	400				
Adjustment to Budget for Loan Repayment (80%+10%)		-90	-90	-90	-90
Adjusted Net Budget	**1,400**	**910**	**910**	**910**	**910**
Of which:					
Department Yellow (Gross Budget)					
Original Budget	1,000	1,000	1,000	1,000	1,000
Adjustment to Budget for Loan to Private Sector	400				
Adjustment to Budget for Loan Repayment (80%+10%)		-90	-90	-90	-90
Increase in spending power due to Repayment receipts		100	100	100	100
Adjusted Gross Budget	**1,400**	**1,010**	**1,010**	**1,010**	**1,010**
Department Yellow (Receipts)					
Original Budget	0	0	0	0	0
Repayment of Loan from Private Sector		-100	-100	-100	-100
Adjusted Receipts	**0**	**-100**	**-100**	**-100**	**-100**
Total Department Yellow Budget	**1,400**	**910**	**910**	**910**	**910**

Note: The above example assumes that there is no conventional Capital DEL released. However, in the case where a departmental proposal releases conventional Capital DEL, 50% of the released funding will be retained by the department with the remaining 50% having to be returned to the 'Centre'.

ANNEX B

RING-FENCED FINANCIAL TRANSACTIONS FUNDING

PRO FORMA

Introduction

This pro forma is designed to provide DFP with a minimum level of information required to initially assess departmental proposals. Any further relevant information that departments consider important should be appended when submitting this pro forma. The information provided may then be used as a basis for further discussion with departments.

1. Ring-Fenced Financial Transaction Proposal

Title:	
Responsible Officer	

2. Costs

£000s	**2013-14**	**2014-15**
Cost of Proposal		
CDEL (or RDEL) Replaced (if applicable)		

2. Proposal Description

Please provide a brief description of the proposal, including whether the scheme will replace existing Capital DEL (or Resource DEL) in your departmental baseline.

3. Impact on Programme for Government (PfG)

Explain how the proposal will positively impact on the delivery of the PfG priorities and your department's own key objectives.

4. EU State Aid Issues / Legal Authority

Confirm that the proposal is allowable under EU State Aid rules and that the department has legal authority to take the scheme forward.

5. Repayment Schedule

Set out a preferred repayment schedule of the proposed loan / equity investment (capital element only). This should initially assume 100% capital repayment, although any reduction in the amount payable agreed with Treasury will be shared equally between the department and the 'Centre'.

6. Equality Impact

Confirm that the proposal has been assessed in accordance with Section 75 of the NI Act 1998 and attach a standard High Level Impact Assessment form. State if there are any adverse equality impacts and explain any mitigation measures taken as a result.