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**Committee: Prosperous Communities**

**1st May 2018**

**Subject: West Lindsey Commercial Loan Policy and Framework**

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| Report by: | Ian Knowles<br>Director of Resources |
| Contact Officers: | Tracey Bircumshaw<br>Finance and Business Support Manager<br>01427 676560<br>tracey.bircumshaw@west-lindsey.gov.uk<br><br>Marina Di Salvatore<br>Senior Growth and Projects Officer<br>01427 676635<br>marina.disalvatore@west-lindsey.gov.uk |
| Purpose / Summary: | To consider the viability and implications of a Commercial Loan Policy and Framework that would allow the Council to lend money to third party organisations. |

**RECOMMENDATION(S):**

**That members recommend the Commercial Loan Policy to Corporate Policy and Resources in order to approve the implementation of a West Lindsey Commercial Loan Policy that would allow the Council to award discretionary commercial loans to third party organisations in support of local growth and economic development.**

## IMPLICATIONS:

**Legal:**

Loans to third party organisations and businesses may be provided under the Council's general power of competence. The General Power of Competence, Localism Act 2011 Sec 1 (1) gives local authorities, including eligible local councils, "*the power to do anything that individuals generally may do*".

This power is not to be relied upon as a specific power to lend or invest but rather to supplement Section 12 of the Local Government Act 2003 or Section 24 of the Local Government Act 1988 when investing or lending.

**Loan Funding**

There are a number of approaches and potential exemptions which they can rely upon when lending. The potential exemptions include the General Block Exemption Regulation (the "GBER") and De Minimis. If a council provides a loan on market terms, it should not be State aid because the council is acting in line with the Market Economy Investor Principle (the "MEIP"). When making such loans, councils will need, amongst other things, to carry out prior due diligence to demonstrate that the loan is a prudent use of the council's resources and such that any other lender (i.e banks) would have provided a loan on those terms

A loan can be non-aid altogether provided it is given on commercial terms and at a market rate. In such a case the fact it is given by a state entity such as WLDC does not matter as it is considered not to confer the *advantage from state resources* necessary to be state aid (i.e. it is deemed to be in effect the same as if obtained from a commercial bank). In order to do verify this, there is a formula for judging market rates as set out by the European Commission involving consideration of prevailing interest rates plus the beneficiary risk rating and level of collateralisation.

It is intended that all loans will be given on commercial terms.

**Financial : FIN/19/18TJB**

The Council is currently exposed to £1.060m of loans equating to 10% of forecast uncommitted useable reserves of £10.566m per the MTFP at 2022/23).

The following risk considerations are to be embedded to mitigate financial risk;

**A maximum exposure level -** should be set at 35% of uncommitted useable reserves which reflects the Council's risk appetite to this type of debt. All loan agreements include clauses to protect WLDC against loss of principle through default on payment i.e. security in the form of a charge on the land/property/asset and through personal or parent company guarantees.

**Commercial Interest Rate** - As most loans are funded from Prudential Borrowing the Councils cost of borrowing needs to be met from the rate of interest applied to the loan. Rates will be set at a level commensurate with a commercial loan for a similar loan agreement.

Rates must be evidenced as commercial to comply with State Aid Rules.

**Costs to administer** - A fixed 1.5% or £5,000 whichever is the higher as an administration charge. Additional penalties for late payments should also be applicable.

**The maximum amount of loan –** the Council's willingness to advance should be proportionate to the scheme and financial standing.

**The maximum period of loan advance -** The preferable loan period is 5 years however for larger projects this could be extended up to 10 years.

**Repayment Terms:** The ability to repay early should not come with penalties, this will encourage early repayment.

**Approval:** All loan advances will require approval of the Corporate Policy and Resources Committee.

**Staffing:** This project will be led by the Commercial and Economic Growth Director (with the support of the Finance Team) and is part of the work plan of the Growth team.

**Equality and Diversity including Human Rights :**

If approved for delivery, the Commercial Loan Policy will be adopted on a discretionary basis. This is to ensure prudent risk management on the part of the Council (as described in the Financial Implications above). Each application will be assessed consistently in accordance with the Council's assessment criteria and due diligence requirements. The assessment criteria will be disclosed to prospective applicants at Expression of Interest stage.

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| **Risk Assessment:**<br>**State Aid compliance**<br><br>**Mitigating Action:** Loans will only be issued at a commercial rate therefore no distortion of competition<br><br>**Default on the loan**<br><br>**Mitigating Action**: Appropriate due diligence to be undertaken, security on the asset through a Charge on the Land, release of the loan based on specific conditions in addition to a parent company or personal guarantee if appropriate |

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| **Climate Related Risks and Opportunities :**<br>This scheme is designed to support economic growth and stimulate development. In this respect applications will have to demonstrate that any proposed activity funded through the loan will support projects that will improve sustainability and will not be at the detriment of both the business and the environment. |

| **Title and Location of any Background Papers used in the preparation of this report:** |
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| "Review of the Gainsborough Growth Fund, its performance over the last 3 years and any recommendations going forward" (Prosperous Communities Committee, 30 January 2018) |

**Call in and Urgency:**

**Is the decision one which Rule 14.7 of the Scrutiny Procedure Rules apply?**

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| i.e. is the report exempt from being called in due to urgency (in consultation with C&I chairman) | **Yes** | | **No** | x |

**Key Decision:**

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| A matter which affects two or more wards, or has significant financial implications | **Yes** | x | **No** | |

# 1 Introduction

## 1.1 Previous decisions

The recommendations outlined in the Gainsborough Growth Fund (GGF) Review Report presented at Prosperous Communities Committee on 30th January 2018 summarised three areas of opportunity for the Council in terms of its role as future provider of business finance and fiscal incentives.

- a revised GGF Scheme that would look at relaunching a wider district Feasibility Fund to be aligned with the Greater Lincolnshire Enterprise Partnership (GLLEP) and regional Midlands Engine Investment Fund Programme[1] (*see Appendix A for full details of financial products);*
- the potential to provide a local business Discretionary Rate Relief Scheme (for consideration via a separate report);
- **the implications to develop a Commercial Loan Policy that would regulate disbursement of loans to third party organisations (to be evaluated in this paper)**

The performance review carried out in relation to the existing GGF Scheme, and the increased funding/financial opportunities available at district and regional level through ESIF (EU), the GLLEP and the Midlands Engine Investment Fund Programme (MEIF), concluded there is little rationale at this stage to explore a continuation of the Scheme in its current format, once resources are depleted from the allocated budget. Also considerations were made whether a grant regime is the most effective commercial and financial mechanism for the Council to continue to support business growth and investment, particularly for high risk capital projects.

## 1.2 Rationale for investment: why should we consider lending?

Government changes in the way councils are funded has prompted local authorities, over the last few years, to look at more commercial and innovative ways of growing income streams from other sources other than Government grants and council tax in order to support their services.

The Council can available through the use of their reserves and/or borrowing from the Public Works Loan Board (PWLB) to support outputs to the growth agenda and to support future revenue income streams by providing loan funding.

[1] MEIF is a collaboration between the government-owned British Business Bank and ten Local Enterprise Partnerships (LEPs) in the West Midlands and East & South East Midlands and provides commercially-focused finance to help SMEs start up and grow.
It is a key part of the government's vision aimed at boosting the region's economy and supporting the growth of smaller businesses between 2017 and 2022.

A commercial loan approach, as opposed to a grant regime, would ensure more measurable outputs in terms of financial returns (revenues generated from interest payments and potentially increase in business rates) will benefit Council resources with the greater economic impact for the District.

Loans to third party organisations and businesses may be provided under the Council's general power of competence. The General Power of Competence, Localism Act 2011 Sec 1 (1) gives local authorities, including eligible local councils, "the power to do anything that individuals generally may do". This power is not to be relied upon as a specific power to lend or invest but rather to supplement Section 12 of the Local Government Act 2003 or Section 24 of the Local Government Act 1988 when investing or lending.

This option would support the Council's Medium Term Financial Plan & Capital Investment Strategy and would allow revenue from loan repayments and arrangement fees to cover the cost.

## 2 Socio-economic analysis

2.1 When evaluating the implications of a Loan Scheme the Council should outweigh the cumulative socio-economic benefits that are generated as a result of a particular investment into the local economy and the risk levels associated to the very nature of disbursement of loans (payment defaults, borrower's creditworthiness, collaterals and securities).

Some of the wider socio-economic benefits for the Council to consider whether entering the lending environment may include:

- **Delivering economic growth**. By lending to commercial entities the Council can support programmes and activities which can generate significant economic impact and job creation;

- **Economic renewal and regeneration.** Loans can support the delivery of regeneration programmes in areas that suffer from lack of investment and can unlock stalled development projects which are struggling to get off the ground;

- **To share good policy on improving access to finance for investors and Small and medium-sized enterprises (SMEs).** By working with institutions like the MEIF and other funding organisations, the Council may stimulate investment locally and encourage local economic growth.

## 3 Commercial Loans: Guidance Notes

### 3.1 Principles and Eligibility

It is proposed that commercial loans be considered to support development projects which have a significant economic impact and support sustainable job creation. Project proposals will need to clearly demonstrate the potential for job creation and alignment to the Council priorities for growth as well as the GLLEP Strategic Economic Plan (SEP).

The Loan will support capital activities, including investment in sites and premises and/or purchase of new machinery and equipment.

Revenue projects are not eligible for the Loan applications. Only capital projects may be considered (usual fees/project management costs which are part of a larger capital project may be eligible).

In addition to financial and credit status, Project deliverability and strength and experience of the management team will be a key factor in the appraisal process.

The maximum amount of the loan will be based on a combination of different factors involving the proportionality of the loan amount to the overall scheme/project proposal and the financial standing of the company.

Any Commercial Loans will be funded by prudential borrowing and projects will be expected to repay their funding so this debt can also be repaid. Early repayment will be prioritised and taken into account alongside value for money and economic impact. A repayment period of no more than 5 years is preferred although loan terms of up to a maximum of 10 years may also be considered.

Any other material factor having a potential impact on project deliverability will be considered in the evaluation process as deemed appropriate.

We will not accept loan requests from individuals.

### 3.2 Application Process

This will involve a five stage process:

- An Expression of Interest (EOI) will be sent for completion and once submitted, assessed by the Screening Team (Senior Growth & Project Officer and Commercial Accountant). This process may take up to two weeks.

- If the EOI is accepted by the Screening Team as meeting the Council's strategic growth priorities and delivering economic outputs, the project applicant will be invited to submit a full application.

- Applications to appear viable will be subject to a thorough due diligence process in order to carry out a detailed examination of the applicant's proposal. Applications that do not appear to be viable will be rejected at this stage and the applicant notified of the decision in writing.

- Progressed applications will be reviewed alongside the associated due diligence and third party review.

- A report will be submitted to Corporate Policy and Resources to recommend approval of the loan application;

## 3.3 Due Diligence Requirements

Projects must satisfy this process before Senior Officers and Executive Director Team can recommend to Committee to fund any project.

It is anticipated that the average due diligence check should take up to four weeks to complete.

Applicants will be required to demonstrate the need for investment from the Council's lending resources and loans must not be used to replace other available sources of finance or funding. Only projects that cannot proceed without the Loan funding will be considered.

The evaluation of the company's business plan including its growth plans and reasons for seeking WLDC investment, will be carried out internally by the Strategic Growth Team or externally if required.

The financial assessment will be undertaken by the WLDC Finance and Growth Teams (and any appointed professional advisers).

**Please note that it is not intention of this Policy to be used to replace other conventional sources of funding and financing– only projects that demonstrate a genuine financial gap will be considered**.

Where possible the Council's Team will work together with businesses and other funding partners in identifying flexible solutions that will aim to deliver a tailored funding package that will suit the growth requirements of the business.

Any external costs will be recovered from the applicant.

## 3.4 Assessment

All applications will be assessed against the following criteria:

- Projects must be capital schemes that are ‘ready to go’ and are able to generate tangible economic benefits within a reasonable delivery period;

- Projects must be located in, and significantly contribute to the economy of West Lindsey;

- Projects should have outline planning consent and/or a reasonable expectation that full planning consent will be granted within six months.

- Projects must be demonstrably capital, meaning that an investment:
  - Must be used for the acquisition or enhancement of an identifiable asset with a life of more than one year
  - Can include the costs (excluding interest) of assets acquired under a finance lease -
  - Cannot be used to fund moveable assets where there is an expectation of immediate re-sale.

Applications will be assessed in terms of the following:
- Deliverability and risks associated with the project
- Job creation benefits and/or other benefits to West Lindsey
- Sustainability and prospects for growth
- Financial standing
- Financial implications
- Value for Money (VFM), based on cost per job; amount of private sector £ leverage
- Any other material factors appropriate at the time

## 3.5 Successful Applications

Successful loan applicants will enter into a legal contract with West Lindsey District Council and will drawdown/repay their loans according to the contract agreement.

It is a requirement of the programme that successful applicants provide regular updates for monitoring purposes. Applicants will periodically be asked to report against project progress and achievement of outputs such as job creation. The Council may request supporting evidence for auditing purposes and reserves the right to invoke clawback of funding for contractual non-compliance, including failure to cooperate with monitoring requirements.

All drawdowns of loan advances will be paid against evidenced expenditure in the creation of the asset.

The schedule of loan disbursement and loan repayments will be bespoke to the type of scheme and project that will be supported. In order to minimise risks the Council may consider disbursement of loan in tranches to ensure successful achievement of project's milestones.

## 4 Financial Analysis: Options appraisal

### 4.1 Promoted Commercial Loans

If WLDC chose to offer commercial loans to SMEs within the locality and openly promote this opportunity, in order to facilitate the process WLDC would be expected to:

- Publicise the rates at which they would offer
- Quantify the levels of loans offered
- Quantify the loan pot available

As indicated by the stretch analysis carried out, there are scenarios whereby WLDC could lose out financially as a result of loan. As the rates would be published, it would not be possible to deviate from the rates prescribed.

This risk could be offset by the mix of loans approved, for example if WLDC provided five loans of which four were to customers with high collateral and high creditworthiness (worst case scenario – Low rate of interest) and one loan to a low collateral and low creditworthiness (high rate of interest). Due to the additional returns gleaned from the low collateral/credit customer, the Council could offset any losses on the high collateral/credit customer.

If the Commercial Loan Scheme were to be openly promoted using a range of marketing means, there could also be a high risk in terms of available resources and internal capacity as certainly in the initial period following the marketing campaign, there would be an expectation of high demand in submissions.

This could inevitably lead to some speculative applications, which in turn could have an impact on resources both within the Finance and Growth Team as all applications received would have to be assessed. If they didn't progress to a loan in full then there would be little opportunity for WLDC to recover the cost and time of the resources utilised.

Finally and perhaps the greatest risk is the customer defaults on loan repayments; whilst there would be procedures in place to prevent this from happening at the assessment stage, there would be still a very real risk this could occur. As it is expected that the majority of the SMEs that would show an interest in the loan fund would be limited companies, once the resources/liquidity of the limited company were exhausted, the loan would have to be written off resulting in a potentially substantial financial loss to WLDC.

### 4.2 Bespoke/discretionary loans

If in alternative to the above WLDC decided to offer discretionary loans to third parties and SMEs the following approach would be adopted:

- Rates would be dictated on an individual basis dependent on financial analysis of the borrower, value and length of loan.

- For bespoke discretionary loans there would be no need to openly and actively publicise the authority’s applicable rates as they would be determined on a case by case basis.

A template has been developed internally that can be used to determine the appropriate rate for a loan. The template ensures that the rate applied will always recover costs. There is also a function to build in desired level of returns. If WLDC required/requested a fixed level of return the template would calculate the rate to be applied accordingly. The returns could be placed in reserves, these could be held over for any abortive costs the Council may experience in scenarios whereby the loan offer would not be taken up.

Due to the fact that the loans would be one offs by their nature this approach would limits the resources that would be required to facilitate an open door policy.

In this context, whilst the risk of loan default could still exist, it could however be prevented through the implementation of a more selective process and in the way priority was given to certain types of projects.

## 5 Conclusions

5.1 The recommended approach to provide discretionary loans on an ‘individual basis only’ would remove the Council from the pressure of having to manage a potentially high risk Finance Scheme with unpredictable and irregular commercial returns.

Whilst the Council is not likely to promote this funding opportunity widely, this policy will provide Senior Officers and Members with an internal financial toolkit and framework that would facilitate a proactive approach in supporting economic development whilst identifying commercially viable opportunities.

In order to add value to the current government led regional programme Midlands Engine Investment Fund (MEIF) and avoid duplication with the existing provision, the Growth and Finance Team feel that would be more appropriate for the Council to promote the MEIF and other suitable schemes available through the GLLEP Growth Hub[2] as mainstream platform of financing/funding products. In this way the Council will ensure that regional finance is diverted into our local economy and is not diluted into recognisably more competitive and high growth parts of the Midlands. In support to the above the Council will introduce the delivery of West Lindsey Feasibility Fund (this scheme will be launched later in the year subject to available funds).

[2]BusinessLincolnshire Growth Hub provides local business information to help new start up and existing businesses. It provides information to help with starting and growing businesses, finances, employment and skills information, contact details for local suppliers, support schemes and services, news from around the region, as well as a list of the training, seminars, and networking events available locally.
Growth hubs work across the country with local and national, public and private sector partners – such as Chambers of Commerce, FSB, universities, Enterprise Zones and banks, co-ordinating local business support and connecting businesses to the right help for their needs.