ESIF Financial Instruments: State aid considerations

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ESIF-funded Financial Instruments

ESIF financial instruments

ESIF FIs can only be used to finance projects

that fulfil specific policy **objective(s)**

of an **ESIF operational programme**

ESIF financial instruments

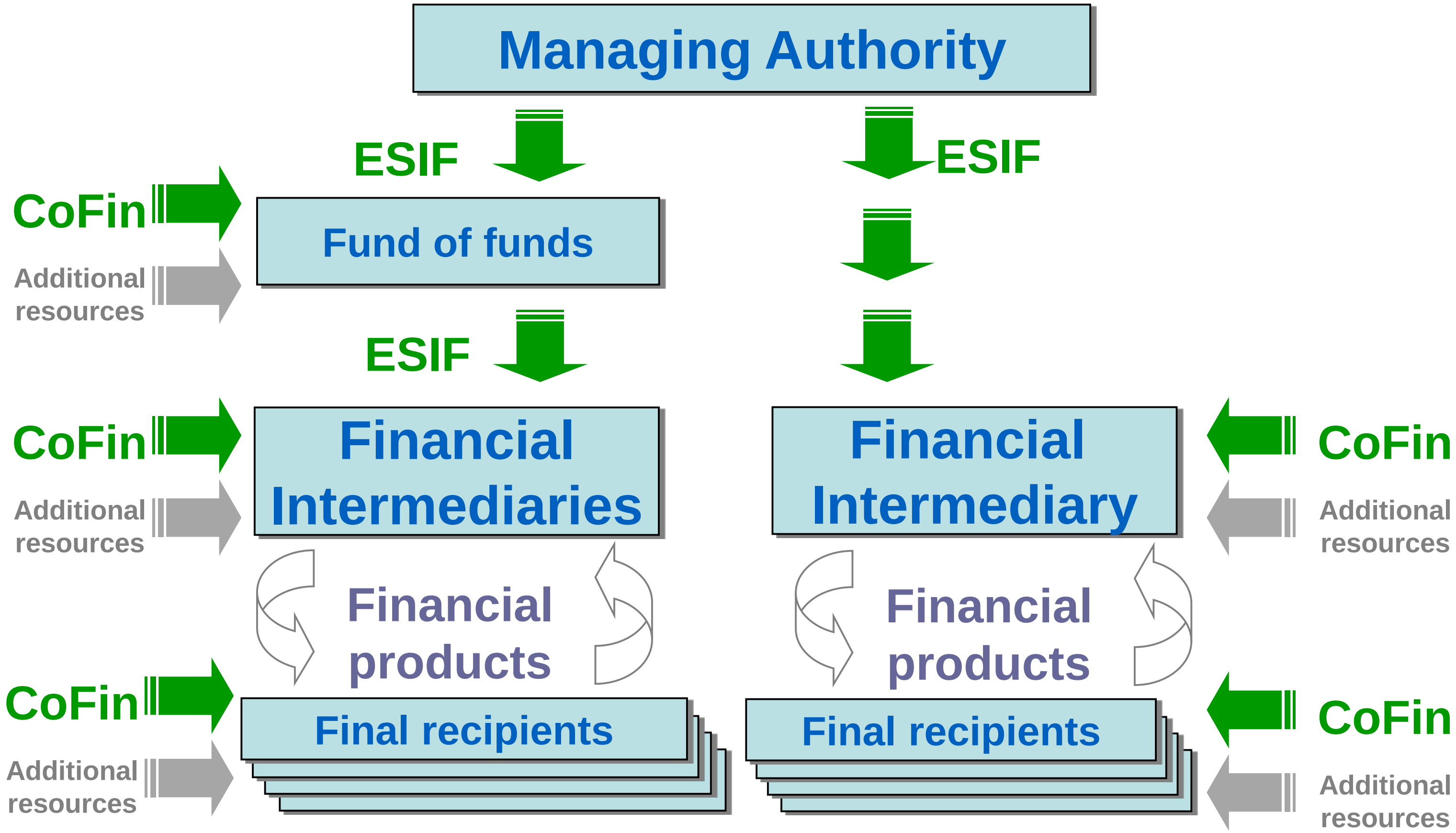
In the context of ESIF programmes financial instruments can be used only:

- For potentially viable investments (revenues/savings to repay the loan)
- Where there is no sufficient funding from market sources
- Where there is a market failure or suboptimal investment situation

ESIF financial instruments

- CPR (incl. CDR, CIR) & State aid rules are distinct legal frameworks which are both applicable to ESIF-financed projects

Resources involved in FI implementation



Contributions to FIs

- Are phased
- Can come in at different levels
- Can have different "qualifications"
  - **ESIF**
  - **National (public or private) co-financing** in the context of the underlying priority axis (subject to CPR rules)
  - **Additional leverage resources** provided to the FI architecture (beyond the scope of the OP and corresponding rules). These can be also private or public

FIs in the 2014-2020 period (until 31.12.2015)

- 21 MS use FIs – 77 Ops - 136 FIs
- 5,7 bln EUR committed to FIs
- 100mln EUR invested in final recipients

FIs in the 2007-2013 period

- 25 MS used FIs - 192 Ops - 1058 FIs across EU
- 15 bln invested in final recipients
- 8.5 bln eur resources returned (revolving)

State aid policy in brief

Purpose of EU competition policy

- Horizontal EU policy which establishes competition rules necessary for the functioning of the internal market (Article 3(1)(b) TFEU)
- Distortions of competition can be caused by anti-competitive behaviour of companies or by public interventions
- By keeping markets open and competitive, competition policy contributes to productivity growth and economic development
- This objective is relevant both for EU competition policy and EU Cohesion policy

Rationale of EU State aid policy

- State aid control by COM enshrined in the Treaty
  - Article 107(1) TFEU: notion of State aid and general prohibition
  - Exceptions: Art 107(2) and (3), Art 106(2), Art 93 TFEU
- The purpose is to prevent undue distortions of competition caused by public interventions, which ensures a level playing field
- Requirement for ESIF FIs to comply with State aid is rules recalled in the CPR provisions on FIs

CPR Articles: 6, 37, 42, 44

2014 State aid modernisation (SAM)

Streamlined and simplified State aid control

- 2016 Notice on the Notion of aid clarifies notion -larger scope for no aid
- Significant extension of GBER (incl. 2017 revision) -enlarged scope of compatible State aid which does not require prior approval by COM
- Ex-post monitoring, transparency and evaluation
- Soft mechanisms accompanying SAM:
    - Bilateral, Multilateral Partnerships with MSs on State aid
    - Continuous guidance (**e-State aid wiki**), training for MSs

When are FIs subject to State aid control?

Notion of State aid: key concepts

- FIs which do not involve State aid are by definition not distortive and not subject to State aid control
- State aid qualification of each transaction under FI
- State aid present when cumulative criteria of Art 107(1) TFEU are met (i. e. if one of the criteria is not met, support does not constitute State aid):
  1. State resources and imputability to the State
  2. Selective advantage (Market Economy Operator Principle)
  3. Economic activity, and
  4. Effect on trade between MSs

1. State resources and imputability

- General principle: if no State resources within the meaning of Article 107(1) TFEU, no State aid
- ESIF FIs are funded through State resources
  - ESI funds which are in shared management with MSs, are at MS control and discretion
- Imputable to the State even if the management of FI is entrusted to financial intermediaries
  - MS defines conditions for FI deployment
  - The EIB Group or development bank "mandate activities" are subject to State aid control

1. State resources and imputability

- Centrally-managed EU FIs are not State resources within the meaning of Article 107(1) TFEU
  - Managed by COM, i. e. not controlled by MSs
  - Designed by COM in consistency with State aid rules to avoid undue distortions competition (requirement in the EU Financial Regulation)

- ESIF contributions to centrally-managed EU FIs would not be imputable to the State, provided:
  - MS do not attach any additional conditions over the use of ESIF contributions, except for the geographic use defined by the Commission under ESIF rules

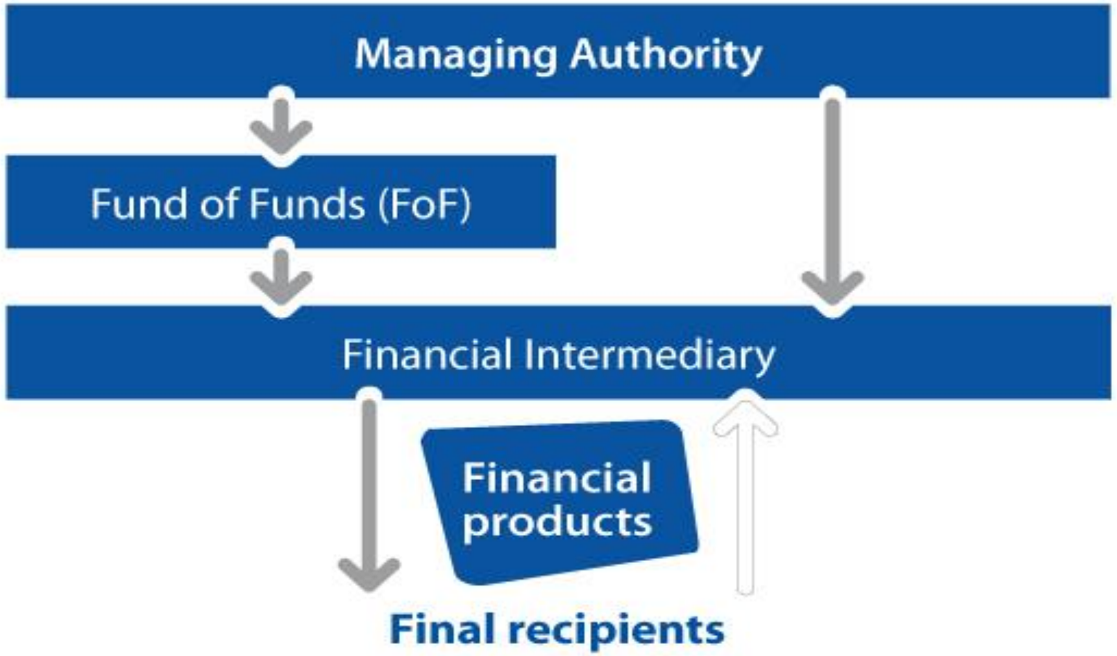
2. Advantage - market economy test

- General principle: no advantage (no State aid) where transaction conforms with market conditions
  - State has the right to act on market (neutrality principle)
  - Market conform FI could in certain cases be appropriate for the achievement of certain policy objectives

- Guidance on market conformity of FIs:
  - Notion of Aid Notice (NOA) (OJ C262 , 19.7.2016)
  - Reference Rate Communication (OJ C 14, 19.1.2008)
  - Guarantee Notice (OJ C 155, 20.6.2008)
  - Risk Finance Guidelines (OJ C 19, 22.1.2014)
  - SWD on State aid and ESIF FIs (156, 2.5.2017)

2. Advantage - market economy test

Where FI involves a chain of transactions – need to assess market conformity of each type of transaction



I. Remuneration for the management services (FoF/Fund manager)

II. Financing or guarantees provided to financial intermediaries - conditions

III. Financing provided to final recipients - conditions

2. Market conform management fee

- General principle: no State aid to FoF/Fund Manager where the management fee is market conform
- Where FI is managed by a development bank (EIB Group, NDBs), the management fee is not State aid in so far as only concerns public remit activities
  - Where NDBs also carries out commercial activities, separation of activities to avoid direct or indirect aid
- Where FI is managed by a commercial financial intermediary, market conform fee when
  - open, transparent and competitive selection process, or
  - fee level assessed by benchmarking or other methods

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2. Market conform financing, guarantee

- General principle: where financing or guarantees are provided on market terms, there is no State aid to financial intermediaries/investors and final recipients

- Public funding provided *pari passu* with private funds is considered market conform
  - Like risk, like rewards - same conditions in the same transaction
  - Substantial private contribution (min 30%)
  - Independent and genuine private investors
    - EIB Group own risk and own resource activities are considered private (not with EFSI or other public guarantee)

2. Market conform financing, guarantee

- Absent private co-investors, market-conformity of transaction to be assessed based on:
  - Benchmarking to compare with market rates
  - Other assessment methods (e. g. whether expected IRR/NPV in the business plan correspond to the risk taken)
- Market proxies for standard debt instruments (safe harbor premiums for SMEs)
  - Loans considered market conform if the interest rates in line with the rates of the Reference Rate Communication
  - Guarantees considered market conform if the fee and other conditions are in line with the Guarantee Notice

3-4. Economic activity and effect on trade

- General principle: support for activities that are non-economic or local in nature is not State aid
- Financing provided to the final recipients would not qualify as State aid where the activities are:
  - Not economic in nature (e. g. public infrastructure – see the infrastructure grids)
  - Local in nature – no effect on trade between MSs
- However, since the activities of commercial financial intermediaries are economic, FIs delivered via them could still constitute State aid

***De minimis* aid**

- General principle: de *minimis* aid deemed not to distort competition and is not considered State aid
  - Aid below € 200.000 during 3 consecutive years per single undertaking (De Minimis Regulation n 1407/2013)
- Debt instruments – two options:
  - Aid element below the de minimis threshold (quantify aid)
  - No quantification – need to comply with the thresholds:
    - 5-year loans up to €1 mln (10-year loans up to € 500K)
    - 5-year loan guarantees up to € 1.5 mln (10-year loan guarantees up to € 750K)
- Equity cannot be *de minimis* aid (not transparent), unless below EUR 200 000

De minimis aid

- For the entire FI to be *de minimis* aid, aid at financial intermediary level must be:
  - limited to *de minimis* aid, or
  - excluded, i. e. fully passed on to the final recipients
- Full pass on of the aid:
  - Firstly, need to quantify the gross grant equivalent of aid based on the Rate Communication or the Guarantee Notice
  - Secondly, need to have a mechanism for the fully pass on of the aid (e. g. corresponding reduction of financing cost)
- Typically, *de minimis* in standard debt instruments

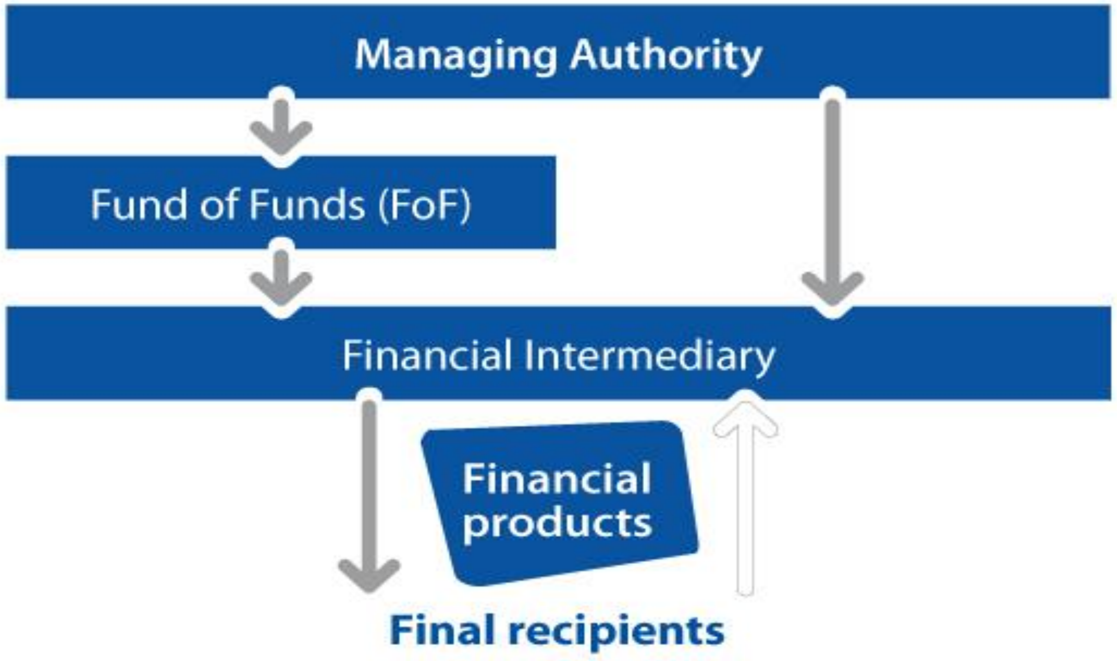
Off-the-shelf FIs - *de minimis* aid

- Off-the-shelf FIs – standard terms and conditions
- 3 off-the-shelf debt instruments as *de minimis* aid:
  - Risk-sharing loan for SMEs
  - Capped portfolio guarantee
  - Renovation loan for residential buildings
- Key parameters:
  - No State aid to the FoF manager
  - No State aid to financial intermediaries: aid quantification formula and a mechanism to pass on the aid
  - De minimis aid to the final recipients

Compatible State aid in FIs

State aid in FIs

Purpose of aided FIs – to address market failures and encourage financial intermediaries/investors to provide financing to the target recipients



- Incentives to financial intermediaries/investors to mitigate the risk and/or improve returns
- Financing to the final recipients provided on favorable terms or which would not be available at all

State aid in FIs

Equity not *pari passu* with private (asymmetric risk/return sharing)

- Asymmetric profit sharing between public and private investors
- Downside protection – public funds taking a first loss position

Sub-commercial loans

- Interest rates below the reference rates or market benchmarks

Sub-commercial guarantees

- Guarantee fee for the risk taken below the reference premiums or market benchmarks

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Compatible State aid: key concepts

Key compatibility principles:

- Sound financial management principles (i.e. focus on market failure or socio-economic cohesion, incentive effect, limiting support to the minimum necessary, etc.)
- Safeguards to minimise competition distortions (no crowding out of private, not supporting inefficient companies, etc.)

Control systems:

- Ex-ante control by COM: notification and clearance
- Exemption from the notification requirement via the General Block Exemption Regulation (GBER, OJ L 187, 26.06.2014)
- Sample-based ex-post monitoring by the Commission

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Compatible State aid: key concepts

1.GBER: if all the relevant conditions are met, State aid is considered compatible with the internal market

- No ex-ante notification to COM, MSs must ensure compliance with the relevant GBER conditions
- Sample-based ex-post monitoring by COM (may suspend or withdraw GBER benefit where non-compliance is identified)

2. Notification: FI notified to COM for ex-ante clearance, State aid compatibility assessed:

- under relevant guidelines (e.g. Risk Finance Guidelines)
- if not covered by the guidelines, directly on the basis of TFEU (e. g. JESSICA cases, development bank cases)

1. FIs under GBER: general principles

For FIs to fall under the GBER, aid must be:

- transparent, i. e. aid must be quantified under the Reference Rate Communication or the Guarantee Notice
- present only at the final recipient level, i.e. fully passed on to exclude advantage to financial intermediaries

Exception for FIs with non-transparent aid and at several levels in the following policy areas:

- Early stage SMEs (GBER Art. 21 and 22)
- Urban development (GBER Art. 16)
- Energy efficiency in residential buildings (GBER Art. 39)

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1. FIs under GBER: Art 21

- Eligible recipients: unlisted early-stage SMEs as defined in Art 21(18)
- Types of FIs: equity, quasi-equity, loans, guarantees
- Max EUR 15 mln (or up to de minimis aid for any SMEs)
- Max. 25% first loss piece, max. 80% guarantee rate
- Minimum private finance in function of the risk (linked to SME development stages), at fund or project level
- Financing of the final recipients only via financial intermediaries (competitive selection, other conditions)
- E. g. Off-the-shelf Equity Co-investment Facility

1. FIs under GBER: Art 22

- Eligible recipients: unlisted small enterprises up to 5 years following their registration (or the start of their economic activities)
- Forms of aid:
  - Loans up to € 1 million/10years in non-assisted areas (€ 1.5 or € 2 million in (c) and (a) areas respectively)
  - Guarantees up to €1.5 million/10 years in non-assisted areas (€2.25 or € 3 million in (c) and (a) areas respectively)
  - Grants and equity up to € 0.4 million/10years in non-assisted areas (€ 0.6 or € 0.8 million in (c) and (a) areas respectively)
  - A mix thereof
  - Aid doubled for "small and innovative enterprises"

1. FIs under GBER: Art 16

- Eligible recipients: urban development projects as defined in Art 16(2),(4)
- Types of FIs: equity, quasi-equity, loans, guarantees
- Only ESIF co-financed FIs
- Max EUR 20 mln funding by financial intermediary
- Min. 30% private capital at fund or project level
- Max. 25% first loss piece, max. 80% guarantee rate
- Financing of the final recipients only via financial intermediaries (competitive selection, other conditions)
- E. g. Off-the-shelf Urban Development Loan Fund

1. FIs under GBER: Art 39

- Eligible recipients: energy efficiency projects in buildings, except energy efficiency improvements to comply with EU standards
- Types of FIs: equity, quasi-equity, loans, guarantees
- Max EUR 10 mln funding by financial intermediary
- Max. 25% first loss piece, max. 80% guarantee rate
- Min. 30% private capital at fund or project level
- Financing of the final recipients only via financial intermediaries (competitive selection, other conditions)
- May involve ESCO, but no aid at ESCO level

2. Noticiation: Risk Finance Guidelines

- **Objective of common interest:** Improving access to finance for SMEs and certain mid-caps
- **Neccesity:** targeted a market failure identified in *ex ante* assessment (ESIF ex-ante assessments accepted)
- **Appropriateness:** appropriate to address the identified market failure compared to no-aid measures
- **Incentive effect:** leveraging private capital to share the risk and ensure commercially-driven decisions
- **Proportionality:** key financial parameters
- **Negative effects:** criteria to assess negative effects at 3 levels & black list

Concluding remarks

- **Consider** potential State aid and its compatibility when **designing** FI: conditions for each type of transaction
- Seek **early guidance**
  - national State aid coordination bodies, DG Competition
  - eState aid wiki for questions on de minimis, GBER, NOA
  - pre-notification/guidance for questions outside GBER
- **Off-the-shelf** FIs provide ready-to-use term sheets which are compliant with State aid rules
- Guidance on State aid in ESIF Financial Instruments

Examples

Market Conform: London Green Fund, UK

- Fund managers procured through open and competitive process
- LGF financing invested along with private investors, only on pari passu basis.
- Interest rates of loans given by energy efficiency fund based on EC’s method for setting reference and discount rates.

GBER : Loan Fund INNODEM2 Belgium

- FI designed based on GBER – incl. SME definition
- Not being active in sectors excluded by GBER
- Location in the intervention area
- Not in financial distress
- Not affected by recovery actions taken by COM because previously awarded aid was incompatible with the common market.

De minimis & GBER: FIs for innovative firms - Spain

- Guarantee & micro loan scheme – de minimis
  - FoF manager required Financial Intermediaries to calculate gross grant equivalent of aid in funded projects
  - Final recipients should declare any aid received in the last 3 years
- Venture capital, co-investment and guarantee schemes – GBER – FoF manager inform COM

De minimis: ESF microcredit fund – Italy

- Fund support was provided under de minimis regime
  - Loans between 5000 and 25000EUR.
  - Repayment up to 60 months, 0% interest and no guarantee required
  - Final recipients were individuals or businesses.

Notification of aid: SAS Jeremie, France

- France notified to DG COMP a State aid scheme entailing the use of a co-investment vehicle
- DG COMP approved it (Decision N 629-2007)
- Co-investment scheme of Languedoc-Roussillon takes into account the elements included in the Commission Decision.