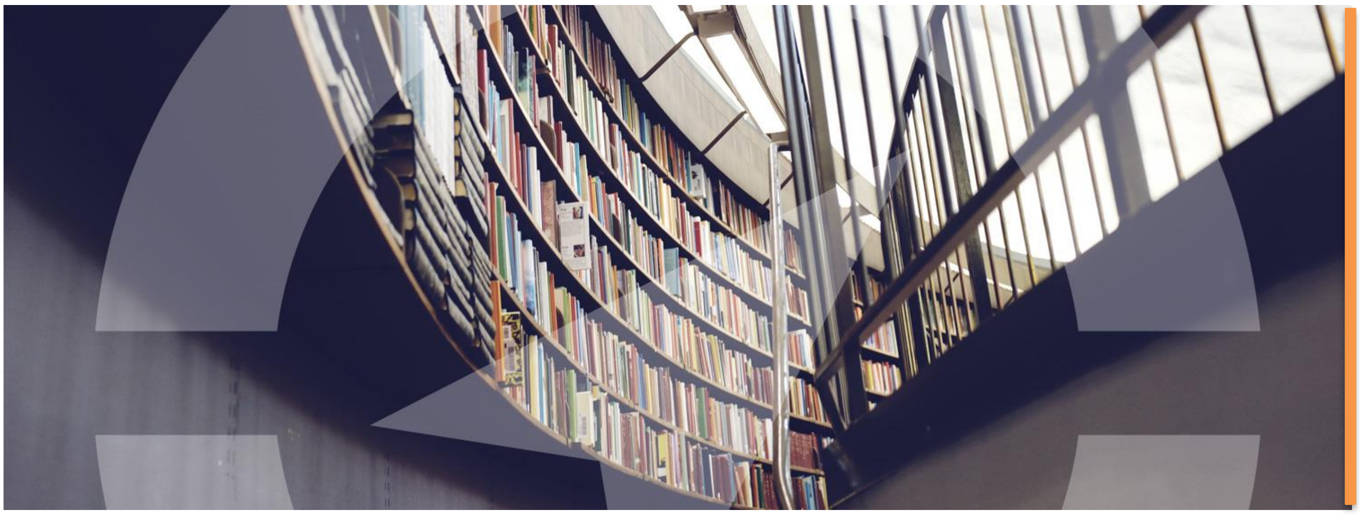
Knowledge Hub



fi-compass Knowledge Hub

State aid

Notes of workshop

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The Knowledge Hub has been developed to meet the growing need amongst experienced practitioners for events and materials that provide a more in-depth look into topics affecting financial instruments. Its format utilises email exchanges to promote a longer term engagement between participants together with traditional face to face workshops to allow experienced practitioners to work together to explore the subject matter through peer to peer exchange and expert-led sessions.

In order to encourage openness between the parties the discussions are undertaken under the Chatham House Rule which states: 'When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.'

In particular, the representatives of the European Commission, namely DG REGIO and DG COMP have participated in the Knowledge Hub to receive feedback from the Member States concerning the application of the State aid rules when implementing financial instruments. The participation of the representatives of DG REGIO and DG COMP should not be interpreted as an official endorsement of any of the suggestions that may be discussed and/or described during the Knowledge Hub and this document.

1. Introduction

As part of the *fi-compass* Knowledge Hub – State aid, a workshop was held in Brussels on Wednesday 19 June 2019. The meeting included 14 representatives from nine different Member States together with participants from the European Commission (DG REGIO and DG COMP) and the European Investment Bank's *fi-compass* and legal teams.

This document is a report of the discussions held during the workshop. It is not definitive guidance in relation to the State aid framework for financial instruments. This account of the discussions does not constitute official endorsement of the points set out in this note.

2. Key notes

Some of the key points that were discussed during the session included:

- A key challenge for **Energy Efficiency financial instrument programmes** is the State aid treatment of **small businesses** based in predominantly residential buildings. In many cases a detailed and time consuming process is set up to identify, record and monitor small amounts of support to local enterprises such as hairdressers and small bookeepers/accountants;
- A possible alternative approach was discussed based on the **ECJ decision in the case Marinvest**[1]. In this case, financial support to a small pleasure port was held to be not liable to affect trade between Member States and therefore not contrary to the State aid rules;
- Applying this analysis to Energy Efficiency schemes could provide a more straightforward and streamlined approach to dealing with **small businesses with only local impact**;
- For financial instruments implemented outside the scope of Arts 16, 21 and 39 **General Block Exemption Regulation (GBER),**[2] it is necessary to demonstrate the **pass on of the benefit** of the ESIF and other public financing to final

[1] Case T-728/17 Marinvest & Porting v Commission

[2] Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (Text with EEA relevance)

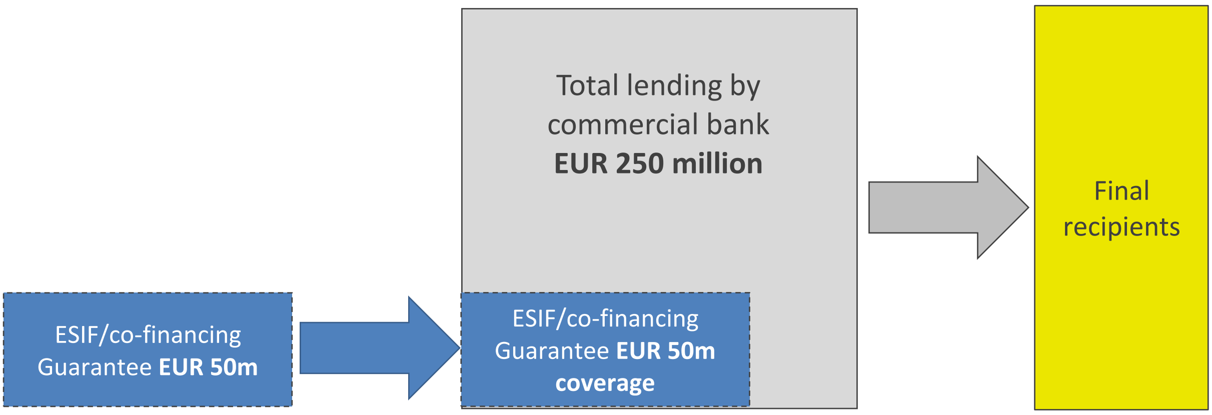
recipients in order to demonstrate that there is no aid at the level of financial intermediaries;

- The **practical steps** taken by managing authorities and National Promotional Banks and Institutions (NPBI) to demonstrate the pass on of benefit were discussed and identified. These include the use of data and competitive pricing during the selection process and the contractualisation of transparent pricing commitments in the funding agreements with financial intermediaries;
- The flexibilities for support for SMEs under the ***de minimis*[3] rules** and **GBER** were discussed and experience shared between the participants.

3. Energy Efficiency financial instruments and small businesses

The indicative case study shown at Figure 1 below was used to discuss the challenge faced by promoters of Energy Efficiency ESIF financial instruments in relation to accounting for support given to small businesses.

Figure 1: The Energy Efficiency fund portfolio guarantee



The model is based on a portfolio guarantee which has been effectively deployed in a number of Member States. Funded risk sharing loan financial instruments are also successfully used to provide finance to home owners to undertake improvements to the energy efficiency of their dwellings. An example of such a model can be found in the 'off the shelf' financial instruments[4] published by the European Commission (EC).

Typically the support given to the final recipients can include, long term, low cost loans combined with interest rate subsidies, grant to meet part of the cost of the works and technical support such as an energy audit and advice. In many cases, where energy

[3] Commission Regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to de minimis aid Text with EEA relevance

[4] Commission Implementing Regulation (EU) No 964/2014 of 11 September 2014 laying down rules for the application of Regulation (EU) No 1303/2013 of the European Parliament and of the Council as regards standard terms and conditions for financial instruments

efficiency measures are undertaken to apartment blocks the owner and/or occupier of each unit takes on a proportionate part of the loan for the works. Owners/occupiers of residential units who are natural persons and are not engaged in economic activity are not treated as 'undertakings' for the purposes of the State aid rules. Most owners/occupiers of the apartment block will fall into this category and therefore are not subject to the State aid rules. However, a small number of units will be owned and/or occupied by undertakings such as hairdressers, small grocery stores or small businesses such as bookeepers/accountants. As a result the managing authority and bodies implementing the financial instrument must develop a strategy to ensure the State aid rules are observed in connection with such businesses.

A key issue highlighted during the workshop is the challenge and associated administration cost of managing and recording small amounts of *de minimis* aid within residential energy efficiency projects supported by ESIF financial instruments. A number of testimonials demonstrated how Member States have had to go to great lengths to identify any units within a multi-apartment block that are owned and/or occupied by small businesses. This work can be time consuming and seems to be disproportionate given that the amount of aid is usually very small.

In response to this issue the recent decision of the European Court of Justice in the case of *Marinvest & Ponting v Commission* was discussed. In this case a small Slovenian marina received State support in the form of tax advantages, free use of land and concessions. This was challenged by a larger Italian marina operator, on the grounds that the support was unlawful State aid. The ECJ when considering the case, however, decided that there was no State aid as the support to the Slovenian marina was not likely to affect trade between Member States, a reference to Article 107 of the Treaty of the Functioning of the European Union which defines State aid as follows (emphasis added):

> *'Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.'*

In the *Marinvest* case the small size and local nature of the Slovenian marina led to the ECJ to conclude in relation to the state support, "even if some marginal distortion of local competition cannot be completely excluded, the alleged measures are not liable to affect trade between Member States." Factors taken into account by the court in reaching this decision included[5]:

- More than 90% of the marina's berths are reserved for local permanent residents
- The majority of the remaining berths are also assigned to Slovenians
- The services offered are of lower quality, compared to the Italian Marina
- Only smaller ships (up to 8 metres) can have access
- Very small share of the market (1.07% of Slovenian mooring market and 0.05% of the Adriatic market of small ports/marinas)

[5] *fi-compass* presentation: Effect on trade in the light of the Marinvest judgment - Péter Staviczky, Attaché responsible for State aid, Permanent Representation of Hungary to the European Union

- The limited income generated by the undertaking
- The Slovenian marina is not advertised internationally

The use of a similar approach to assessing potential State aid in the context of Energy Efficiency financial instruments and small businesses was discussed. Where it can be determined that support to the participating small businesses is not likely to affect trade between Member States due to the size and local nature of the businesses, costly and time consuming administrative measures could potentially be avoided.

When assessing whether such an approach can be adopted, promoters of ESIF financial instruments must ensure they take appropriate specialist advice based on the specific factual circumstances. This note recommends that the approach adopted in the *Marinvest* case is considered by promoters of ESIF financial instruments in appropriate circumstances. However, whether it can be applied to a specific financial instrument can only be determined by reference to the particular facts of the operation concerned.

4. Demonstrating the full pass on of benefit by financial intermediaries

The practical steps taken by Member States and bodies implementing financial instruments to demonstrate that financial intermediaries pass on to final recipients the full benefit of the ESIF and other public contributions to financial instruments was discussed during the workshop.

This approach is commonly used in connection with financial instruments implemented under the *de minimis* rules and the GBER articles other than Articles 16, 21 and 39 (the financial instrument specific articles). There was a strong consensus amongst practitioners that there are some well-established techniques used by Member States and their partners to demonstrate the full pass on of benefit.

In particular, a number of measures taken during the selection process and implemented through the funding agreement signed with the financial intermediaries, are commonly adopted. These include:

- The use of market benchmarking and/or the financial intermediary's historic pricing data to demonstrate the reduction in margin is 'real';
- Inclusion in the competitive selection process the evaluation of the bidder's proposed reduction in loan pricing and/or other advantages resulting from the benefit conferred by the ESIF/national resources;
- A requirement in the selection process for transparency of the bidder's pricing methodology to enable evaluation;
- The contractualisation of the full pass-on of benefits, including the application of the transparent pricing methodology and for the use of any interest earned on ESIF resources held on deposit by the financial intermediary for the purposes of the financial instrument; and
- On-going monitoring of compliance of the contractual commitments by the managing authority or other implementing body.

The application of these principles can be seen in all types of ESIF financial instruments including both SME and Energy Efficiency operations. Further, both risk sharing loan and guarantee financial instruments can adopt similar approaches to transparency of pricing.

In the case of risk sharing loans the calculation of price is usually achieved through 'blending' the lower cost ESIF and public resources with the financial intermediary's contribution calculated in accordance with its usual methodology. The approach for guarantee instruments is more sophisticated: if the guarantee is provided for free to the financial intermediary, this advantage needs to be reflected in the terms of the underlying portfolio loans to SMEs. Normally, financial intermediaries will propose a range of reductions in margin and/or reduced collateral requirements, retaining a degree of flexibility to reflect the potential different risks associated with the underlying loans in the portfolio.

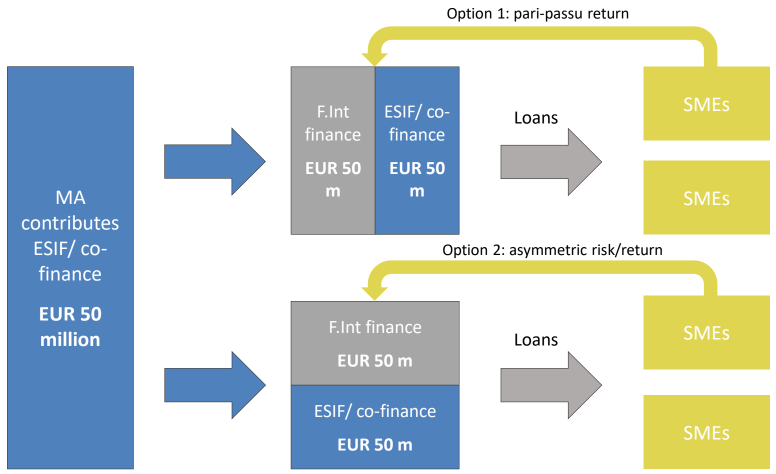
5. SME financial instruments and State aid

The discussion regarding the SME financial instrument was based on the indicative case study shown at Figure 3. The workshop considered two options for a financial instrument to support SMEs: (1) a straightforward risk sharing loan, where the risks and returns are shared pari passu between the ESIF and financial intermediary's own resources; and (2) an asymmetric risk and return sharing financial instrument where the financial intermediary benefits from a preferential risk/return position.

It was acknowledged that in designing a financial instrument with an asymmetric risk/return, it is prudent for managing authorities or fund of funds managers to ensure that the financial intermediary remains incentivised to manage investments, throughout the life of the financial instrument. The development of a mechanism for apportioning repayments and/or losses from final recipients to ensure financial intermediaries retain some risk throughout the term of the underlying loans was identified as an important consideration.

The workshop considered how to ensure State aid compliance at the level of the financial intermediaries for the two models. The importance of the *de minimis* rules for pari passu ESIF financial instruments to support SMEs (Option 1) was emphasised. This confirmed the findings of the *fi-compass* State aid survey which found *de minimis* to be the most common basis for ESIF financial instruments due to its simplicity and ease of implementation.

Figure 3: Structure of a funded risk sharing instrument



The need to demonstrate the pass on of benefit (as outlined at Section 4 above) was discussed for the pari passu type fund in Option 1, which would typically rely on *de minimis* to demonstrate State aid compliance at the level of the final recipient.

On the other hand, for an asymmetric risk sharing financial instrument, the financial intermediaries and/or private investors will benefit from preferential risk-reward sharing, i.e. economic advantages that qualify as State aid that might not be passed on fully to final recipients. Unless it is possible to apply a quantification methodology approved by the EC, this aid is so-called non-transparent aid, as it is not possible to quantify exactly the gross grant equivalent (GGE) of the economic advantages.

In such cases the Risk finance aid model under Art 21 GBER, may be relied on to demonstrate the compatibility of any possible aid to the financial intermediary. The options under Art 21 GBER include as follows:

Financing amounts below the de minimis threshold under Art 21(18) GBER

Where the financial instrument provides financing to SMEs below the *de minimis* threshold (while containing aid to the financial intermediary/investors), it can be block-exempted under the simplified conditions laid down in Art 21(18) of the GBER under which any SMEs are eligible. However, Article 21(18)(c) requires that minimum 60% private investment.

It was, however, noted during the workshop that the 60% co-financing threshold for application of Art 21(18) (which also applies under Art 21(10)) is not achievable in some territories. It is often the case that private sector institutions would prefer to take on a lower co-financing rate (30%) without the benefit of asymmetric risk/return rather than committing to 60% co-financing.

Financing amounts above the de minimis threshold

Where the instrument provides financing above the *de minimis* threshold it has to comply with all the conditions laid down in Art 21 of the GBER. The main requirements are as follows:

- Objective of the financial instrument – it has to support only undertakings that are qualified as SMEs meeting the eligibility conditions of Art 21(5) GBER (e.g. they have been operating in any market for less than 7 years following their first commercial sale) at the time of the first risk finance investment;
- Access to finance gap – the maximum financing amounts (nominal amount of the investment) shall not exceed the maximum thresholds laid down in Art 21(9) GBER;
- Minimum private leverage – the financial instrument has to leverage private capital in line with the minimum thresholds laid down in Art 21(10) GBER;
- Financial design of the instrument – meets the minimum requirements laid down in Art 21(13) GBER;
- Requirements for financial intermediaries – financial intermediaries have to comply with the requirements laid down in Art 21(14-15) GBER;
- Competitive selection of financial intermediaries – investors -risk-reward and pricing sharing determined through a competitive process as laid down in Art 21(13) GBER; and
- The financial intermediaries should ensure that all the advantages are passed on to the largest extent possible to the final beneficiaries as laid down in Art 21(16(a)).

These factors must be taken into account in the design and implementation of the financial instrument. The implications for the selection of financial intermediaries is considered further below.

Risk-reward and pricing sharing determined through the competitive selection of the investors

For the asymmetric loan fund (Option 2), one of the compatibility criteria under Article 21(13)(b) GBER is that investors shall be selected via an open, transparent and non-discriminatory call, and the risk-reward sharing arrangement is also established via this call.

In the *fi-compass* Knowledge Hub, the following options were identified as to determining the appropriate level of risk-reward sharing via the open and transparent selection process:

- Bidders should be required in their offers in the selection procedure to state what level of first loss protection they would require, if any, up to the maximum cap of 25% as allowed by Article 21(13)(c) GBER; and
- At the same time, based on that protection, bidders should be asked to describe the return on their co-financing they would require.

Article 21(13)(c) GBER requires that the selection procedure gives preference to asymmetric profit sharing compared to downside protection. In the case of the indicative case study, both measures (i.e. 0% return and maximum 25% downside protection) may be necessary. Therefore, to ensure compliance with Art 21(13)(b) GBER, the managing authority's requirements could leave open the appropriate combination of the two measures, allowing bidders to submit, under competitive conditions, their own proposals.

With respect to the pricing of the loans to the final recipients, it is anticipated that the bidders would not propose a single rate for their investment but would assess and price each individual loan based on the risks associated with the particular undertaking, and in line with industry practice. Therefore, the bid could describe, as part of the business plan, the bidder's target return on capital and, in the context of its market analysis, the necessary asymmetric return on the ESIF contribution. The selection documentation would include guidance to ensure bids were submitted on a consistent basis.

The workshop identified a number of further points of interest relating to SME financial instruments and State aid, including:

The use of the Reference Rate Communication (RRC).

Examples were given where the reference rate is significantly different to the actual market rate in a given territory/sector. In such circumstances, it might be preferable to use the actual market rate (such as the intermediary's historical/standard market rate for example) instead of the RRC proxy rates.

It was noted the recommended margins under the RRC are to be applied 'in principle'. Therefore, in certain circumstances it would be possible for other margins to be used. If this approach was taken it would need to be applied consistently across the financial instrument: a 'cherry picking' approach would not be acceptable, i.e. that within one instrument, one loan could be priced according to the RRC, and another according to the financial intermediary's standard rate. It should be considered further how this may be applied in practice.

Modifications to the terms of a loan

Participants discussed during the workshop how assessing and recording the implications for State aid of ex post modifications to the terms of a loan can cause difficulties in practice. Where a business receives an initial loan and then experiences some unexpected difficulties it may be necessary for the financial intermediary (on sound business grounds) to provide a further advance, adjust the repayment profile, extend the term or make other changes to the terms of the loan.

It was noted that the State aid implications will be accounted for when the contract is initially signed. Further State aid will only arise if a modification of the terms of a loan results in further material financial support that constitutes State aid being given to the company, at which point the additional aid would need to be identified, quantified and accounted for appropriately as additional aid.

Recording de minimis aid

The workshop discussed the complexity of maintaining an accurate national register of *de minimis* aid. In particular the challenges created by the need to include all group companies within a single undertaking was highlighted as a difficulty and challenging.

Notification

The time taken to notify measures was identified as a potential barrier for Member States using this approach. The 'cycle of implementation' which inevitably follows the seven year ESIF programming period can create a time pressure that disincentivises managing authorities developing financial instruments that would require notification.

It may be worth considering whether measures could be introduced that would give greater confidence of a positive outcome. The role of the Risk Finance Guidelines provides a clear framework for notification of measures and it may be worth considering further whether such guidance is also useful and could be replicated for other sectors.

6. Next steps

During the event DG COMP presented the several activities it was undertaking to provide further support and guidance for practitioners in ESIF financial instruments including:

- drafting additional rules for financial instruments under InvestEU;
- preparing a complement to the REGIO Staff Working Document[6] that will update the Guidance to reflect Omnibus changes and will include two new annexes with examples; and
- undertaking a fitness check of the existing rules through a series of consultation exercises.

An update on progress was provided during FI Campus 2019 by DG COMP[7].

Since the workshop, a timeline[8] for the various activities has been published by the European Commission.

[6] EC Regulatory Guidance (Guidance on State aid in European Structural and Investment (ESI) Funds financial instruments in the 2014-2020 programming period)

[7] *fi-compass* presentation – FI Campus 2019

[8] https://ec.europa.eu/competition/state_aid/legislation/timeline_table_SA_final.pdf

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