FINE

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EPRC POLICY BRIEFING

FINANCIAL INSTRUMENTS AND THE STATE AID RULES 2014-20: MORE FLEXIBILITY *AND* COMPLEXITY?

- **EU level and off-the-shelf instruments offer new options for State aid compliance**
- **Existing options for State aid compliance are enlarged under draft GBER and RFIG**
- **Draft GBER proposes: higher investment ceiling - €15m, instead of annual €1.5m tranches; minimum private participation linked to risk level of investment not location; more stages of SME investment eligible, including follow-on; aid for alternative trading platforms and 'scouting'; aid for JESSICA-type projects in assisted areas**
- **New RFIG adopted: allows for possible aid to small midcaps (up to 499 employees) and innovative midcaps (up to 1500 employees); and other risk finance measures falling outside GBER, with compatibility based on common assessment criteria**
- **Commission and EIB seek to clarify State aid compliance of EIB involvement in financial instruments**

2014 heralds the start of a new era in both EU Cohesion policy planning and the State aid rules. Financial instruments are set to play a growing role in European Structural and Investment Funds (ESIF), though they proved to be one of the most challenging aspects of implementing policy in 2007-13, with State aid compliance a major factor. Although some key elements of policy are now settled for 2014-20 – notably the Common Provisions Regulation and the Risk Finance Investment Guidelines (RFIG) – others are out to consultation and/or remain in draft form.

The aim of this paper is to set out the current state of play in the relationship between financial instruments and State aid compliance. The paper is structured as follows: it begins by outlining the current context for change in State regulation; second, there is brief overview of 'State aid proof' instruments under ESIF, covering both EU-level and so-called 'off-the-shelf' instruments; third, the new State aid context for policymakers 'going it alone' on financial instruments is reviewed. As now, this comprises three main options: to design 'no aid' instruments; to comply with the GBER; and to

notify. Each of these options is considered in turn, focusing on the scope of the draft GBER and outlining the new possibilities provided for by the RFIG.

1. CONTEXT

In the 2007-13 Cohesion policy period, the relationship between financial instruments (FI) and the State aid rules was among the most troublesome aspects of implementing FI.[1] Several factors explain this. First, some key aspects of the State aid rules lack clarity – not least the definition of what a State aid actually *is* – and the rules are perceived to be complex to apply in practice. Second, although the Treaty ban on State aid is tempered by a number of derogations, these tend to be cast in terms of *policy* objectives (e.g. R&D&I, SME) rather than the *form* of intervention, so several different texts may need to be considered in designing FI measures; this has typically been more complex in the case of JESSICA, because of the absence of any specific State aid urban development framework. Third, the State aid rules have seemed relatively ill-equipped to deal with the emphasis on FI under Cohesion policy, and domestic policymakers have often criticised the working relationship between DG REGIO, DG COMP and the EIB.

The 2014-20 European Structural and Investment Funds (ESIF) period is set to see a substantial reinforcement of the use of FI across a wider range of policy interventions. In parallel, State aid control is undergoing significant changes, some with direct implications for the deployment of FI in the new funding period. These flow from the European Commission's State Aid Modernisation initiative (SAM),[2] adopted in 2012, which launched a review of almost all existing State aid rules. SAM seeks to re-focus State aid control against the backdrop of Europe 2020, but it also regards State aid control as 'crucial in order to improve the efficiency and effectiveness of public spending'. Added to the mix, the economic crisis and its aftermath continue to affect the availability of finance, especially for SMEs. Against the background of this changing policy and regulatory context, a number of developments will affect the interface between the operation of FI and State aid compliance.

At a general level, State aid issues are among the *ex ante* conditionalities listed in the Common Provisions Regulation (CPR) which forms the basis for the operation of ESIF for 2014-20.[3] Of course, compatibility with the State aid rules has always been a requirement under the Structural Funds Regulations, but the *ex ante* conditionalities extend the criteria beyond compliance to include arrangements for training and dissemination of information and ensuring adequate administrative capacity for applying the rules. This is an important component of the Commission's so-called 'trust and verify' approach to State aid compliance, which is reflected in the General Block Exemption

[1] Michie, R and Wishlade, F (2011) *Between Scylla and Charybdis: Navigating Financial Engineering Instruments through Structural Funds and State Aid Requirements,* IQ-Net Paper No. 29(2), Aachen, Germany, 7-9 December: http://www.eprc.strath.ac.uk/iqnet/downloads/IQ-Net_Reports(Public)/ThematicPaper29(2)Final.pdf

[2] State aid modernisation, COM(2012) 0209 final, see: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0209:FIN:EN:PDF

[3] Article 19 and Annex XI of Regulation 1303/2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006, OJ L347/320 of 20 December 2013: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:347:0320:0469:EN:PDF, which are complemented by European Commission (2013) Draft guidance on *Ex ante* Conditionalities, Part II, 20 August 2013: http://ec.europa.eu/regional_policy/what/future/pdf/preparation/20092013_guidance_part_2.pdf

Regulation (GBER)[4] discussed below. The key principle here is that domestic authorities are exempt from notifying defined measures for prior Commission approval, but subject to a number of conditions.

More specifically, the CPR provides for possible new structures for the implementation of FI in Cohesion policy which, among other things, aim to simplify or eliminate State aid compliance issues for Managing Authorities. At the same time, changes to the State aid rules concerning *de minimis* aid, the GBER and new rules on risk investment finance reshape the potential for using FI, especially in the context of SMEs but also for a new size category of firm in the State aid context, so-called midcaps.

2. STATE AID 'PROOFING'? EU LEVEL INSTRUMENTS AND 'OFF-THE-SHELF' FINANCIAL INSTRUMENTS

The CPR provides for two new structures through which Managing Authorities can implement FI. First, contributions can be made to EU-level instruments which are managed directly or indirectly by the Commission.;[5] Second, while remaining under the responsibility of the Managing Authority, FI can use pre-determined terms and conditions that, among other things, ensure State aid compliance – these have become known as 'off-the-shelf' instruments.[6]

Under the provisions for ***EU-level instruments***, funds can be channelled to initiatives such as Horizon 2020 (equity and risk-sharing instruments), COSME (equity and guarantees), and the Connecting European Facility (e.g. project bonds). This relieves the Managing Authority of much of the administration associated with design, tendering, reporting and compliance issues, including ensuring State aid compatibility.

Off-the-shelf instruments are designed to deal with a range of compliance issues. In the context of State aids, this involves structuring FI such that their terms and conditions either do not involve State aid at all, or do not require State aid notification and subsequent clearance from the European Commission.

Under the draft terms and conditions,[7] five measures are envisaged:

- **Risk-sharing loan:** loans with subsidised interest rates for SMEs. Falls within the *de minimis*[8] ceilings for beneficiaries; no aid for financial intermediaries provided certain conditions are met (including market rate remuneration, *pari passu* risk sharing).

[4] The current GBER is Commission Regulation 800/2008, OJEU L214/3: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:214:0003:0047:EN:PDF, which has been extended to 30 June 2014. A draft GBER is currently out to public consultation (which closes on 12 February 2014): http://ec.europa.eu/competition/consultations/2013_consolidated_gber/gber_regulation_en.pdf

[5] Article 38(1)(a), CPR.

[6] Article 38(3)(a), CPR.

[7] These are currently in draft form and were presumably awaiting the adoption of the CPR and perhaps also the finalisation of the General Block Exemption Regulation. The current (July 2013) draft is here: http://ec.europa.eu/regional_policy/what/future/pdf/preparation/3_draft_standard_terms_conditions_financial_instruments_17072013.pdf

[8] Regulation 1407/2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid, OJ L352/1 of 24 December 2012: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:352:0001:0008:EN:PDF

- **Capped portfolio guarantee for SMEs:** credit-risk protection up to a maximum loss amount. Falls within the *de minimis* ceilings for beneficiaries; no aid for financial intermediaries, provided certain conditions are met (including minimum level of risk retained by intermediary and either the Guarantee Notice[9] is respected or any benefits are passed to the beneficiary).
- **Equity investment fund for SMEs:** co-investment equity fund involving State aid but compliant with the 2008-13 GBER[10] and therefore not subject to notification.
- **Renovation loan:** loans for energy efficiency and renewables in the residential sector. Designed to be aid-free either on the basis of the *de minimis* Regulation, or the *de minimis* threshold for providers of Services of General Economic Interest (SGEI)[11] or as compatible aid in the form of public service compensation for SGEI in the context of social housing.[12]
- **Loan for sustainable urban development:** an off-the-shelf measure for urban development funds is also under preparation, but details are not currently available. It seems probable that this would take advantage of the exemption for regional urban development aid proposed in the draft GBER.[13]

It remains to be seen whether these new initiatives to reduce the administrative burden of operating FI are attractive to domestic policymakers. There may, for example, be concerns at the lack of flexibility and control for Managing Authorities in the EU-level instruments and questions over the added-value of simply channelling funds 'back up' to the EU level, through the complexities of EU financial circuitry. Moreover, the off-the-shelf templates would have been more valuable in 2007-13 – many Managing Authorities spent a large part of the last funding period gaining the experience and establishing the structures needed to operate financial instruments and have now mechanisms in place, many of which are likely to be capable of being rolled forward.

3. 'GOING IT ALONE' ON STATE AID COMPLIANCE

Managing Authorities also have the option of designing their own FI from scratch or using existing instruments independently of EU-level instruments or templates, as is the case under domestic policy. As now, there are three principal options regarding State aid compliance:

- to design measures so that no aid is involved;
- to design measures that fit within the parameters of the GBER so that measures can be implemented without prior Commission approval;
- to notify measures to the Commission and await approval prior to implementation.

[9] Commission notice on the application of Article 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJEU No C155/10 of 20 June 2008: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:155:0010:0022:en:PDF

[10] As noted above, the 2008-13 GBER has been extended to 30 June 2014 and a replacement text is currently out to consultation; this may ultimately enable offer more flexible / generous terms to be offered.

[11] Regulation 360/2012 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid granted to undertakings providing services of general economic interest SGEI, OJ L114/8 of 26 April 2012: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:114:0008:0013:EN:PDF

[12] Commission Decision on the application of Article 106(2) of the Treaty on the Functioning of the European Union to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, OJ L7/3 of 11 January 2012: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:007:0003:0010:EN:PDF

[13] Article 16, Draft GBER.

Each of these has either been subject to change in recent weeks, or will be in the months to come.

3.1 The 'no aid' route

An ongoing issue in State aid compliance is that the notion of State aid is not precisely defined in Article 107(1) TFEU and indeed continues to evolve. This can render the task of ensuring that a transaction does not involve aid rather complex. Nevertheless, Commission decisions and case law provide the main contours of what constitutes a State aid, and this has recently been complemented by a proposed Notice on the notion of State aid, which is currently the subject of public consultation.[14]

A major complication in assessing the State aid compliance of some FI is that aid may exist at one or more different levels – for example, in relation to the ultimate beneficiary (e.g. the firm in receipt of a loan), holding fund managers who are remunerated for investment management services and investors or lenders where loans are guaranteed or where the private and public contributions are asymmetric. In relation to *intermediaries*, aid can be excluded by ensuring that transactions take place on market terms – for instance, the public and private sector investing on a *pari passu* basis or the appointment of fund managers following an open and transparent tender procedure. In relation to ultimate *beneficiaries*, the main options under the 'no aid' route are also to ensure that transactions take place on market terms and there is accordingly no 'advantage' beyond that which the market would deliver (so that there is no aid) - or to ensure the intervention remains below *de minimis* levels (so that support falls outside the scope of Article 107(1)).

The *de minimis* Regulation adopted in December 2013[15] does not significantly change the scope of the existing provision – the general ceiling of €200,000 over three years, to a single undertaking remains in place. This is in effect a grant-equivalent amount, which also applies to public support in the form of equity. Also as now, guarantees are considered *de minimis* if they do not exceed 80 percent of loans of up to €1.5 million. A new provision is that loans are considered *de minimis* (even if their gross grant equivalent calculated on the basis of the reference interest rates exceeds the €200,000 threshold) if they are at least 50 percent secured by collateral and the loan is no more than €1m over five years or €500,000 over ten years.

3.1.1 Guarantees

The Commission has set out various criteria[16] which enable both individual guarantees and guarantee schemes *not* to involve State aid; in both cases a slightly simplified approach applies to SMEs. In the case of guarantee *schemes*, the key criteria are that:

- borrowers should not be in difficulty;
- the guarantee should be linked to a specific transaction, for a maximum amount and limited in time; it should generally not cover more than 80 percent of the loan;

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[14] See: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html. The consultation closes on 14 March 2014.

[15] Regulation 1407/2013, OJ L352/1 of 24 December 2013: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:352:0001:0008:EN:PDF

[16] Notice on State aid in the form of guarantees, OJEU C155/10 of 20 June 2008: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:155:0010:0022:EN:PDF, as corrected: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:244:0032:0032:EN:PDF

- premia should be such as to make the scheme self-financing, including normal risk, administrative costs and yearly remuneration of an adequate capital; premia should be reviewed annually;

- the eligibility criteria and terms for guarantees should be transparent for applicants;

- for SMEs, there is scope for either 'safe-harbour' premia or the use of a single yearly guarantee premium for all SMEs for amounts up to €2.5m.

3.1.2 Loans

Loans which are offered at market rates and terms do not involve State aid; whether market rates are offered is determined by the so-called 'reference rate'. The reference rate is based on the one-year inter-bank offered rate (IBOR) increased by margins ranging from 60 to 1000 basis points (i.e. 0.6 percentage points to 10 percentage points), depending on the creditworthiness of the company and the level of collateral offered. This approach is in line with the revised international capital framework introduced under the Basel II Accords. The base rates are published online[17] and the margins to be added are set out in a Commission communication.[18]

3.1.3 Risk capital

The situation for risk capital is more complex since, as confirmed in the new Risk Finance Investment Guidelines (RFIG) adopted on 15 January 2014,[19] aid may be present at one or more levels – notably: investors, investment fund/vehicle and/or its managers, as well as in the firm in which the investment is made.

At the level of the *investor*, there is no State aid if the investment is effected on a *pari passu* basis between public and private investors. This means that both categories of investor must intervene simultaneously, on the same terms and conditions and the private investment must be 'significant'.[20] In this context, 30 percent independent private investment is considered 'significant' under the new RFIG; this is more flexible than the current SARC Guidelines (which RFIG replace from 1 July 2014), where 'normally' at least 50 percent of the funding has to come from private investors in order to fulfil the *pari passu* criterion.[21]

The Commission normally considers that an *investment fund* or vehicle is an intermediary vehicle for the transfers of funds to a firm, rather than a beneficiary of aid itself, unless the fund is managed by an entrusted entity which is co-investing, in which case aid may be present. As far as *fund managers* are concerned, there is a presumption of no aid if the management company is chosen through an open and transparent public tender procedure and if it does not receive any other advantages. Where the financial intermediary and its manager are public entities and there is no such tendering process,

[17] See: http://ec.europa.eu/competition/state_aid/legislation/reference_rates.html
[18] Communication on the method for setting the reference and discount rates, OJEU C14/6 of 19 January 2008.: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:014:0006:0009:EN:PDF
[19] Guidelines on State aid to promote risk finance investments (RFIG), OJEU C19/4 of 21 January 2014: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2014:019:0004:0034:EN:PDF
[20] Para 34, RFIG.
[21] Para 3.2, Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (SARC), OJ C194/2 of 18 August 2006: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:194:0002:0021:EN:PDF

they will not be considered recipients of aid if the management fee is capped and the remuneration reflects market conditions and is linked to performance.[22]

Regarding *target firms,* if intervention is made on terms that would be acceptable to a private investor in a market economy, then no State aid is involved. Alternatively, if the measure provides public capital only up to the *de minimis* threshold (€200,000), then this falls outside the scope of Article 107(1).

Summary of main 'no aid' criteria for financial instruments

De minimis	▪ transparent support ▪ <€200,000 cash grant equivalent over 3 years ▪ 80% guarantees relating to loans <€1.5 million ▪ loans (at least 50% collateral secured) <€1m over 5 years or < €500,000 over 10 years
Guarantees	▪ maximum 80% of loan ▪ premia cover normal risks, costs and adequate capital ▪ premia within safe harbour limit *or* single SME premium rate for guaranteed amounts up to €2.5m
Loans	▪ interest at or over reference rates
Equity / risk capital	▪ *investors:* public sector invests on *pari passu* basis ▪ *funds/fund managers:* no specific transfers or benefits; manager selected by open tender ▪ *target firm:* investment on 'market economy investor principle' or public capital <€200,000

Note: There may also be scope for 'no aid' financial instruments under the provisions on State aid and services of general economic interest (SGEI), on the basis of the SGEI *de minimis* regulation (see: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:114:0008:0013:EN:PDF)

3.2 GBER compliant aid – draft GBER proposals

Under the GBER, provided that a given measure meets the conditions set out in the Regulation, there is a *presumption* that the measure is compatible with the Treaty. The main purpose of the block exemption approach is to obviate the need for prior notification and approval of so-called 'good' aid – in recent years the Commission has facilitated the use of certain types of aid which it considers beneficial and in line with wider agendas such as Lisbon, Gothenburg or Europe 2020 (e.g. support for SMEs or R&D), while subjecting other forms of support (e.g. rescue and restructuring or investment aid to large firms – 'bad' aid) to increased scrutiny.

The reform of the GBER for 2014-20 has been the subject of successive rounds of consultation. The final round is due to end in February 2014, with a view to the new GBER being adopted by the Commission in spring 2014 and entering into force on 1 July 2014. The draft GBER widens the range of measures exempt from notification, but imposes new or additional conditions relating to evaluation, incentive effect, reporting and transparency, among other things.

In the context of financial instruments, there is both stability and change. On the one hand, for loans and guarantees to support investment projects, State aid compatibility issues remain broadly as now. On the other hand, there are significant changes in respect of so-called 'risk finance' measures which both relax and extend the block exemption in relation to FI, as well as introducing new provisions on aid for start-ups, alternative trading platforms specialised in SMEs and aid for scouting costs. In addition, specific provision is made for urban development aid.

[22] Para 37-42, RFIG.

For ***investment-related aid***, the grant-equivalent ceilings for guarantees and loans vary by firm size, type of expenditure (general investment, RD&I etc.) and in some cases according to whether the beneficiary is located in an assisted area. For SMEs, the absolute grant equivalent ceiling for investment aid under the draft GBER remains unchanged at €7.5 million per investment per project; for R&D, it is proposed to double the ceilings.[23] For projects located in assisted areas, higher rates of award apply than in the non-assisted areas, but the aid ceilings will, in general, be lower from 1 July 2014 than in 2007-13; however, the precise scope of the assisted areas will not be known until the new maps have been approved by the Commission on the basis of the 2014-20 Regional Aid Guidelines.[24]

As now, ***loans*** related to investment can be rendered GBER compliant by ensuring that the interest rates payable respect the grant-equivalent thresholds, taking account of the relevant reference rate, as described earlier. Similarly, schemes which comprise a ***guarantee*** element may be considered transparent if the Commission has accepted the methodology used to calculate the intensity of the guarantee. A number of countries have notified methodologies for calculating the grant-equivalent of measures.[25] These methodologies have been endorsed by the Commission, which effectively renders aid calculated according to these methods transparent.[26] This enables the Member State concerned to report schemes under the GBER that use the methodology to calculate aid values and increases the scope of the GBER to include measures that would otherwise lack the transparency for exemption.

3.2.1 Draft GBER proposals on access to finance for SMEs

The main FI-related changes proposed under the draft GBER relate to what is now termed 'risk finance aid', a broader concept than that of risk capital measures provided for in the current GBER. In addition, there are specific provisions for aid for start-ups, for alternative trading platforms specialised in SMEs and for scouting costs.

The *current* GBER exempts risk capital measures in the form of participation in a private equity investment fund which, among other things, meet the following criteria: [27]

- the tranches of investment made by the fund in any target SME should not exceed €1.5 million in any 12-month period;
- at least 70 percent of the fund should be invested in SMEs in the form of equity or quasi-equity;

[23] Article 4, Draft GBER.
[24] Guidelines on regional State aid for 2014-20 OJ C209/1 of 23 July 2013: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:209:0001:0045:EN:PDF
[25] For example, Commission Decision N 677b/2007 – *France: Méthode de calcul de l'équivalent subvention brut (ESB) pour les aides sous forme de garantie publique de prêts bancaires pour le financement d'investissements des entreprises*, 29 April 2009; Commission Decision N 197/2007 – *Germany: Method to calculate the aid element in guarantees*, 25 September 2007; Commission Decision N 185/2008 – *Austria: Methodology of AWS GmbH to calculate the aid element of guarantees*, 24 March 2009; Commission Decision no. SA.33022 (2011/N) – *Denmark: Calculation methodology for the State aid element in guarantees*, 4 August 2011; Commission Decision N 201/a/2007 – *Hungary: Method to calculate the aid element in guarantees (to be applied by Hitelgarancia Zrt.),* 12 November 2008; Commission Decision N 182/10 – *Italy: National method to calculate the aid element in guarantees for SMEs*, undated decision.
[26] Article 5(1), GBER.
[27] Article 29, GBER.

- for SMEs in assisted areas (‘a’ regions and ‘c’ areas) and small firms in any region, risk capital is available for seed capital, start-up and/or expansion capital; for medium-firms in non-assisted areas expansion capital is excluded from the scope of the GBER;
- at least 50 percent of the financing of the fund is provided by private investors - except where the fund exclusively targets SMEs in assisted areas, in which case the threshold is 30 percent.

In passing, it is worth noting that, in many circumstances, it may be questionable whether there is any aid at all involved in measures that comply with Article 29 of the GBER. For example, where the public and private sectors invest on a 50/50 basis, investments are profit-driven and fund manager remuneration is performance-related, it is difficult to see how either the investor, the fund manager or the target SME would be ‘favoured’ in the sense of Article 107(1) TFEU.

(i) Risk finance aid

The *draft* GBER proposes significant increases in the scope of risk finance aid measures falling with the scope of the exemption and refers to FI more generally, rather than just in terms of risk capital. Moreover, the text refers explicitly to “risk finance aid to independent private investors”,[28] which can include public and private intermediaries. Aid can take the form of equity, quasi-equity, financial endowments, or loans to finance investments directly or indirectly in eligible firms or guarantees to cover the losses from such investments. In addition, for natural persons (i.e. *not* undertakings) aid may also take the form of tax incentives. By contrast, the current GBER refers simply to ‘participation into a profit driven private equity investment fund.’

Although the new text has yet to be adopted, it is clear that the future block exemption will cover a larger part of the life cycle of new firms and a wider range or firms, irrespective of their location, higher levels of risk finance and include the potential for follow-on investment. More specifically, the draft GBER proposes the following:

- the €1.5 million annual tranche approach is replaced by a ceiling of €15 million per eligible firm under any risk finance measure;[29]
- the minimum equity requirement of 70 percent is removed, facilitating the use of a wider range of instruments, including equity, quasi-equity, loans, guarantees or a mix thereof;
- there is no discrimination between assisted and non-assisted areas, nor in relation to firm size in relation to the stage for which risk finance is available; there is scope for follow-on investment;[30]
- the minimum private capital participation rate of 50 percent in non-assisted areas and 30 percent in assisted areas is abolished in favour of linking the minimum private participation to the risk level of the investment.[31] The levels proposed are:
    - 10 percent of the risk finance provided to firms prior to their first commercial sale on any market;
    - 40 percent in relation to firms operating on the market for less than seven years following their first commercial sale; and

[28] Article 20(2), Draft GBER.
[29] Article 20(9), Draft GBER.
[30] Article 20(6), Draft GBER.
[31] Article 20(10), Draft GBER.

- 60 percent in the case of follow-on investment.

The Draft GBER, like the current GBER, requires measures to be profit-driven,[32] but it also emphasises that financial intermediaries should undertake investments that would not have been carried out at all or in the same way without the aid,[33] and should be able to demonstrate that they operate mechanisms to ensure that all the advantages are passed on to the greatest extent to the final beneficiaries through higher volumes of financing, riskier portfolios, or lower collateral, guarantee premia or interest rates.

(ii) Aid for start-ups

The Draft GBER introduces new provisions on aid to start-ups[34] (up to five years from registration) in the form of soft loans, guarantees that do not conform to market conditions. The proposed amounts are:

- loans of up to €1 million (€1.5 million in 'c' areas and €2 million in 'a' regions) of up to 10 years duration;
- guarantees covering up to 80 percent of loan amounts of up to €1.5 million (€2.25 million in 'c' areas and €3 million in 'a' regions);
- other sources of support – including equity, quasi-equity, interest rate and guarantee premium reductions of up to €0.4 million gross grant equivalent (€0.6 million in 'c' areas and €0.8 million in 'a' regions);
- doubled maxima for small *and* innovative enterprises.

This provision would effectively replace and consolidate the existing exemptions for aid to newly-created enterprises in the assisted areas,[35] those established by female entrepreneurs,[36] and young innovative entreprises,[37] although in all of these cases aid could take the form of grants rather than involving only repayable instruments, as is proposed under the Draft GBER.

(iii) Aid to alternative trading platforms

The Draft GBER also proposes to exempt measures aimed at the development of alternative trading platforms specialised in SMEs.[38] Where the proposed operator is a small enterprise, it may be eligible for the measures for start-ups just described. Eligible costs are not specified, which implies that these would be determined primarily with reference to block-exempted SME or regional investment aid schemes.

[32] Article 29(2), GBER and Article 20(14) Draft GBER,
[33] Article 20(16), Draft GBER,
[34] Article 21, Draft GBER.
[35] Article 14, GBER.
[36] Article 16, GBER.
[37] Article 35, GBER.
[38] Article 22, Draft GBER.

(iv) Aid for scouting costs

Aid to cover up to 50 percent of so-called ‘scouting’ costs is also proposed.[39] This can take the form of a grant and would contribute towards initial screening and formal due diligence undertaken by managers of financial intermediaries or investors to identify eligible undertakings for the purposes of risk finance investment.

3.2.2 Draft GBER proposals on regional urban development aid

The Draft GBER proposes to add regional urban development aid as an exemption category;[40] this proposal is new to the text - it was not in the document on which the Commission consulted in May 2013. However, the exemption is only available in respect of projects that fulfil all three of the following criteria:

- implemented through urban development funds *in assisted areas;*
- co-financed by the EU Structural and Investment Funds;
- support the implementation of an integrated approach to sustainable urban development.

In addition, it is proposed to cap the total investment into an urban development project at €20 million. An important point to note here is that the exemption applies only to urban development projects that are located in assisted areas. This refers to the ‘a’ and ‘c’ area maps that are currently under preparation in the Member States following the adoption of the 2014-20 Regional Aid Guidelines (RAG) mentioned earlier. Two key points flow from this: first, in many countries there is not necessarily an overlap between the areas targeted for regional policy and those targeted for urban development; second, for those urban development that *do* fall within assisted areas, there is an important distinction between ‘a’ regions and ‘c’ areas, namely that under Draft GBER and RAG 2014-20, large firms are generally not eligible for investment aid in ‘c’ areas where they already have a presence in that NUTS 3 region.

As noted earlier, the Commission is currently preparing an off-the-shelf FI for urban development. However, it is unclear, whether, from a State aid perspective, this will be built around these GBER provisions.

More generally, the scope of this provision in the GBER is rather limited, partly owing to the spatial coverage restrictions limiting the exemption to the assisted areas (and associated impact on the eligibility of large firms) and partly due to the overall limit of €20 million currently proposed. As a result, it seems probable that most JESSICA-type measures in future will either have to be structured in order not to contain aid or will require notification (which is the case at present).

[39] Article 23, Draft GBER.
[40] Article 16, Draft GBER.

Summary of main 'Draft GBER compliant' criteria for financial instruments

Guarantees	• Approved valuation methodology • Gross grant equivalent does not exceed SME aid, regional aid, R&D aid ceilings as appropriate
Loans	• Interest rate reduction does not exceed gross grant-equivalent ceilings for SME aid, regional aid, R&D aid ceilings as appropriate
Risk finance aid	• Target firms: up to €15m (in equity, quasi equity, loans, guarantees…) per eligible SME; covers period from first commercial sale to follow-on investment • Private investment: 10%-60% of risk finance, depending on development stage of target firm • Fund/fund managers: selected by open call or assigned to an entrusted entity commercially-managed, profit-driven, but additionality and aid benefits demonstrably transferred to target firms.
Aid for start-ups (<5 yrs from registration)	• Loans up to €1-2m (depending on area) and 10 years duration • Guarantees up to 80% of loans of €1-3m (depending on area) • Equity, quasi-equity, interest rate reduction etc. up to €0.4-8m (depending on area) • For small *and* innovative firms, these maxima are doubled
Aid for alternative trading platforms	• Terms not specified – assumes promoters are SMEs?
Aid for scouting costs	• Grants of up to 50% of due diligence and initial screening costs
Regional urban development aid	Must fulfil *all* the following • Implemented via urban development funds located in 'a' regions or 'c' area • Co-financed by ESIF • Support integrated approach for sustainable urban development • Proposed maximum investment of €20m into a single project • Private sector contribution 30% • Similar conditions for investors and fund managers as for risk finance aid

3.3 Notifying financial instruments

The third option open to domestic policymakers is to notify the measures proposed and gain approval in advance of implementation. This may be necessary where it is uncertain whether a measure involves aid or when the GBER is not considered to offer sufficient scope to support a project in the way envisaged or at the level of intervention desired. The key benefit of notification is legal certainty; the main disadvantage tends to be the time taken for a decision.

Where a measure may constitute aid and does not fit within the GBER parameters, Member States are duty bound to gain authorisation from the Commission before the measure is implemented. A notified measure may fall to be assessed under one or more of a number of sets of guidelines or, it may be assessed directly against the Treaty provisions. In practice, most financial instruments notified to date have been assessed in relation to the SARC Guidelines, soon to be replaced by the RFIG. However, six Jessica measures have been assessed directly against the Treaty and one Jessica (Portugal) has been cast in terms of the GBER.

3.3.1 The Risk Finance Investment Guidelines (RFIG)

Looking forward, a major development is the adoption of the new Risk Finance Investment Guidelines in January 2014 and set to apply from 1 July 2014. Overall, the RFIG expand significantly on the scope for risk finance measures provided for in the SARC Guidelines. The RFIG need to be read alongside the GBER since they provide a framework for assessing measures that fall beyond the

Exemption Regulation. Given the residual scope of the RFIG the precise contours of those measures requiring notification will only be known once the GBER is adopted. Nevertheless, these are considered likely to fall into three main categories:

- Risk finance measures which target undertakings that do not fulfil all the eligibility requirements in the GBER, including:[41]
    - small mid-caps that exceed SME definition; broadly, small mid-caps are firms with fewer than 499 employees, and either annual turnover below €100 million or an annual balance sheet below €86 million;
    - innovative mid-caps carrying out R&D and innovation activities; these are essentially firms with up to 1,500 employees whose R&D and innovation costs are at least 15 percent of operating costs in one of the three years preceding investment under the risk finance measure, or more than ten percent of operating costs in each of the three years preceding the investment;
    - undertakings receiving initial risk finance investment more than seven years after their first commercial sale;
    - undertakings requiring overall risk finance investment exceeding the cap set in the GBER (€15 million is proposed);
    - alternative trading platforms not fulfilling the conditions in the GBER.

- Risk finance measures where the design parameters differ from those in the GBER, including:
    - private participation rates lower than provided for in the GBER;[42]
    - financial instruments other than guarantees where investors, fund managers or intermediaries are selected by giving preference to protection against potential losses;
    - fiscal incentives to corporate investors.

- Schemes which fall outside the GBER owing to their large budget.[43] The draft GBER proposes that schemes which involve annual State expenditure exceeding 0.01 percent of national GDP and annual State expenditure exceeding €100 million should be subject to notification and not fall within the exemption regulation.[44]

Schemes that fall outside the ambit of the GBER are assessed on the basis of criteria set out in the RFIG[45] which are framed in terms of the 'common principles' for the compatibility of State aid with the called for under SAM.[46] The approach in the RFIG is consistent with the 'balancing test' in other areas of State aid.[47] In considering a notified measure, the Commission essentially seeks to analyse whether the positive impact of the measure in addressing an objective of common interest outweighs its potential negative effects on trade and competition. In doing so, the Commission will consider a range of criteria. The application of these criteria will depend heavily on the provision of *ex ante*

[41] Para 47, RFIG.
[42] Para 48, RFIG.
[43] Para 49, RFIG.
[44] Article 1(2)(a), Draft GBER.
[45] Section 3, RFIG.
[46] European Commission (2012) EU State aid modernisation – SAM, COM(2012) 209 final, 8 May.
[47] See, for instance, Section 3, RAG 2014-20.

assessments by the Member States. All of the following criteria must be met for the measure to be considered compatible under the balancing test.

a) **Contribution to a well-defined objective of common interest:**[48] for risk finance aid, the general policy objective is to improve the provision of finance to viable SMEs, from early-stage development through to growth, and in certain circumstances, small mid-caps and innovative mid-caps. Notified measures must define the specific policy objectives in view these general objectives, based on the *ex ante* assessment, which must also identify the relevant performance indicators (e.g. private sector investment, expected number of beneficiaries, jobs created, anticipated yields, etc). The investment strategy of the financial intermediary must be in line with the policy objectives and there must be appropriate monitoring and reporting mechanisms in place.

b) **Need for state intervention:**[49] the proposed measure must be designed on the basis of an *ex ante* assessment demonstrating the existence of a funding gap. The nature of this assessment will vary according to the type of measure – for instance, the extension of measures to include mid-caps or funding for alternative trading platforms that go beyond the scope of the GBER. Where the measure is co-financed from the ESIF, the *ex ante* assessment required under the CPR[50] will be considered to meet the requirements of the RIFG, though the Commission reserves the right to question the validity of the data.

c) **Appropriateness:**[51] the proposed measure must be appropriate while being the least distortive to competition. This will include a consideration of whether the policy objectives can be met by other means – e.g. regulatory measures to improve the functioning of financial markets, investment-readiness schemes or public investment on market terms. The *ex ante* assessment must analyse existing and, where possible, envisaged national and EU measures targeting the same market failure, take into account the efficiency and effectiveness of other policy tools and must, among things, justify the specific form of FI proposed.

d) **Incentive effect:**[52] aid is only compatible if it alters the behaviour of the beneficiary. At the level of the final beneficiary, an incentive effect is present when the firms can raise finance that would otherwise not be available in the same form, amount or timescale. A risk finance measure is considered to have an incentive effect if it mobilises investment from market sources so that the total financing provided to eligible undertakings exceeds the budget of the measure. The assessment of the incentive effect is closely linked to the need for aid discussed above.

e) **Proportionality:**[53] In general, at the level of final beneficiaries, risk finance aid is considered proportionate if the total amount of syndicated funding (public and private) is limited to the size of the funding gap identified in the *ex ante* assessment. At the level of investors, aid must be limited to the minimum necessary to attract private capital in order to achieve the minimum leverage effect and bridge the funding gap. For financial instruments (as opposed to fiscal instruments of

[48] Para 57-62, RFIG.
[49] Para 63-88, RFIG.
[50] Article 37(2), CPR.
[51] Para 89-129, RFIG.
[52] Para 130-132, RFIG.
[53] Para 133-154, RFIG.

alternative trading platforms), the nature and value of the incentives to financial intermediaries must be determined through an open selection process among competing bids. Under the RFIG, if asymmetric risk-adjusted returns or loss-sharing is established in this way, then this is considered to reflect a fair rate of return (FRR) and the FI is considered proportionate. Where private investors are not selected through such a process, the FRR must be established by an independent expert.

f) **Avoidance of undue negative effects on competition and trade:**[54] the negative effects on trade and competition must be limited and outweighed by the contribution to the objective of common interest. For risk finance, this will be considered at three levels: the investors, the financial intermediaries and their managers and the final beneficiaries. Commission assessment will focus on a range of factors, including: issues of crowding-out in the risk finance market; the potential impact of aid measures on the market power of intermediaries; the viability of potential target investments (to avoid the situation in which risk finance amounts to a grant); the commercial management and profit orientation of investment decision-making; fund size, especially those with a limited regional focus, which are considered to have insufficient scope and to be less attractive to private investors; and the product market of the final beneficiaries, notably where the proposed measure has a sectoral orientation.

g) **Transparency:**[55] Member States must publish on a single website the text of notified measures, total Member State participation in the scheme, the identity of the entrusted entity and/or the names of selected financial intermediaries and specified information on beneficiaries.

A further innovation introduced in the new generation of State aid frameworks and present in the RFIG is the emphasis on evaluation. RFIG provides the possibility for the Commission to limit the duration of aid schemes and for an evaluation to be carried out.[56] The precise terms of any evaluation requirement would be defined in the approval decision on the aid measure. However, evaluations must by undertaken by experts independent from granting authorities and must be made public. The types of measure likely to be subject to evaluation include: large schemes; schemes with a regional or a narrow sectoral focus and schemes with novel characteristics.

3.3.2 Other options for notifiable aid?

The new RFIG outlined above coupled with the Draft GBER significantly alters the context for FI aimed at SMEs, small and innovative mid-caps, and potentially offers new opportunities for fiscal aid to investors and support for alternative trading platforms.

For the time being, however, there is no equivalent reform of the approach to aid under urban development or Jessica-type measures. Those which involve aid and fall outside the scope of the GBER would therefore fall to be assessed directly against the Treaty.

[54] Para 155-165, RFIG.
[55] Para 166, RFIG.
[56] Para 170-172, RFIG

4. FINAL REMARKS

As noted earlier, the Draft GBER is not expected to be finalised before spring 2014 and anyway will not enter into force until 1 July 2014, timed to coincide with application of the RFIG. Nevertheless, it is clear that with the RFIG coupled with the proposed GBER represent a significant overhaul of the existing rules on risk finance for SMEs and midcaps.

Other uncertainties remain, not least of which is the status of EIB measures in the context of the State aid rules. In this regard, a joint statement[57] between Commissioner Almunia and the President of the EIB was issued in January 2014. This purports to set out a number of principles, but in practice merely sets out areas where further clarification and cooperation is needed, as well as setting up a 'permanent working relationship'. The statement distinguishes between three situations.

- *Where the EIB employs own resources:* these do not constitute aid and are not considered to contribute towards the *de minimis* threshold. However, where Member States offer guarantees on EIB loans or there is co-financing, Member States are responsible for notifying any State aid element. The statement provides for revisions to the Memorandum of Understanding between the EIB Group and the Commission to reinforce exchange of information in connection with such measures.
- *Where the EIB implements and manages Member States programmes:* the State aid rules apply (though clearly not all transactions will be caught), and the Member States are responsible for compliance. An 'enhanced dialogue' between the Commission and the EIB is to be set up to clarify issues of compatibility and implementation for different financial products. The scope for 'safe harbours' to avoid multiple notifications of similar schemes is also mooted.
- *Where the EIB acts under a Commission mandate and manages EU funds:* EU funds alone do not qualify as State aid. Nevertheless, the Financial Regulation specifies that EU financial instruments must be 'consistent' with the State aid rules.[58] It is anticipated that 'clear, concrete and easily implementable criteria' will be set out in agreements between the relevant Commission services and the EIB.

More generally, it can be said that the changes reviewed in this paper rather 'buck the trend' insofar as State aid rules have typically tended to grow tougher with maturity.[59] On the other hand, it is questionable whether the 'scope to clarify and simplify' the rules, as identified in SAM, has really been exploited.

[57] Joint statement by Joaquín Almunia, Competition Commissioner and Werner Hoyer, President of the EIB on State aid matters in relation to the activities of the EIB group, 21 January 2014: http://ec.europa.eu/competition/state_aid/modernisation/joint_statement_en.pdf

[58] REGULATION (EU, EURATOM) No 966/2012 on the financial rules applicable to the general budget of the Union, OJ L298/1 of 26 October 2012: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:298:0001:0096:EN:PDF

[59] Cf. the regional aid rules.

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Financial Instruments: A Stock-taking Exercise in Preparation for the 2014-2020 Programming Period, by Rona Michie and Kaisa Granqvist (EPRC) with Mazars and Ecorys, Report to the European Investment Bank (2013): http://ec.europa.eu/regional_policy/thefunds/instruments/doc/fls_stocktaking_final.pdf

Access to finance in Europe's disadvantaged regions: Can 'new' financial instruments fill the gap? by Colin Mason, Rona Michie and Fiona Wishlade, EoRPA Regional Research Consortium Paper 12/6 (2012): http://www.eprc.strath.ac.uk/eorpa/Documents/EoRPA_12_Public/EoRPA%20Paper%2012-6%20Financial%20Instruments.pdf

Between Scylla and Charybdis. Navigating Financial Engineering Instruments through Structural Funds and State Aid Requirements, by Rona Michie and Fiona Wishlade,, IQ-Net Thematic Paper 29(2), (2011): http://www.eprc.strath.ac.uk/iqnet/downloads/IQ-Net_Reports%28Public%29/ThematicPaper29%282%29Final.pdf

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