



**Sharing Methodologies
on Financial Engineering
for Enterprises**

GUIDELINES FOR THE IMPLEMENTATION OF FINANCIAL INSTRUMENTS

*Building on FIN-EN – sharing methodologies on
FINancial ENgineering for enterprises*



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Guidelines for the Implementation of Financial Instruments

Building on FIN-EN – sharing methodologies on FINancial ENgineering for enterprises

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GLOSSARY AND LIST OF ABBREVIATIONS

FIN-EN GLOSSARY		REFERENCES 2007-2013
Beneficiary	if there is a holding fund, it is the holding fund itself; if not it will be the financial instrument	COCOF_10-0014-05-EN REVISED VERSION 08/02/2012
Co-funder	a private subject co-funding the financial instrument	
Default	failure of an SME to repay its credit under contractual conditions	European Court of Auditors, Special report n.2
ERDF	European Regional Development Fund	Regulation 1080/2006
ESF	European Social Fund	Regulation 1081/2006
Evergreen	a financial instrument without a fixed end	European Court of Auditors, Special report n.2
FEI Manager	is the subject entitled to manage the financial instrument, it does not coincide with Managing Authority or financial intermediary	COCOF_10-0014-05-EN REVISED VERSION 08/02/2012; FINAL VERSION 21/02/2011 COCOF_10-0014-04-EN
Final recipient	enterprises, public-private partnerships, projects and any legal or natural person receiving repayable investments (namely through equity participations, loans, guarantees and other forms of repayable investments implemented through similar transactions, with the exception of grants) from an operation	COCOF_10-0014-05-EN REVISED VERSION 08/02/2012
Financial Engineering Instrument	is an action which makes repayable investments or provide guarantees for repayable investments in enterprises, public private partnerships or other urban projects included in integrated plans for sustainable urban development, and funds or other incentive schemes for energy efficiency and use of renewable energy in buildings, including in existing housing	Regulation 1083/2006 art.44, COCOF_10-0014-05-EN REVISED VERSION 08/02/2012, COCOF Note COCOF_10-0014-04-EN point 2.1.3 decisional process
Financial Intermediary	the entity acting as intermediary between sources of capital supply and demand	European Court of Auditors, Special report n.2
Grant	non-reimbursable budgetary contribution from the EU or any Member State public institution	European Court of Auditors, Special report n.2
Holding Fund	fund set up to invest in several venture capital funds, guarantee funds, loan funds, urban development funds, funds or other incentive schemes providing loans, guarantees for repayable investments, or equivalent instruments, for energy efficiency and use of renewable energy in buildings, including in existing housing	COCOF_10-0014-05-EN REVISED VERSION 08/02/2012



FIN-EN GLOSSARY		REFERENCES 2007-2013
Holding Fund Manager/Fund Holder	is the subject entitled to manage the fund set up to invest in several venture capital funds, guarantee funds, loan funds, urban development funds, funds or other incentive schemes providing loans, guarantees for repayable investments, or equivalent instruments, for energy efficiency and use of renewable energy in buildings, including in existing housing.	
Intermediate Body	any public or private body or service which acts under the responsibility of a managing or certifying authority, or which carries out duties on behalf of such an authority vis-à-vis beneficiaries implementing operations;	<i>Regulation 1083/2006 art.2</i>
Jeremie	Joint European Resources for Micro to Medium Enterprises is an initiative of the European Commission developed together with the European Investment Fund. It promotes the use of financial engineering instruments to improve access to finance for SMEs via Structural Funds interventions.	http://ec.europa.eu/regional_policy/thefunds/instruments/jeremie_en.cfm#1
Leverage effect	how many euro of funding (public and private) have been paid for each euro of public funding paid	<i>COCOF_10-0014-05-EN REVISED VERSION 08/02/2012</i>
Managing Authority	national, regional or local public authority or a public or private body designated by the Member State to manage the operational programme	<i>Regulation 1083/2006 art.59</i>
NACE Rev.2	Statistical classification of economic activities in the European Community	http://epp.eurostat.ec.europa.eu/portal/page/portal/nace_rev2/introduction
NUTS II	The NUTS classification (Nomenclature of territorial units for statistics) is a hierarchical system for dividing up the economic territory of the EU: - NUTS 1: major socio-economic regions - NUTS 2: basic regions for the application of regional policies - NUTS 3: small regions for specific diagnoses	<i>Regulation 1059/2003</i> http://epp.eurostat.ec.europa.eu/portal/page/portal/nuts_nomenclature/introduction
Operation	the operation is constituted by the financial contributions from an operational programme to financial engineering instruments (including holding funds) and the subsequent investments made by the financial engineering instruments	<i>COCOF_10-0014-05-EN REVISED VERSION 08/02/2012</i>



FIN-EN GLOSSARY		REFERENCES 2007-2013
Operational Programme	document submitted by a Member State and adopted by the Commission setting out a development strategy with a coherent set of priorities to be carried out with the aid of a Fund	<i>Regulation 1083/2006 art.2</i>
Priority Axis	one of the priorities of the strategy in an operational programme comprising a group of operations which are related and have specific measurable goals;	<i>Regulation 1083/2006 art.2</i>
Public co-funding	National or regional co-funding	
Revolving	when a contribution to financial instruments, after a first utilization or cycle, get recycled/ reutilized	<i>COCOF_10-0014-05-EN REVISED VERSION 08/02/2012</i>
SMEs	Small, medium size enterprises	<i>COMMISSION RECOMMENDATION of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises</i>
Winding up	liquidation: process entailing selling all the assets, paying off creditors, distributing any remaining assets to the owners and dissolving the fund	<i>COCOF_10-0014-05-EN REVISED VERSION 08/02/2012</i>
Working capital	enterprises' current assets (short term inventory, receivables, cash equivalents, cash) minus current liabilities (short term liabilities, prepayments)	<i>COCOF_10-0014-05-EN REVISED VERSION 08/02/2012</i>

List of abbreviations	
EAPB	European Association of Public Banks
EIB	European Investment Bank
EIF	European Investment Fund
FEI	financial engineering instrument
FI	financial instrument
GBER	General Block Exemption Regulation – Regulation (EC) No. 800/2008
HF	Holding Fund
HFM	Holding Fund manager
JEREMIE	Joint European Resources for Micro to Medium Enterprises
TAC	Technical Advisory Committee
TWG	Thematic Working Group
TWG1 report	The report of Thematic Working Group 1 on Programming coordinated by the project partner Auvergne Region (France)
TWG2 report	The report of Thematic Working Group 2 on Implementation coordinated by project partner Agencia IDEA (Spain)
TWG3 report	The report of Thematic Working Group 3 on Monitoring and Reporting coordinated by project partner Hungarian Ministry for National Economy (Hungary)



PREFACE

The FIN-EN project has supported the exchange of experience on a cross-section of 2007-13 financial instruments in both Convergence and Competitiveness regions, providing a comprehensive picture of the strengths and weaknesses of their implementation. The FIN-EN partners' experiences have been brought together in these Guidelines, along with an overview of the changes expected in the 2014-20 programme period. In considering the evidence and results presented in the Guidelines, it is important to stress the need for capacity building, continuity and flexibility, as well as caution concerning leverage, timing and certification:

- **Capacity building.** In terms of the ability of public institutions to evaluate and address crucial questions related to policy choices and implementation methods, the 2007-13 experience of setting up and managing financial instruments was the first such attempt for most of the project partners, as only a few had previous experience in this field. It is clear that all the partners recognise that the 2007-13 programme period has entailed the development of expertise through 'learning by doing'. Public sector staff had to incorporate a new perspective, working to support territorial development over the seven-year period, while also guaranteeing revenues for the future, and moving away from a 'grant' culture. Even if mistakes were made, they resulted in useful experience for the future.

At the same time, the global economic crisis affected economic development in Europe, and influenced the performance of financial instruments. In consequence, and looking towards 2014-20, there is a need to move away from an 'aggregating approach' (viewing programmes as simply the sum of different actions) to a 'matrix approach', where each action is required to generate added value not only directly (to final recipients) but also indirectly (i.e. 'horizontally'). This can create positive externalities. In the context of financial instruments, this is reflected in the support for final recipients provided by Managing Authorities (as public bodies) which, through fund managers and financial intermediaries, also produces indirect positive effects. In this context, Structural Funds can provide a strong incentive to public bodies to combine spillover effects and efficiency with the proactive involvement of local and regional stakeholders. This is fundamental to exploiting the benefits of financial instruments, especially in the case of tailor-made instruments.

- **Continuity.** This refers to continued use of existing tailor-made instruments, renewed on the basis of an ex ante assessment for 2014-20, but exploiting the know-how and experience gained in 2007-13; building on this experience may be the most appropriate solution for partners. The Commission's off-the-shelf models are perceived as helpful for organisations without experience of managing financial instruments. However, where instruments have performed well, it is better for stakeholders and final recipients alike, who are already accustomed to the various products and procedures, if the same measures are continued. Of course, in the interests of simplification, continuity must not be confused with 'inflexibility' as there is an ongoing requirement to reduce the administrative burden on recipients. Continuity also offers other benefits in terms of reducing 'Time to Market', i.e. the period of time between a financial instrument being designed and resources committed and it becoming available to final recipients. The experience gained through procedures which have already been tested (even if they need refining) should reduce the incidence of bottlenecks. The value of continuity is also evident in terms of effects, since policy stability can result in greater overall impact.
- **Flexibility.** This concept has been discussed frequently at FIN-EN project meetings and in FIN-EN reports. In 2007-13, the concept was not clearly explained in the regulatory framework and has been interpreted differently. There are two main types of flexibility in financial instruments – flexibility in composition and flexibility referring to adaptability to change.

Flexibility in composition – as financial instruments are intended to address a gap identified by an ex ante assessment of demand and supply in the relevant territory, the nature and scale of a financial instrument is the result of a complex evaluation. Thus, the opportunity to combine instruments, (e.g. grants and revolving instruments) was appreciated and found suitable by the majority of FIN-EN project partners.



The need to adapt general instruments to local specificities is important to bear in mind in the context of tailor-made instruments. Fortunately, in 2014-20, the Financial Regulation (art.139) and General Regulation (art.37.7) support the option of combining financial instruments as follows: *'Financial instruments may be combined with grants, interest rate subsidies and guarantee fee subsidies. Where support from ESI Funds is provided by means of financial instruments and combined in a single operation, with other forms of support directly related to financial instruments targeting the same final recipients, including technical support, interest rate subsidies and guarantee fee subsidies, the provisions applicable to financial instruments shall apply to all forms of support within that operation.'*

What is not expressly described, but is valuable evidence from the FIN-EN analysis, is the added value that can be generated by financial instruments that combine funding and training. Final recipients can benefit not only from financial support but also from management and administrative assistance; this is often needed by start-up companies which may have strong technical know-how but lack business experience.

Flexibility in changes – the use of financial instruments must already be indicated in Operational Programmes and an ex ante assessment must be carried out prior to funds being committed. Experience in 2007-13 suggests that both 'need' and 'economic context' could change in the framework of a seven-year period and so, consequently, should the financial instrument. It is therefore advisable not to be too specific in the Operational Programme on the financial instruments to be used, indicating that further detail will be developed in the ex-ante assessment. This will help prevent the need for modification of the OP, which requires the approval of the EC.

Concerning the compulsory ex ante assessment, minimum requirements are specified in the General Regulation and guidelines, but, if the context or territorial needs change, it can be updated and modified. A potentially critical issue is that, even if the ex ante assessment is a compulsory document and must be submitted to the monitoring committee, it is not formally approved. This means that the document could be always called into question by the EC.

- **Leverage.** During the 2007-13 period, the concept of leverage was strongly used to push for the use of financial instruments instead of traditional grants. The idea of 'multiplying' the amount available to final recipients thanks to co-financing with private stakeholders was one of the key innovative elements, together with the revolving effect introduced by financial instruments.

As the period progressed, it became evident that 'leverage' should not be an overriding priority. The analysis suggests that in some cases (e.g. innovation, start-up companies, etc.) the design of a financial instrument need not envisage significant leverage, but should focus on achieving the policy objective. In this regard, the 'Ex ante assessment methodology for financial instrument in the 2014-2020 programming period' – Volume I, which provides a guide to how to develop ex ante assessment and how to quantify the value added of a financial instrument, describes leverage as the non-EU financial contribution by third parties to the financial instrument; in other words, the national contribution is included in the contribution by third parties. This means that all financial instruments have a leverage effect, even if there is no other co-financing. This interpretation of leverage means that leverage does not need to be artificially high, but can be evaluated from time to time and the priority of a financial instrument can be stated differently.

- **Timing.** The evaluation of time taken to set up and run financial instruments was one of the critical issues emerging in the FIN-EN analysis. The 2007-13 period was focused on setting up new instruments and there were a number of new issues related to implementation to be addressed. In consequence, although many instruments were set up, the length of the process affected their effectiveness.

In 2014-20, public bodies must control the phasing of FI implementation more tightly than in 2007-13, since the certification of OP spending depends on effective expenditure of the FI. It is therefore crucial that each phase of the instrument life cycle reflects the most appropriate solution, including speed of disbursement. This can be ensured in the design phase, for example, by renewing an already existent financial instrument, and in the implementation phase, for example, by using a quick method to select financial intermediaries. Managing Authorities should introduce 'time' as



an evaluation criterion to select managing bodies and financial intermediaries, in order to manage the overall 'time to market' of the instrument.

Another consideration is that the timetable of financial instruments does not sit easily with that of the Structural Funds. Given that it is already possible to set up an OP priority axis entirely dedicated to FIs, could it also be possible to consider a 'dedicated' management approach to FIs which would also take account of their different schedules?

- **Certification.** The new 2014-20 regulations present a completely different method of certification of expenses for financial instruments. In 2007-13, the entire amount devoted to the instrument could be considered as certified from the start, with a cross check at the end of the programme period, providing considerable management freedom. In contrast, under the new rules the programme contribution paid to the financial instrument included in applications for interim payments cannot exceed 25 percent; moreover, this is dependent on reaching a minimum expenditure threshold. This means that, whereas in 2007-13 the performance trend of the instrument was not relevant until the end of the programme period, for example where a financial instrument could not spend very much in the first years but gained ground in later years, this is not feasible in 2014-20. If finance does not reach the final recipient, the expenditure cannot be certified and, in any case, certification cannot exceed 25 percent of the total amount of the instrument. In consequence, the ex ante assessment must also consider whether the forecast expenditure trend is compatible and appropriate for EU co-funding.

Finlombarda S.p.A., FIN-EN Lead Partner



1. INTRODUCTION

1.1 The FIN-EN Project

FIN-EN project - sharing methodologies on FINancial ENgineering for enterprises- is financed by the European Regional Development Fund (ERDF) under INTERREG IVC. The aim of the project is to enhance cooperation between regional and national authorities across Europe on the methodologies and instruments used for implementing financial instruments in the framework of EU Structural Funds, in order to find concrete solutions to common problems and promote a more efficient and effective use of financial instruments in the future. FIN-EN is a wide and stable network of 13 regional and national institutions coming from 13 different EU Member States, managing 45 financial instruments under 2007-2013 Structural Funds for a total budget of circa 3,5 billion euro, without the support of the European Investment Fund (EIF).

FIN-EN comprises partners from across the EU, including both Convergence and Competitiveness regions, which have accrued substantial experience with the use of financial instruments in 2007-13:

- **Finlombarda SpA. (Italy) – Lead Partner with endorsement of Lombardy Region**
- **European Association of Public Banks A.I.S.B.L. (Belgium)**
- **Agencia IDEA - Agencia de Innovación y Desarrollo de Andalucía - Agency for Innovation and Development of Andalucía, IDEA (Spain)**
- **Nemzetgazdasági Minisztérium - Ministry for National Economy, Deputy State Secretariat Responsible for Implementing Economic Development Programs, Managing Authority (previously the National Development Agency, Operational Programme for Economic Development Managing Authority) (Hungary)**
- **Conseil Régional d’Auvergne - Regional Council of Auvergne (France)**
- **SID – Slovenska izvozna in razvojna banka, d.d. -SID Bank (Slovenia)**
- **VAS Latvijas Attīstības finanšu institūcija Altum - Latvian Development Finance Institution (Latvia)**
- **UAB Investiciju ir verslo garantijos – Investment and Business Guarantees Ltd.- INVEGA (Lithuania)**
- **Region Midtjylland - Central Denmark Region (Denmark)**
- **Wirtschafts- und Infrastrukturbank Hessen - WIBank (Germany)**
- **Hellenic Fund for Entrepreneurship and Development SA - ETEAN SA (Greece) (until July 2013)**
- **Autoridade de Gestão do COMPETE, Programa Operacional Factores de Competitividade – Managing Authority of COMPETE/POFC (Portugal)**
- **North West Competitiveness Operational Programme, Department for Communities and Local Government (England, UK)**

The following institutions were involved as Observers:

- *Bulgarian Development Bank (BDB) (Bulgaria)*
- *Investitionsbank Berlin (IBB) (Germany)*
- *Bank of Valletta p.l.c (Malta)*



Since the launch of the network in 2012, a series of networking and exchange of information activities have taken place. The first step was the development of a **comprehensive database of information on the 45 financial instruments** operated by the partners: an updatable and easy-to-use database resuming the main quantitative and qualitative characteristics of each instrument which represented the basis for partners' exchange of experience. Three **Thematic Working Groups** were set up to examine and report on the programming, implementation and monitoring phases of operating FIs, identifying main critical problems and related good practices:

- Thematic Working Group 1: Programming – Synthesis Report: April 2013
- Thematic Working Group 2: Implementation - Synthesis Report: March 2014
- Thematic Working Group 3: Monitoring and Evaluation - Synthesis Report: April 2014

In addition, **study visits** have been held in Lisbon, Auvergne and North-West England, and the mid-term conference took place in Auvergne (December 2013). The final conference is planned for November 2014. More information are available on the project website, at <http://www.fin-en.eu/>.

1.2 The Guidelines

The 'Guidelines for the Implementation of Financial Instruments: Building on FIN-EN – sharing methodologies on FINancial ENgineering for enterprises' represent the final and most relevant project output and are intended to be an useful tool offered to regional and national authorities willing to implement financial instruments in 2014-2020 programming period. They illustrate the main findings of FIN-EN networking activity: the first part considers the 'lifecycle' of financial instruments and deals with aspects of programming, implementation and monitoring, essentially common to all financial instruments; the second part reviews each type of financial instrument in turn, considering issues that are specific to that form of intervention. Throughout the report, prominence is given to the experience of the FIN-EN partners, taking advantage of good practices identified, and to the changes implied by new rules and regulations for 2014-20.



2. FINANCIAL INSTRUMENTS LIFECYCLE

This part of the Guidelines addresses issues that are common to all financial instruments operating in the context of Cohesion policy in 2007-13. It is structured in three main sections – **programming** (2.1), **implementation** (2.2) and **monitoring and reporting** (2.3), broadly reflecting not only the chronology of the FI lifecycle, but also the structure of the Thematic Working Groups, referred to in Section 1.1.

2.1 Programming Financial Instruments

This section focuses on the preparatory phase of incorporating financial instruments into Cohesion policy programmes. It draws, in particular, on the work of the FIN-EN Thematic Working Group 1,¹ and focuses on the analysis of the **need for financial instruments**, the **investment strategy**, the **incorporation of financial instruments in the operational programmes**, and the management of **financial flows**.

2.1.1 Analysis of the need for financial instruments

(i) Context

A crucial issue in considering the role for financial instruments (FI) in economic development is whether there is a need for public policy intervention or whether the market is already providing the requisite finance of an appropriate type and scale. There may be market failure or a sub-optimal investment situation due to the high risk of the sector involved (e.g. R&D&I), expectations of low profitability, high costs associated with available funding sources or the 'space' and 'place' effects of an uneven geography of finance.² For the 2007-13 programme period there was no explicit requirement for an ex ante evaluation or assessment to be carried out specific to financial instruments. Nevertheless, the usefulness of such analysis was recognised by the Commission, which co-financed so-called 'gap assessments' with the European Investment Fund (EIF) at the request of Member States or regions; these were provided free-of-charge.

(ii) Lessons from FIN-EN

FIN-EN partners took different approaches to determining the 'need' for financial instruments in 2007-13. For many FIN-EN partners, a gap assessment/analysis was undertaken by the EIF, while others opted to undertake the analysis themselves. For both these approaches, three main shortcomings were identified by TWG1: not enough involvement of local actors; insufficiently comprehensive or detailed analysis of the market situation leading to, for example, under or over-allocations of funds to FIs; and failure to anticipate economic change. As a result, a number of key lessons emerge:

- the need for a **thorough understanding of the locality** in order to take account of the specific characteristics of a region and their impact on market failures and potential
- **specialist analysis of the SME financing market** improves the reliability of the overall assessment
- **involvement of public and private stakeholders** facilitates the analysis and helps to ensure a balanced perspective
- while the analysis focuses on the ability of the existing market to fulfil funding needs, it must also take account of the **capacity of the stakeholders** within that particular territory to set up and run appropriate instruments

¹ FIN-EN Thematic Working Group 1 "Programming" report (hereafter TWG1), see: http://www.fin-en.eu/files/5213/8121/6839/FIN-EN_TWG1_Programming_Report.pdf (accessed May 2014)

² European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period. General methodology covering all thematic objectives, Quick reference guide http://ec.europa.eu/regional_policy/thefunds/fin_inst/pdf/ex_ante_vol0.pdf (accessed July 2014); Mason C, Michie R and Wishlade F (2012) Access to finance in Europe's disadvantaged regions: Can 'new' financial instruments fill the gap? EoRPA Regional Research Consortium Paper 12/6, European Policies Research Centre, University of Strathclyde, Glasgow. http://www.eprc.strath.ac.uk/eorpa/Documents/EoRPA_12_Public/EoRPA%20Paper%2012-6%20Financial%20Instruments.pdf (accessed July 2014).



- the overall **investment strategy should be based on an in-depth analysis** that takes account of strategic objectives, funding sources (including proportion of private co-funding), options for fund structure and management, financial and legal aspects
- the analysis should include **a forward looking element** to take account of changing economic conditions and the funding needs of firms
- there is a case for a **mid-term re-evaluation of the market** on which basis instruments could be readjusted (although it is important to note that while a mid-term re-evaluation might, for example, recommend additional funding, this does not mean that funding will still be available from the operational programme to allocate to FIs).

Case study: internal ex ante evaluation WIBank Hessen

Land Hessen entrusted the gap analysis to WIBank, a public institution with an economic development remit, and its subsidiary, BM H. The analysis drew not only on their knowledge of the local market, but also expertise in private equity and market failures in SME access to finance. Carrying out the task internally, as opposed to through the EIF, facilitated a swift turnaround.³

The lessons and concerns raised by FIN-EN partners are consistent with the observations made by the European Court of Auditors, which was highly critical of many of the gap assessments in their sample of FIs studies.⁴ Moreover, a recent EIF working paper echoes many of these lessons.⁵

(iii) Implications of ESIF 2014-20 and adaptation to the new regime

The ex ante analysis for FI is one of several key areas of change in ESIF 2014-20. The new Common Provisions Regulation (CPR) requires that support for financial instruments be:⁶

“...based on an ex ante assessment which has established evidence of market failures or suboptimal investment situations, and the estimated level and scope of public investment needs, including type of financial instruments to be supported...”

Importantly, this ex ante *assessment* is specifically related to FIs and is distinct from the ex ante *evaluation* which must be undertaken for the operational programme. The ex ante assessment for FI must be done before the managing authority decides to make programme contributions to an FI and should include the following elements:

- a) An analysis of market failures and investment needs.
- b) An assessment of the value added of the FI under consideration, their consistency with other interventions, State aid implications and proportionality.
- c) Estimates of the potential leverage effect and the potential need for preferential remuneration of counterpart investors.
- d) An assessment of lessons learned from past practice.
- e) An examination of implementation options, reflecting the additional opportunities outlined in the CPR,⁷ the types of product to be offered, final recipients targeted etc.

³ Other FIN-EN partners note, however, that there may be drawbacks to internally-conducted ex ante evaluation studies, such as a potential lack of objectivity.

⁴ ECA (2012) Financial instruments for SMEs co-financed by the European Regional Development Fund, Special report no. 2, see: http://www.eca.europa.eu/Lists/ECADocuments/SR12_02/SR12_02_EN.PDF (accessed May 2014).

⁵ Kraemer-Eis, H and Lang, G (2014) Guidelines for SME Access to Finance Assessments (GAFMA), EIF working paper 2014/22, see: http://www.eif.org/news_centre/publications/eif_wp_22_gafma_april14_fv.pdf (accessed May 2014).

⁶ Article 37(2), Regulation 1303/2013.

⁷ Article 38, Regulation 1303/2013.



- f) A specification of the expected results and how the FI is expected to contribute to the specific objectives set out in the relevant priority.
- g) Scope for the ex ante assessment to be reviewed and updated in line with changes in market conditions.

Many of these requirements are in line with the lessons from FIN-EN. Importantly, however, a number of additional elements are specified, partly reflecting the so-called 'results orientation' of ESIF 2014-20, but also the need to learn from past experience and to explore the additional implementation options provided for in the new period. Member States have sought more detailed guidance from the European Commission on what is required in terms of ex ante assessment. This is now available from DG Regio.⁸

2.1.2 Investment strategy

(i) Context

The investment strategy forms a key link between the assessment of a market gap and the financial instruments put in place to address that gap. However, the 2007-13 regulations said little about what an investment strategy should contain; they simply stated that an investment strategy should be part of the funding agreement between the managing authority/Member State and representative of a financial instrument. Following criticism from the European Court of Auditors,⁹ a COCOF note elaborated on this and included mention of an 'underlying' and 'coherent' investment strategy.¹⁰

(ii) Lessons from FIN-EN

A number of key lessons emerge from FIN-EN relating to the formulation of an investment strategy:

- the investment strategy should be **flexible** and able to be adapted to the changing economic context and changing needs of companies when appropriate (considering the use of holding funds may be helpful in this regard)
- related to the need to adapt to the changing environment, and the potentially changing needs of recipients, **the investment strategy should be kept up to date** as a consequence of updating the ex ante assessment
- the managing authority/fund manager should maintain a close relationship with final recipients, and **follow-up** with them to ensure the quality of investments made.

The need for flexibility in the investment strategy is emphasised by recent research which found that in around half of cases studied where a market assessment had been undertaken, the FIs set up deviated from the strategy set out in the market assessment.¹¹ In one-third of cases, this was due to issues caused by the political situation, financial risks, technical issues or administrative capacity, but in the remaining two-thirds, changes to the strategy were caused by a change in market demand due to the economic and financial crisis. In the majority (66 percent) of the cases where the market conditions changed, this led to different products being introduced as part of the portfolio of FIs.

The report also found that challenges were experienced in implementation of FIs where investment strategies were focused too closely on specific target groups, especially where this was combined with geographical limitations. Flexibility was identified as being important to adapt to changing economic circumstances and

⁸ The guidance covers both general and specific (thematic) aspects and is available here: http://ec.europa.eu/regional_policy/thefunds/fin_inst/index_en.cfm (accessed July 2014).

⁹ ECA (2012) *Op cit*.

¹⁰ COCOF_10-0014-04 (21/02/2011) Guidance note on Financial Engineering Instruments under Article 44 of Council regulation (EC) No 1083/2006 (Guidance Note 3).

¹¹ Van Ginkel J, Vyas L, Cairns R, Michie R, Granqvist K and S Atkinson (2013) Financial Instruments. A Stocktaking Exercise in preparation for the 2014-2020 Programming Period. Final Report. Report for European Investment Bank. http://ec.europa.eu/regional_policy/thefunds/instruments/doc/fls_stocktaking_final.pdf (accessed July 2014).



consequent changing requirements for finance; including the possibility to change products or broaden investment criteria.

Case study: ensuring flexibility - JEREMIE Fondo Multiinstrumento (Andalucia)

JEREMIE Fondo Multiinstrumento (Andalucia) offers flexibility by using a variety of financial instruments (equity capital, mezzanine funding, loans, convertible loans, guarantees) which enables it to offer a tailor-made solution to nearly all situations of early stage expansion companies. The financial solutions usually consist of a combination of two instruments according to the needs of the company. The (strategic) flexibility of the Multi-instrument makes relatively easy to refine the financial conditions, even after having signed the contract. In contrast, if a single instrument does not perform, it is very difficult to adjust after contracting.

Case study: ensuring flexibility and follow up - Midtjysk Iværksætterfond (Denmark)

As the gap analysis detected potential for acting on both loan and investment markets, Central Denmark Region introduced Midtjysk Iværksætterfond, a fund (without a holding fund), which is notable for its flexibility: the fund manager decides on a case-by-case basis whether to use a loan or investment (or a combination of the two) as capital. This decision is made after the companies have completed a 6 month qualifying accelerator programme supervised by the fund manager. As well as a development opportunity, the programme serves as a due diligence test of a company's capacity to implement the 12-18 month growth plan that is part of the capital bundle offered by the fund. The companies that receive capital are followed closely by the fund manager who works actively with them at least once a week during the growth plan implementation period.

(iii) *Implications of ESIF 2014-20 and adaptation to the new regime*

For the 2014-20 period, the now mandatory ex ante assessment must include an examination of the proposed investment strategy (Article 37(2)(e)). The regulations specify that this must cover:

- the options for implementation arrangements (within the meaning of Article 38)
- financial products to be offered
- financial recipients targeted
- envisaged combination with grant support if appropriate.

In this regard, the FIN-EN suggested list of **elements to be included in the investment strategy** is helpful as a basis. This includes:

- the type of FIs to be set up
- the implementation structure
- governance and management arrangements
- the degree of private sector participation to be sought and at what stage
- type of company and sector targeted
- company development stage targeted
- the amounts needed



- the investment period and timetable
- performance indicators and objectives.

Two additional points could usefully be added to this list in future:

- the **level of legacy funds expected to be created**, and plans for their future use, in reference to Court of Auditors recommendations, and
- a **discussion of any envisaged combination with grant support**, as required in the regulatory provisions.

2.1.3 Incorporation in the operational programmes

(i) Context

Operational programmes (OP) are agreed with the European Commission and set out how Structural and Cohesion Funds resources will be allocated across eligible territorial areas and in line with priority objectives. In 2007-13, financial instruments could be set up for three specific purposes: to invest in SMEs and enterprises (Article 44a), urban development (Article 44b), and energy efficiency and renewable energy in buildings (Article 44c). The majority of instruments were co-funded by the ERDF, but there were also some examples of European Social Fund (ESF) co-funded FIs. It was not possible to set up FIs under the Cohesion Fund in 2007-13.

Member States or managing authorities had to indicate in their OPs plans to use FIs to contribute to the achievement of programme goals. The use of FIs had to form part of the implementation strategy for the OP, and be agreed between the Member State and the Commission. However, the decision on specific instruments to be used fell entirely within the competences of the Member State/managing authority concerned. Member States/managing authorities could also decide whether to devote an entire priority to FI, or whether to deploy FI as measures under one or more priorities. FIN-EN partners were divided fairly evenly between these two approaches. The partners who chose to consider FI as separate priority in their OP had several reasons:

- the amount of funding allocated was such that it required a separate priority in the OP
- it provided a clearer differentiation to grant support, the rules for which were different
- it helped emphasise the priority being given nationally to FI measures, and guaranteed public funding.

Those partners who chose to introduce FIs as a measure under a wider priority tended to view FIs as just one tool among a wider range of measures helping improve SMEs access to finance (e.g. along with grant support) and did not aim to prioritise FIs over other forms of support.

(ii) Lessons from FIN-EN

A number of key lessons emerge from FIN-EN relating to the incorporation of FIs into OPs:

- It is important to **think ahead about any regulatory changes that will be required** at national and regional level to facilitate implementation of FIs, as regulatory modifications have proved to be a lengthy and difficult process. Related, it is important to **gain expertise in the relevant regulations**, and to **resolve regulatory problems as soon as possible**, as this saves time in later stages.



Case study: anticipating regulatory changes at national level –Slovenia

In the *Programme for financing of technological projects 2011–13*, the provision to set up FIs was included in the operational programme. At the same time, the national Public Finance Act, which governs the annual budget, provided for rules on financial engineering. Changing the national law saved considerable time in setting-up the initiative and created a safe legal environment, avoiding mistakes.

- When incorporating FIs into the OP, **aim for clarity and simplicity** as this helps prevent problems arising over interpretation.

Case study: describing FI plans in the OP - KMU-Fonds Berlin (SME-Fund Berlin)/Berlin Kapital, Germany

Land Berlin provided for FIs in the operational programme. A deliberate strategy to limit the detail in the OP was made so the measures could be more open to changes in market demand. The OP simply noted the target group, the objectives, a total amount of resources and result indicators. This broad-brush approach facilitated changes such as those related to the economic crisis, by redirecting the investment strategy, and altering the allocation of financial resources by instrument and/or target.

- More generally, partners recommended **looking for opportunities to use FIs beyond ERDF**, as other Structural Funds can also be used successfully.

Case studies: going beyond ERDF...

ENALIO Fund Greece, co-financed by the Fisheries Fund

This fund uses two financial engineering instruments: a Loan Fund and a Guarantee Fund. However, it was initially decided to start only with the formation of the “Enalio Guarantee Fund”. The Enalio Guarantee Fund will provide guarantees to bank loans, which are part of business plans approved in the Greek Fisheries OP.

JEREMIE ESF, Lombardia, Italy

This pilot initiative by Finlombarda is considered to be innovative in terms of objectives (fighting social exclusion) and beneficiaries (individuals, rather than firms). Financial intermediaries selected through public procurement offer micro-credits to final beneficiaries (which are the members and often the workers of cooperatives). The micro-loans are used to subscribe shares of the company, contributing to the capitalisation of the cooperative.

The European Court of Auditors recommended that Member States should aim to include all co-financed FIs within a single OP per Member State in order to rationalise the planning process and remove one of the key delaying factors.¹² The importance of close links between the ex ante assessment process and the OP was also emphasised, as it was recognized that the contents of the OP can constrain how FIs are implemented (e.g. allocation between different types of instruments, territorial constraints, monitoring and reporting requirements). The OP monitoring requirements in particular can be challenging, since, in 2007-13, OP indicators did not distinguish between FIs and grants. This meant that some indicators were unhelpful in assessing the progress of FIs.¹³

¹² ECA (2012) *Op cit.* The report specifically covered the ERDF co-financing of FIs for SMEs.

¹³ ECA (2012) *Op cit.*; Michie R and Wishlade F (2011) ‘Between Scylla and Charybdis: Navigating financial engineering instruments through Structural Fund and State aid requirements’, *IQ-Net Thematic Paper No. 29(2)*, European Policies Research Centre, University of Strathclyde, Glasgow, see: [http://www.eprc.strath.ac.uk/iqnet/downloads/IQ-Net_Reports\(Public\)/ThematicPaper29\(2\)Final.pdf](http://www.eprc.strath.ac.uk/iqnet/downloads/IQ-Net_Reports(Public)/ThematicPaper29(2)Final.pdf) (accessed May 2014).



(iii) *Implications of ESIF 2014-20 and adaptation to the new regime*

The CPR for 2014-20 specifies that any financial instrument supported by ESIF must comply with the relevant OP objectives, priorities, eligibility rules, expenditure-related provisions, co-financing elements, monitoring and reporting requirements. The regulation requires each priority axis to include a description of actions ... 'and the planned use of financial instruments'. It should therefore be indicated at priority axis level where there is consideration of FIs (this can take the form of 'broad text'), on the basis of the ex ante evaluation of the OP and with reference to the thematic objectives selected in the Member State's Partnership Agreement. This may be supplemented by the information available from any on-going ex ante assessment(s). At a minimum, the managing authority should mention that it envisages the use of FIs. The aim is to achieve a balance between providing sufficient information and avoiding the need for a later programme modification by not being too specific.

The OP need not identify the specific FIs to be used. Indeed, this can only be decided after the ex ante assessment is carried out, and this can take place after the programme is adopted. However, where managing authorities decide to devote an entire OP priority to FIs, and benefit from the incentive of a 10 percent top-up for the priority, or where they decide to dedicate a whole priority to support an EU-level FI, and apply a 100 percent co-financing rate to that priority, the European Commission would seek more detailed information in the OP (or a later programme modification).

The scope for FI use is being expanded and enlarged in 2014-20 to cover all funds (including the Cohesion Fund) as well as all thematic objectives and priorities in the OPs. The new regulations are non-prescriptive with regard to sectors, beneficiaries, types of projects and activities to be supported. Although experience with using Funds other than ERDF to co-fund FIs has generally been limited in 2007-13,¹⁴ there is useful experience among FIN-EN partners that could support those wishing to explore FIs under ESF in particular.

2.1.4 *Managing financial flows from the OP*

(i) *Context*

In the 2007-13 period, funds were slow to reach final recipients from many FIs set up under Structural Funds. By the end of 2012, of the €5,957 million of OP contributions paid to holding funds, under half (€2,812 million) had been subsequently transferred to specific funds for enterprises, meaning that €3,145 million of OP contributions (including €2,340 of Structural Funds and €801 million of national co-financing) still remained at the level of holding funds. In addition, €6,601 million of OP contributions, with €4,050 million of Structural Funds and €2,551 million of national co-financing had been paid directly from managing authorities to specific funds set up without a holding fund. The amounts paid to specific funds set up without a holding fund at the end of 2012 represent 62 percent of the amount committed in legal agreements.

In total, €9,413 million of OP contributions (including €6,024 million of Structural Funds) reached specific funds and was available to support final recipients. At the end of the reporting period, only 37 percent of this amount (i.e. €4,684 million) had been invested in final recipients.¹⁵

(ii) *Lessons from FIN-EN*

There have been no major lessons emerging from FIN-EN partners, largely owing to the lack of precedent in terms of managing financial flows from operational programmes to holding funds and FIs, and then ensuring onward progressing to final recipients.¹⁶ The quality of gap analyses may also have contributed to difficulties knowing the appropriate level of funds that should be allocated to FIs at the start of the period. There were few constraints posed by the Structural Funds regulations on how financial flows should take place, and this was an

¹⁴ Michie and Wishlade (2011) *Op cit.*

¹⁵ European Commission (2013) *Op cit.*

¹⁶ Nevertheless, it should be noted that the Hungarian FIN-EN partner has developed a system for loans where funding is provided in tranches. If a financial intermediary doesn't use its tranche for a long period of time, it may be asked to pay it back. Transfer of funds is therefore already based on the real funding needs of financial intermediaries and final recipients.



issue that was subject to criticism by the European Court of Auditors, specifically that Member States that had implemented holding funds were not subject to automatic decommitment during the life of the operational programme when holding fund disbursements had not taken place.¹⁷

(iii) *Implications of ESIF 2014-20 and adaptation*

Important changes are taking place in 2014-20, with the introduction of staged payments linked to disbursements to final recipients and new restrictions on 'parking' funds to avoid decommitment. The new regulations provide that:

- each application for interim payment shall not exceed 25 percent of the total programme contributions committed to a FI
- each interim payment can also include up to 25 percent of the national co-financing expected to be paid to the FI or final recipient, ensuring that the whole amount of ESIF contributions to a FI will be reimbursed even when national co-financing is provided at a later stage (before the end of the eligibility period)
- the second application for interim payment can only be submitted once 60 percent of the amount included in the first interim payment has been spent as eligible expenditure (disbursed to final recipients/ committed for guarantee contracts/ paid as management costs and fees etc.).
- the third and subsequent applications for interim payment can only be submitted once 85 percent of the amounts included in the previous applications for payment have been spent as eligible expenditure.¹⁸

¹⁷ ECA (2012) *Op cit.* While the ECA report specifically refers to holding funds, this was also the case for FIs that had been implemented without a holding fund.

¹⁸ European Commission (2014) Financial instruments in ESIF programmes 2014-2020. A short reference guide for managing authorities (Ref. Ares (2014)401557 - 18/02/2014), http://ec.europa.eu/regional_policy/thefunds/fin_inst/pdf/fi_esif_2014_2020.pdf (accessed July 2014).



2.2 Implementing Financial Instruments

This section focuses on the implementation phase of FIs in Cohesion policy, including decisions about implementation **structures**, selecting **fund managers and financial intermediaries**, issues related to **management fees, co-financing and leverage, communication strategies** and **closure**. It draws, in particular, on the work of the FIN-EN Thematic Working Group 2.¹⁹

2.2.1 Implementation structures and options

(i) Context

In 2007-13, when choosing to set up a financial instrument, managing authorities had four basic options:

- to make a direct contribution to an instrument (without using a holding fund);
- to contribute to a holding fund, the management of which is put out to public tender;
- to contribute to a holding fund and contract the management to EIF/EIB; or
- to contribute to a holding fund and contract management to a national financial institution without tender under national law (if compatible with the Treaty).

Managing authorities also had to decide whether to establish a distinct legal entity for the instrument (including the holding fund) or whether to set up a separate block of finance within an existing institution.

By the end of 2012, most Member States using financial instruments to support enterprises were using both organisational approaches (i.e. holding funds and direct contributions, with just over half - 445 funds out of 816 - having been set up using holding funds).²⁰ In terms of the overall pattern of management, the majority of holding funds were managed by either national financial institutions or were put out to public tender (384 out of a total of 487), rather than being managed by the EIF or EIB.

(ii) Lessons from FIN-EN

Among the FIN-EN partners, the use of holding funds predominates with nine partners having established 11 holding funds between them; these holding funds account for 35 of the 45 FIs operated by the partners. Seven of the holding funds are operated as separate blocks of finance while the remaining four are established as independent legal entities. Among the 10 FIs that operate without a holding fund, three are established as separate legal entities and seven as separate blocks of finance within a financial institution. Half of the FIN-EN partners (seven out of 14) used the European Commission/European Investment Bank JEREMIE technical assistance initiative.

The choices made by the FIN-EN partners are largely context driven, so that the scope for lesson-drawing from this aspect of FI implementation may be limited. Nevertheless, the FIN-EN experience suggests that:

- using a separate block of finance within an existing institution may facilitate **rapid implementation**
- holding fund structures **increase flexibility**, since funds may be switched between instruments, depending on their performance.

More generally, a number of advantages to the use of holding funds to manage financial instruments can be identified. In particular:

¹⁹ FIN-EN Thematic Working Group 2 "Implementation" report (hereafter TWG2). Not yet publicly available – provided to EPRC by Finlombarda.

²⁰ European Commission (2013) *Summary of data on the progress made in financing and implementing financial engineering instruments co-financed by Structural Funds*, September 2013, see: http://ec.europa.eu/regional_policy/thefunds/instruments/doc/summary_data_fei_2012.pdf (accessed July 2014).



- **Overall scale:** holding funds can help to achieve funding on an adequate scale; critical mass is an important element.
- **Flexibility:** holding funds increase the scope for flexible management of the funds over the period of operation - i.e. the possibility of moving allocations between funds within the holding fund and the corresponding FIs depending on demand and/or performance of the FI in question (at least for a certain period of time, depending on the national legislation governing each fund).
- **Portfolio approach:** holding funds facilitate the use of a portfolio approach – this enables a mix of instruments to be used if appropriate, diversifying risk and expected returns.
- **Strategic investment:** holding fund managers can take a more holistic view of the investment strategy than if instruments are managed independently.
- **Leverage and match funding:** match funding can be secured at holding fund level, and at sufficient scale to attract European Investment Bank (EIB) funding. Holding funds in theory enable the ‘triple leveraging’ of the ERDF contribution: at the holding fund level; at the financial instrument level and at the level of the individual ‘deals’ (i.e. investment in final beneficiaries). Funds can be pre-matched at national or sub-national levels.
- **External expertise:** managing authorities can delegate some of the tasks required to implement financial instruments to outside professionals (e.g. design of financial products and the procurement of fund managers).
- **Rationalisation:** audit, reporting and other administration costs are pooled at holding fund level; and the holding fund management should have the capacity to manage ERDF reporting requirements.
- **Experience:** holding fund structures can be particularly appropriate in regions with weak or no risk capital financing capacity, which are unlikely to be able to set up financial instruments with other public and private sector partners without support.

In 2007-13, one of the most beneficial aspects for managing authorities has been the **flexibility** gained by making allocations from the OP into a holding fund, which provides time to decide what specific funds to establish and subsequent scope to move allocations between funds depending on demand and performance. Importantly, however, the Commission’s proposals for 2014–20 provide for stricter discipline with the introduction of phased payments by managing authorities, which must pay programme contributions to financial instruments in at least four tranches, and subsequent payments on the basis of investment rates in relation to programme contributions. This follows criticism from the European Court of Auditors, which noted that under the current Structural Funds regulations, Member States that have implemented holding funds are not subject to automatic decommitment during the life of the OP when holding fund disbursements have not taken place.

A less positive aspect has been that holding funds have been found to involve **extra indirect costs**, with overheads costs being relatively high compared to other models. These may arise from additional monitoring and scrutiny need to mitigate ‘objective drift’, as well as the additional layer of management fees, since each financial instrument within the holding fund sets its own management costs, in addition to those of the holding fund. Additional layers may also impede transparency.

Regarding **leverage**, the claims made for the holding fund model are not supported by the ECA report, which did not find significant leverage from the private sector at the level of the holding fund in either the 2000-06 or 2007-13 programme periods. The ECA report found that typically, no explicit leverage requirements were specified in the funding agreements between managing authorities and financial intermediaries, except for certain equity funds in the United Kingdom, which had binding leverage requirements for private co-investors.²¹

²¹ Among FIN-EN partners, experience has been that even where leverage requirements were introduced in funding agreements, penalties were not set for expected leverage amounts not being reached.



(iii) Implications of ESIF 2014-20 and adaptation

In 2007-13 managing authorities could only set up tailor-made FIs at national or regional level. By contrast, for 2014-20, the options include tailor-made FIs at national, regional, transnational or cross-border level: with or without holding funds (termed ‘fund of funds’ in 2014-20), and two new options. First, contributions can be made to EU-level instruments which are managed directly or indirectly by the European Commission.²² Second, while remaining under the responsibility of the managing authority, FI can use pre-determined terms and conditions or templates for implementation; these have become known as ‘off-the-shelf’ (OTS) instruments.²³

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 Europe 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, such as those pertaining to State aid. By mid-2014, draft terms and conditions were available for three of these:

- **Risk-sharing loan:** loans with subsidised interest rates for SMEs.
- **Capped portfolio guarantee for SMEs:** credit-risk protection up to a maximum loss amount.
- **Renovation loan:** loans for energy efficiency and renewables in the residential sector.

Another two instruments are envisaged or at an earlier stage of development (draft terms and conditions not yet available):

- **Equity investment fund for SMEs:** co-investment equity fund.
- **Loan for sustainable urban development:** an off-the-shelf measure for urban development funds is also under preparation.

It remains to be seen whether these new initiatives to reduce the administrative burden of operating FIs are attractive to domestic policymakers – early indications, from the FIN-EN partners and elsewhere, are that they may hold limited appeal.²⁴ 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.

Managing authorities also have the option of designing their own FIs from scratch or using existing instruments independently of EU-level instruments or templates, as is the case under domestic policy.

2.2.2 Selecting fund managers and financial intermediaries

(i) Context

Managers of holding funds and/or the financial instruments themselves play a key role in the operation of FIs. In 2007-13, fund managers could be public or private institutions. There were several possibilities for selecting holding fund managers, either:

- the award of a public contract through public procurement; or

²² Article 38(1)(a), CPR.

²³ Article 38(3)(a), CPR.

²⁴ Michie R (2014) ‘Managing the demands of two programme periods - state of play of the 2014-20 and 2007-13 programmes’ *IQ-Net Review Paper 34 (1)*, European Policies Research Centre, University of Strathclyde, Glasgow (not yet publically available).



- the award of a direct financial contribution to the EIB or to the EIF, or
- to a financial institution without a public procurement process, subject to national law compatible with the Treaty.

For financial instruments themselves, financial intermediaries can be appointed with or without a procurement process, depending on national legislation.²⁵

With regard to possible State aid implications, as far as fund managers (and financial intermediaries) 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 they do not receive any other advantages.

A notable finding from the stocktaking report carried out for the EIB was that in 2007-13, negotiation of funding agreements was a major source of delay and deviation from implementation plans for FIs. This was both at the level of holding fund manager and at the level of fund manager for specific instruments. Negotiation of funding agreements frequently took longer than expected, for example, regarding the practicalities of proposed conditions, uncertainty over terms and negotiation of terms, and legal work. However, on a positive note, the lengthy discussions were, with hindsight, seen to have paved the way for faster implementation of remaining processes.²⁶

(ii) *Lessons from FIN-EN*

Within the FIN-EN network, selected fund managers and financial intermediaries are typically existing financial institutions (not always banks) or entities under state control, with previous experience in similar fields (such as other financial instruments, mortgages, public financial services, etc.) Only three FIN-EN partners chose private sector fund managers (and one of these was a joint public/private group – see Auvergne case study below). FIN-EN partners note that there is no predominant or most suitable method to appoint fund managers or financial intermediaries, although some processes (especially the competitive dialogue process) seem to suit many. Among selection criteria, predominant criteria relate to technical and financial capacity, proposed leverage and price. Most partners found regulation (especially public procurement regulation compliance) to be the main difficulty with regard to the selection of fund managers/intermediaries. For risk capital, sometimes this was even found to be a barrier to the selection of the best candidate.

Recommendations from the partnership include:

- devoting **sufficient time and effort** to the selection of financial intermediaries and fund managers, because a sound process is crucial
- ensuring funding agreements are **attractive to intermediaries, easy to enforce and flexible** (and provide exit/closure options)
- adopting **standardized selection criteria** (especially for equity funds, selection criteria should be adjusted for loans and guarantees).

Case study: simplifying the selection of financial intermediaries, FRIM ERDF Lombardia

In the case of FRIM (Fondo di Rotazione per l'Imprenditorialità) ERDF in Lombardia, instead of selecting financial intermediaries through a public tender, a document fully describing the role, activities, remuneration and deadlines to be respected by the financial intermediary was produced. Accordingly, financial intermediaries willing to participate did not have to submit an offer, they just had to sign the document. This reduced the time needed in the selection process of financial intermediaries.

²⁵ Regulation 1083/2006 Article 44(b)(ii).

²⁶ Van Ginkel et al (2013) *Op cit.*



The experience of FIN-EN partners suggests that the selection criteria for holding fund managers should include:

- **track record**
- team expertise and skills, especially on the **technical aspects of financial instruments** co-financed by Structural Funds
- **local presence**, with a strong understanding of regional, national and European financial and banking networks and knowledge of local financial needs
- **flexibility** and creative approaches
- **understanding of the policy challenges** and the capacity to develop ad hoc solutions
- **administrative capacity**, and
- ability to **add value**.

Case study: public procurement of holding fund manager (Auvergne)

Following a public procurement procedure, two bids were received, one of which fully met the criteria: a joint tender by the multiregional private management firm, SOFIMAC PARTNERS, together with the Auvergne Region Chamber of Commerce and Industry (CCIA). The public/private partnership is considered an innovative approach to covering all requirements, benefitting from the expertise and skills of each of the structures involved. SOFIMAC PARTNERS manages the holding fund and oversees follow-up of the venture capital investment portfolio and mezzanine debt portfolio and CCIA manages the loan fund portfolio.

When fund managers/ financial intermediaries have been selected, a funding agreement is drawn up which sets out the terms and conditions for contributions from the OP to the FI. FIN-EN partners recommend public law expertise being available at this stage, the importance of creating a working team which combines legal and operational specialists, and the need to foster dialogue with the relevant authorities to adapt regulations and settle differences in interpretation.

(iii) *Implications of ESIF 2014-20 and adaptation*

Under the CPR for 2014-20, managing authorities again have a number of options regarding implementation:²⁷

- a) invest in the capital of existing or newly created legal entities, including those financed from other ESI Funds, dedicated to implementing financial instruments consistent with the objectives of the respective ESI Funds, which will undertake implementation tasks;
- b) entrust implementation tasks to:
 - (i) the EIB;
 - (ii) international financial institutions in which a Member State is a shareholder, or financial institutions established in a Member State aiming at the achievement of public interest under the control of a public authority;
 - (iii) a body governed by public or private law; or
- c) undertake implementation tasks directly (loans and guarantees only).

27 Article 38(4) CPR.



Where part of the implementation is entrusted to entities other than the EIB, (ie. a), b)(ii) and b)(iii) above) certain minimum requirements must be met. These are specified in the Commission Delegated Regulation:²⁸

- entitlement to carry out relevant implementation tasks under EU and national law
- adequate economic and financial viability
- adequate capacity to implement the financial instrument, including organisational structure and governance framework providing the necessary assurance to the managing authority
- existence of an effective and efficient internal control system
- use of an accounting system providing accurate, complete and reliable information in a timely manner, and
- agreement to be audited by Member State audit bodies, the Commission and the European Court of Auditors.

The managing authority should take into account the nature of the financial instrument to be implemented, the body's experience with the implementation of similar financial instruments, the expertise and experience of proposed team members, and the body's operational and financial capacity. The selection criteria should include:

- robustness and credibility of the methodology for identifying and appraising financial intermediaries or final recipients as applicable;
- the level of management costs and fees for the implementation of the financial instrument and the methodology proposed for their calculation;
- terms and conditions applied in relation to support provided to final recipients, including pricing;
- the ability to raise resources for investments in final recipients additional to programme contributions;
- the ability to demonstrate additional activity in comparison to present activity;
- in cases where the body implementing the financial instrument allocates its own financial resources to the financial instrument or shares the risk, proposed measures to align interests and to mitigate possible conflicts of interest.

Where the entities selected (again see a) and b) above) are implementing funds of funds, they may further entrust part of the implementation to financial intermediaries. Financial intermediaries must be selected on the basis of open, transparent, proportionate and non-discriminatory procedures, avoiding conflicts of interest,²⁹ as well as meeting the criteria above.

²⁸ Article 7, Commission Delegated Regulation (CDR) 480/2014, OJ L 138/ of 13 May 2014.

²⁹ Article 38(5) CPR.



2.2.3 Management costs and fees

(i) Context

The Implementing Regulation for 2007-13 included some guidance on management costs and fees (Article 43), but during the period concerns were raised about transparency and the lack of clarity over whether management costs were based on fund size, investment size or tied to financial performance of the investments.³⁰ In 2010, amendments to the General Regulation clarified the need to keep management fees in line with market practices.³¹ Commission data on management costs and fees gathered for their summary reports has been somewhat patchy, but is improving.

(ii) Lessons from FIN-EN

A number of recommendations can be drawn from the FIN-EN partners:

- design a flexible and adjustable scheme for management fees
- ensure that the design of the remuneration schemes is consistent with the investment strategy
- balancing the different components of a remuneration scheme is key to delivering the desired behaviour.

(iii) Implications of ESIF 2014-20 and adaptation

For 2014-20 the regulatory provisions set out more detailed rules on management costs and fees. Management costs comprise direct or indirect cost items reimbursed against evidence of expenditure, while management fees refer to an agreed price for services rendered established through a competitive market process, where applicable. Management costs and fees are to be based on a performance-based calculation methodology.³² According to the Delegated Act, a performance-based approach should take into account:³³

- the disbursement of contributions provided by the ESI Funds programme
- the resources paid back from investment or from the release of resources that had been committed to guarantees
- the quality of investment support measures to final recipients
- the contribution of the financial instrument to the objectives and outputs of the programme.

The methodology for setting management fees should be included in the funding agreement and advised to the monitoring committee, who should also receive annual reports on the management costs and fees paid.

The Delegated Act also sets thresholds for management costs and fees.³⁴ These distinguish the maximum rates payable for the management of funds of funds and for the management of specific types of instruments. For specific types of instruments, the Delegated Act provides for a maximum base remuneration related to the scale of the programme contributions to the instrument and a performance-related component. In addition, the Act caps the aggregate amount of management fees and costs over the eligibility period. These are expressed as a percentage of total programme contributions made and vary between funds of funds and between instruments.

³⁰ Van Ginkel et al (2013) *Op cit*, CSES (2007) *Comparative Study of Venture Capital and Loan Funds Supported by the Structural Funds, Final Report*, August 2007. http://ec.europa.eu/regional_policy/sources/docgener/studies/pdf/2007_venture.pdf (accessed July 2014).

³¹ European Commission (2012), *Commission Staff working document. Financial Instruments in Cohesion Policy*. SWD (2012) 36 final. 27.2.2012, Brussels; European Commission (2012) *Factsheet: Financial instruments in Cohesion Policy 2014-2020*, DG Regional Policy, Brussels.

³² Article 42(5) CPR.

³³ Article 12 CDR.

³⁴ Article 13 CDR.



2.2.4 Co-financing and leverage

(i) Context

Co-financing refers to the public contribution to a financial instrument from the Member State/regional level, and also any private sector contribution (at the level of the OP). All Structural Fund resources are required to be co-financed by other public or private resources for managing authorities to be able to spend Structural Funds.

One of the perceived benefits of FIs is their capacity to attract private contributions, thereby increasing the sums available for investment in SMEs. This contribution may take place at the level of the holding fund (if there is one), the individual fund or the deal/final recipients.³⁵ This mobilisation of private resources is known as leverage, and this leverage effect has been one of the main elements of added value reported by managing authorities using FIs in 2007-13.³⁶ In the European Commission's summary report (which covers the period up to the end of 2012), Member States (providing optional information on additional resources paid to financial instruments outside the OPs), reported additional public/private resources paid which represented an additional 25 percent on top of the OP contributions paid to financial instruments in those Member States. The additional private sector resources alone are not reported.³⁷

While attracting private sector participation is one of the main areas where added value can be identified, it has been difficult to do, particularly during the economic crisis. The European Court of Auditors noted a poor ability to leverage in private investment compared to other EU SME programmes, which they attributed to a lack of fit between the Structural Funds regulations and the specific features of financial instruments, as well as weaknesses in the gap analyses carried out.³⁸ This is likely to continue to be challenging in 2014-20, with public sector budget cuts in many Member States; the EIB stocktaking report in 2012 highlighted that many managing authorities and fund managers felt that there will be a growing need to attract the required co-financing as well as attracting additional co-investors from the private sector, and that this is likely to be challenging.³⁹

(ii) Lessons from FIN-EN

FIN-EN partners have generally found it challenging to attract private co-financing at all levels. Reported difficulties have related to: the type of instrument used; the strategy (e.g. targeting innovative sectors, non-profit oriented, high-risk profile, too lengthy investments, etc.); regional characteristics (e.g. size); the market targeted (e.g. newly established enterprises); and the availability of suitable actors. This has been exacerbated by the economic crisis and the current situation of financial markets, and in general, the conditions have been more complex than envisaged when designing the current strategies and instruments.

In some cases, maximizing leverage is not recommended as it can hinder effectiveness, e.g. where co-financing can become a constraint for the achievement of the pursued objectives. For example, in cases of severe market gaps where no private money is available (e.g. very early stage funding), trying to reach a certain level of leverage may cause funds to be underutilised.

One cautious conclusion from the FIN-EN partners is that co-funding at the fund level has been easier to achieve than co-investment at the level of each deal. They have found that this avoids having to secure private leverage on every deal, making it easier and quicker to invest the funds in businesses.

A number of lessons have been learned on **maximising leverage at fund and investment** levels. In general, **forming partnerships with Community institutions** such as the EIB / EIF is found to be very advantageous in terms of maximizing leverage, as these are public entities but their funds are considered 'private money'. In addition, the regulatory constraints for them are low in comparison with government and arm-length bodies (e.g. relating to procurement).

³⁵ Contributions (co-financing) at this level are distinct from the co-financing of the OP, the rate of which is determined in the General Regulation by country and policy objective.

³⁶ Van Ginkel et al (2013) *Op cit.*

³⁷ European Commission (2013) *Op cit.*

³⁸ ECA (2012) *Op cit.*

³⁹ Van Ginkel et al (2013) *Op cit.*



Case study: EIB as a private co-investor (North West of England, UK)

After obtaining €102 million in ERDF co-funding, the North West Fund (a holding fund) required an equivalent amount from the European Investment Bank in the form of a reimbursable loan. A financing agreement was signed between the region and the EIB, clearly mentioning that the loan taken out must be reimbursed as a priority. It included an obligation for the holding fund to keep separate accounts between the funds from the ERDF and those from the EIB.

In general, to optimise co-financing, it is recommended ensuring that strategy, fund and portfolio design is **attractive for a private investor**, potentially by involving potential co-funders in the design and implementation of funds and instruments. This can include providing clear incentives for investment.

Additional recommendations are: to **partner with state-controlled private financial institutions**; to **include private leverage in the criteria** for FI selection; **engage a respected professional fund manager**, preferably one with a wide network of potential investors; **organise deal flow through partners** (business angels, investment funds, incubators, etc.) so that the deals come 'prequalified' and with a previous decision of private investment; **use a consortium** of co-financing partners for each project facilitating subsequent rounds without public participation; **allow public and private investors to act independently** (e.g. to exit or to stay), and minimize the public co-investment to the minimum amount of risk sharing that the private participants require.

Case study: Providing clear incentives for private investment (New Hungary Venture Capital Programme)

Hungary is encouraging private investors to provide capital to SMEs during early and expansion lifecycle that due to the level of risk currently do not receive capital from the market. In order to make venture capital calls attractive for private investors in the JEREMIE programme, the Hungarian government introduced *yield restriction* and *loss mitigation* clauses:

- Yield restriction: where the fund is liquidated and has a positive yield, the yield due to the State may be capped to a pre-defined sum and any surplus paid to private investors
- Loss mitigation: if the fund has a negative yield, a percentage of loss equal to the highest subscribed capital of the fund is absorbed by the JEREMIE (state owned) part of the fund. The remaining loss is shared between the State and the private investors in proportion to their contribution.

Case study: including private co-investors as a selection criteria for fund managers, Midtjysk Iværksætterfond, Denmark

The identification of co-financiers was a selection criterion of the call for tenders launched to select the fund manager in Central Denmark Region. The tenderers had to bring in co-investors whose contribution would be equivalent to the ERDF financing (1:1). Having had previous experience of investing in start-ups, the investors understood the difficulties and risks, but were convinced that this initiative, with the Accelerator coaching model built in, would give the participating companies a greater chance of success, and was therefore more likely to generate a return for them. The region considers that this worked well because of the fund manager's strong relationship with the private sector investors, and also the fund's focus on elite start-ups with a very high potential for growth – a broader target group would be less likely to attract the interest of private investors.

At European Commission level, the partners expressed the wish for common provisions to be drafted to calculate leverage effect. A common leverage standard at the EU level, in accordance with generally recognised standards of business practice, providing clear rules, criteria, etc. for calculating leverage for each type of financial instrument, and thus allowing safe and reliable benchmarking and comparisons between the regions, would be welcomed.



(iii) *Implications of ESIF 2014-20 and adaptation*

For 2014-20, significant additional flexibility has been introduced whereby national public and private co-financing contributions may be provided at the level of the financial instrument (fund of funds or financial intermediary) or at the level of the final recipient (including in-kind contributions where relevant, except for the EAFRD). National co-financing does not have to be paid to the financial instrument upfront but may be provided at later stages of financial instrument implementation. It has to be provided before the end of the eligibility period. However, the provisions on payments allow for the full reimbursement of ESI Fund contributions even when material co-financing is provided at a later stage.⁴⁰ The expected leverage effect should be assessed by the ex ante appraisal.

2.2.5 **Communicating the strategy and publicising instruments**

(i) *Context*

Communication activity can serve two main purposes: creating a general awareness of the financial instruments and publicising the policy approach, specific activity linked to attracting potential recipients and improving deal flow. Among FIN-EN partners, communication and other marketing activities have not been given very high priority in 2007-13. The activity that has taken place has tended to be carried out mostly by managing authorities and holding fund managers, through the use of advertising, events and networking. These activities were mostly carried out to create deal flow and raise general awareness. There has been some uncertainty over communication obligations where there is a potential conflict between the obligations deriving from the use of Structural Funds and, for example, the preference for confidentiality on the part of the final recipient.

(ii) *Lessons from FIN-EN*

FIN-EN partners suggest that activities such as seminars, events and networking seem to be the most effective approach for improving deal flow, in particular for equity and combined instruments. Qualified investors and other actors can act as good deal flow generators, and building strong networks (for example, through business schools, innovation networks and incubators) can help secure a continuous flow of good projects.

Case study: Communication and promotion – INVEGA fund, Guarantee fund and Entrepreneurship Promotion Fund, Lithuania

A range of complementary measures are used by INVEGA to publicise their funds, including information and project visit trips for journalists, annual events, press releases, press conferences, radio and TV programmes, items in major news portals, participation in various events and fairs, communication in social media, joint activities with government, social, economic and media partners, and the websites www.invega.lt and www.esparama.lt. One of the most innovative and successful activities has been a media campaign implemented in March-July 2013. The media campaign Business Spike was launched in the largest Lithuanian internet news portal in December 2012 with articles and short video clips illustrating 13 business success stories. This was then built on in March 2013 by targeting Lithuania's second biggest news portal and using additional communication measures, including interactive banners promoting financial instruments. Two 'business heroes' were introduced to discuss their business situations and solutions to problems. This campaign also included radio shows and TV reports about business success stories, how EU support and different financial instruments helped them to start and expand their business. In two months, 29 'stories' were presented. The campaign also featured a 'business expert' who had supported start-ups and small firms. Short video stories were added and a YouTube channel was launched. As a result of this campaign and other measures, the visitor flow to the INVEGA website (especially new visitors) and general awareness about financial engineering measures for business visibly increased.

40 Article 41(1)(b) CPR.



(iii) Implications of ESIF 2014-20 and adaptation

The EIB stocktaking report identified that there may be a need to build 'soft' skills, particularly in the area of communications, as desk officers, managing authorities and fund managers have had to, and will continue to have to, communicate with wide range of partners on a fairly new and highly complex topic.⁴¹ In 2007-13, the EIB Group played a significant role in providing support and promoting financial instruments. The Commission has also produced guides aimed at managing authorities.⁴² For 2014-20, to encourage information dissemination and communication over the use of financial instruments over a wider range of funds and sectors, the Commission has asked the EIB to set up, implement and manage the Financial Instruments Technical Advisory Platform for ESI Funds (FI-TAP), which will play a role in preparing methodological guidance, developing and delivering capacity building services, designing and delivering awareness raising campaigns and disseminating information through a variety of delivery channels (see Annex 2).

2.2.6 Closure and exit

(i) Context

Closure of a financial instrument takes place at the end of its lifetime, or before, if it is underperforming. FIN-EN partners have identified a number of required processes including the tasks necessary to stop the operation, liquidation of assets, ownership transfer, transferring of funds, ensuring eligibility of expenditure, etc. Exits, on the other hand, refer to the termination of specific deals (e.g. when a loan is repaid in full (or is defaulted on), or when the stock in an equity investment is sold). Important topics related to the exits identified by FIN-EN partners include the criteria for exits and expected outcomes (rules, time, returns, default rate, etc.), and the process (tasks necessary for exit, destination of funds, vehicles for exits, etc.).

The 2012 European Parliament report identified room for improvement in the areas of setting up clear exit strategies and winding-up provisions.⁴³ The lack of clarity and lack of experience have been noted by FIN-EN partners.

(ii) Lessons from FIN-EN

So far, there is limited experience, knowledge and few lessons learned available in the regions for both closing of a FI (especially extraordinary closure) and exits out of an investment (equity disinvestment, loan full repayment, defaults, etc.). However, a few recommendations from FIN-EN partners related to closure and exit can be identified:

- It is important to consider the whole life-cycle of each FI and each transaction at planning stage, and to **incorporate information on processes and rules for exit and closure policy in funding agreements**. Due to underperformance, for example, because of the impact of the economic crisis, some regions have faced the need for an extraordinary closure of certain FIs, which in general was not envisaged in the design and implementation of the instruments, so the rules and procedures have not been clear. This emphasises the need to **specify clear rules/criteria in case of underperformance and defaults** of the FI and extraordinary exits out of the FI, in the instrument design.
- Related, at EU level there is a need for greater certainty in EU rules and procedures for the 2014-20 programme period.

41 Van Ginkel et al (2013) *Op cit.*

42 European Commission (2014) *Op cit.*

43 European Parliament (2012) Overview of Financial instruments used in the EU Multiannual Financial Framework period 2007-2013 and the Commission's proposals for 2014-2020. Analytical Study. DG for Internal Policies, Policy Department D: Budgetary Affairs, Brussels, see: <http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=73151> (accessed July 2014).



Case study: minimising disruption from fund manager performance – North-West Fund, England, UK

In North-West England UK, the appointment of fund managers to the holding fund followed a two-stage procurement process in the EU Official Journal: first, appointment to a Framework Panel then a mini-competition round to select the fund managers for the different funds from the Framework Panel. The fund management contracts that are in place are standard for the market with the option of contract termination for any serious breach of contract. Due to changes in one of the fund manager's investment activity in the UK, it was agreed with the holding fund to hand over the management of the fund to a new fund manager. The panel approach used by the holding fund to select the fund manager was beneficial, in that it enabled the holding fund to appoint a fund manager for the new mezzanine fund arrangement without having to restart a full procurement process in the Official Journal.

(iii) *Implications of ESIF 2014-20 and adaptation*

The new regulations provide more detailed guidance on closure, namely regarding eligible expenditure, notably in relation to eligible expenditure and management costs and fees. In addition, Annex IV of the CPR states that funding agreements should include conditions for a possible total or partial withdrawal of programme contributions from programmes to financial instruments, including the fund of funds where applicable.⁴⁴

⁴⁴ Annex IV 1(k), CPR.



2.3 Monitoring and Reporting Financial Instruments

This section focuses on the **monitoring and reporting phase** of FI in Cohesion policy. It deals in particular with internal issues for tracking progress as well as the verifications and checks required by the Commission. It draws, in particular, on the work of the FIN-EN Thematic Working Group 3.⁴⁵

2.3.1 Internal monitoring and reporting

(i) Context

Effective monitoring of the implementation of FIs is required both for the internal assurance of probity and effectiveness as well as to ensure that the required reporting to national government and the European Commission is accurate and based on the best possible data. Article 44 of the 2007-13 General Regulation requires that holding funds report to Member States or managing authorities and monitor the implementation of investments in accordance with applicable rules. This requires effective methods for monitoring at the level of the final recipients of funding, with data being provided to the FI or holding fund manager. This data then needs to be aggregated for reporting to the managing authority or European Commission. Additional authorities may also require the reporting of all or selected data depending on the country-specific governance systems.

(ii) Lessons from FIN-EN

All of the FIN-EN partners have had to establish monitoring and reporting systems in order to meet the administrative requirements of the funding, although the nature of these systems varies according to the institutional context and the reporting requirements of partners. Good practices therefore have to be placed within these contexts, and relate more to the design and management of monitoring procedures rather than the specific contents of data collected.

At the outset, the MAs **should identify all actors in the reporting system and map which forms of data need to be collected and reported** to each of the actors. Different reports may be needed at different levels of frequency and the management of this data flow is a key element in the design of the monitoring and reporting system. So, for example, in Central Denmark region, the FI manager identified a range of partners who need to receive regular reports. It is important that the monitoring and reporting system functions well at the level of the implementing bodies (financial intermediaries, FI and holding fund managers, managing authorities) to avoid increasing the administrative burden on final recipients. Even though shared systems among all the actors may not be possible, it is important that there is frequent (daily) communication between the different systems in order to be able to have up-to-date information on every stage of the implementation process.

The data collected should make it possible for Member States/managing authorities to **carry out in-depth analyses** and **provide a global assessment on the performance of FIs**. In addition, monitoring data and information (including results of evaluations, surveys, etc.) on FIs **could be made public to a larger extent**.

The timing of reporting is also diverse with reporting periods varying from annual to monthly or even daily in some situations, in addition to ad hoc reports. This demands that **effective monitoring and reporting systems are established that gather data on a timely and regular basis**, and hold that data in a **flexible format that permits reporting at different points in time** and for different periods.

⁴⁵ FIN-EN Thematic Working Group 3 “Monitoring and reporting” report (hereafter TWG3). Not yet publicly available – provided to EPRC by Fin-lombarda.



Case study: using a software tool for monitoring investment processes and reporting (JEREMIE North West England)

The UK has a number of procedures in place to effectively monitor the JEREMIE Fund in North West England. The reporting requirements are a condition of the grant funding agreement and the holding fund manager (HFM) must adhere to them strictly. The HFM must supply reports to the managing authority on a quarterly basis and this will include information on the investments made, default rate and the progress made in the quarter to the achievement of outputs. Apart from the day to day monitoring of the fund a number of formal audits are carried out, covering topics such as procurement, State aid and eligibility. Through the regular and in-depth monitoring, the managing authority has been able to identify issues and perform corrective measures, and has been able to identify a number of irregularities before Article 16 audits which has meant that they have not been included in the error rate. This monitoring also means that the managing authority has up to date information on all the funds and is able to keep various stakeholders and committee members informed.

The CRM system used by the Holding Fund Manager is a custom-made software tool for monitoring investment processes and reporting, and it has been highly beneficial in the monitoring process, as it provides the managing authority with reliable and up to date information. The Microsoft CRM system was selected after researching the market and was tailored to meet management and reporting requirements at the Holding Fund and Fund Manager level. Applications to the Fund come through the website and go directly to the CRM system. They are automatically allocated to the most relevant Fund Manager. The Fund Manager updates progress of the application on the CRM system and can link this to their emails, so when they send an email to applicants a copy can be attached to the CRM record. The Fund Manager can also put reminders on records of when monitoring and output information is due.

The CRM system has improved the effectiveness and efficiency of monitoring the investment process and reporting. The Holding Fund can see at any time how many applications have been received, where from, source of referrals etc. and have designed reports within the system which enable them to run progress monitoring reports quickly and accurately. The system has also been beneficial in providing assurances to the MA that the data they receive from the Holding Fund is reliable, up to date and with an ability to respond to information requests quickly.

Standard templates should be used to collect data on a consistent basis, ideally through a web-based data entry system. Templates may be revised over time in response to new needs, but changes should be minimized and implemented in major revisions rather than incrementally.

An ideal approach to developing a monitoring system is to develop it in conjunction with a **web-based data input and management system**, so that all those involved in the project have to enter data in real time and only need to enter data once. In this way monitoring data is always available on a real-time basis.

Case study: FRIM ERDF web-based system (Lombardia)

The FRIM (Fondo di Rotazione per l'Imprenditorialità) ERDF instrument developed in Lombardia is a web-based data management system, through which data is collected from the first application throughout the project. The system allows operators belonging to different institutions involved to make queries at any time and receive updated information. There is also an integrated reporting tool (report template) used by the FI manager to report to the managing authority which summarizes results every six months. This has simplified reporting duties and significantly reduced the time needed to assemble reports and ensures that data is timely and accurate.



(iii) *Implications of ESIF 2014-20 and adaptation to the new regime*

For 2014-20, the Commission stresses the importance of reporting in order to assess FI performance. Monitoring committees are charged with a specific responsibility to examine FIs, and should be supplied with specific information of the type supplied to the European Commission as an Annex to the Annual Implementation Report. The information to be provided has been expanded in 2014-20 to include elements such as leverage and performance, and also now includes the Cohesion Fund, EAFRD and EMFF, where appropriate.

2.3.2 Reporting to the Commission

(i) *Context*

The first reporting exercise on FIs set-up in the 2007-13 period was carried out on a voluntary basis by managing authorities in 2011. The data provided by the Member States in various formats was collected and aggregated by the European Commission in the synthesis report first published in December 2011. At the end of 2011, the General Regulation⁴⁶ was amended to introduce an obligation for Member States to formally report on FIs within the Annual Implementation Reports by 30 June. Article 67 of the amended Regulation introduces some compulsory elements that must be reported and a number of optional data categories. 2012 was therefore the first year when MAs formally reported on FIs on this basis.

The Commission published a summary of the data; however, this had many omissions and inaccuracies, so the Commission invited managing authorities to verify the information they had submitted. An updated report was then published by the European Commission.⁴⁷ The second formal reporting exercise took place in 2013, when the Commission prepared and presented to the Member States updated guidance on FI reporting.⁴⁸ While improved, the data is still problematic.

(ii) *Lessons from FIN-EN*

FIs use a range of indicators, with great variation in the number produced, some producing a significantly greater number than others. FIN-EN partners recommend that the indicators measuring FI performance should be clearly identified, and that a broad range of indicators should be provided for the Annual Implementation Report to the Commission to encompass operational indicators, output indicators and results indicators. Care should be taken to ensure that all data required by the Commission has been collected and is available in the reports.

The identification of suitable indicators for FIs has been problematic. Indeed, as early as 2007, an evaluation of co-financed FIs raised questions over monitoring, and the usefulness/appropriateness of the indicators being used. For example, the evaluation pointed out the potential mismatch between funds investing in technology-based businesses designed to provide long-term returns and high-quality jobs, and ERDF measures on job creation during the programme period.⁴⁹ Another report found that managing authorities noted the difficulty of reconciling FIs with the targets and indicators set out in the OPs. Some managing authorities have been investigating more suitable indicators to use with FIs in 2014-20.⁵⁰

The majority of FIs within the FIN-EN group have received an audit from the Commission. There appears to be no common problem as a wide variety of issues was identified. These included missing data and information,

46 Council Regulation (EC) No 1083/2006.

47 European Commission (2013) Summary of data on the progress made in financing and implementing financial engineering instruments co-financed by Structural Funds, September 2013, http://ec.europa.eu/regional_policy/thefunds/instruments/doc/summary_data_fei_2012.pdf (accessed July 2014).

48 http://ec.europa.eu/employment_social/sfc2007/quick-guides/sfc2007_reporting%20instruction_fei_air_updated_version.pdf (accessed July 2014).

49 CSES (2007) *Op. cit.*

50 Michie and Wishlade (2011) *Op cit.*



weaknesses in verification procedures, weaknesses in the evaluation plans, and changes to the approach of the funds from that which was agreed. In order to reduce these issues, FIs should invest in better monitoring data, verification processes and evaluation plans as a minimum. Linked to the internal reporting requirements discussed above, monitoring systems should be able to collect data in a form which is convenient for a swift elaboration of annual reports.

(iii) *Implications of ESIF 2014-20 and adaptation*

Building on the reporting requirements in 2007-13, the new framework requires managing authorities to send to the Commission a specific report on operations comprising FIs as an Annex to the Annual Implementation Report. Based on the reports submitted, the Commission will provide summaries of data collected.

The specific report referred to must include the following information for each FI:

- (a) identification of the programme and of the priority or measure from which support from the ESI Funds is provided;
- (b) description of the financial instrument and implementation arrangements;
- (c) identification of the bodies implementing financial instruments, the bodies implementing funds of funds where applicable, and the financial intermediaries;
- (d) total amount of programme contributions by priority or measure paid to the financial instrument;
- (e) total amount of support paid to the final recipients or to the benefit of final recipients, or committed in guarantee contracts by the financial instrument for investments in final recipients, as well as management costs incurred or management fees paid, by programme and priority or measure;
- (f) the performance of the financial instrument including progress in its set-up and in selection of bodies implementing the financial instrument, including the body implementing a fund of funds;
- (g) interest and other gains generated by support from the ESI Funds to the financial instrument and programme resources paid back to financial instruments from investments;
- (h) progress in achieving the expected leverage effect of investments made by the financial instrument and value of investments and participations;
- (i) the value of equity investments, with respect to previous years;
- (j) contribution of the financial instrument to the achievement of the indicators of the priority or measure concerned.

Templates for reporting are provided on the Commission's SFC system.⁵¹

⁵¹ http://ec.europa.eu/employment_social/sfc2007/quick-guides/index_en.htm (accessed July 2014).



2.3.3 Checks and verification

(i) Context

Verification is the internal system of checks to ensure that projects selected for funding by the FI are in accordance with the criteria applied by the fund, the operational programme and national and EU regulations. Verification checks may include:

- document-based checks
- on-the-spot checks (sometimes for all projects, for example where there are relatively few final recipients)
- sampling among projects, sometime using risk analysis (where there are a high number of final recipients)
- 'extraordinary' or ad hoc checks.

Thematic Working Group Report 3 identifies two models of verification checks among the FIN-EN partners:

- the 'cascade model', in which typically only the level directly below the certain entity is checked but not the further levels lower in the hierarchy;
- the 'ladder model' in which typically the entity checks all lower levels below in the hierarchy.



Cascade model

Actor who performs the check	Entities checked			
	HFM	FEI Manager	Financial intermediary	Final recipient
Managing Authority	X	(X)		
HFM			X	
FEI Manager			X	(X)
Financial intermediary				X
Final recipient				

Ladder model

Actor who performs the check	Entities checked			
	HFM	FEI Manager	Financial intermediary	Final recipient
Managing Authority	X	X	X	X
HFM		(X)	X	X
FEI Manager			X	X
Financial intermediary				X
Final recipient				

(ii) Lessons from FIN-EN

FIN-EN partners present diverse practices in terms of verification checks, however many common features could be found and a number of general recommendations made:

- Verification processes are usually undertaken internally within the fund and may be undertaken at different points in the process and at different levels in the organisation. However it is good practice if the verification process is a **regular, planned element as part of wider administrative procedures**.
- As verification is a preventive action it is important to **create procedures for verification at all levels** that play a role in FI implementation (i.e. financial intermediaries, FI manager, holding fund manager, managing authority).⁵²
 - o On-the spot visits should take place for every level of the implementation system.
 - o HFM/FI managers should visit contracted partners to check the documentation of funded projects, comparing data received through the IT system.
 - o The MA should carry out its verification duties visiting the HFM/FI managers in order to examine specific topics, processes related to a certain product, etc.
- If using a sampling approach, **investigation of the relevance of using risk analysis** instead of random sampling to better address potential risks is recommended.
- **Central (national/regional) databases of public subsidies should be developed** to limit the possibility of approving public financing over defined thresholds.

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Note that verification should only be carried out at the level of the final recipient where there is insufficient documentation/verification at the level of the managing authority or financial instrument.



Case study: Procedures to carry out verifications (Portugal COMPETE)

COMPETE has predefined guidelines, instructions and checklists for management verifications, developed and improved through experience and through contributions from the national audit and certification authorities.

COMPETE has an annual verification plan for on-the-spot checks. The verification plan is based on a sample of FI operations managed by the HF and FI managers. The sample is defined randomly, after excluding certain groups, e.g.: (i) operations already audited by COMPETE or other entities; and (ii) operations not yet in a phase that justifies verification. The exclusion criteria are redefined every year in the planning of the on-the-spot checks. The sampling method includes around 10 percent of equity operations and 3 percent of guarantees, if they have more than 1,000 final recipients; for equity the rate agreed with the National Audit Authority was 5 percent, but in 2012 and 2013 it was decided to double the sample so that a larger number of operations could be checked.

Administrative (or document based) checks are performed for each operation by the FI in final recipients:

- (a) whenever additional funding is requested for the operation; or
- (b) during the analysis of the quarterly report of the HF / FI manager.

The practice is considered a success as the fact that the monitoring procedures are implemented and known by all the stakeholders helps prevent problems, resulting in a low rate of irregularities. The key success factor is to make all the stakeholders of the process aware of the monitoring procedures from the start of implementation.

(iii) *Implications of ESIF 2014-20 and adaptation*

Adequate management verification is a key requirement of the management and control system in 2014-20. Several implementing acts are envisaged to deal with different aspects of monitoring, verification and control, but at the time of writing, these have not been published.⁵³ MAs must submit a proposed methodology for carrying out on-the-spot checks if the Commission does not do so.

2.3.4 Evaluation

(i) *Context*

Evaluation of FIs is usually a part of the overall evaluation of operational programmes, given the scale of the FIs within such programmes. Whilst such evaluations vary in format and objectives, the scale and nature of FIs suggests that evaluations should be undertaken *within* the FI to ensure effective and efficient implementation and to ensure that the FIs are correctly targeted. Evaluations can be expected to provide feedback on operational, performance and absorption issues also in view of future programming.

Among FIN-EN partners, the majority have plans for qualitative and quantitative interim and ex-post evaluations of FIs. Planned evaluation activity varies in frequency:

- In the case of the Spanish FIs there are evaluations on a monthly and an annual basis.
- In France, the MA evaluates the FI once a year.
- In Hungary, typically one interim and one ex post evaluation is planned for FIs.

⁵³

See: http://ec.europa.eu/regional_policy/what/future/pdf/preparation/implementing_acts_summary_inforegio_180614.pdf (accessed July 2014).



In some cases the evaluation is not specific to the FI but is part of a complex evaluation project. For example in the case of the Portuguese FIs, the evaluation is planned and included in a broader performance evaluation of the OP, while in the case of Hessen Kapital I GmbH and Mittelhessenfonds GmbH the evaluation is part of the regular report to the relevant Ministry.

(ii) *Lessons from FIN-EN*

Evaluation plans should be drawn up at the outset as part of the effective management of FIs, both to ensure that the effective use of public funds can be accounted for, but also to help with the management and targeting of the funds on an ongoing basis, as well as to provide guidance on future needs and funding strategies. FIs should be assessed through, as a minimum, ex ante, interim and ex post evaluations with these evaluations feeding into programme-wide evaluations where applicable.

Interim evaluations should be undertaken after an initial tranche of deals so that processes and policies can be assessed, and corrective measures can be put in place as early as possible, if needed. This can also serve to verify whether context conditions have changed and whether the policy and FIs need to be readdressed.

The evaluation should involve external and independent reviewers but the involvement of fund managers in the process is also advantageous to ensure that lessons are embedded.

Case study: Internal review (North-West England, UK)

In the case of the North-West Fund in England, an internal review of the fund was undertaken in 2012 to determine if the strategic rationale was still relevant and whether the outputs and targets could be met. The review involved the HFM, the fund managers and the MA, and involved interviews with relevant stakeholders. The review suggested areas of improvement to increase efficiency and ensure that the fund is fully invested by 2015.

Regular updates of needs or gap analysis should be undertaken alongside evaluation to ensure that the FI continues to be targeted on needs. In addition, satisfaction surveys can be used to provide fresh feedback of final recipients' needs and on specific tools implemented.

Case study: SME survey (IBB, Berlin)

IBB works in partnership with a local credit research company which conducts interviews with 1,000 SMEs in Berlin each year. These interviews assess the ease of access to debt finance and the extent to which companies use public finance. The results of this survey are then used to evaluate, improve or adjust the financial instruments.

(iii) *Implications of ESIF 2014-20 and adaptation*

In 2014-20, regulatory provisions have been strengthened in terms of the monitoring of FIs. The managing authority must report annually to the Commission on the operations comprising FIs as an annex to the Annual Implementation Report. Provisions are also made in the regulations for the ex ante evaluation and evaluation of Cohesion policy programmes during the programme period. Specifically, an evaluation should be carried out for each priority at least once during the period to assess how support from the ESI Funds has contributed to its objectives. It is worth noting also the Commission's emphasis in 2014-20 on the assessment of the *impact* of Cohesion policy programmes. The strengthened monitoring and data gathering should assist greatly in future evaluation of the impact of FIs under Cohesion policy programmes.



3. SPECIFIC FINANCIAL INSTRUMENTS

Financial instruments under Cohesion policy can take three principal forms:

- **Loans** (sometimes referred to as debt) – where the capital is loaned to the borrower and must be repaid.
- **Guarantees** – where capital is wholly or partially secured in the case of a default.
- **Equity** – where a holding or share is taken in the capital of a firm.

Financial instruments may also be offered in **combination**, for example, different programme contributions and different funds in one financial instrument, as well as combination of financial instruments and grants and other forms of assistance. This section highlights lessons from the FIN-EN partners which relate specifically to certain types of financial instrument, although most lessons are horizontal in nature and have been described in the earlier sections of this report.

Academic and policy literature generally argues that there is no ideal model to be established based on particular existing conditions, but the choice of specific models must stem from the market gap analysis, or, in the 2014–20 programme period specifically, the ex ante assessment.

3.1 Equity

(i) Context

A comprehensive set of definitions and guidance on the implementation of FIs was not available until 2011, four years after the start of the 2007–13 programme period and approval of the General Regulations. The guidance states that:

"Equity is the (ordinary) share capital of an enterprise. Typical features of equity capital include an entitlement to the profits of the enterprise, a proportionate share of the proceeds upon liquidation and subordination to creditors."

while equity investment: *"refers to the acquisition of an equity participation (ownership) in an enterprise (or a start-up enterprise)".⁵⁴*

Although the co-funding of equity instruments by the public sector has gained a higher profile in recent years, equity instruments have been less widely used than other forms of FI under Structural Funds programmes. Equity investment represented a comparatively small proportion of co-financed FIs in 2007–13. By the end of 2012, in terms of *numbers* of final recipients, just 2,024 had been supported through equity, out of a total of 158,520. They accounted for around €790 million of investments, just under 17 percent of the total for all specific funds. However, the average equity investment (at around €370,000) was much higher than the average loan (at around €52,000). By the end of 2012, there were 124 funds providing equity finance, suggesting that the average number of operations per fund was relatively small.⁵⁵

In 2007–13, equity funds were being used more in EU15 countries than in the EU12. In general, equity financing tends to be used to support innovative firms and business start-ups with high growth potential, but which are subject to a relatively high degree of uncertainty, and therefore risk, in respect of the return on investment and how long it will take to come through.⁵⁶

⁵⁴ Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006 COCOF_10-0014-04-EN, 21/02/2011.

⁵⁵ European Commission (2013) *Op cit.*

⁵⁶ Ward T (2012) *Expert evaluation network 2012. The use of the ERDF to support Financial Engineering Instruments. A report to the European Commission Directorate-General for Regional Policy.* See: http://ec.europa.eu/regional_policy/sources/docgener/evaluation/pdf/eval2007/expert_innovation/2012_evalnet_fei_synthesis_final.pdf (accessed 23 July 2014).



The frequently regional character and relatively small size of the co-funded equity instruments set up in 2007-13 has been criticised.⁵⁷ Also problematic have been issues related to follow-on investments and exits. Among other things, the State aid rules have constrained the capacity for follow-on investments. At the same time, the economic climate has reduced the scope for exits from investment, while a more general concern has been the difficulty of reconciling the lifespan of equity funds with the programme period duration, especially in the context of often lengthy delays in the setting-up process.

(ii) *Lessons from FIN-EN*

The table below highlights equity instruments used by FIN-EN partners in 2007-13.

MS/REGION	PARTNER	TITLE	H. FUND	BUDGET (M€)	
			YES/ NO	EU	TOTAL
DE (Hessen)	WIBank	Hessen Kapital I GmbH	N	19.0	38.0
		Mittelhessenfonds GmbH	N	5.0	10.0
ES (Andalusia)	Agency for Innovation & Development of Andalusia	JEREMIE Andalusia Fondo de Capital Riesgo	Y	40.0	75.0
FR (Auvergne)	Regional Council of Auvergne	FCPR Jeremie Innovation 1	Y	10.3	14.4
		FCPR Jeremie Mezzanine 1	Y	2.6	3.7
HU	Ministry for National Economy (formerly National Development Agency)	New Hungary Venture Capital Programmes	Y	147.6	233.4
HU (excluding Central-Hungarian region)	Ministry for National Economy (formerly National Development Agency)	New Szechenyi Venture Capital Programmes - Joint Seed Fund sub-programme	Y	0	0
		New Szechenyi Venture Capital Programmes - Joint Growth Fund Sub-programme	Y	0	0
UK (North West England)	Department for Communities & Local Government (DCLG)	Biomedical Fund	Y	13.7	27.5
		Development Capital Fund	Y	24.7	49.5
		Energy & Environmental Fund	Y	11.0	22.0
		Digital & Creative Fund	Y	8.2	16.5
		Venture Capital Fund	Y	16.5	33.0
TOTAL				298.6	523

⁵⁷ Tykvo T, Borell M and Kroencke TA (2012) *Potential of Venture Capital in the European Union*, European Parliament, Directorate-General for Internal Policies, Policy Department A, Economic and Scientific Policy.



Distinct from FIN-EN loan and guarantee products, equity instruments offered by the partners vary widely in terms of purpose and are differentiated by, for example, sectoral focus or maturity of the target market. Most FIN-EN equity FIs are regional in scope. A large proportion of private actors, or a public-private mix of actors, are involved in implementation, as the involvement of actors with specific experience of venture capital markets is sought. Few constraints of the kinds of investment financed are specified. The minimum and maximum amount of investment varies according to targeted size of companies. The rate of required own resources varies widely and the majority do not require any own resources from the final recipient at all. The picture is mixed in terms of State aid compliance, and includes exemption based on the GBER, individual notifications and exemption based on *de minimis*. Most FIN-EN equity FIs have some share of private co-financing. Performance is found to vary widely.⁵⁸

FIN-EN partners have identified a number of lessons specific to equity instruments:

- Equity instruments have been characterised in an analysis by the network partners as being of **low efficiency and high efficacy** (where efficiency describes the extent to which time, effort or cost are well used for the intended task or purpose, and efficacy is the capacity to produce an effect).
- Equity can be more appropriate than debt instruments where there is a risk of substitution for bank lending.
- Taking into consideration the 45 financial instruments implemented by FIN-EN partners, the **lowest levels of leverage** have been achieved in equity instruments. This has been found to be the case especially for seed and early stage instruments. In general, leverage maximization in equity is found to be difficult to achieve, especially because when ERDF funding is included, the entire fund must comply with ERDF regulations, whether the ERDF share is 10 percent or 90 percent of the fund total.
- Equity instruments have involved a **relatively standard pattern of remuneration**, based on the established market standard for private equity (combination of fixed management fee plus carried interest).
- Investment in projects where equity is a suitable instrument, but where the private sector is unwilling to invest alone, **will involve an element of risk**.
- It is recommended that **standardised selection criteria** be used for the selection of financial intermediaries for equity instruments. Selection criteria should include:
 - o Investment strategy
 - o Track record
 - o Minimum experience
 - o Ability to attract private capital
 - o Distribution cascade – determination of timing of returns
 - o Management fees.



Some further key **advantages** of equity have been identified in the literature:⁵⁹

- Equity instruments have been shown to create economic value added when designed appropriately and used in a relevant context.⁶⁰
- Equity finance is primarily suited to firms that have high growth potential but lack the cash-flow necessary to borrow from conventional sources. From the perspective of the managing authority or investor, equity investment has the **potential to generate substantial returns** through what may turn out to be investment in high-growth enterprises.
- The **capital input may be very substantial**, and it does not have to be repaid (although an entrepreneur may ultimately opt to buy-out an investor in order to regain total control of the firm).
- The investor **may also bring considerable skills**, experience and contacts that can support the development of the firm.
- For public investors, an equity-type instrument can provide a **higher level of management control**, through higher involvement of the fund in project management or the management of target companies.
- Mezzanine finance may be attractive to small firms which are resistant to pure equity.

The literature also highlights some potential **disadvantages** of the use of equity instruments:

- Equity investment is a **highly specialised form of finance and is only appropriate for a very small minority** of firms.⁶¹
- Equity investors are purchasing part ownership, so there will be **partial loss of management control** of the firm. (However, although this may be a disadvantage for an entrepreneur, it could potentially be an advantage for the public investor.)
- The main issues to arise in the design of equity instruments using ESI Funds relate to their **complexity**.⁶²
 - Difficult State aid issues may arise depending on the type and scale of investment targeted.
 - Management costs may be high, partly owing to the due diligence to be carried out.
 - It may prove difficult to lever in private sector investment.
 - Returns are unpredictable both in terms of scale and timing and depend on the capacity to exit the investment.

⁵⁹ Michie R, Wishlade F and Granqvist K (2013) Financial Instruments for Business Development in EU Cohesion Policy: National Experiences, Issues and Options. Report to Lombardy Region on the 2007-13 Operational Programme, European Policies Research Centre, Glasgow; Schneidewind P, Radzyner A, Hahn M, Gaspari E, Michie R and Wishlade F (2013) *Financial Engineering Instruments in Cohesion policy*, Report to the European Parliament, Directorate General for Internal Policies, Policy Directorate B, Structural and Cohesion Policies, http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/495870/IPOL-REGI_ET%282013%29495870_EN.pdf (accessed July 2014).

⁶⁰ Cowling M (2012) "Credit rationing, equity gaps and policy solutions for financing entrepreneurial business in Europe: Theory, tests, evidence and the design and effectiveness of policy instruments." Expert Evaluation Network delivering policy analysis on the performance of Cohesion policy 2007-13 Year 2 – 2012, Task 1: Financial engineering Literature Review. Report to DG REGIO of the European Commission.

⁶¹ Cowling (2012) *Ibid.*

⁶² Michie R, Wishlade F and Granqvist K (2013) *Op cit.*



- These instruments are **less successful in regions and countries where the innovation infrastructure and ecosystem is not developed enough** to support and sustain the creation of knowledge that can be commercialised.⁶³
- Access to venture capital is **very dependent on proximity** of venture capital firms and urban centres.⁶⁴
- There is **evidence of poor performance** where funds are geographically constrained.⁶⁵

Case study: IN2:BA – Business Angels Co-investment schemes (Portugal COMPETE)

Two Business Angel (BA) co-investment schemes, managed by the Portuguese Competitiveness OP managing authority (COMPETE) were designed to address market failure and sub-optimal investment situations for early stage businesses. These are two similar schemes, with differing asymmetric models for distribution of results, and with different budget allocation models. For both schemes, the investment is split 65:35 between the public investor (COMPETE) and participating BA societies (which are the financial intermediaries of the instrument). In the first model, the budget was allocated to BA societies at the start of the process (initial portfolio approval). In the second model, selection of investors is done on a deal-by-deal basis (on-going single operation approval). This approach, and the asymmetric distribution of earnings, has proved popular within the BA community. The distribution of earnings is carried out in three phases:

In Phase A, all earnings received by the BA society are distributed as follows – 80 percent to the BA societies and 20 percent to COMPETE (i.e. to the holding fund and re-invested). The distribution of earnings in Phase A is the same for both models. Phase A ends when the BA societies' investment is repaid.

For Phase B, the asymmetric distribution of earnings starts. For Instrument 1, the returns are split 50:50 between the BA societies and the public investor (COMPETE). For Instrument 2, the returns are split 80 percent to COMPETE and 20 percent to the BA societies. Phase 2 finishes when COMPETE's investment is repaid.

When both private and public investment has been reimbursed, Phase C starts, and profits are distributed to both partners. For Instrument 1, this is at the rate of 80 percent to the BA societies and 20 percent to COMPETE; for Instrument 2, this is at the rate of 50:50 between the BA societies and COMPETE.

(iii) Implications of ESIF 2014-20 and adaptation

For 2014-20, the main definitions applying to FIs can be found in different legal bases: the Financial Regulation and its Implementing Rules, the CPR, the ESI Fund-specific regulations, and the applicable State aid framework. In the Financial Regulation setting the rules applicable to the EU budget for 2014-20, two different definitions are set, one for "equity investment" and the other for "quasi-equity investment", the former meaning: *"the provision of capital to a firm, invested directly or indirectly in return for total or partial ownership of that firm and where the equity investor may assume some management control of the firm and may share the firm's profits"*; whereas the latter concerns *"a type of financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity. Quasi-equity investments can be structured as debt, typically unsecured and subordinated and in some cases convertible into equity, or as preferred equity"*.⁶⁶

⁶³ Cowling (2012) *Ibid.*

⁶⁴ Rigby J and Ramlogan R (2013) Access to Finance: Impacts of Publicly Supported Venture Capital and Loan Guarantees, NESTA Working Paper No. 13/02.

⁶⁵ Rigby and Ramlogan (2013) *Ibid.*

⁶⁶ Regulation (EU, EURATOM) no 966/2012 of the European Parliament and of the Council of 25 October 2012 on the financial rules applicable to the general budget of the Union and repealing Council Regulation (EC, Euratom) No 1605/2002 in EUJ L298/1 issued 26.10.2012.



The role of equity instruments in different OPs will be determined by the outcomes of the ex ante assessment, which will assess to what extent they can be designed to fill a gap in the market. The ex ante assessment methodology for FIs in 2014-20 developed for the European Commission and European Investment Bank by PWC identifies a series of advantages and disadvantages for each type of instrument. For quasi-equity/mezzanine finance these are outlined below.

Advantages	Disadvantages	Key considerations
<p>Allows bridging the equity gap needed for leveraging additional loans.</p> <p>Reduced exposure to loss in case of insolvency (compared to equity).</p>	<p>High risk borne by the financial intermediary (but lower than equity).</p> <p>No active role in the project management or the management of the target companies.</p> <p>High transaction costs related to the complexity of the products.</p>	<p>Silent participations and other forms of mezzanine loans require a very detailed due diligence, an ad hoc contract and a very specific scheme for the exit phase.</p> <p>One of the opportunities lies in an upside ('equity kicker') participation, which could be agreed upon by the fund.*</p>

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, General methodology covering all thematic objectives, Volume I (Version 1.2, April 2014) (with minor adaptation by EPRC).

* Also known as an 'equity sweetener'. An option to buy equity, often used in mezzanine financing transactions where the lender receives equity interests in the borrower as an additional financial reward for making loans. (Thomsons Reuters Practical Law, <http://uk.practicallaw.com/7-382-3440>)

For equity and venture capital the key issues are set out below:

Advantages	Disadvantages	Key considerations
<p>Active role in project management and access to shareholder's information.</p> <p>Allows high impact per € invested (projects with sufficient level of equity are able to gather other types of finance).</p>	<p>High risk borne by the financial intermediary (full insolvency risk for the invested capital in the target companies).</p> <p>Venture capital (early stage) investments are time-consuming and cost intensive (due diligence is carried out for several potential business plans before investment).</p>	<p>High involvement of the fund in the project management or the management of the target companies.</p> <p>The due diligence already includes considerations on it.</p>

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, General methodology covering all thematic objectives, Volume I (Version 1.2, April 2014) (with minor adaptation by EPRC).

It is worth noting that early drafts of European Commission proposals for 'off-the-shelf' instruments envisaged an equity investment fund for SMEs and starter companies based on a co-investment model (co-investments facility), although this has not been included in later drafts. Off-the-shelf instruments are designed to deal with a range of compliance issues, including ensuring State aid compatibility. However, interviews with the FIN-EN partners suggest limited interest in such templates; largely owing to the experience and expertise built-up in 2007-13, such templates were generally considered 'too little, too late'.

Notwithstanding the availability of off-the-shelf instruments, the ESIF 2014-20 regulations imply some specific changes for equity-based instruments, including special provisions with regard to eligible expenditure (Article 42 of the CPR), while maximum thresholds for fees and costs are set out in the Delegated Act. A further key area of change concerns State aid compliance, where there are more changes in respect of equity than for other types of instrument (see Annex III).



3.2 Loans

(i) Context

Loans are the most widely used form of finance by SMEs. The provision of loans (and the accompanying loan guarantees) by the public sector to fill an identified market gap has been a well-established policy option in a number of Member States and such FIs have been in operation for several decades in countries such as Austria, Germany, Finland and Sweden.⁶⁷ The use of micro-finance is also widespread, often with a social inclusion aspect, with a focus on the long-term unemployed and on disadvantaged areas. Within Structural Funds programmes, FIs offering loan finance have been co-funded over several programme periods and a great deal of experience has been built up in some programme areas.

According to the Commission's summary report for 2013, the number of co-financed loans offered up to the end of 2012 was 38,501, accounting for 47 percent of the value of OP funds committed. By the end of 2012, there were 351 specific funds supported by the Structural Funds offering loans; the average loan being for just over €50,000.⁶⁸

(ii) Lessons from FIN-EN

In total, 7 FIN-EN partners operate loan-type FIs. In an analysis carried out by the FIN-EN network, loan instruments were characterised by high efficiency and low efficacy (where efficiency describes the extent to which time, effort or cost are well used for the intended task or purpose and efficacy is the capacity to produce an effect). The main reported burdens for beneficiaries are red tape and the collateral required. The table below shows loan instruments used by FIN-EN partners in 2007-13.

MS/REGION	PARTNER	TITLE	HF	BUDGET (M€)	
			Y/ N	EU	TOT
FR (Auvergne)	Regional Council of Auvergne	Réseau Entreprendre Auvergne + Initiative Auvergne	Y	3.9	5.4
HU	Ministry for National Economy (formerly National Development Agency)	New Széchenyi Loan Programme	Y	181.2	229.4
		New Hungary SME Loan Programme	Y	15.2	35.8
		New Hungary Working Capital Loan Programme	Y	12.6	28.6
LT	Invega	Small credits	Y	27.5	27.5
		Open Credit Fund	Y	43.4	57.9
IT (Lombardia)	Finlombarda SpA	Fondo di Rotazione per l'Imprenditorialità FESR	N	13.9	35.0
LV	(Hipoteku banka) Altum banka	ERDF Promotional Programme for improvement of Competitiveness of Entrepreneurs (Nr.X399/2009)	N	54.6	83.2
SI	SID Bank, Slovenia	The development-promotional programme for financing of technological projects 2011 - 2013	N	N/A	150.0
UK (North West England)	Department for Communities and Local Government (DCLG)	Business Loans Fund	Y	19.2	38.5
TOTAL				371.5	691.3

Loan-type FIs offered by FIN-EN partners mainly aim to provide access to credit for micro and SMEs, with several particularly targeting RD&I. The geographical coverage of loans offered is mixed, with only the larger countries with more powerful and/or established regions tending to launch FIs at regional level (e.g. UK, France, Italy).

⁶⁷ It should be noted that 'double financing' is not permitted by the European Commission, who considers that if a loan financed by ESI Funds is also backed by guarantees financed by ESI Funds, the same expenditure has been financed twice which is not acceptable.

⁶⁸ European Commission (2013) *Op cit.*



Most have public FI managers and banks are the most popular type of financial intermediary operating FIN-EN loans. The loan-type FIs typically finance expansion of business activities and investments; working capital or current asset financing were mentioned frequently as an auxiliary-type activity, and innovation and/or R&D-type activities were also covered. A very wide range of loan sizes is offered. In terms of the amounts of own resources required from final recipients, on average the FIN-EN loan-type FIs operate with zero to moderate own resources requirements and so leverage triggered by final recipients is quite limited. With respect to State aid, all FIN-EN loan-type FIs were exempted from State aid either on the basis of the *de minimis* regulation (seven cases) or the General Block Exemption Regulation (GBER) (four cases) (and, in one case, both). The partnership found that loan-type FIs were relatively simple to launch early and quickly compared to other types of instrument, and the market uptake of these products is also quicker than for other types of FI.⁶⁹

The literature identifies a number of **advantages** to loan instruments:⁷⁰

- Firms may prefer debt to equity due to the lower information and dilution costs.⁷¹
- There is no loss of control over how the business is managed.
- The amount of capital and interest are known amounts that can be factored into business planning.
- The interest rate offered can incorporate a subsidised element so that the loan is offered below market rates.
- For MAs and intermediaries, loans are relatively straightforward to administer and the assessment of State aid compatibility is straightforward if a subsidy element is incorporated.
- Returns to the fund should be quite predictable.

Disadvantages have also been identified:⁷²

- Loans may lack flexibility; they must be repaid on a fixed timescale and the burden of repayments may affect cash flow and/or the capacity of the firm to expand.
- Changes in market conditions can affect the ability of the firm to repay the loan.
- Collateral might be required, this can involve debt being secured on property or guarantees, for which payment is required.
- For MAs and intermediaries, the key disadvantages are:
 - o a capital outlay is required at the outset
 - o returns may be unpredictable.
- Loans funded through Cohesion policy may be either crowding-out private investment or investing in projects which the private sector has, for sound reasons, rejected.
- In some countries, there have also been administrative issues surrounding the use of loan repayments and how these are managed in practice.

⁶⁹ FIN-EN Summary report on the mapping of FIs, Version 2.2, February 2014.

⁷⁰ Michie R, Wishlade F and Granqvist K (2013) *Op cit*; Schneidewind *et al.* (2013) *Op cit*.

⁷¹ Rigby and Ramlogan (2013) *Op cit*.

⁷² Michie R, Wishlade F and Granqvist K (2013) *Op cit*.



Case study: KMU-Fonds Berlin (SME-Fund Berlin) / Berlin Kapital

The Investitionsbank Berlin (IBB) recommends combining small and high volume loans. The SME loan fund offers microcredit and loans of up to €5m where a return is expected. This combination of high volume loans and microcredit which does not cover costs ensures that the FI as a whole covers costs, while still also meeting social/development objectives.

Case study: Fonds JEREMIE AUVERGNE

Under Jeremie Auvergne, loans are managed through a network of 14 small 'loan on trust' associations spread throughout the region. These associations know their territory well, and loans are provided to the entrepreneurs rather than to the companies, so that the loan amount can be brought in to the capital of the company. The loans on trust do not require any guarantee or personal liability and are interest-free. Administration and coordination is carried out by the regional Chamber of Commerce, which has oversight over the network of loan associations.

(iii) Implications of ESIF 2014-20 and adaptation

As noted elsewhere, the role for loans in the implementation of the various OPs will be decided on the basis of the ex ante assessment. The ex ante assessment methodology for FIs in 2014-20 developed for the European Commission and European Investment Bank by PWC identifies a series of advantages and disadvantages for each type of instrument. For loans these are outlined below.

Advantages	Disadvantages	Key considerations
<p>Addresses specific liquidity and risk capacity constraints in a given market segment.</p> <p>Limited management cost (yet higher than guarantees) in cases where the due diligence of the financial intermediary receiving the guarantee can be accepted as a delegated process – so no own diligence is necessary.</p>	<p>Funded products such as loans require more initial support than unfunded products such as guarantees.</p> <p>As loans assume part of the risk and provide liquidity at the same time, there are no uncovered liabilities.</p> <p>When a grant scheme is transformed into a loan scheme, particular efforts are needed to establish a realistic PD (Probability of Default) and LGD (Loss Given Default) ratio. Once assessed, these values should be monitored carefully during the implementation phase.</p>	<p>Key issues are the definition of the terms of the loan (e.g. soft loan in a revolving fund) and its eligibility, the required interest rates and potential losses from insolvency risk of final recipients.</p>

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, General methodology covering all thematic objectives, Volume I (Version 1.2, April 2014) (with minor adaptation by EPRC).

The European Commission proposals for 'off-the-shelf' instruments include a risk-sharing loan with subsidised rates for SMEs. This falls within the *de minimis* ceilings for beneficiaries and provides no aid for intermediaries, provided certain conditions are met (including market rate remuneration and *pari passu* risk sharing). However, as noted earlier, it remains to be seen whether the off-the-shelf instruments will hold any appeal for managing authorities that have already run OPs with financial instruments within them.



Notwithstanding the availability of off-the-shelf instruments, the ESIF 2014-20 regulations imply some limited changes for loan instruments, with specific management fees and cost maxima outlined in the Delegated Regulation.

3.3 Guarantees

(i) Context

Guarantee funds provide support to companies unable to obtain finance, typically debt finance, due to a lack of collateral. Guarantee funds (and cross or counter-guarantee funds that provide support to intermediaries providing guarantee funds) are an important source of support for new businesses.

The most common form of co-financed FI is the guarantee, with 96,989 having been committed for disbursed loans and other risk-bearing instruments by the end of 2012. The average commitment per guarantee for one loan disbursed to the final recipient is €20,000. Note that guarantees funds are only disbursed when there is a default on the associated loan. By the end of 2012, there were 128 Structural Funds-supported funds offering guarantees.⁷³

(ii) Lessons from FIN-EN

Only four FIN-EN partners reported using guarantee instruments in 2007-13.

MS/REGION	PARTNER	TITLE	H F	BUDGET (M€)	
			Y/N	EU	TOTAL
BG (through EAPB)	Bulgarian Development Bank	First Loss Portfolio Guarantee Financial Instrument	Y	66.6	78.4
HU	Ministry for National Economy (formerly National Development Agency)	New Széchenyi Credit Guarantee	Y	40.0	47.1
		New Széchenyi Counter-Guarantee Programme	Y	161.2	189.6
IT (Lombardy)	Finlombarda SpA	Joint European Resources for Micro to Medium Enterprises	Y	7.9	24.0
		Made in Lombardy	N	13.1	33.0
LT	Invega	Guarantee Fund	N	37.4	37.4
TOTAL				326.2	409.5

Guarantee instruments offered by FIN-EN partners typically aim to improve access to finance for SMEs (although one example is a counter-guarantee instrument, which secures guarantees rather than loans (the New Széchenyi Counter-Guarantee Programme in Hungary) and the Made in Lombardy instrument includes large companies beyond SMEs among final recipients). Most of the guarantee-type FEIs are national in scope, with only two regionally-focused guarantee schemes (in Lombardia, Italy). No private FI managers are involved in the implementation of FIN-EN partner guarantees, and commercial banks are the most frequently reported financial intermediaries. Reported projects include investments in fixed and current assets, infrastructure development, business expansion, industrial research, experimental development, technology innovation and company organisational development, which are financed primarily through a loan supported by the guarantee schemes. All guarantee-type FIs among FIN-EN partners use the *de minimis* regulation. Co-financing is marginal as the budget covers the losses of defaulting loans.⁷⁴

⁷³ European Commission (2013) *Op cit.*

⁷⁴ FIN-EN Summary report on the mapping of FEIs, Version 2.2, February 2014.



In an analysis by the FIN-EN network partners, guarantee instruments were characterised by high efficiency and low efficacy (where efficiency describes the extent to which time, effort or cost are well used for the intended task or purpose and efficacy is the capacity to produce an effect). There were some doubts expressed about the effectiveness of guarantees, and it was not considered to be clear that guarantees alter the investment decision, rather they may just lower the risk to the lender. Also, in the context of the economic crisis, guarantees have been found to be of limited use because of the lack of liquidity. However, the highest levels of leverage have been achieved in guarantee instruments.⁷⁵

The literature finds a number of **advantages** to using guarantees:⁷⁶

- They are relatively simple to design and administer and typically require that investment appraisal is conducted on a commercial basis, minimising deadweight.⁷⁷
- They have the most potential for high and positive effects in countries and regions where collateral-based lending is the norm and where the entrepreneurial population is not asset-rich.⁷⁸
- They provide access to finance that would not be available otherwise; in some cases, finance may also be available more cheaply as a result of the guarantee (because the lender is taking less risk, so charges less interest).
- For managing authorities and financial intermediaries, guarantees require less capital outlay. In addition, State aid clearance is relatively easy, especially if the country concerned has a notified and approved formula for calculating the aid equivalent.
- Guarantees can also be useful in addressing credit rationing, for example: where the banking sector is highly concentrated and there is a lack of 'relationship' banking; where commercial loans require assets to be placed as security; where there is a diverse entrepreneurial population (poor as well as rich entrepreneurs); where there is substantial diversity in the quality of lending institutions; and where access to loans is conditional on factors not related to project quality.
- Evidence suggests that access to credit is of greater concern to firms than the cost of credit, implying that loan guarantees might be a more appropriate policy instrument than soft loans.
- An evaluation of the Small Firms Loan Guarantee Scheme in the United Kingdom in 2010 (now the Enterprise Finance Guarantee, EFG) found that the Loan Guarantee Scheme, which is distributed by participating banks in the UK, appeared to be a particularly cost effective way of creating additional employment.⁷⁹
- Easing access to finance for credit-constrained SMEs, through schemes such as loan guarantees, provides support for important agents in the regeneration of deprived areas and businesses who are employers of under-represented groups in the labour market.⁸⁰

75 TWG2 reports some concerns that this data may be misleading, due to the above-mentioned questions of whether guarantees just lower the risk to the lender rather than alter the investment decision.

76 Michie R, Wishlade F and Granqvist K (2013) *Op cit.*

77 Cowling (2012) *Op cit.*

78 Cowling (2012) *Ibid.*

79 Cowling M (2010) *Economic Evaluation of the Small Firms Loan Guarantee (SFLG) Scheme*, Report to BIS, Department for Business, Innovation and Skills.

80 Cowling (2010) *Op cit.*



Assessing the need for loan guarantee schemes

Critical indicators of the need for loan guarantee schemes identified by Cowling (2012) include:

- a highly concentrated banking sector (few large banks)
- less dense local branch networks and a general lack of relationship banking
- low levels of housing or general (tangible) asset ownership
- most commercial loans require assets to be placed as security
- falling asset values
- a diverse entrepreneurial and latent entrepreneur population (poor as well as rich potential entrepreneurs)
- access to loans is conditional on criteria not related to the quality of the entrepreneur or of their investment proposal (e.g. collateral availability)
- the spread of interest rates on bank loans is narrow (indicating rationing is favoured over risk-adjusted lending)
- there is substantial diversity in the relative quality of lending institutions.

Source: Cowling M (2012) "Credit rationing, equity gaps and policy solutions for financing entrepreneurial business in Europe: Theory, tests, evidence and the design and effectiveness of policy instruments." Expert Evaluation Network delivering policy analysis on the performance of Cohesion policy 2007-13 Year 2 – 2012, Task 1: Financial engineering Literature Review. Report to DG REGIO of the European Commission.

A number of **disadvantages** have also been highlighted:⁸¹

- Guarantees may be costly and there may be no reduction in interest rates in relation to the market rate.
- The disadvantages of loans also apply to guarantees.
- For MAs/intermediaries, the 'additionality' of guarantees may be difficult to determine – it may be that guarantees are providing cover for bank loans that lenders would have offered anyway. One study takes this further by outlining a framework of Type 1 and Type 2 errors: if a loan guarantee scheme secures a loan for a firm that subsequently fails, this represents a Type 1 error, indicating that banks made the correct decision in the first instance not to lend to the firm in the absence of a loan guarantee scheme, whereas government-backed loans which are successfully repaid would, in the absence of a guarantee scheme, represent a missed opportunity for the bank. This would be termed a Type 2 error⁸² It is also impossible to measure the counterfactual.⁸³
- The use of guarantees requires clarity of objectives – is it to encourage lending to riskier projects, which would entail higher levels of default? Who should assess the level of risk?
- From a Structural Funds financial management perspective, a further disadvantage is the unpredictability of claims on the guarantee, making the full costs difficult to determine.⁸⁴

⁸¹ Michie R, Wishlade F and Granqvist K (2013) *Op cit.*

⁸² Astebro T and Bernhardt E (2003) The winners curse of human capital. *Small Business Economics*, 24. 1-16, cited in Cowling (2012) *Op cit.*

⁸³ Rigby and Ramlogan (2013) *Op cit.*

⁸⁴ For other forms of FI, there must be a capital outlay at the start and funds can be allocated until they are exhausted; for guarantees, a claim is only made on the funds if there is a default on the loan, making it more difficult to assess whether the budget limit is likely to be reached and potentially less likely that the entire amount allocated is actually spent.



- The relationship between loan guarantees and innovation is opaque and the literature is divided on whether publically funded loan guarantee schemes are effective instruments for promoting lending to SMEs.⁸⁵

Case study: INVEGA Guarantee Fund (Lithuania)

In Lithuania, INVEGA, the national guarantee agency, manages the Guarantee Fund. The fund, co-financed by ERDF, is a public fund and operates as a scheme of counter-guaranteeing of losses in INVEGA's guarantee portfolio. All credit institutions/leasing companies which operate in Lithuania and which have signed a cooperation agreement with INVEGA can apply for INVEGA's guarantees. SMEs then apply to the intermediary for the loan or leasing, after which the intermediary applies to INVEGA for the guarantee. INVEGA evaluates the project and makes a decision whether or not to issue the guarantee. After the guarantee is issued, INVEGA takes a decision on including that guarantee in the Guarantee Fund portfolio. Only guarantees which comply with additional criteria can be included in the Guarantee Fund portfolio. If the SME defaults, the intermediary asks INVEGA to guarantee payment, and, if the guarantee was included in the Guarantee Fund portfolio, the guarantee payment is made from Guarantee Fund resources.

Using the Guarantee Fund scheme, INVEGA can apply a significantly lower guarantee fee to be paid by the final beneficiary, i.e. SME, as compared to a guarantee fee established according to safe harbour principles. Thus, the INVEGA Guarantee reduces SME business financing costs and facilitates SME access to finance. Furthermore, with its payments being reimbursed, INVEGA is able to provide credit institutions with more individual guarantees, thus promoting SME development.

(iii) Implications of ESIF 2014-20 and adaptation

As for other instruments, the future role of guarantees in any given OP will be determined by the ex ante assessment. The ex ante assessment methodology for FIs in 2014-20 developed for the European Commission and European Investment Bank by PWC identifies a series of advantages and disadvantages for guarantees. These are outlined below.

Advantages	Disadvantages	Key considerations
<p>Addresses specific risk capacity constraints in a given market segment.</p> <p>Actual disbursement takes place only in case of default.</p> <p>Allows consolidation of the financing structure of a large number of projects with relatively few resources.</p> <p>Allows reduction of the risk premium for request of further financing.</p>	<p>The main problem of all unfunded instruments is the control of potential liabilities. This can be mitigated by a prudent analysis of the risk and measures to limit potential liabilities.</p> <p>Proving the incentive effect of FIs using this type of financial product might be more complex than that of others.</p> <p>Assessing the value added needs more effort.</p>	<p>It is crucial to define an appropriate and prudent multiplier ratio between the OP contributions set aside to cover expected and unexpected losses and the corresponding loans or other risk-sharing instruments covered by the guarantees.</p>

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, General methodology covering all thematic objectives, Volume I (Version 1.2, April 2014) (with minor adaptation by EPRC).

The ex ante assessment guidelines provide more detailed recommendations with regard to guarantees. As mentioned in the table, these relate to the need to estimate in advance expected and unexpected losses, the need to put a cap on liability of the funds and the likely premium that will be required by a financial intermediary to accept such a cap on liabilities. Additional costs to financial intermediaries of operating unfunded instruments

85 Rigby and Ramlogan (2013) *Op cit.*



can include (possibly substantial) administration costs and the amount of capital underpinning required by the relevant regulations. Several further suggestions are made:

- financial intermediaries should retain at least 20 percent of the risk to align their interest with those of the managing authority; and
- a specific risk assessment for guarantees in addition to the general ex-ante assessment should be carried out to assess the leverage of the funded products.

The ex ante assessment guidelines suggest that a prudent approach to risk assessment will result in unfunded instruments such as guarantees not showing advantages over funded instruments such as loans, and a careful check of whether a funded product could deliver the same objective instead is recommended. If not, the managing authority should set a maximum amount of the guarantees significantly smaller than the total volume of the FI, and identify possible partners such as financial institutions with relevant own risk-bearing capacities such as commercial or promotional banks or private mezzanine and loan funds.

The European Commission proposals for off-the-shelf instruments include a guarantee fund for SMEs (capped portfolio guarantee). From a State aid perspective, this falls within the *de minimis* ceiling for beneficiaries and offers no aid to financial intermediaries, provided certain conditions are met.

The off-the-shelf instrument aside, the new regulations imply some specific changes in respect of guarantees. In particular, the Delegated Act 480/2014 includes specific requirements with regard to guarantees:

- an appropriate multiplier ratio shall be achieved between the amount of the programme contribution set aside to cover expected and unexpected losses from new loans or other risk-sharing instruments to be covered by the guarantees and the value of corresponding disbursed new loans or other risk-sharing instruments;
- the multiplier ratio shall be established through a prudent ex ante risk assessment for the specific guarantee product to be offered, taking into account the specific market conditions, the investment strategy of the financial instrument, and the principles of economy and efficiency. The ex ante risk assessment may be reviewed where it is justified by subsequent market conditions;
- the programme contribution committed to honour guarantees shall reflect that ex ante risk assessment;
- if the financial intermediary or the entity benefiting from the guarantees has not disbursed the planned amount of new loans or other risk-sharing instruments to final recipients, the eligible expenditure shall be reduced proportionally.

3.4 Combined Financial Instruments

(i) Context

Combined FIs are the most popular type of financial instrument among FIN-EN partners. Altogether 16 combined instruments were reported by 10 partners. This covers a wide range of combinations, not only of FIs with grants, but more commonly different types of FIs together (equity and quasi equity, loans and guarantees, as well as guarantee fee and interest rate subsidies, equity and loans and FIs with 'soft support' such as training and consultancy).

The use of such 'combined' financial instruments was discussed at the JEREMIE Networking Platform in Brussels in May 2011, where several participants outlined their rationales for complementing repayable forms of support with grant support:⁸⁶

⁸⁶ Finlombarda (2011) *Designing schemes which combine grants and repayable financial instruments in Lombardia*, presentation to JEREMIE Networking Platform, Brussels 20 May 2011; Asselberghs R (DG REGIO) (2011) *Combination of repayable financial instruments with grants*, presentation to JEREMIE Networking Platform, Brussels 20 May 2011.



- it can be used to tailor support to beneficiaries' needs, particularly taking into account the effects of the economic crisis
- the mix of grant and repayable financial instruments can be modulated according to different typologies and recipients e.g. higher aid intensities for more innovative projects in sectors of regional interest with more difficulty accessing traditional finance
- it enables a 'smooth shift towards more innovative forms of finance to sustain the development of sectors which have traditionally benefited from 'non repayable' forms of finance
- it makes financial engineering mechanisms more attractive to SMEs
- it allows a balance to be found between meeting beneficiaries' needs and increasing the financial resources available, and
- it helps ensure that public sector funds are being spent in line with their strategic objectives.

(ii) *Lessons from FIN-EN*

Among FIN-EN partners, combined instruments are found to be very attractive, but complex to implement due to regulatory and operational issues, and their State aid status is often unclear. Loan and grant procedures can be difficult to coordinate. The table below illustrates the combined instruments used by FIN-EN partners in 2007-13.

MS/REGION	PARTNER	TITLE	HF	BUDGET (M€)	
			Y/N	EU	TOTAL
BG (through EAPB)	Bulgarian Development Bank	Risk Capital Fund(s) Financial Instrument	Y	17.8	30.0
		Growth Capital Fund Financial Instrument	Y	0	0
		Mezzanine Fund(s) Financial Instrument	Y	0	0
		Entrepreneurship, Acceleration and Seed Financing Instrument	Y	0	0
		JEREMIE funded financial instrument with an embedded risk sharing	Y	0	0
DE (Berlin through EAPB)	Investitionsbank (IBB), Berlin	KMU-Fonds Berlin (SME-Fund Berlin) / Berlin Kapital	N	50.0	100.0
DK (Central Denmark Region)	Central Denmark Region	Midtjysk Iværksætterfond	N	6.7	13.42
ES (Andalusia)	Agency for Innovation & Development of Andalusia	JEREMIE Fondo Multiinstrumento	Y	148.0	185.0
GR	ETEAN SA	Fund for entrepreneurship - loan fund, fund for entrepreneurship - guarantee fund	Y	386.5	1,060.0
HU	Ministry for National Economy (formerly National Development Agency)	Combined micro-credit	Y	60.7	78.5
IT (Lombardy)	Finlombarda SpA	Joint European Resources for Micro to Medium Enterprises	Y	8.5	37.5
LT	Invega	Entrepreneurship Promotion Fund	Y	14.5	15.8
LV	(Hipoteku banka) Altum banka	ESF programme "Support to Self-employment and Business Start-ups"	N	17.3	32.8
PT (North, Center, Alentejo)	MA Compete	Venture Capital Funds	Y	118.0	211.0
		Credit lines combined with Guarantees	Y	107.9	154.2
		Business Angels Program	Y	27.0	44.0
TOTAL				962.9	1962.22

Combined instruments among FIN-EN partners are diverse and include: equity and quasi-equity (Bulgaria and Portugal); loans and guarantees (Bulgaria, Greece and Italy (Lombardia)); equity and loans (Bulgaria and Denmark (Central Denmark Region)); FIs with other loans and guarantees that are provided on a commercial basis (Spain); FIs with grants (Italy, Latvia and Hungary); and FIs with business consultancy and training (Latvia and Lithuania). The purposes of combined FIs are also diverse and wide-ranging. Of the total of 45 FIN-EN instruments, four are



co-financed by ESF (rather than ERDF) and these are all combined FIs (Midtjysk Iværksætterfond in Denmark, ESF Programme ‘Support to Self-Employment and Business Start-ups’ in Latvia, the Entrepreneurship Promotion Fund in Lithuania and JEREMIE FSE in Lombardia, Italy). The combined FIs include both those which are national and regional in scope. The type of FEI manager and financial intermediary involved tends to reflect the profile of the individual FIs which have been combined. Minimum and maximum investment amounts also vary widely. In terms of State aid, just over half of the FIN-EN combined instruments are exempted based on the *de minimis* regulation. Several FIs are exempted based on the GBER, and two are not only exempted but also notified. Combined FEs have the largest financial allocation compared to other FI types and private co-financing is substantial. Financial progress of the combined FIs has been slower than average, due in part to the late start of these instruments and their complexity.⁸⁷

Combined instruments can be one way of trying to introduce flexibility to FI implementation. The need for flexibility during the programme period has been a key issue among FIN-EN partners and this is expected to continue to be the case in 2014-20. The changing economic environment during 2007-13 emphasised the importance of flexibility in FI design and implementation, including:

- the ability to reallocate funding between programme priorities/measures
- the ability to reallocate funding between financial instruments, changing the investment strategy
- the flexibility to adjust target groups/the focus of funds (e.g. type, sector, location or size of companies supported)
- the ability to offer tailored solutions for SMEs (FIs combined with grants and other kinds of ‘soft’ support), and
- the need for active monitoring of the market gap/conditions and consequent adjustments required in the products offered, changing, expanding or downsizing the products offered.

The EIB stocktaking report identified that in the majority (66 percent) of reported cases where market conditions changed, this led to different products being introduced as part of the portfolio of FIs, for example, through the introduction of an equity scheme in addition to loan funds, or increases in the provision of both.⁸⁸

⁸⁷ FIN-EN Summary report on the mapping of FEIs, Version 2.2, February 2014.

⁸⁸ Van Ginkel *et al* (2013) *Op cit*.



Case study: Combined instruments (Hipoteku banka, Latvia)

The ESF Start Programme (ESF Programme “Support to Self-employment and Business Start-ups”) in Latvia provides good practice for establishing an innovative FI comprising different tools (loans, grants and services). The financial intermediary is a bank, whose consultants evaluate businesses at an early stage. Then they give advice on requirements, and by means of a test/ interviews they assess the applicant’s knowledge and practical experience. If necessary, additional training in particular modules, e.g., management, accounting and taxes, marketing etc. is made available. In later stages, consultancy on drafting a business plan and implementation of the project is provided. After submission of the business plan and related documentation, the loan officers examine applications according to selected criteria and select viable projects to be financed.

Case study: Combined instruments (New Szechenyi Combined Micro Loan programme, Hungary)

In Hungary, the New Szechenyi Combined Micro Loan programme combines reimbursable and non-reimbursable EU assistance, plus the applicant’s own contribution. The applicant submits both the reimbursable loan application and the non-reimbursable grant application to a financial intermediary. The financial intermediary assesses the loan application, makes a decision about the loan element and forwards the grant application to the Intermediate Body (IB) of the relevant MA. The IB evaluates the grant application by checking all the acceptance criteria and carrying out eligibility and content checks of the application. One of the criteria they check is whether the loan decision is positive or negative. The application for the reimbursable EU assistance therefore acts as a filter.

State aid approaches used for combined instruments among FIN-EN partners include: no aid (three out of 16); use of *de minimis* (nine out of 16); and use of GBER (four out of 16, two of which were not only exempted but also notified).

Case study: Central Denmark region: Strategic flexibility through a combined instrument (loan/equity plus a business development coaching programme)

Central Denmark Region has a combined FI (loans, equity) which was launched in 2012. Applications are accepted twice a year by the fund manager, who recommends 20-50 companies to a screening committee. The screening committee then selects up to 10 companies to join a 6-month ambitious and high quality Accelerator programme. The programme performs as a test for the entrepreneurs, who must complete an agreed action plan within 12-18 months. During the Accelerator programme, the fund manager’s commercial development experts work closely with the companies to help them develop, and to get to know the participants, and their potential, very well. The companies completing the programme apply to obtain investment capital in ‘Midtjysk Iværksætterfond’. Applicant companies are evaluated by an investment committee, and investments are made on the basis of the company’s performance during the 6 month Accelerator programme and their attractiveness as an investment. The fund manager screens for potential syndicating private co-investors, who are typically business angels.

The model used for screening companies and selecting which companies are to be granted investment has so far proven to be not only very effective, but also very attractive among the target group. The effectiveness of the screening model has made the instrument attractive to business angels. The flexibility in the management company in being able to make ongoing selections on which instrument to use (loan or equity) for each case (as well as the possibility of making syndicated investments), has also proven to be very smooth and effective. On the other hand, the model used for screening companies and selecting which companies are to be granted investments is time-consuming and also demands significant economic resources, and in the long-term, thought needs to be given to ways of ensuring that the costs of the screening process and Accelerator programme do not erode the Fund.



(iii) Implications of ESIF 2014-20 and adaptation

The new regulations contain clear rules to enable better combination of financial instruments with other forms of support, in particular with grants. As the Commission's guide to FI for managing authorities states:

"The CPR makes it clear that all types of combination will be possible: combination of different programme contributions and different funds in one financial instrument, combination of financial instruments and grants and other forms of assistance."⁸⁹

The Commission's view is that combining funds from different sources in one FI can help achieve critical mass and economies of scale as well as cover a wider spectrum of policy objectives. For the combination of FIs with grants or other assistance from ESI Funds, there are two possibilities:

- certain types of grants (interest rate subsidy, guarantee fee subsidy or technical support as specified in the Delegated Act) and financial products can be combined within the same operation and to be treated as a financial instrument.
- the grant operation and financial instrument operation support can be combined to finance the same investment at the level of final recipient as separate operations.

The same expenditure cannot be declared twice to the Commission, and grants must not be used to reimburse support received from FIs, and FIs must not be used to pre-finance grants. Separate records must be maintained for each source of assistance.

Combining FIs with grants for specific Thematic Objectives

The ex ante assessment methodology guidelines find combining grants with FIs to be particularly relevant under Thematic Objectives 1 (RTDI) and 3 (SMEs). The uncertainty of RTDI project outcomes can prohibit generating a sound cash flow. Grants can be used, for example, to overcome the premium rates required by specialised suppliers to recompense the uncertain outcomes. Grants can also be useful to provide technical support for innovative start-ups and spin-offs e.g. to cover expenses to address property rights issues, to pay for preparation of a business plan or to provide capacity building and professionalisation of commercial research activities in academic spin-offs. Training and coaching can help raise awareness of existing financing opportunities, particularly for SMEs operating in sectors or regions where access to bank finance is relatively weak. The importance of coordination of the different forms of support (e.g. through a mapping exercise) is emphasised in the guidelines, to avoid issues of overlapping and duplication.

Source: European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, Strengthening research, technological development and innovation, (Thematic Objective 1), Volume II (Version 1.0, April 2014); European Commission, EIB, PWC (2014) Ex ante assessment methodology for financial instruments in the 2014-2020 programming period, Enhancing the competitiveness of SME, including agriculture, microcredit and fisheries (Thematic Objective 3) Volume III, (Version 1.2, April 2014).

89 European Commission (2014) *Op cit.*



4. CONCLUSIONS

There is still considerable uncertainty among FIN-EN partners regarding their future plans for FI use in 2014-20. Many have not yet started the ex ante assessment process, and final decisions about the amount of funds to be allocated to financial instruments will depend on these and, in some cases, other political factors outside the control of managing authorities. Little interest has been noted so far in the Commission's off-the-shelf models, possibly as many managing authorities would prefer to build on the experience they have gained during the 2007-13 period. There is a strong desire for continuity where possible (and where this is justified by the ex ante assessment) in terms of instruments, and also in terms of management arrangements, using existing structures where these are already working well. Alongside this desire for stability and continuity, however, there are nevertheless plans to devote additional funding to FIs (including recycled funds from 2007-13), expand existing successful FIs, introduce new instruments (expanding into new thematic areas and using new ESI Funds), to introduce more effective monitoring and communication strategies and to draw on the experience of other FIN-EN partners where their practices in these areas are perceived to have been successful.

The new regulations introduce greater clarity and certainty on the use of FIs under Structural Funds programmes in 2014-20. Managing authorities, financial intermediaries and fund managers have built up considerable expertise over the last few years. However, challenges and areas of uncertainty remain. There are new provisions that must be adhered to in the regulations, particularly relating to monitoring and reporting, FIs must be adapted to the new State aid requirements, and there is increased pressure on all projects and instruments funded under ESI Funds to be able to demonstrate the impact they have achieved. FIN-EN partners have discussed many of these issues and shared possible solutions, such as how to ensure flexibility and the ability to adapt FIs to changing market conditions, how to combine different instruments to produce successful levels of outputs while still being able to address niche markets, combining instruments to ensure sustainability of the FI portfolio, effective means of monitoring, and how to communicate FI achievements to a wider audience.

Further challenges have been identified by partners - finding effective ways to incentivise fund managers while ensuring value for money, ensuring effective leverage and involving the private sector to a greater degree, and calculating the leverage effect. In this regard, the FIN-EN partners would welcome common provisions at EU level to calculate leverage effect, providing a common standard allowing reliable benchmarking and comparisons between regions. A further question, which may only be addressed towards the end of the 2014-20 period, is how the new off-the-shelf proposals will compare to the tailor-made instruments which have been in operation in 2007-13.

The continued need for support and Technical Assistance in the area of FI is clear. In recognition of this, the Commission has launched a new technical assistance platform (TAP) to provide common and fund-specific support related to FIs. Alongside this support, managing authorities may wish to allocate dedicated Technical Assistance to supporting FI design and implementation. As a capacity-building network, FIN-EN has been greatly valued by its partners since its inception in 2012, and discussions amongst peers has allowed learning, capacity building and exchange of ideas to take place. The TAP seems set to provide a useful mechanism for addressing many of the issues facing those implementing and managing FI. FIN-EN is a powerful and qualitative complement to this EU-wide initiative. Based on a comparatively small number of diverse partners who have come to know one another well, FIN-EN provides the basis for more fine-grained analysis and learning and the transfer of best practice between partners and beyond.

Case study: benefits of participation in FIN-EN, Bulgarian Development Bank

Participation in FIN-EN study visits has provided valuable information and practical examples which have been useful in the preparation for the set-up of a new subsidiary of the Bulgarian Development Bank in 2014, engaged in equity financing. The experience gained during the FIN-EN meetings, including the one in England in early 2014, was subsequently transferred to the BDB's working group on the creation of the Capital Investment Fund. The study visits allowed similar funds and structures to be viewed, and although the market for private equity in England is much more developed, the basic instruments and practices remain the same and this valuable experience will be used in the process of creation of the Capital Investment Fund in Bulgaria.



ANNEX I: FOCUS ON THE TECHNICAL ASSISTANCE PLATFORM FOR FINANCIAL INSTRUMENTS

In 2007-13, the JEREMIE, JESSICA and JASMINE initiatives were launched by the Commission to provide support for managing authorities wishing to co-fund financial instruments under their Structural Funds programmes.

Towards the end of the 2007-13 programme period, two studies funded by the EIB confirmed a strong demand from stakeholders for greater capacity building and technical assistance activity related to FIs in 2014-20, through all stages of the programme lifecycle and across thematic areas.⁹⁰

Recognising this demand, a new technical assistance platform (TAP) was developed for the 2014-20 period. The TAP will apply to all ESI Funds and is intended to provide common and fund-specific products related to FIs, covering the whole implementation cycle.

There will be two main strands of the TAP. The first is a horizontal strand, focusing on **advisory services for all Member States and types of FI** (e.g. exchange of best practice, networking, training, guidance on common themes such as ex-ante assessments, public procurement, State aid). This will be carried out by the EIB, and activities under this strand would be initiated through the definition of a horizontal work programme (top-down approach). Such activities would typically include the exchange of best practice and networking across Member States, as well as training sessions or methodological guidance on common themes such as ex-ante assessments, public procurement, regulatory aspects concerning Cohesion policy, State aid, etc. This could also include initiatives to promote the development of FIs in sectors with high potential but limited experience in the Cohesion policy framework, such as energy efficiency and renewable energies, research and innovation, social infrastructure and services.

The second strand covers **multi-region assistance responding to stakeholder proposals**. This must benefit at least two managing authorities in at least two Member States. Such activities would typically include support for the development of FI targeting development objectives or market failures that are shared by a number of regions, such as energy efficiency interventions in large housing estates in Central and Eastern Europe or support to cross-border initiatives aimed at reaching economies of scale and integration.

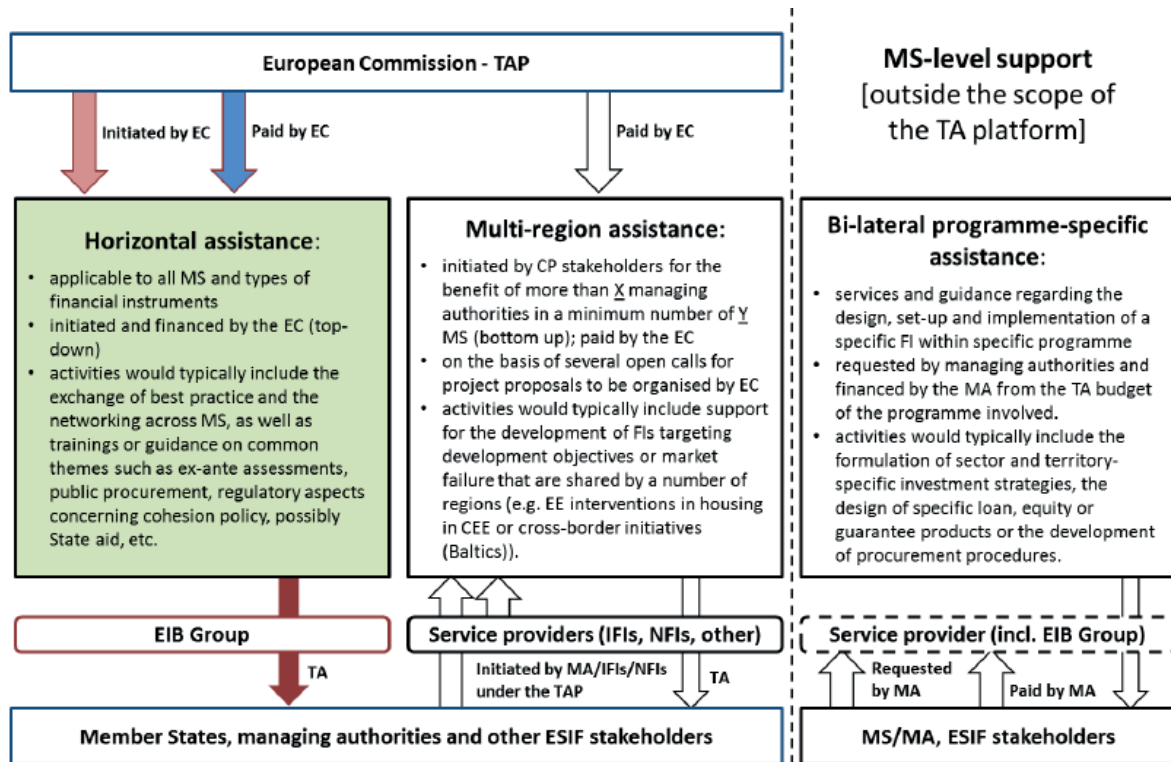
A further strand covers **bilateral assistance including ex-ante assessment for FIs**. Bilateral Assistance would typically support individual MSs and MAs intending to set up and implement FIs in their territory. However, this is strictly speaking outside the scope of the FI-TAP, and Member States must use their own TA budgets for tasks such as the ex-ante assessment or hiring a specialised body to assist the setting up of a FI in their programme area.

Figure 1 summarises the areas of activity covered by the TAP and by Bilateral Assistance.

⁹⁰ http://ec.europa.eu/regional_policy/thefunds/instruments/doc/fls_stocktaking_final.pdf; http://ec.europa.eu/regional_policy/thefunds/instruments/doc/20130621_ta_survey_en.pdf



Figure 1: Horizontal, multi-region and bilateral assistance under the Technical Assistance Platform

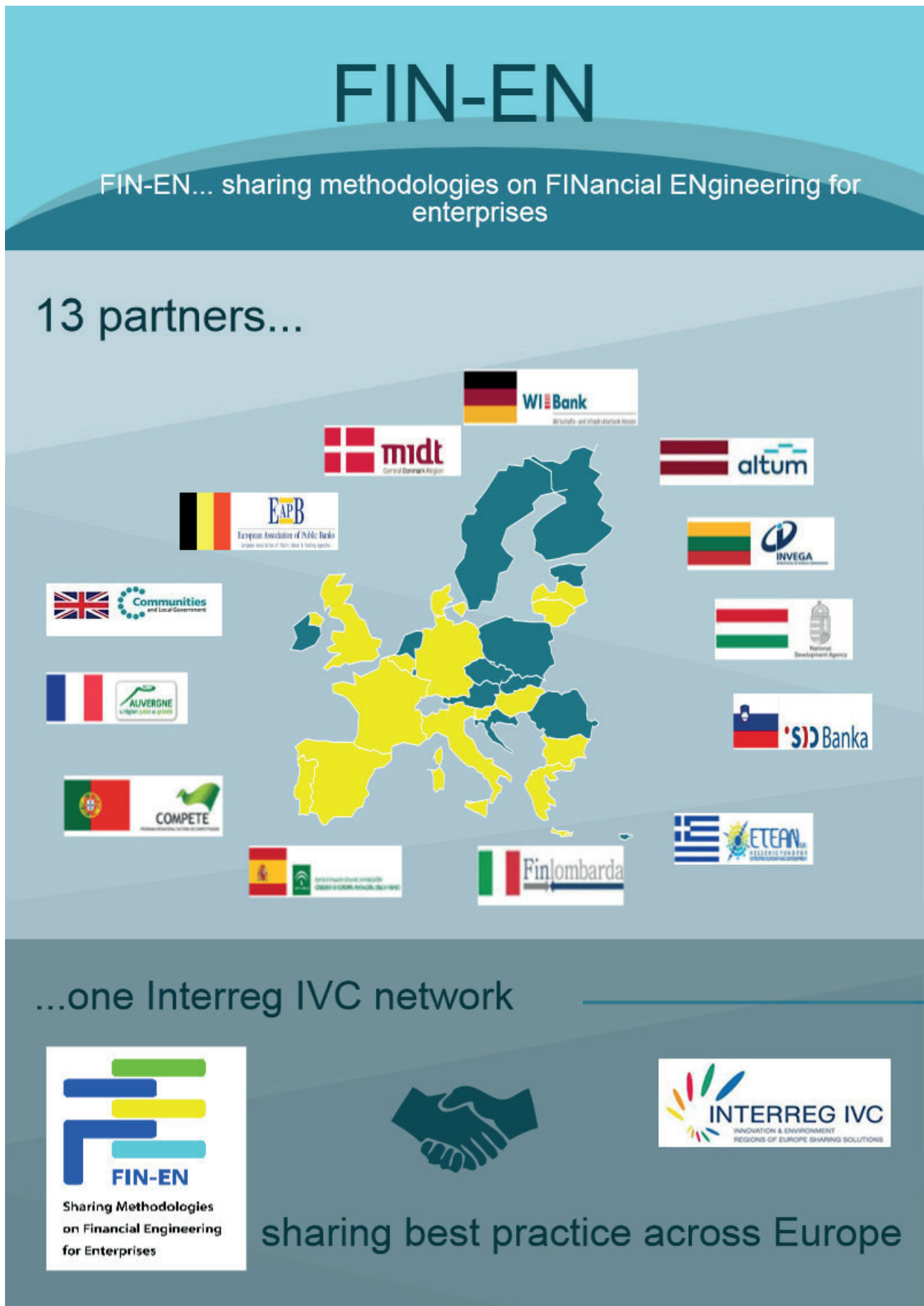


Source: Horizontal Advisory Services for the use of ESIF FIs in the 2014-20 Programming Period Terms of Reference



ANNEX II: FIN-EN INFOGRAPHICS

Infographic 1 – The project



Infographic 2 – the Network

The FIN-EN network

An easy-to-use and updatable database of 45 financial instruments, validated by partners...



... exchange of experience

and best practice...



...concrete solutions to common problems

Thematic working group

meetings, discussions, study visits...

Report on programming

Thematic working group

meetings, discussions, study visits...

Report on implementation

Thematic working group

meetings, discussions, study visits...

Report on monitoring & evaluation

www.fin-en.eu

resource and information sharing...

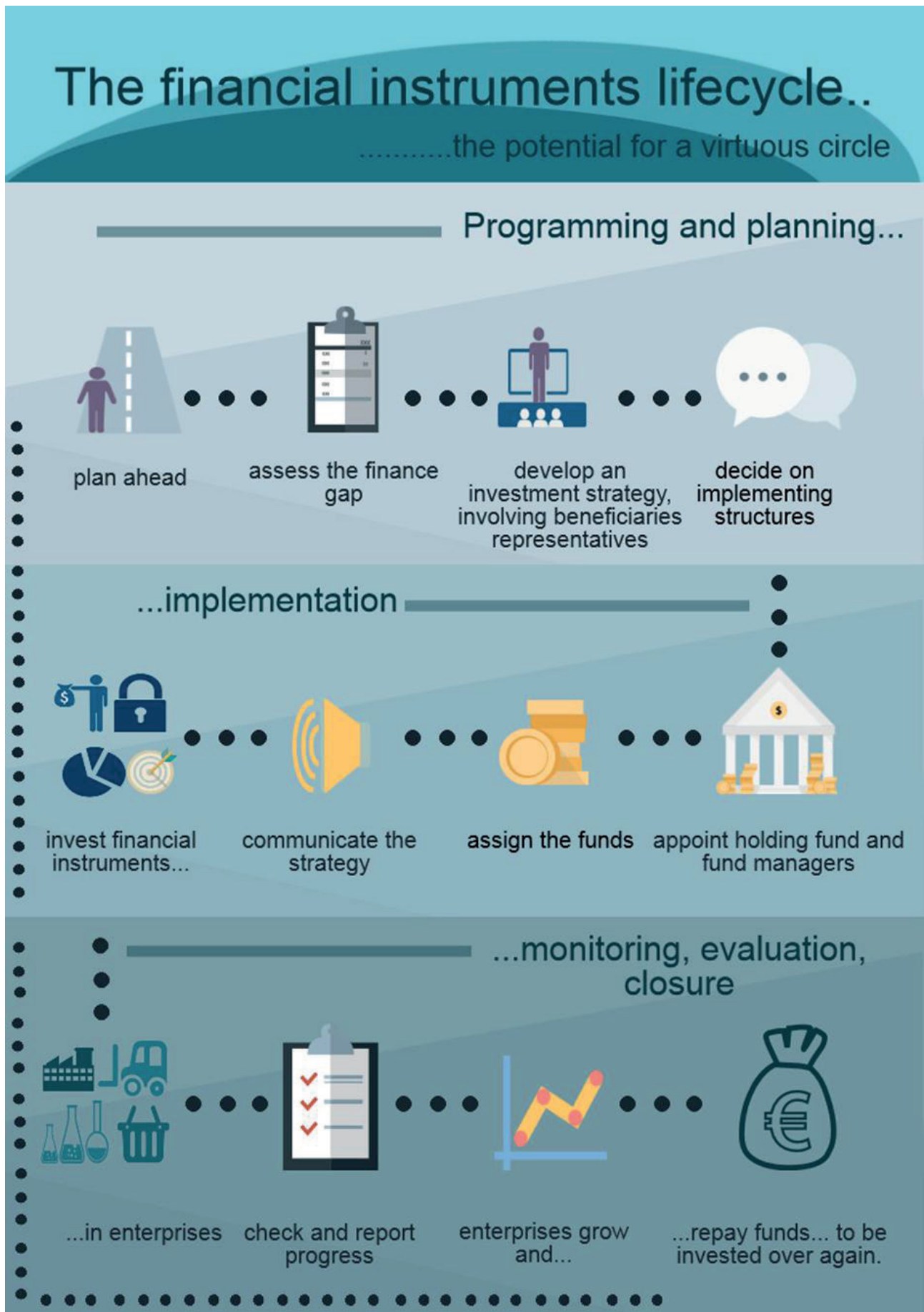
EU Open Days and final project conference

wider dissemination of results and best practice

Final report & guidelines for implementation of financial instruments



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Exchanging experience: FIN-EN partner examples

Experiences in programming, implementation and monitoring...

Carrying out an internal ex ante evaluation ensured a swift turn-around



Changing the national law at the same time as setting up the FI helped create a safe legal environment and save time



Innovative campaigns using social media can increase awareness and deal flow



A custom-made software tool ensured effective monitoring and reporting by providing up-to-date information



Yield restriction and loss mitigation clauses encouraged private sector investment



Preparing a document describing the role, activities, remuneration and deadlines for financial intermediaries to sign reduced the selection process time



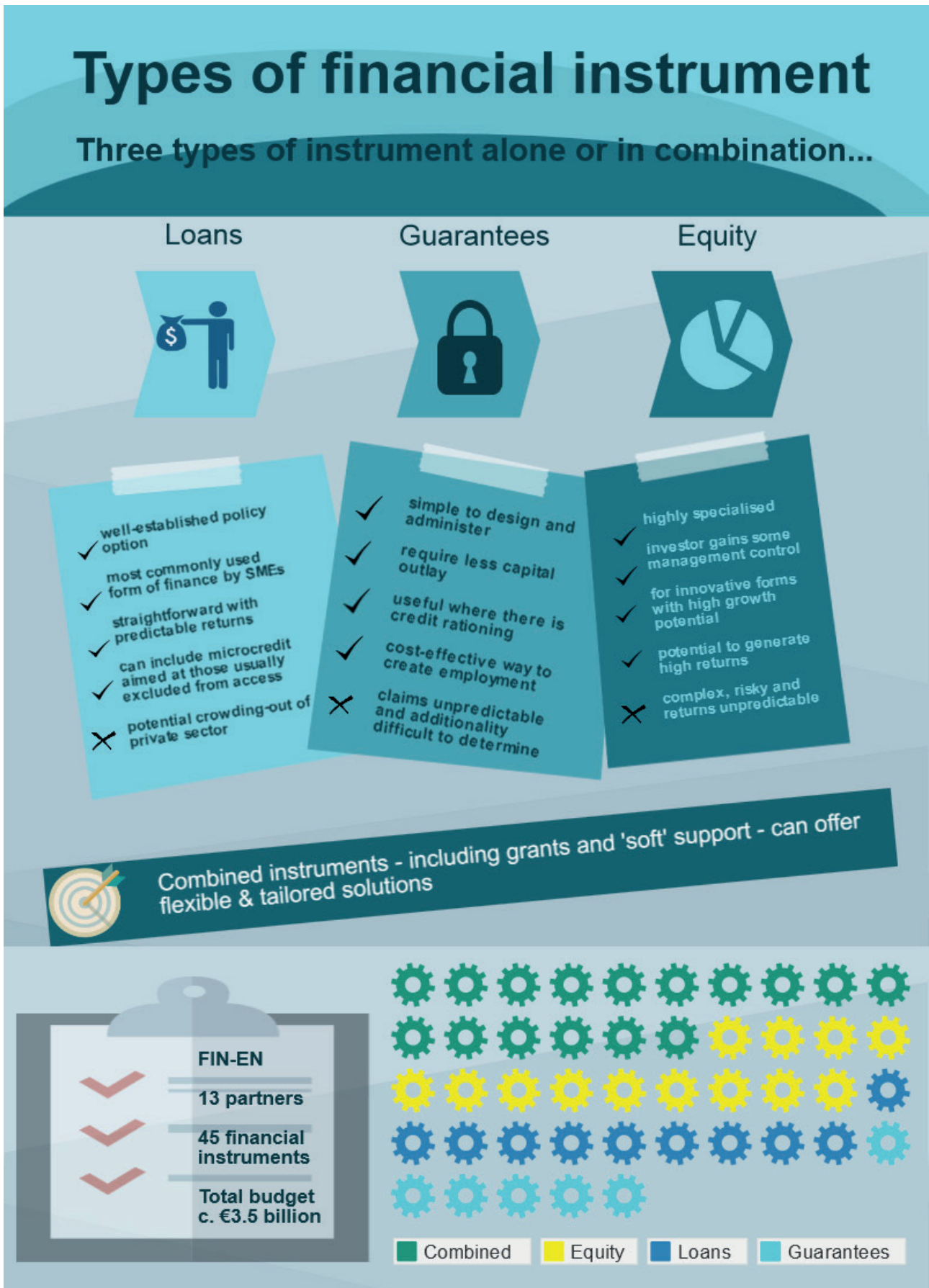
Annual SME surveys are used to evaluate, improve and adjust financial instruments



The FIN-EN study visits gathered useful information to feed in to the development of new funds



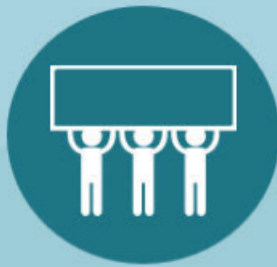
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Infographic 7 – Some findings from the exchange of experience

Shared experience of financial instruments

Financial instruments are not only for ERDF...



Micro-credits are used to support cooperatives under European Social Fund (ESF)



Enalio Guarantee Fund financed through the European Fisheries Fund (EFF)



Combining financial instruments can improve impact...



The New Szechenyi Combined Micro Loan programme combines loans and grants: approved borrowers can qualify for non-reimbursable support.



A combined ESF FI offers loans/equity plus a business coaching programme (the Accelerator programme). Companies completing the programme apply for investment capital



ESF Start Programme combines loans and grants with consultancy and training in management, accounting and marketing.



Innovative financial instrument design...



The IN2:BA – Business Angels Co-investment schemes aim to address market failure and sub-optimal investment situations for early stage businesses. The selection of investors on a deal-by-deal basis and the asymmetric distribution of earnings is popular within the Business Angel community.

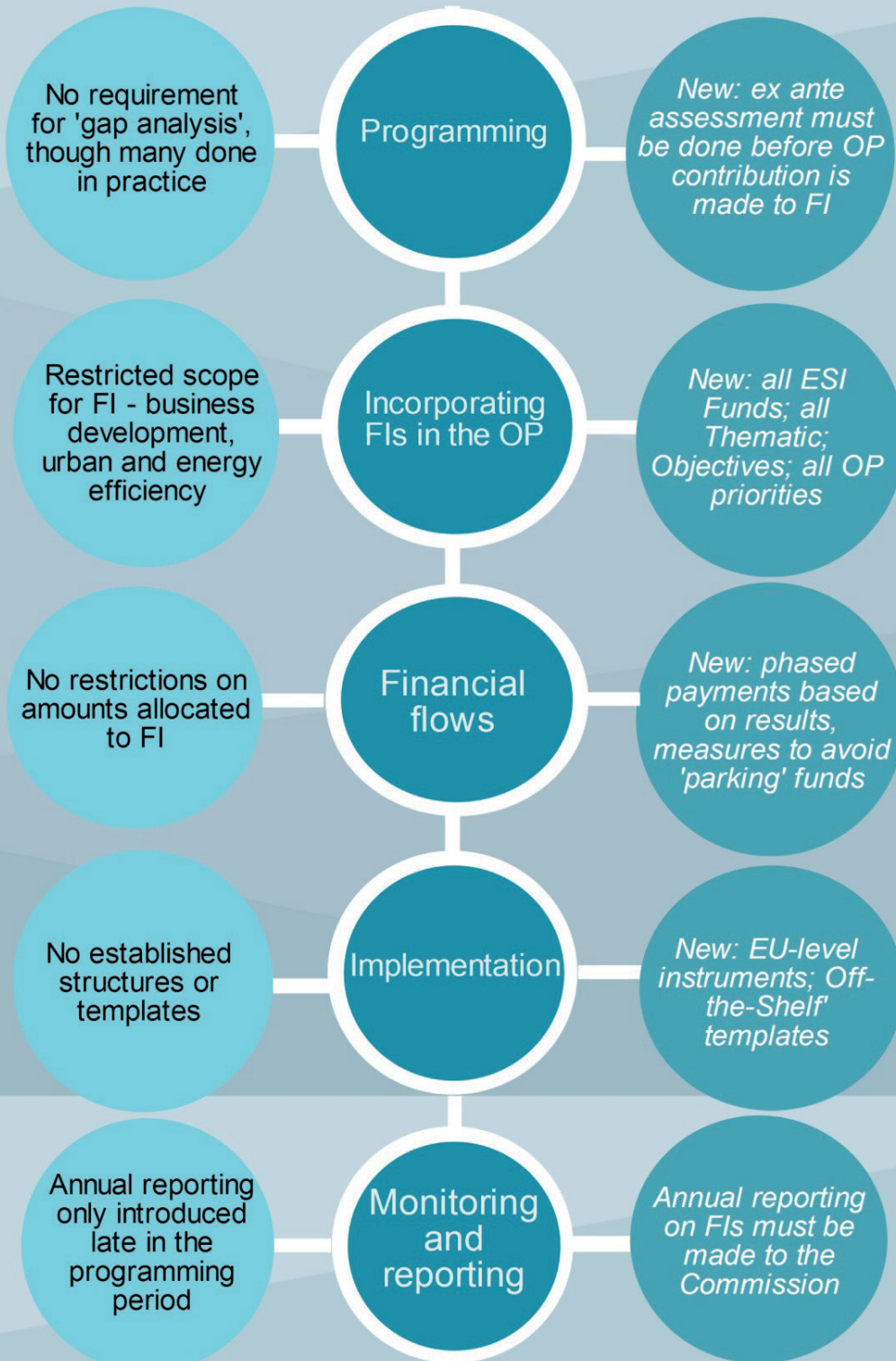


JEREMIE Fondo Multiinstrumento offers flexibility by using a variety of financial instruments (equity capital, mezzanine funding, loans, convertible loans, guarantees) to offer a tailor-made solutions for expanding early stage companies.



Infographic 8 – Main changes in 2014-2020

Financial instruments - main changes in 2014-20



ANNEX III: FINANCIAL INSTRUMENTS AND STATE AID

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INTRODUCTION

As part of the Cohesion Policy, the regulation laying down common provisions⁹¹ aims to promote measures which provide for the use of financial instruments with funding by member States using European Structural and Investment Funds (ESIF), and increasing the use of *equity* and debt instruments. In fact, “financial instruments are increasingly important due to their leverage effect on the ESI Funds, their capacity to combine different forms of public and private resources to support public policy objectives, and because revolving forms of finance make such support more sustainable over the longer term”⁹².

The European Commission therefore promotes measures which involve use of financial instruments in ESI Funds and defines the rules of compliance of these financial instruments with said funds. However, when this is State aid according to the treaty on functioning of the European Union, said measures are also subject to restrictions deriving from the rules of the treaty itself on State aid. In other words, the obligation of complying with the rules contained in regulations on ESI Funds is accompanied by the obligation of complying with European Union rules on State aid.

As shown by the diagram below, any analysis of whether a public intervention satisfies the rules of European Union law on State aid must start by assessing whether said intervention is State aid pursuant to article 107, paragraph 1, of the Treaty on the Functioning of the European Union (TFEU). This part of the evaluation therefore relates to the notion of State aid, which will be examined in [part I of this paper](#). At the end of this evaluation, it may be concluded that the intervention is not State aid; in this case, it is not subject to the restrictions deriving from the treaty on State aid.

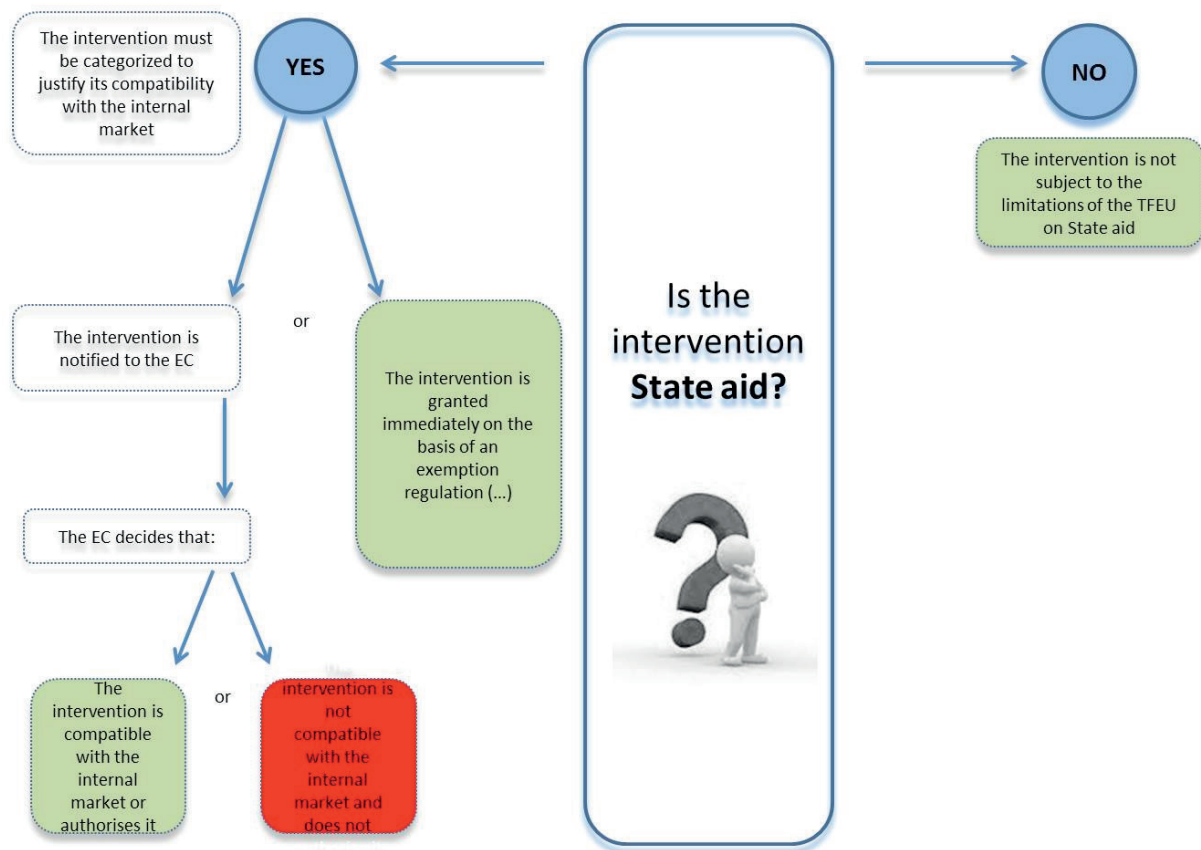
If the analysis leads to the conclusion that the measure is State aid, it must then be categorised under the rules on aid which is compatible with the internal market or the decision-making practices of the European Commission. This aspect will be examined in part II of this paper, but we must point out that there are various options: in the first place, the aid may be considered within the framework of a regulation which exempts the member States from the notification requirement (so-called exemption rule); in the second place, the European Commission may be notified of the intervention to allow it to assess its compatibility. These aspects will be examined in [part II of this paper](#).

If there are doubts over whether the measure may be considered State aid, there are two main possibilities (not shown in the diagram): 1) notifying the European Commission of the intervention and claiming (and justifying this claim) that the intervention is not considered to be “State aid”; 2) treating it as if it were clearly “State aid” and complying with the rules of the treaty and those deriving from it.

⁹¹ Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 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

⁹² *Ivi*, recital n. 34.





Before examining the basic aspects of the two phases of evaluating a public intervention, it is worth identifying what is meant by financial instruments in the rules on State aid (Foreword).

Foreword: definition of “financial instruments”

For definition of financial instruments, the regulation laying down common provisions on ESI Funds⁹³ refers, save where otherwise provided in the Regulation itself, to the definition contained in the financial regulations, according to which financial instruments are measures of financial support which take “...the form of equity or quasi-equity investments, loans or security, or other risk-sharing instruments ...”⁹⁴.

European Union regulations on State aid contain a definition of “financial instruments” in the *Guidelines on State aid to promote risk finance investments*⁹⁵ (hereinafter the “Guidelines on State aid to risk finance”), according to which “financial instruments include instruments other than aid, which may take the form of debt instruments (loans, guarantees) or equity instruments (pure equity, quasi-equity or other risk-sharing instruments)”⁹⁶.

Said guidelines also provide several specific definitions, the principal ones of which are indicated below⁹⁷:

- “equity investment”: the provision of capital to an undertaking, invested directly or indirectly in return for

⁹³ Regulation (EU) No 1303/2013, *op. cit.*, article 2, point 11).

⁹⁴ Regulation (EU, EURATOM) No 966/2012 of the European Parliament and of the Council of 25 October 2012 on the financial rules applicable to the general budget of the Union and repealing Council Regulation (EC, Euratom) No 1605/2002 [Official Journal L 298, 26.10.2012], article 2 (p). It states that these instruments “...may, where appropriate, be combined with grants”. This paper doesn’t deal with this eventuality, as according to state aid rules each component is treated individually. Thus, the state-aid analysis of a combined instrument (revolving and grant) will consider two separated analysis, one for each component. The same will occur for the definition of the state aid contribution as gross grant equivalent (GGE).

⁹⁵ *Official Journal of the European Union*, n. C 19, 22.1.2014.

⁹⁶ Guidelines on State Aid to promote risk finance investments, footnote n. 12

⁹⁷ Cfr. Guidelines on State Aid to promote risk finance investments, point 52.



the ownership of a corresponding share of that undertaking;

- “guarantee”: a written commitment to assume responsibility for all or part of a third party’s newly originated risk finance loan transactions such as debt or lease instruments, as well as quasi-equity instruments;
- “loan instrument”: an agreement which obliges the lender to make available to the borrower an agreed amount of money for an agreed period of time and under which the borrower is obliged to repay the amount within the agreed period. Debt instruments may take the form of a loan, or another funding instrument, including a lease, which provides the lender with a predominant component of minimum yield.
- “risk finance investment”: equity and quasi-equity investments, loans including leases, guarantees, or a mix thereof, to eligible undertakings;
- “quasi-equity investment”: a type of financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity and whose return for the holder is predominantly based on the profits or losses of the underlying target undertaking and which is unsecured in the event of default. Quasi-equity investments may be structured as debt, unsecured and subordinated, including mezzanine debt, and in some cases convertible into equity, or as preferred equity.

The above definitions refer to their use under the Guidelines on State aid to risk finance. Other documents may therefore contain different definitions or widen the category of financial instruments. In particular, there is also a definition of guarantee in the *European Commission Notice on application of articles 87 and 88 of the EC Treaty to State aid in the form of guarantees* (hereinafter the “Guarantees notice”)⁹⁸. Said notice is concerned, in particular, with specifying that various forms of guarantee may exist, “...depending on their legal basis, the type of transaction covered, their duration etc.”⁹⁹, even though the commonest form “...is the one associated with a loan, or other financial obligation to be contracted by a borrower with a lender¹⁰⁰”. Said notice also provides a non-exhaustive list of the various forms a guarantee may take¹⁰¹:

- general guarantees, i.e. guarantees provided to undertakings as such as opposed to guarantees linked to a specific transaction, which may be a loan, an equity investment, etc.;
- guarantees provided by a specific instrument as opposed to guarantees linked to the status of the undertaking itself; guarantees provided directly or counter guarantees provided to a first level guarantor;
- unlimited guarantees as opposed to guarantees limited in amount and/or time. The Commission also regards as State aid in the form of a guarantee the more favourable funding terms obtained by enterprise whose legal form rules out bankruptcy or other insolvency procedures or provides an explicit State guarantee or coverage of losses by the State. The same applies to the acquisition by a State of a holding in an enterprise if unlimited liability is accepted instead of the usual limited liability;
- guarantees clearly originating from a contractual source (such as formal contracts, letters of comfort) or another legal source as opposed to guarantees whose form is less visible (such as side letters, oral commitments), possibly with various levels of comfort.

In the case of loans, the *Communication from the Commission on the revision of the method for setting the reference and discount rates*¹⁰² (hereinafter the “rates communication”) does not provide a specific definition of “loan instruments”, but contains information to determine the “reference” and “discount” rates¹⁰³.

⁹⁸ Official Journal of the European Union n. C 155, 20.6.2008, revised version n. C 244, 25.9.2008.

⁹⁹ Guarantees communication, section 1.2.

¹⁰⁰ Guarantees communication, section 1.2. In the communication, “borrower” refers to the main beneficiary of guarantees, while “lender” means the entity whose risk is reduced thanks to the state guarantee (cfr. section 1.3).

¹⁰¹ Guarantees communication, section 1.2.

¹⁰² Official Journal of the European Union n. C 14 of 19.01.2008.

¹⁰³ Cfr. *infra*, p. 17 and p 27.



I. Notion of State aid

References:

- Regulation of reference: article 107, paragraph 1, of the TFEU
- Case law of the European Court of Justice
- Reference deed or other document: Draft notice of the European Commission on State aid pursuant to article 107, paragraph 1, of the TFEU. Available in various languages on the following page: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html

Article 107, paragraph 1 of the TFEU, in addition to containing the principle of incompatibility of State aid, which allows derogations, outlines the boundaries of the notion of State aid.

According to this regulation, “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”.

Case law of the European Court of Justice is constant in stating that qualification as aid requires the following four conditions to be satisfied. Firstly, it must be an intervention of the State or through State resources. Secondly, said intervention must be liable to effect trade between member States. Thirdly, it must provide a selective benefit. Fourthly, it must distort or threaten to distort competition¹⁰⁴.

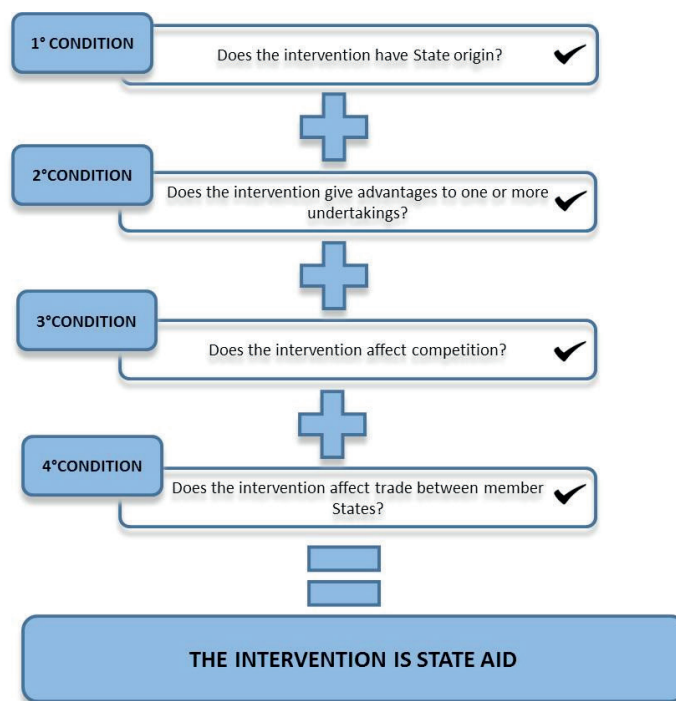
Therefore, for a measure or an intervention to be State aid, **four cumulative conditions** must be satisfied. Specifically, the measure or intervention must:

- be “State” in origin: “...aid granted by a Member State, or through State resources ...”;
- lead to the presence of a (selective) advantage for certain undertakings or the production of certain goods: “...by favouring certain undertakings or the production of certain goods ...”;
- distort or threaten to distort competition;
- affect trade between Member States.

The diagram below shows the analysis to be conducted in evaluating whether an intervention qualifies as State aid. The order chosen is the one used by the European Commission, but this does not necessarily mean that it may not be useful to start with one condition rather than another as far as concerns the State origin of the aid. If one of the conditions (indicated in the questions) is not satisfied, the intervention is not State aid according to article 107(1) TFEU.

¹⁰⁴ Cfr. Judgment of the General Court of 13 September 2012, Italy v/ European Commission, case T-379/09, point 34. Cfr. Judgement of the Court of 10 June 2010, Fallimento Traghetti del Mediterraneo SpA, case C-140/09, point 31. Recently, judgements of the Court of 18 January 2012, Djebel v/ Commission, case T-422/07, point 81, 28 February 2012, Land Burgenland and Austria v/ Commission, joint cases T-268/08 and T-281/08, point 45 and 20 March 2013, Rousse Industry AD v/ Commission, case T-489/11, point 29.





NB.
If even ONLY ONE of the above four conditions is NOT satisfied, the intervention is NOT State aid

These four conditions contain various elements constituting the notion of State aid. For example, article 107(1) TFEU states that the advantage must be granted "...to certain undertakings or the production of certain goods ...". This implies that, in order to be considered as such according to this regulation, said aid must be granted to a party which may be qualified as an undertaking. In other words, aid is interventions which "...favour certain undertakings directly or indirectly ..."¹⁰⁵. It is therefore necessary to define the notion of an undertaking, which obviously does not depend on the status of the entity according to national law.

Furthermore, the notion of advantage includes the notion of selectivity. In fact, the condition on existence of an advantages requires the measure in question to favour "certain undertakings or the production of certain goods" compared with other undertakings which are, with respect to the objective being pursued by this measure, in an identical *de facto* and *de jure* situation. This condition of specificity, or selectivity, of a measure is one of the characteristics of the notion of State aid¹⁰⁶.

The various elements which, according to case law, form State aid according to this regulation will be clarified in a Notice of the Commission which is currently available in the draft version¹⁰⁷. This draft notice mentions the following elements: the existence of an undertaking, applicability of the State measure, its funding through State resources, granting of an advantage, selectivity of the measure and its potential effects on competition and trade inside the European Union.

On the pages which follow, the four conditions identified by case law and forming the notion of State aid are examined, namely: the State origin of the aid (a), the existence of an advantage (b), distortion of competition (c) and the effect on trade between Member States (d). The notion of advantage will be examined in greater detail, as it is the one in which certain aspects distinguish financial instruments from other forms of aid.

In fact, in analysing whether an intervention is State aid pursuant to article 107(1) TFEU, an aspect which distinguishes financial instruments from other forms of aid (subsidies, for example) relates to the need to examine the presence of ad advantage by evaluating the risks. For example, the premium or fee which a

¹⁰⁵ Judgment of the Court of 8 September 2011, *Commission v/ Netherlands*, Case C-279/08 P, point 87.

¹⁰⁶ Cfr. Judgement of the Court of Justice of 1 July 2010, *BNP Paribas and Banca Nazionale del Lavoro SpA (BNL) v/ Commission*, Case T-335/08, point 160.

¹⁰⁷ Draft notice of the European Commission on State aid pursuant to article 107, paragraph 1, of the TFEU. Available in various languages on the following page: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html



financial institute demands from an undertaking to provide a guarantee is determined on the basis of individual evaluation of the risk of losses in relation to said guarantee. The same applies for the interest rate on granting of a loan. It is therefore necessary to examine in detail here this element of the notion of aid.

However, before examining the aforesaid four conditions, it must be specified that the presence of aid should be analysed with reference to each of the parties involved in the intervention of the public authority. For example, granting of State guarantees to an undertaking connected with a bank loan requires examination of the presence of any aid, not only to the undertaking receiving the guarantee, but also to the bank granting the loan, as it could enjoy an indirect benefit which may be qualified as “State aid”.

a) State origin of aid, in any form

References:

- Regulation of reference: article 107, paragraph 1, of the TFEU
- Case law of the European Court of Justice
- Reference deed or other document: Draft notice of the European Commission on State aid pursuant to article 107, paragraph 1, of the TFEU. Available in various languages on the following page: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html
- section 3 in particular.

Article 107(1) TFEU considers as incompatible with the internal market “...aid granted by a Member State or through state resources, in any form ...”. This expression implies that the intervention must have “State origin” and that qualification as aid does not depend on the form of the intervention. In other words, the intervention must be attributable to a behaviour of the State and may take various forms.

In the Draft notice of the European Commission on the notion of State aid pursuant to article 107(1) TFEU, it is specified that “*In cases where a public authority grants aid to a beneficiary or designates a private or public body to administer the measure, this transfer is imputable to the State, even if the public authority enjoys autonomy. Imputability is less evident, however, if the advantage is granted through one or more intermediate bodies, be they public or private, and in particular through public undertakings*”¹⁰⁸.

The notion of State is therefore interpreted in a broad sense, including in State origin of the aid all public authorities of a Member State. The Court has specified that article 107(1) TFEU, “... by referring to aid granted ‘by Member States or through state resources in any form’, refers to all aid funded with public money”. It is therefore possible to consider as State aid interventions performed by entities, bodies or firms (defined as “public firms”) which are directly or indirectly under public control (the State intended in all its parts, such as ministries, regional and local authorities)¹⁰⁹.

The draft notice in question indicates a series of characteristics which allow imputability to the State of an aid measure adopted by a public entity. These characteristics result from the circumstances of the case in question and the context in which the measure is adopted¹¹⁰.

Case law has also specified that State resources are an essential element of the notion of State aid. In other words, an intervention with State origin (a law, for example), which gives an advantage to specific beneficiaries (second condition of the notion of aid), distorts or threatens to distort competition (third condition of the notion of aid) and affects trade between Member States (fourth condition of the notion of aid), cannot be qualified as “State aid” pursuant to article 107(1) TFEU unless it involves use of State resources. In fact, case law has specified that public interventions which do not involve use of public resources are excluded from the area of application of article 107(1) TFEU: “... advantages granted through means other than State resources are excluded from the area of application of the regulations ...”¹¹¹ on State aid.

This aspect is also mentioned in the draft notice of the Commission on the notion of State aid, which specifies

¹⁰⁸ *Ivi*, point 42.

¹⁰⁹ Please refer to section 3.2.2 of the notice from the Commission on the notion of State aid.

¹¹⁰ Cfr. Draft Commission Notice on the notion of State aid, paragraph 3.1.1.

¹¹¹ Judgement of the Court of 19 March 2013, Bouygues SA, case C-399/10 P, point 99.



that only advantages granted directly or indirectly through State resources can constitute State aid¹¹².

Lastly, it is worth noting that article 107(1) TFEU includes “... aid granted by Member States or through state resources, in any form ...”. An intervention imputable to the State is therefore aid, irrespective of the form it takes. Aid may therefore be in the classic form of a subsidy, or even reduction of or exemption from tax¹¹³. Other forms are attributable to the definition of “financial instruments” referred to here¹¹⁴: for example, a loan at subsidised interest rates¹¹⁵, a guarantee¹¹⁶ or risk finance instruments¹¹⁷.

b) Presence of a selective advantage in favour of undertakings

For article 107(1) TFEU to be applicable, the aid must favour certain undertakings or the production of certain goods. In other words, the State intervention must give an advantage to certain undertakings compared with their competitors.

As already mentioned¹¹⁸, article 107(1) TFEU states that the advantage must be granted “...to certain undertakings or the production of certain goods ...”. This implies that, in order to be considered as such according to this regulation, said aid must be granted to a party which may be qualified as an undertaking. Furthermore, the notion of advantage also includes the notion of selectivity.

It is therefore necessary first to examine the notions of undertaking (i) and selectivity (ii). Subsequently, it will be necessary to examine the essence of the very notion of advantage (iii), which is economic in nature and is relevant irrespective of whether it is direct or indirect. This latter aspect is the one which involves the greatest peculiarities with reference to financial instruments.

(i) Notion of an undertaking

References:

- Regulation of reference: article 107, paragraph 1, of the TFEU
- Case law of the European Court of Justice
- Reference deed or other document: Draft notice of the European Commission on State aid pursuant to article 107, paragraph 1, of the TFEU. Available in various languages on the following page: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html
- section 2 in particular.

The beneficiary must therefore be qualifiable as an undertaking. A notion of undertaking according to EU law exists. As specified by the European Commission “the Court of Justice has consistently defined undertakings as entities engaged in an economic activity, regardless of their legal status and the way in which they are financed. The classification of a particular entity as an undertaking thus depends entirely on the nature of its activities¹¹⁹”. Any activity which consists in supplying goods or services on a specific market constitutes economic activity¹²⁰. Furthermore, “the economic or non-economic character of an activity does not depend on the private or public statute of the entity performing it nor on the profitability of said activity¹²¹”.

¹¹² Cfr. Draft Commission Notice on the notion of State aid, point 49.

¹¹³ There is indeed deployment of public resources even in case of reduction of or exemption from taxes. This kind of operation directly affects the State budget as it generates a reduction of taxes.

¹¹⁴ Cfr. *supra*, p. 1.

¹¹⁵ Cfr. Communication from the Commission on the revision of the method for setting the reference and discount rates (Official Journal of the European Union n. C 14 of 19.01.2008).

¹¹⁶ Cfr. Notice of the Commission on the application of articles 87 and 88 of the Treaty on State Aid granted as guarantees (Official Journal of the European Union n. C 155 of 20.6.2008, revised on su Official Journal of the European Union n. C 244 of 25.9.2008).

¹¹⁷ Guidelines on State aid to promote risk finance investments (Official Journal of the European Union, n. C 19 of 22.1.2014).

¹¹⁸ Cfr. *supra*, p. 5

¹¹⁹ Progetto di comunicazione della Commissione sulla nozione di aiuto di Stato, punto 7.

¹²⁰ *Ivi*, punto 29. Cfr. anche le sentenze del Tribunale del 1° luglio 2009, *KG Holding e.a./ Commissione*, cause riunite T-81/07 a T-83/07, Racc. 2009, p. II-2411, punto 178, e del 24 marzo 2011, *Mitteldeutsche Flughafen AG c/ Commissione*, cause riunite T-443/08 e T-455/08, punto 89.

¹²¹ Judgement of the Court of 19 December 2012, MF and FLH, case C-288/11P, point 50.



The draft notice on the notion of State aid, to which reference is made for further details, indicates the three consequences connected with this notion (or definition) of undertaking:

- Firstly, the status of the entity in question under national law is irrelevant¹²².
- Secondly, application of regulations on State aid, as such, does not depend on the fact that the entity is created to obtain profits¹²³.
- Thirdly, an entity is always classified as an undertaking in relation to a specific activity. An entity performing both economic and non-economic activities is considered as an undertaking only with regard to the former. Furthermore, two entities with a separate legal status may be considered as a single economic unit. Said economic unit is therefore considered as the undertaking concerned¹²⁴.

On this point, we may add that a public entity - such as a local or regional authority - may be considered as an undertaking, but only insofar as concerns a part of its activities, if these are qualified as economic activities¹²⁵.

The distinction between economic and non-economic activities depends on various factors, such as policy choices and economic development of a specific Member State. In consideration of development of these elements, the European Commission has decided that it is not possible to draft *a priori* an exhaustive list of activities which are never economic in nature. Such a list would not provide genuine certainty of the law and would therefore not be very useful¹²⁶.

However, it is worth remembering that activities linked with exercising the typical prerogatives of public powers by the State or authorities acting within the limits of their public office do not possess economic aspects which justify application of the regulations on competition contained in the treaty¹²⁷, even if said activities are performed by a private entity on assignment of the public authorities¹²⁸. In fact, in this case, it is irrelevant whether the State is acting directly through an entity forming part of the public administration or through a separate entity to which it has granted special or exclusive rights¹²⁹.

In the draft notice on the notion of State aid, the Commission has listed certain cases in which case law or practice has recognised qualification of activities relating to exercising of public powers¹³⁰ and also refers to the criteria for distinguishing between social security systems which involve economic activities and those which do not¹³¹.

(ii) Selectivity

References:

- Regulation of reference: article 107, paragraph 1, of the TFEU
- Case law of the European Court of Justice
- Reference deed or other document: Draft notice of the European Commission on State aid pursuant to article 107, paragraph 1, of the TFEU. Available in various languages on the following page: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html
- section 5 in particular.

122 ""For example, an entity that is classified as an association or a sports club under national law may nevertheless have to be regarded as an undertaking within the meaning of Article 107(1) TFEU. The same applies to an entity that is formally part of the public administration. The only relevant criterion in this respect is whether it carries out an economic activity." (Draft Commission Notice on the notion of State aid, point 8).

123 For examples, non-profit entities can offer goods and services on a market too (cfr. Draft Commission Notice on the notion of State aid, point 9).

124 In this respect, the Court of Justice considers the existence of a controlling share and other functional, economic and organic link (cfr. Draft Commission Notice on the notion of State aid, point 11).

125 Cfr. Judgment of the General Court of 12 September 2013, *Germany v/ Commission*, case T-347/09, point 28.

126 Cfr. Draft Commission Notice on the notion of State aid, point 15.

127 Cfr. Judgement of the Court of 19 January 1994, *Sat Fluggesellschaft MBH v/ Eurocontrol*, case C-364/92, Racc. p. I-43, point 30.

128 Cfr. Judgement of the Court of 18 March 1997, *Diego Calí & figli v/ porto di Genova S.p.A.*, case C-343/95, Racc. p. I-1547, spec. points 16 e 17.

129 Cfr. Judgment of 16 June 1987, *Commission / Italy*, case 118/85, Racc. 1987, p. 2599, points 7 e 8

130 Examples are activities related to: the army or the police; air navigation safety and control; maritime traffic control and safety; anti-pollution surveillance; the organisation, financing and enforcement of prison sentences; the collection of data to be used for public purposes on the basis of a statutory obligation imposed on the undertakings concerned to disclose such data (cfr. Draft Commission Notice on the notion of State aid, section 2.2).

131 Cfr. Draft Commission Notice on the notion of State aid, section 2.3.



In order for there to be an advantage, the State intervention must be selective. Consequently, not all measures favouring economic operators fall within the notion of aid, but only those which grant an advantage selectively to certain undertakings or categories of undertakings or specific economic sectors¹³².

For example, selectivity allows a distinction to be made between interventions giving advantages to certain undertakings and general measures, which do not involve any selectivity, as they do not discriminate, for example, according to the size of the undertaking¹³³, the sector of activity¹³⁴, criteria which allow discrimination of another type between undertakings¹³⁵, the territory where the measure is applied (geographical selectivity)¹³⁶ or on the basis of the discretionary powers of the public authorities¹³⁷ with regard to implementation of the measure.

The Commission distinguishes between material selectivity and geographical selectivity “material selectivity of a measure implies that the measure applies only to certain (groups of) undertakings or certain sectors of the economy in a given Member State”¹³⁸, whereas geographical selectivity relates to the territory.

Concerning material selectivity, the Commission distinguishes between *de jure* and *de facto* selectivity: the former results directly from the legal criteria for granting a measure which is formally reserved for certain undertakings only, whereas the latter may be established in cases where, although the formal criteria for the application of the measure are formulated in general and objective terms, the structure of the measure is such that its effects significantly favour a particular group of undertakings¹³⁹. The European Commission also mentions selectivity resulting from discretionary administrative practices, which is the case of “... measures which *prima facie* apply to all undertakings, but are (or may be) limited by the discretionary power of administration”¹⁴⁰ and are therefore considered to be selective.

Concerning geographical selectivity, it may be stated that “in principle, only those measures whose scope encompasses the entire territory of the State escape the selectivity criterion laid down in Article 107(1) TFEU”¹⁴¹. However, there may be cases in which a measure favouring solely undertakings active in a part of the national territory might not be considered as selective. This is the case, for example, of sub-State territorial entities with tax autonomy.

In fact, in the case of tax measures, the existence of an advantage may only be established with reference to taxation qualifiable as “normal”, i.e. the taxation normally applicable to undertakings in a *de facto* and *de jure* situation comparable to those of the beneficiary undertaking¹⁴². Therefore, qualifying a tax measure as “selective” presumes that the common (or ordinary or normal) taxation system applicable in the Member State concerned has first been identified and examined. In the case of territorial collectivity with tax autonomy, therefore, it is

¹³² Ivi, point 118.

¹³³ Cfr. For example, Judgment of the Court of 26 September 2002, case C-351/98, Racc. 8031, points 39 e 40 and Commission decision of 10 July 2002 about the state aid scheme agreed to Finland in favour to insurance undertakings dependant on a group, acting in the province of Åland, point 52 (Official Journal of the European Union L 329 of 5.12.2002).

¹³⁴ In the case *Maribel bis/ter*, for example, the General Court recalls that “...the reduction of the benefit of higher reductions agreed to some sectors of activity makes” state measures “...selective, in order to satisfy requirements of specificity” (Judgment 17 June 1999, *Belgio v/ Commission*, case C-75/97, Racc. p. I-3671, point 31).

¹³⁵ In the Commission Decision of 21 November 2001 on the tax-free provisions introduced by France for setting up establishments abroad (Official Journal L 126 of 13.5.2002), the EC concluded that only certain firms producing in France were eligible for the measure: firms producing in France but not exporting, firms with establishments abroad whose main business is not marketing goods produced in France; firms producing in France and exporting but without any establishments abroad, firms engaged solely in trading.

¹³⁶ In an important Commission Decision about Italy, Commission concluded that “*Selective reductions which favour certain firms in a particular Member State, whether the selectivity operates at individual, regional or sectoral level, constitute, for the differential part of the reduction, State aid within the meaning of Article 87(1) of the Treaty, i.e. aid which distorts competition and could affect trade between Member States*”. In fact “...This differential benefits firms which operate in particular areas of Italy as the aid was not granted to firms in other areas” (Commission Decision of 11 May 1999 concerning aid granted by Italy to promote employment (Notified under document number C(1999) 1364); OJ L 42 of 15.2.2000). This decision has been the object of a recent judgment of the Court of Justice, even if on another aspect (Judgement of 7 March 2002, *Italy v/ Commission*, case C-310/99, Racc. p. I-2289).

¹³⁷ In a judgment of 11 July 2002, The Court (first instance) specified that this provision “...does not favour only certain undertakings or the production of only certain good” it must be remembered that “the debt remissions criticized by the Commission do not flow automatically from the application of the law, but from the discretionary decisions made by the public bodies in question. It is, moreover, settled case-law that where the body granting financial assistance enjoys a degree of latitude which enables it to choose the beneficiaries or the conditions under which the financial assistance is provided, that assistance cannot be considered to be general in nature (Judgment of the Court 29 June 1999, case C-256/97, *DM Transport*, Racc. pag. I-3913, point 27)”.

¹³⁸ Draft Commission Notice on the notion of State aid, point 121.

¹³⁹ Draft Commission Notice on the notion of State aid, point 122.

¹⁴⁰ Ivi, point 124.

¹⁴¹ Ivi, point 142.

¹⁴² Cfr. Judgement of the Court of 1 July 2010, *BNP Paribas et BNL v/ Commission*, case T-335/08, in particular points 160-162, 169, 187, 204.



necessary to determine whether the common taxation system is the State system or the system of the sub-state territorial entity concerned. Therefore, in relation to the common taxation system, it is then necessary to evaluate and ascertain any selectivity of the benefit granted by the tax measure considered, demonstrating that the latter derogates from said common system¹⁴³, by introducing differentiation between operators which are, in terms of the objective being pursued by said Member State, in a comparable *de facto* and *de jure* situation.

Tax measures which are regionally or locally applicable therefore might not be considered as selective if certain conditions established by the case law of the Court of Justice are satisfied. The European Commission has clearly summarised said conditions and the various scenarios concerning tax measures in the draft notice on the notion of aid, to which reference should be made¹⁴⁴.

Said draft notice also clarifies specific fiscal aid issues, concerning cooperative societies, collective investment undertakings, tax amnesties, tax settlements and rulings, depreciation/amortisation rules, flat-rate tax regimens for specific activities, anti-abuse rules and excise duties¹⁴⁵. The Commission also refers to several legal principles which establish criteria for assessment of other measures as well (such as tax or social security exemptions), which must be assessed in a three-step analysis: 1) identify the system of reference; 2) determined whether a given measure constitutes a derogation from that system; 3) establish whether the derogatory measure is justified by the nature or the general scheme of the (reference) system¹⁴⁶. In fact, a measure derogating from application of the general taxation system may be justified by the nature and general structure of the taxation system and not constitute State aid when the Member State concerned is able to demonstrate that said measure derives directly from the underlying or basic principles of its taxation system.

(iii) *Notion of advantage, direct and indirect*

References:

- Regulation of reference: article 107, paragraph 1, of the TFEU
- Case law of the European Court of Justice
- Reference deed or other document:
 - Draft notice of the European Commission on the notion of State aid pursuant to article 107, paragraph 1, of the TFEU. Available in various languages on the following page: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html
 - section 4 in particular.
 - Guidelines on State aid to promote risk finance investments (*Official Gazette of the European Union*, no. C 19 of 22.1.2014)
 - section 2.1 in particular.
 - European Commission Notice on application of articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (*Official Gazette of the European Union* no. C 155 of 20.6.2008, corrected in *Official Gazette of the European Union* no. C 244 of 25.9.2008)
 - Communication from the Commission on the revision of the method for setting the reference and discount rates (*Official Gazette of the European Union* no. C 14 of 19.01.2008)

As specified by the Court of Justice, the concept of advantage is **essentially economic in nature**: “in order to assess whether a State measure is aid, it is necessary ... to establish whether the beneficiary undertaking receives an economic advantage which not have been obtained under normal market conditions”¹⁴⁷. In other words, the State contribution must contribute to “... sustaining costs which would normally weigh on the undertaking’s own financial resources ...” thereby preventing “... market forces from having their normal effects”¹⁴⁸. Section 4.2 of the draft notice on the notion of State aid contains detailed indications for evaluating whether an advantage

¹⁴³ Cfr. Judgement of 7 March 2012, *British Aggregates Association v/ Commission*, case T-210/02 RENV, point 49.

¹⁴⁴ Cfr. Draft Commission Notice on the notion of State aid, section 5.3.

¹⁴⁵ Cfr. *Ivi*, section 5.4.

¹⁴⁶ Cfr. *Ivi*, section 5.2.3.

¹⁴⁷ Judgement of the Court of Justice of 11 July 1996, *Syndicat français de l'Express international (SFEI) e altri c/ La Poste e altri*, case C-39/94, Racc. p. I-3547, point 60.

¹⁴⁸ Judgment of the Court of Justice of 14 February 1990, *Francia v/ Commission*, case 301/87, Racc. p. I-307, point 41. Cfr. also Judgement of the Court of 11 September 2012, *Corsica Ferries France v/ Commission*, case T-565/08, point 138.

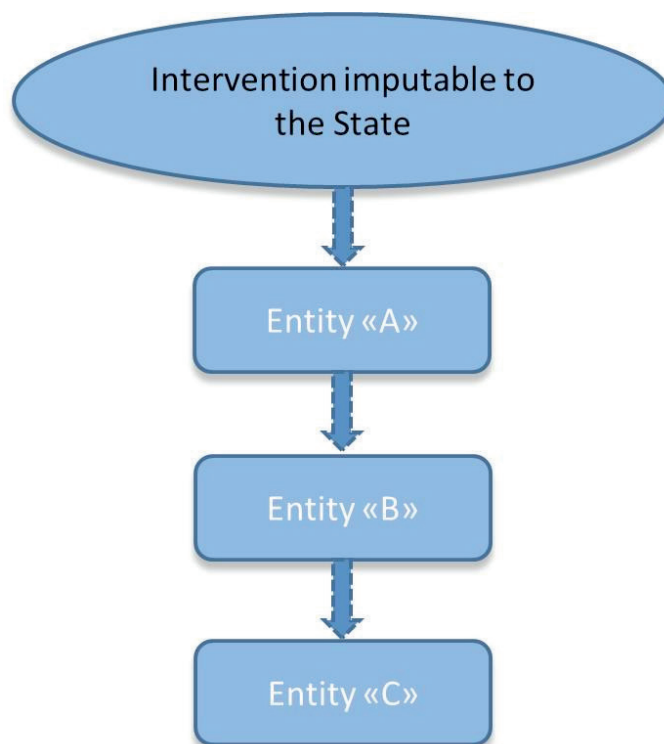


is obtained under normal market conditions.

It should be remembered here that “only the effect of the measure on the undertaking is relevant, neither the cause nor the objective of the State intervention. Whenever the financial situation of an undertaking is improved as a result of State intervention, an advantage is present to assess this, the financial situation of the undertaking following the measure should be compared with its financial situation if the measure had not been introduced. Since only the effect of the measure on the undertaking matters, it is irrelevant whether the advantage is compulsory for the undertaking in that it could not avoid or refuse it”¹⁴⁹.

Furthermore, a public intervention may lead to a **direct or indirect advantage** or to both.

The diagram summarises the possible relationship: by means of an intervention imputable to the State, there



may be transfer of State resources in favour of entity A, which could be the beneficiary of the advantages. This transfer of State resources could also lead to advantages in favour of entity B or even entity C.

An intervention may therefore lead to a direct advantage for certain beneficiaries - to whom the State resources are transferred - but also have (indirect) secondary effects on other beneficiaries.

As reiterated by the European Commission, “An indirect advantage is present if the measure is designed in such a way so as to channel its secondary effects towards identifiable undertakings or groups of undertakings. This is the case, for example, if the direct aid is, de facto or de jure, made conditional on the purchase of goods or services produced by certain undertakings only (e.g. only undertakings established in certain areas)¹⁵⁰”. According to the diagram, “entities B” are the undertakings which benefit from purchase of the goods and services and “entities A” are the undertakings forced to purchase goods from “entities B”. In this case, there is indirect aid in favour of “entities B” which sell the goods or services. Such indirect advantages should be distinguished from mere secondary economic effects that are inherent in almost all State aid measures (e.g. through an increase of output).¹⁵¹.

As already observed, transfer of State resources may take many forms, such as direct grants, loans, guarantees, direct investment in the capital of enterprises and benefits in kind¹⁵². Financial instruments involve specific peculiarities leading to the need to define specific methodologies or criteria to measure the entity of the

¹⁴⁹ Draft Commission Notice on the notion of State aid, point 68.

¹⁵⁰ *Ivi*, point 75.

¹⁵¹ *Ivi*, point 75.

¹⁵² Cfr. *Ivi*, point 53.



advantage (or the aid), where possible, or simply to assess its presence or reduce it to the minimum necessary to achieve the purposes being pursued by the aid. Part I of this paper deals with assessment of the presence of an advantage. In fact, in the absence of an advantage, the financial instrument cannot be qualified as State aid, whereas in the presence of an advantage, its entity must be measured in order to assess whether it is compatible with the internal market¹⁵³.

Loans at subsidised interest rates and aid in the form of a guarantee require determination, respectively, of the market interest rate and the market premium of the guarantee. In other words, if the undertaking seeks a loan or a guarantee on the market (from a bank, for example), it must pay the operator in the form of interest for the loan or the premium for the guarantee. Therefore, when an administration grants a loan or a guarantee, it must determine the market rate and apply it to the beneficiary undertaking to ensure that the transaction is not State aid (absence of an advantage for the beneficiary).

The European Commission states that “as for any other transaction, loans and guarantees granted by public entities (including public undertakings) may entail State aid if they are not in line with market terms¹⁵⁴”. In fact, “... a borrower who obtains a secured loan from the public administration of a Member State normally receives an advantage within the limits in which the financial costs it sustains are lower than those it would have sustained if it had obtained the same loan and the same guarantee at the market price¹⁵⁵”.

More generally speaking, in order to determine whether a financial instrument allows an advantage to be obtained, it is necessary to base the evaluation on the “principle of a private investor operating on a market economy”. It would therefore be necessary to consider the effective possibility of the beneficiary undertaking obtaining equivalent financial resources on the capital market. The intervention is not State aid when a source of funding is granted at conditions which would be acceptable for a private operator operating in normal circumstances on a market economy.

The Market Economy Operator criteria is illustrated by the Commission in the draft notice on the notion of State aid¹⁵⁶ and is also used as a benchmark in the Guidelines on State aid to risk finance¹⁵⁷.

As already noted, the Commission takes a different approach, depending on whether this is a guarantee, a loan or risk finance, as will be seen more clearly below.

* **Loans**

The *Communication from the Commission on the revision of the method for setting the reference and discount rates*¹⁵⁸ indicates a method for calculating the reference rate “...which should act as a proxy for the market price in situations where comparable market transactions are not straightforward to identify (which is more likely to apply to transactions involving limited amounts and/or transactions involving SMEs)...”¹⁵⁹.

However, this is a purely indicative value to determine the presence of an advantage: “...this reference rate is only a proxy. If comparable transactions have typically taken place at a lower price than that indicated as a proxy by the reference rate, the Member State can consider that this lower price is the market price. If, on the other hand, the same company has carried out recent similar transactions at a higher price than the reference rate and its financial situation and the market environment have remained substantially unchanged, the reference rate may not constitute a valid proxy of market rates for that specific case¹⁶⁰”.

* **Guarantees**

In order to assess whether the principle of a Market Economy Investor is satisfied for a specific guarantee measure, the *European Commission Notice on application of articles 87 and 88 of the EC Treaty to State aid in the form of guarantees*¹⁶¹ lists a series of conditions sufficient to confirm that aid is absent. In particular, in this notice,

¹⁵³ Cfr. *Infra*, p. 27 e ss.

¹⁵⁴ *Ivi*, point 111.

¹⁵⁵ Judgement of the Court of 3 April 2014, *Francia v/ Commission*, case C559/1 P, point 96.

¹⁵⁶ Cfr. Draft Commission Notice on the notion of State aid, section 4.2.

¹⁵⁷ Cfr. Guidelines on State aid to promote risk finance investments, section 2.1.

¹⁵⁸ Official Journal of the European Union n. C 14 of 19.01.2008.

¹⁵⁹ Draft Commission Notice on the notion of State aid, point 116.

¹⁶⁰ Draft Commission Notice on the notion of State aid in accordance with article 107, paragraph 1, of TFUE, point 116 (available at the following link: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html).

¹⁶¹ Official Journal of the European Union n. C 155 of 20.6.2008, revision on Official Journal of the European Union n. C 244 of 25.9.2008.



the Commission provides detailed indications on approximate values (and on safety zones for SMEs): “... to rule out the presence of aid it is normally sufficient that the borrower is not in financial difficulty, that the guarantee is linked to a specific transaction, that the lender bears part of the risk and that the borrower pays a market oriented price for the guarantee”¹⁶².

Said notice also illustrates the conditions which allow the presence of aid in granting individual guarantees or in guarantee schemes to be excluded.

In the first place, the notice distinguishes between aid to the borrower¹⁶³ and aid to the lender¹⁶⁴. The beneficiary of the aid is usually the borrower, but the lender may also receive State aid in certain circumstances. For example, as stated in the guarantees notice “...if a State guarantee is given ex post in respect of a loan or other financial obligation already entered into without the terms of this loan or financial obligation being adjusted, or if one guaranteed loan is used to pay back another, non-guaranteed loan to the same credit institution, then there may also be aid to the lender, in so far as the security of the loans is increased”¹⁶⁵.

The guarantees notice provides the criteria for excluding the presence of State aid to the borrower. The criteria vary depending on whether it is an individual guarantee or a guarantee scheme¹⁶⁶. “An «individual guarantee» means any guarantee provided to an undertaking and not awarded on the basis of a guarantee scheme”, while “a «guarantee scheme» means any tool on the basis of which, without further implementing measures being required, guarantees can be provided to undertakings respecting certain conditions of duration, amount, underlying transaction, type or size of undertakings (such as SMEs)”¹⁶⁷.

The conditions for individual guarantees may be summarised as follows¹⁶⁸:

- a) The borrower is not in financial difficulty;
- b) The extent of the guarantee can be properly measured when it is granted;
- c) The guarantee does not cover more than 80% of the outstanding loan or other financial obligation; this limitation does not apply to guarantees covering debt securities;
- d) A market-oriented price is paid for the guarantee.

Exceptionally, if the borrower¹⁶⁹ is a small or medium sized enterprise (SME), the Commission may accept a simpler evaluation of whether or not a loan guarantee involves aid. For individual guarantees, the evaluation is based on the “safe-harbour premium” method¹⁷⁰, which allows a market-oriented price of the guarantee to be determined, derogating from the criteria indicated in letter d) above. The conditions of letters a), b) and c) must be satisfied in all cases.

The notice provides a table which, based on the borrower’s rating, provides the minimum annual premium (“safe-harbour premium”). If the public authority granting the guarantee charges the borrower said minimum annual premium, the guarantee itself cannot be qualified as State aid. The notice then specifies certain aspects linked with specific situations (e.g. SME which have no credit history or a rating based on a balance sheet approach, a single guarantee premium paid in advance, etc.).

The conditions for guarantee schemes may be summarised as follows¹⁷¹:

- a) the scheme is closed to borrowers in financial difficulty;
- b) the extent of the guarantees can be properly measured when they are granted;
- c) the guarantees do not cover more than 80% of each outstanding loan (or other financial obligation);
- d) the terms of the scheme are based on a realistic assessment of the risk so that the premiums paid by the

¹⁶² Draft Commission Notice on the notion of State aid, point 117.

¹⁶³ Main beneficiary of the guarantee.

¹⁶⁴ Entity whose risk is reduced thanks to state guarantee.

¹⁶⁵ Guarantees communication, point 2.3.1.

¹⁶⁶ Guarantees communication, section 1.3 (a).

¹⁶⁷ Guarantees communication, section 1.3 (b).

¹⁶⁸ Cfr. Guarantees communication, section 3.2.

¹⁶⁹ In the Guarantees communication “borrower” refers to the main beneficiary of guarantees, while “lender” means the entity (for example the bank which grants a loan secured by the State) whose risk is reduced thanks to the state guarantee.

¹⁷⁰ Cfr. Guarantees communication, section 3.3.

¹⁷¹ Cfr. Guarantees communication, section 3.2.



beneficiaries make it, in all probability, self-financing;

- e) in order to have a proper and progressive evaluation of the self-financing aspect of the scheme, the adequacy of the level of the premiums has to be reviewed at least once a year on the basis of the effective loss rate of the scheme over an economically reasonable time horizon, and premiums adjusted accordingly if there is a risk that the scheme may no longer be self-financing;
- f) in order to be viewed as being in line with market prices, the premiums charged have to cover the normal risks associated with granting the guarantee, the administrative costs of the scheme, and a yearly remuneration of an adequate capital, even if the latter is not at all or only partially constituted;
- g) in order to ensure transparency, the scheme must provide for the terms on which future guarantees will be granted, such as eligible companies in terms of rating and, when applicable, sector and size, maximum amount and duration of the guarantees.

For guarantee schemes as well, if the borrower¹⁷² is a small or medium sized enterprise (SME), the Commission allows two simplified evaluation methods¹⁷³:

- the use of safe-harbour premiums as defined for individual guarantees to SMEs,
- the valuation of guarantee schemes as such by allowing the application of a single premium and avoiding the need for individual ratings of beneficiary SMEs.

The notice also specifies that failure to satisfy one of the conditions set out does not mean that the guarantee or guarantee scheme is automatically regarded as State aid. If there is any doubt as to whether a planned guarantee or guarantee scheme constitutes State aid, it should be notified to the Commission¹⁷⁴.

* Risk finance

The approach introduced by the Commission for risk finance measures is different to the previous ones. In fact, the aforementioned *Guidelines on State aid to promote risk finance investments*¹⁷⁵ do not provide an actual method for determining a “market value” or approximate value deemed as such of a risk finance transaction. In order not to be considered as State aid pursuant to Article 107(1) TFEU, risk finance must pass the “market economy operator test”.

However, this notice does not apply to all financial instruments, but solely to the risk finance measures envisaged therein and performed through financial intermediaries or alternative trading platforms, except in the case of tax incentives applicable to direct investments in admissible undertakings.

A public intervention is not State aid if it satisfies the market economy operator test, which checks whether the economic transactions to which the public intervention refers are performed in line with normal market conditions: if the economic transactions performed by public entities or undertakings do not lead to an advantage for the other party to said transactions, they are not State aid.

The test must be performed on each of the parties involved in the intervention. In other words, the greater the number of parties involved, the greater the number for which the presence of State aid must be checked.

The guidelines on State aid to risk finance specify this aspect: *“Risk finance measures often involve complex constructions creating incentives for one set of economic operators (investors) to provide risk finance to another set of operators (eligible undertakings). Depending on the design of the measure, and even if the intention of the public authorities may be only to provide benefits to the latter group, undertakings at either or both levels may benefit from State aid. Moreover, risk finance measures always involve one or more financial intermediaries which may have a status separate from that of the investors and the final beneficiaries in which investments are made. In such cases, it is also necessary to consider whether the financial intermediary can be considered to benefit from State aid”*¹⁷⁶.

¹⁷² In the communication, “borrower” refers to the main beneficiary of guarantees, while “lender” means the entity whose risk is reduced thanks to the state guarantee.

¹⁷³ Cfr. Guarantees Communication, section 3.5.

¹⁷⁴ Cfr. *ivi*, section 3.6.

¹⁷⁵ *Official Journal of the European Commission*, n. C 19 of 22.1.2014.

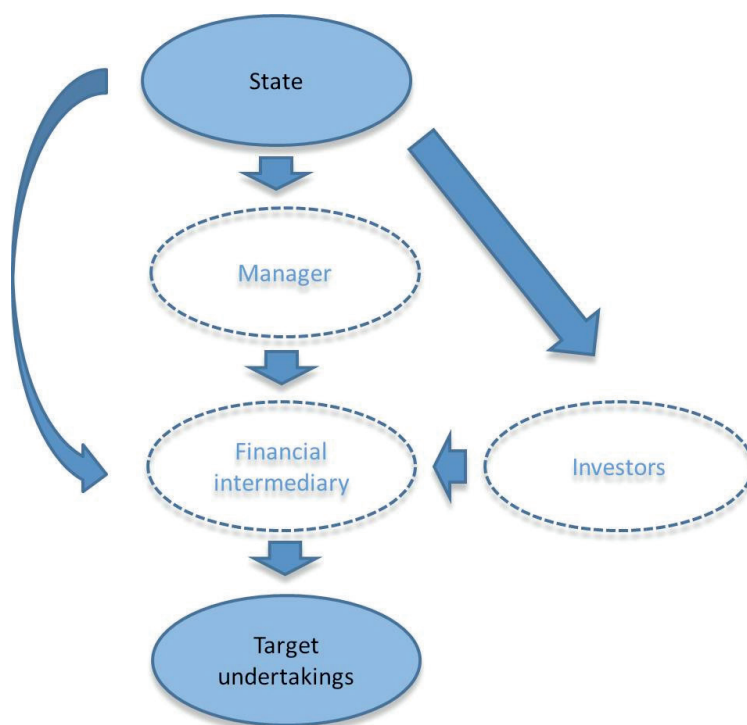
¹⁷⁶ Guidelines on State aid to promote risk finance investments, point 29.



The guidelines provide several criteria for evaluating the presence of State aid at the various levels:

- aid to investors (section 2.1.1 of the guidelines);
- aid to financial intermediaries and/or their managers (section 2.1.2 of the guidelines);
- aid to the undertakings in which the investment is made (section 2.1.3 of the guidelines).

The diagram summarises a situation in which a specific risk finance measure involves several parties, in addition to the State. There could be, for example, a measure with State origin, which could involve the presence of aid to the aforementioned parties: aid to the investors, who could receive benefits from the State (such as tax relief) to invest in favour of intermediaries, who therefore benefit from an indirect advantage, but who could also receive direct loans from the State. State loans could also then lead to benefits for the managers, due, for example, to returns which are too high compared with the market return. Lastly, the target undertakings are those which should benefit from the risk capital finance measures.



c) Effect on (or distortion of) competition

References:

- Regulation of reference: article 107, paragraph 1, of the TFEU
- Case law of the European Court of Justice
- Reference deed or other document: Draft notice of the European Commission on State aid pursuant to article 107, paragraph 1, of the TFEU. Available in various languages on the following page: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html
- section 6.2 in particular.

In addition to the conditions examined so far, aid must threaten to distort or distort competition in order to fall within the area of application of Article 107(1) TFEU. As stated by the European Commission, distortion of competition and the effect on trade between Member States are two distinct and necessary elements of the notion of aid, but, in practice, these criteria are often treated jointly in the assessment of State aid as they are, as a rule, considered inextricably linked¹⁷⁷.

177 Draft Commission Notice on the notion of State aid, point 187.



There is actually a close link between the three separate criteria: advantage, distortion of competition and effect on trade between Member States. In fact, the European Commission itself refers to case law, according to which: “a measure granted by the State is considered to distort or threaten to distort competition when it is liable to improve the competitive position of the recipient compared to other undertakings with which it competes. For all practical purposes, a distortion of competition within the meaning of Article 107 TFEU is thus assumed as soon as the State grants a financial advantage to an undertaking in a liberalised sector where there is, or could be, competition¹⁷⁸”.

The presence of competition can be excluded on markets which, under both national and EU law, are closed to competition.

The Commission states that the fact that local authorities assign a public service to an in-house provider does not as such exclude a possible distortion of competition. In fact, this situation is different to a legal monopoly, in which “...a given service is reserved by law or regulatory measures to an exclusive provider, with a clear prohibition for any other operator to provide such service ...”¹⁷⁹, and is not admitted “... not even to satisfy a possible residual demand from certain customer groups”¹⁸⁰. When a provider of services has a legal monopoly and is not in competition with similar (liberalised) services and cannot be active (due to regulatory or statutory constraints) in any other liberalised (geographical or product) market, competition is excluded¹⁸¹.

Leaving aside specific situations linked to particular aspects of the market or service, distortion of competition is almost always present, particularly if it is considered that the notion of distortion of competition must be interpreted in the broadest sense, considering not only the actual effect on competition, but also even only the threat to competition¹⁸². It is also not necessary to determine the existence of distortion of actual competition, but sufficient to consider the effect on potential competition, as is the case when the creation of competing undertakings is threatened, thereby limiting access to the market.

The Advocate General, Philippe Léger has referred to the broad interpretation given to the notion of distortion of competition: “the Court concludes that competition is distorted when financial aid granted by the State reinforces the competitive position of the beneficiary undertaking with respect to its competitors. It may normally be presumed that any public aid distorts or threatens to distort competition”¹⁸³. In fact, as more recently stated by the Court, “... according to constant case law, aid directed at assisting an undertaking in paying the costs it would normally incur in its current operation or its normal activities, in principle, distorts competition”¹⁸⁴.

d) Effect on trade between Member States

A final condition which must be satisfied for an intervention to fall within the area of application of Article 107(1)

References:

- Regulation of reference: article 107, paragraph 1, of the TFEU
- Case law of the European Court of Justice
- Reference deed or other document: Draft notice of the European Commission on State aid pursuant to article 107, paragraph 1, of the TFEU. Available in various languages on the following page: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html
- section 6.3 in particular.

TFEU is that it affects trade between Member States.

¹⁷⁸ *Ivi*, point 188.

¹⁷⁹ *Ivi*, note n. 247.

¹⁸⁰ *Ibid.*

¹⁸¹ *Ivi*, point 188.

¹⁸² Article 107 of the TFEU refers to aids that “...distort or threaten to distort competition”.

¹⁸³ Conclusions of the Solicitor general Philippe Léger in case C-280/00, *Altmark*, submitted on 19 March 2002, Racc. p. I-7747, point 103. Ma Léger recalls judgments of 17 September 1980, *Philip Morris Holland c/ Commissione*, case 730/79, Racc. p. 2671, point 11, and of 11 November 1987, *Francia v/ Commissione*, case 259/85, Racc. p. 4393, point 24), and conclusions of the Solicitor General Capotorti in case 730/79, *Philip Morris v/ Commissione*, Racc. p. 2698.

¹⁸⁴ Judgement of the Court of 16 December 2010, *Paesi Bassi e a. v/ Commissione*, joint cases T-231-06 e T-237/06, point 119. Cfr. also Judgement of the Court of Justice of 20 March 2014, *Rousse Industry AD c/ Commissione*, case C-271/13 P, point 44.



The Court of Justice has confirmed, to a certain extent, the existence of a connection between the notions of “advantage granted to certain undertakings or the production of certain goods”, “distortion of competition” and “effect on trade between Member States”. In fact, according to constant case law of the Court “... where State financial aid strengthens the position of an undertaking as compared with other undertakings competing in intra-Community trade, the latter must be regarded as affected by the aid”¹⁸⁵.

The Court also states that it is not necessary to determine an actual effect on trade, but sufficient to examine whether the aid could potentially affect trade¹⁸⁶. The notion of “effect on trade between Member States”, like the others, is open to broad interpretation. Even aid of a minimal amount could affect trade, as could a loan granted to an undertaking of modest dimensions¹⁸⁷.

In the draft notice on the notion of aid, the Commission indicates several basic principles¹⁸⁸:

- public support can be considered capable to affect intra-EU trade even if the recipient is not directly involved in cross-border trade
- even a public subsidy granted to an undertaking which provides only local or regional services and does not provide any services outside its State of origin may nonetheless have an effect on trade between Member States
- in principle, trade can also be affected even if the recipient exports all or most of its production outside the Union
- in establishing a distortion of competition or an effect on trade, it is not necessary to define the market or to investigate in detail the impact of the measure on the competitive position of the beneficiary and its competitors, but all that must be shown is that the aid is such as to be liable to affect trade between Member States and to distort competition.

However, the Commission has, in several cases, considered that certain activities had a purely local impact and that aid to these activities consequently did not affect trade between Member States¹⁸⁹.

¹⁸⁵ Please refer to Judgement of the Court of 9 September 2009, *Holland Malt / Commission*, case T-369/06, Racc. p. II-3313, point 47. Cfr. and Judgement of the Court of Justice of 20 March 2014, *Rousse Industry AD v/ Commission*, case C-271/13 P, point 43.

¹⁸⁶ In particular, there is no need to develop an economic analysis of the interested market, of the market area of the company which benefits from aid, of the position of competitive companies and of exchanges between Member states (Judgement of the Court of 18 January 2012, *Djebel / Commission*, case T-422/07, points 89 e 90).

¹⁸⁷ Cfr., for example, Judgement of the Court of Justice of 21 March 1990, *Kingdom of Belgium v/ European Commission*, case 142/87, Racc. p. I-959, point 43.

¹⁸⁸ Cfr. Draft Commission Notice on the notion of State aid, points 192-195.

¹⁸⁹ Cfr. *Ivi*, points 196-197.



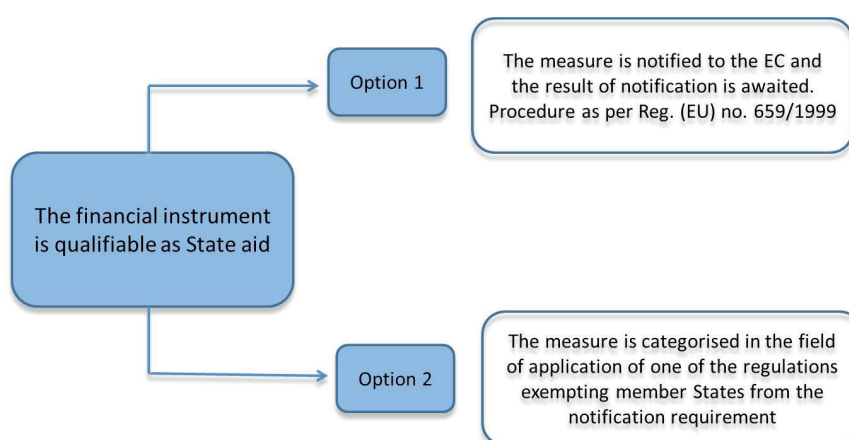
II. Rules of compatibility of State aid

When a public intervention is State aid, it must be subject to one of the derogations envisaged by the treaty to be admissible. In fact, article 107(1) TFEU contains the principle of incompatibility of State aid with the internal market, but this regulation also admits the existence of derogations from said principle. The derogations are contained in articles 93, 106, paragraph 2, and 107, paragraphs 2 and 3, of the treaty.

Article 108, paragraph 3, of the TFEU requires the Member States to inform the European Commission of any plans to grant aid, to allow it to express an opinion on their compatibility with the internal market. However, as shall be seen, derogations from this notification requirement are admitted.

On the basis of the treaty requirements, the Commission has adopted several documents – published for the most part in the Official Gazette of the European Union and available on the website of the General Department of competition¹⁹⁰ – which indicate the guidelines and criteria followed by the Commission to evaluate compatibility of State aid of which it is informed. In addition to these documents, the Commission has also adopted several regulations and a decision which exempt Member States from the notification requirement.

Therefore, in the case of a measure qualifiable as State aid, the authorities of a Member State have two possible options, as shown in the figure below.



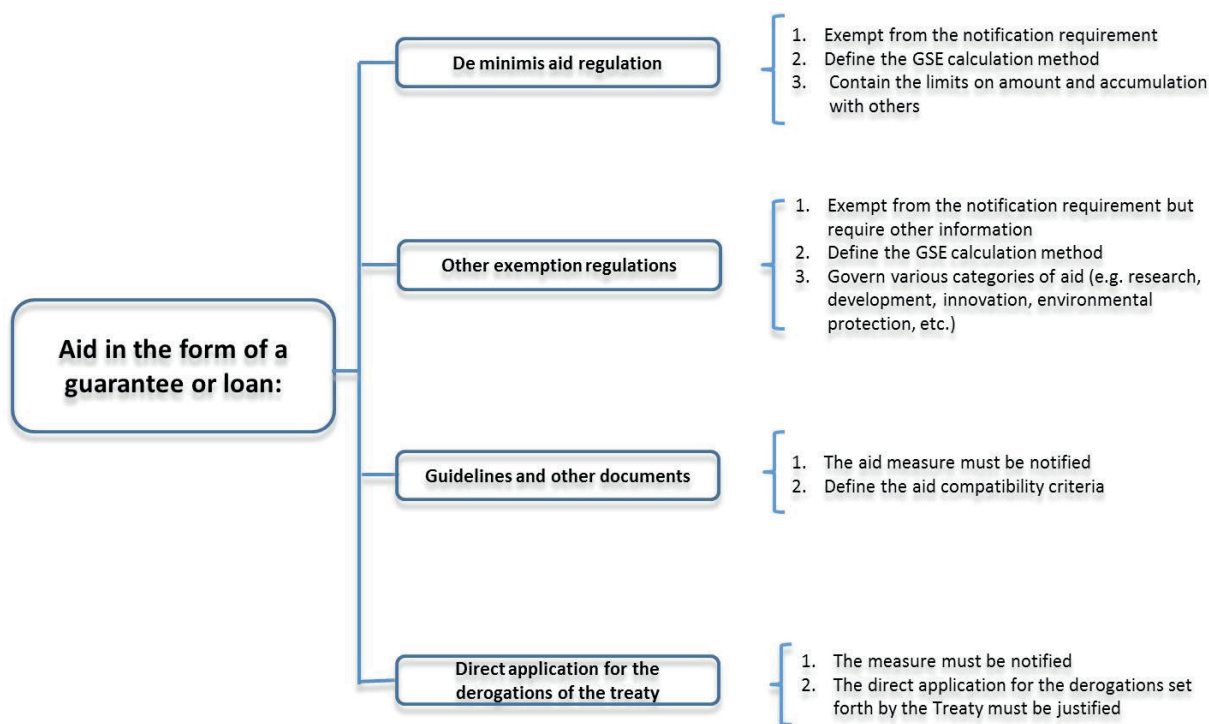
In part I of this paper, we examined several aspects of guarantees, loans and risk finance, in analysis aimed at verifying whether the interventions performed with these financial instruments qualify as State aid. We based this analysis on the guarantees notice, the rates notice and the guidelines on State aid to risk finance. These same documents provide us with useful criteria for evaluating compatibility of aid, but there is an extremely important difference between the notices on guarantees and rates with respect to the guidelines on State aid to finance. Furthermore, compatibility analysis must also consider other guidelines and exemption rules. Therefore:

- For guarantees and loans: the guarantees notice and the rates notice simply provide methods or criteria for calculating the subsidy equivalent of aid in the form of a guarantee or a loan at subsidised rates, without establishing the criteria for evaluating compatibility of that aid. Compatibility must be evaluated by referring to other documents which establish the rules of compatibility of aid depending on the objective being pursued (for example, regional aid, aid for protection of the environment, for research and development and innovation, employment, training, etc.);
- For risk finance: the guidelines on State aid to risk finance, on the other hand, provide all the criteria for evaluating compatibility of a risk finance measure, which may take different forms. The general block exemption regulation defines the characteristics of a risk finance measure which is compatible with the internal market and exempt from the notification requirement.

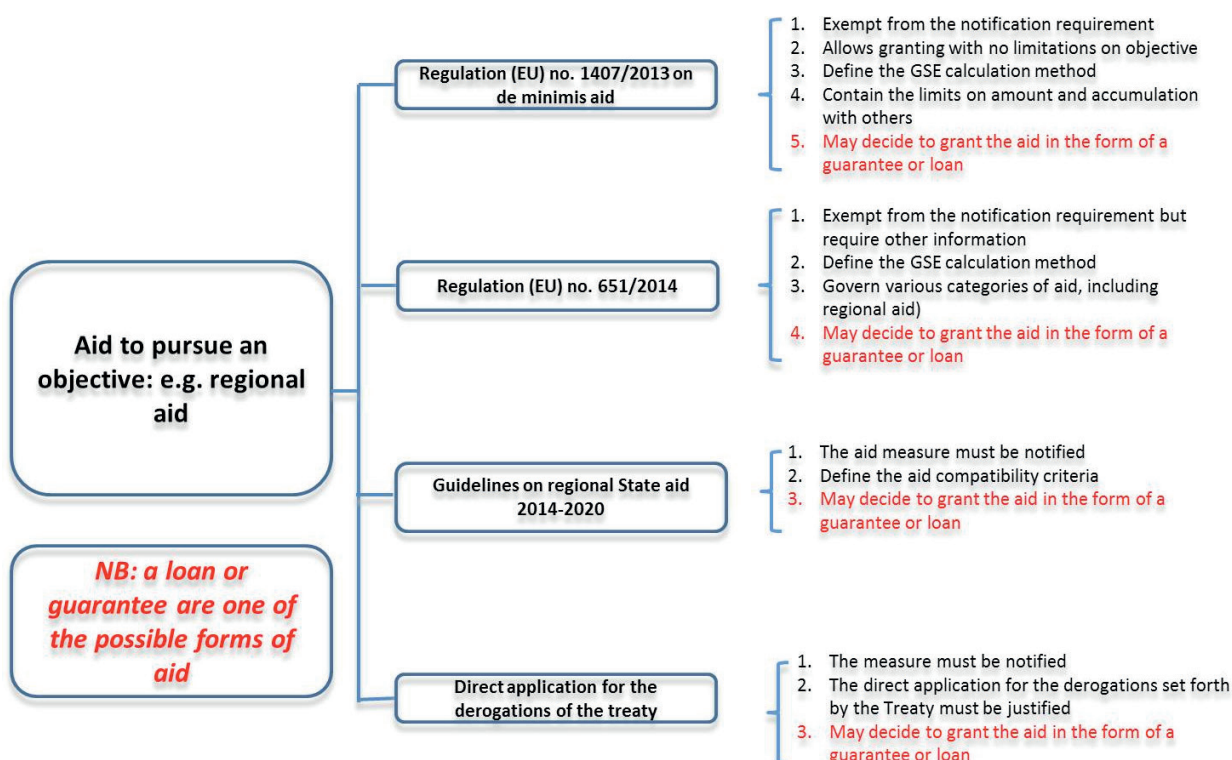
In other words, while, for the risk finance, the documents which allow the aid measure to be categorised (guidelines or exemption regulations) provide all the elements defining compatibility of the measure with the internal market, the approach is different for financing in the form of a loan or a guarantee: it is necessary to identify the document on the basis of which to grant the aid (de minimis regulation, other exemption regulations, guidelines or other documents), or to ask the Commission, on informing it, to apply directly one of the derogations set forth by the treaty. The documents on the basis of which aid is granted specify the GSE calculation method.

¹⁹⁰ http://ec.europa.eu/competition/state_aid/legislation/legislation.html





In fact, as already mentioned, guarantees and loans are one of the forms of aid to grant financing to pursue specific objectives, such as research, development and innovation, training, protection of the environment, regional development, etc. The diagram below shows granting of aid to pursue the objective of regional development through “regional aid”.



As the diagram shows, there are many possible scenarios for aid in the form of a guarantee or a loan:

1. Regulations exempting the Member States from the notification requirement;
2. Notification on the basis of the guidelines or other documents which specify the evaluation criteria of the European Commission of aid notified to it;



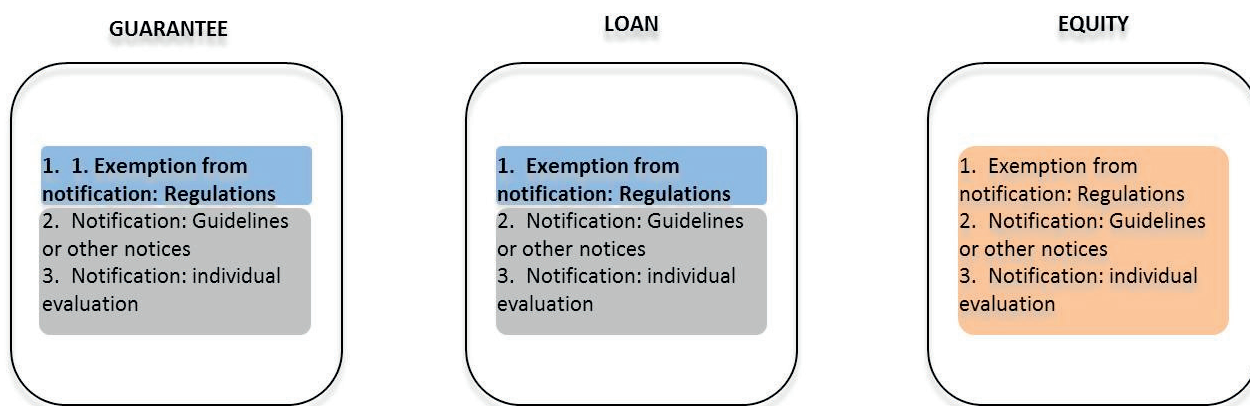
3. Notification for individual evaluation, outside the area of application of the regulations, guidelines or other documents, asking the European Commission to evaluate direct applicability of one of the derogations set forth by the treaty.

The exemption regulations define the methods of calculation of a subsidy equivalent to the aid in the form of a guarantee or loan, also referring to the notice on guarantees and the notice on rates. In the case of notification, the responsible authority of the Member State proposes the subsidy equivalent calculation methods to the Commission.

The possibilities for aid to risk finance are the following:

- a. General block exemption regulations and de minimis rules, which exempt Member States from the notification requirement;
- b. Guidelines on State aid to risk finance;
- c. Notification for individual evaluation, outside the area of application of the regulations, guidelines or other documents, asking the European Commission to evaluate direct applicability of one of the derogations set forth by the treaty.

State aid – financial instrument



KEY

The regulations specify how to calculate the GSE, also referring to the notices on guarantees and rates

The GSE calculation method is defined on notification

The GSE is not determined, but compatibility of the aid directly: aid limited to minimum

The essential aspects of the principal rules on aid compatible with the internal market are examined below, with reference to financial instruments, starting with loans and guarantees (a), then examining risk finance (b).



a) Guarantees and loans

References:

- European Commission Notice on application of articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (*Official Gazette of the European Union* no. C 155 of 20.6.2008, corrected in *Official Gazette of the European Union* no. C 244 of 25.9.2008)
 - Communication from the Commission on the revision of the method for setting the reference and discount rates (*Official Gazette of the European Union* no. C 14 of 19.01.2008)
 - Exemption regulations (cited in the section)
 - Guidelines or other documents governing the evaluation criteria of aid notified to the European Commission
- The various deeds are available on the following website: http://ec.europa.eu/competition/state_aid/legislation/legislation.html

As already said, guarantees and loans may simply be a form of aid granted as de minimis aid or aimed at assisting achievement of objectives such as regional development, protection of the environment, research, development and innovation, training, etc.

The scheme is shown in the figure. Aid in the form of a loan or guarantee may therefore be categorised under the de minimis regulations, other exemption regulations or other documents (e.g. guidelines) which govern the evaluation criteria of the Commission of the measures notified. Each regulation indicates the method to use to calculate the subsidy equivalent (amount of the aid) in the case of aid in the form of a guarantee or loan, also referring to the notice on guarantees and the notice on rates.

The principal characteristics of the exemption rules are discussed below, specifying the calculation method indicated therein, starting with the rules on de minimis aid(ii), then moving on to the principal regulations exempting compatible State aid from the notification requirement (iii). The approach to aid subject to the notification requirement is then briefly examined (iv).

Before proceeding with this description, it is worth specifying the calculation methods of the subsidy equivalent of aid in the form of a guarantee or a loan (i), which may be used when indicated in the exemption regulations or in authorisation decisions adopted by the European Commission following notification.

(i) Calculation methods of the subsidy equivalent of aid in the form of a guarantee or a loan

* Guarantees

As already mentioned in the first part of this paper¹⁹¹, the notice on guarantees provides the criteria for excluding the presence of State aid to the borrower. However, for SMEs only, it provides a simplified method for calculating the “market value” of a guarantee. This method is based on the so-called “safe-harbour” premiums and also allows the gross subsidy equivalent (GSE) of a guarantee to be calculated, as specified in sections 4.3 (for individual aid) and 4.4 (for guarantee schemes) of said notice.

The GSE of aid to SMEs in the form of a guarantee is calculated by taking into account the difference between the safe-harbour premium and the premium effectively paid by the beneficiary, but also the duration of the guarantee:

- if the premium for a specific guarantee does not correspond with the value fixed as the minimum for its rating class, the difference between said minimum level and the premium charged will be considered as aid;
- if the guarantee lasts for more than one year, the annual negative differences are discounted using the pertinent discount rate, calculated as indicated in the notice on rates.

The notice on rates indicates the method for determining the discount rate, as shall be seen below.

191 Cfr. *supra*, p. 17 e ss.



* Loans

As already mentioned in Part I of this paper, the notice on rates provides a reference rate, which is considered an indicative value. However, despite the purely indicative nature of the reference rate, if regulations or decisions of the Commission on aid schemes use it as a reference in identifying the amount of the aid "... the Commission will consider it as a fixed no-aid benchmark (safe-harbour)"¹⁹². The notice on rates therefore provides the elements necessary to calculate the GSE of a loan, to be used when the exemption regulations on which granting of aid is based refer to it. The same method could be used for aid which has been notified to and authorised by the Commission, when the decision of the Commission itself refers to it.

The calculation method is the following:

- The European Commission sets a base rate, which it revises periodically and which is published in the Official Gazette of the European Union and on the European Commission website.
- A margin which varies on the basis of the rating of the undertakings concerned and the guarantees they provide is added to this. For debtors with no credit history or a rating based on a balance sheet approach, the margin corresponds with at least 400 base points (depending on the guarantees available) and can never be lower than the one which would be applicable to the parent company.
- The sum of these two components (base rate + margin) identifies the reference rate, which is an indicative value of the market price of a loan.
- The aid is given by the difference between the reference rate and the rate effectively paid. The amounts of aid determined on the basis of this rate difference are discounted to the moment when the aid is granted. The discount rate is given by the base rate plus a fixed margin of 100 base points.

(ii) *De minimis aid rules*

De minimis aid may be granted on the basis of one of the following exemption regulations, applicable according to the sectors of activity being funded:

- Commission Regulation (EU) no. 1407/2013 of 18 December 2013, on application of articles 107 and 108 of the Treaty on Functioning of the European Union to «de minimis» aid¹⁹³;
- Commission Regulation (EU) no. 717/2014 of 27 June 2014, on application of articles 107 and 108 of the Treaty on Functioning of the European Union to «de minimis» aid in the fishery and aquaculture sector¹⁹⁴;
- Commission Regulation (EU) no. 1408/2013 of 18 December 2013, on application of articles 107 and 108 of the Treaty on Functioning of the European Union to «de minimis» aid in the agriculture sector¹⁹⁵;

The Commission has also adopted Regulation (EU) no. 360/2012¹⁹⁶, specific to *de minimis* aid to services of general economic interest (SGEI).

Each of these regulations indicates the method of calculating the subsidy equivalent of aid granted in the form of a guarantee or a loan. In certain cases, reference is made to the methods set forth by the notices on guarantees and rates, but, for guarantees, the regulations also allow the possibility of using a calculation method notified by the Member state to the European Commission and approved by it.

For **guarantees**, regulations no. 1407/2013, no. 1408/2013 and no./..... offer three possibilities for calculating the gross subsidy equivalent (GSE):

- a specific method for *de minimis* aid, which consists in determining the GSE with reference to the guaranteed amount and to the duration of the guarantee, taking into account the limitation that the guarantee cannot exceed 80 % of the underlying loan;
- use of the method based on "safe-harbour" premiums referred to in the notice on guarantees¹⁹⁷;

¹⁹² Draft Commission Notice on the notion of State aid, in accordance with article 107, paragraph 1, of TFUE, point 116, footnote n. 174 (available at the following link: http://ec.europa.eu/competition/consultations/2014_state_aid_notion/index_en.html).

¹⁹³ Official Journal of the European Union n. L 352 of 24.12.2013.

¹⁹⁴ Official Journal of the European Union n. L 190 of 28.6.2014.

¹⁹⁵ Official Journal of the European Union n. L 352 of 24.12.2013.

¹⁹⁶ Commission Regulation (EU) n. 360/2012 of 25 April 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 (Official Journal n. L 114 of 26.4.2012).

¹⁹⁷ Cfr. *supra*, p. 27.



- use of a method notified by the Member State to the European Commission.

Regulation no. 360/2012 sets forth only one specific method, which is slightly different (it does not consider the duration), and the possibility of using a notified and authorised method. No reference is made to the “safe-harbour” premiums method.

For **loans**, regulations no. 1407/2013, no. 1408/2013 and no. 717/2014 offer two possibilities for calculating the gross subsidy equivalent (GSE):

- a specific method for de minimis aid, which consists in determining the GSE with reference to the amount of the loan and to the duration of the guarantee, taking into account the limitation that the loan must be secured by a guarantee covering at least 50% of the loan;
- use of the method based on the reference rate determined as indicated in the notice on rates.

Regulation no. 360/2012 allows only the second of the two possible methods.

(iii) State aid exempt from the notification requirement

The other exemption regulations define the rules applicable to specific categories of aid, depending on the sectors concerned.

Like the de minimis regulations, they provide indications on the method of calculating the subsidy equivalent of aid in the form of a loan and a guarantee, also referring to the guarantees notice and the notice on interest rates.

The principal exemption regulations are:

- Commission regulation no. 651/2014 of 17 June 2014, which declares certain categories of aid compatible with the internal market in application of articles 107 and 108 of the treaty¹⁹⁸, is a regulation applied to several sectors exempting the following categories of aid from the notification requirement:
 - *Regional aid (Chapter III – Section 1)*
 - *Regional investment aid*
 - *Regional operating aid*
 - *Regional urban development aid*
 - *Aid to SMEs (Chapter III – Section 2)*
 - *Investment aid to SMEs*
 - *Aid for consultancy in favour of SMEs*
 - *Aid to SMEs for participation in fairs*
 - *Aid for cooperation costs incurred by SMEs participating in European Territorial Cooperation projects*
 - *Aid for access to finance for SMEs (Chapter III – Section 3)*
 - *Risk finance aid* (note that this category of aid is mentioned only to provide complete information, but relates solely to risk finance and will be discussed in the specific section¹⁹⁹)
 - *Aid for start-ups*
 - *Aid to alternative trading platforms specialised in SMEs*
 - *Aid for scouting costs*
 - *Aid for research and development and innovation (Chapter III - Section 4)*
 - *Aid for research and development projects*
 - *Investment aid for research infrastructures*
 - *Aid for innovation clusters*
 - *Innovation aid for SMEs*

¹⁹⁸ Official Journal of the European Union n. L 187 of 26.06.2014.

¹⁹⁹ Cfr. *infra*, p. 36.



- *Aid for process and organisational innovation*
- *Aid for research and development in the fishery and aquaculture sector*
- *Training aid (Chapter III – Section 5)*
 - *Training aid*
- *Aid for disadvantaged workers and for workers with disabilities (Chapter III – Section 6)*
 - *Aid for the recruitment of disadvantaged workers in the form of wage subsidies*
 - *Aid for the employment of workers with disabilities in the form of wage subsidies*
 - *Aid for compensating the additional costs of employing workers with disabilities*
 - *Aid for compensating the costs of assistance provided to disadvantaged workers*
- *Aid for environmental protection (Chapter III – Section 7)*
 - *Investment aid enabling undertakings to go beyond Union standards for environmental protection or to increase the level of environmental protection in the absence of Union standards*
 - *Investment aid for early adaptation to future Union standards*
 - *Investment aid for energy efficiency measures*
 - *Investment aid for energy efficiency projects in buildings*
 - *Investment aid for high-efficiency cogeneration*
 - *Investment aid for the promotion of energy from renewable sources*
 - *Operating aid for the promotion of electricity from renewable sources*
 - *Operating aid for the promotion of energy from renewable sources in small scale installations*
 - *Aid in the form of reductions in environmental taxes under Directive 2003/96/EC*
 - *Investment aid for remediation of contaminated sites*
 - *Investment aid for energy efficient district heating and cooling*
 - *Investment aid for waste recycling and re-utilisation*
 - *Investment aid for energy infrastructure*
 - *Aid for environmental studies*
- *Aid to make good the damage caused by certain natural disasters (Chapter III – Section 8)*
 - *Aid schemes to make good the damage caused by certain natural disasters*
- *Social aid for transport for residents of remote regions (Chapter III – Section 9)*
 - *Social aid for transport for residents of remote regions*
- *Aid for broadband infrastructures (Chapter III – Section 10)*
 - *Aid for broadband infrastructures*
- *Aid for culture and heritage conservation (Chapter III – Section 11)*
 - *Aid for culture and heritage conservation*
 - *Aid schemes for audiovisual works*
- *Aid for sport and multifunctional recreational infrastructures (Chapter III – Section 12)*
 - *Aid for sport and multifunctional recreational infrastructures*
- *Aid for local infrastructures (Chapter III – Section 13)*
 - *Aid for local infrastructures*



Commission regulation no. 702/2014 of 25 June 2014, for State aid in the agricultural and forestry sectors and in rural areas 2014-2020 is a sector regulation exempting the following categories of aid from the notification requirement²⁰⁰:

- *Aid in favour of SMEs active in primary agricultural production, the processing of agricultural products and the marketing of agricultural products (Chapter III - Section 1)*
 - *Aid for investments in tangible assets or intangible assets on agricultural holdings*
 - *Aid for agricultural land consolidation*
 - *Aid for investments concerning the relocation of farm buildings*
 - *Aid for investments in connection with the processing of agricultural products and the marketing of agricultural products*
 - *Start-up aid for young farmers and the development of small farms*
 - *Start-up aid for producer groups and organisations in the agricultural sector*
 - *Aid for the participation of producers of agricultural products in quality schemes*
 - *Aid for knowledge transfer and information actions*
 - *Aid for advisory services*
 - *Aid for farm replacement services*
 - *Aid for promotion measures in favour of agricultural products*
 - *Aid to compensate for damage caused by adverse climatic event which can be assimilated to a natural disaster*
 - *Aid for the costs of the prevention, control and eradication of animal diseases and plant pests and aid to make good the damage caused by animal diseases or plant pests*
 - *Aids to the livestock sector and aid for fallen stock*
 - *Aid for the payment of insurance premiums*
- *Aid for investments in favour of conservation of cultural and natural heritage located on agricultural holdings (Chapter III - Section 2)*
 - *Aid for investments in favour of the conservation of cultural and natural heritage located on agricultural holdings*
- *Aid to make good the damage caused by natural disasters in the agricultural sector (Chapter III - Section 3)*
 - *Aid to make good the damage caused by natural disasters in the agricultural sector*
- *Aid for research and development in the agricultural sector (Chapter III - Section 4)*
 - *Aid for research and development in the agricultural sector*
- *Aid in favour of forestry (Chapter III - Section 5)*
 - *Aid for afforestation and the creation of woodland*
 - *Aid for agroforestry systems*
 - *Aid for the prevention and restoration of damage to forests from forest fire, natural disasters, adverse climatic events which can be assimilated to a natural disaster, other adverse climatic events, plant pests and catastrophic events*
 - *Aid for investments improving the resilience and environmental value of forest ecosystems*
 - *Aid for disadvantages related to Natura 2000 forest areas*
 - *Aid for forest-environmental and climate services and forest conservation*
 - *Aid for knowledge transfer and information actions in the forestry sector*



- *Aid for advisory services in the forestry sector*
- *Aid for investments in infrastructure related to the development, modernisation or adaptation of the forestry sector*
- *Aid for investments in forestry technologies and in processing, mobilising and marketing of forestry products*
- *Conservation of genetic resources in forestry*
- *Aid for forestry land consolidation*
- *Aids in favour of SMEs in Rural Areas co-financed by the EAFRD or granted as additional national financing to such co-financed measures (Chapter III - Section 6)*
 - *Aid for investments concerning the processing of agricultural products into non-agricultural products or the production of cotton*
 - *Business start-up aid for non-agricultural activities in rural areas*
 - *Aid for advisory services for SMEs in rural areas*
 - *Aid for knowledge transfer and information actions in favour of SMEs in rural areas*
 - *Aid for new participation of active farmers in quality schemes for cotton and foodstuffs*
 - *Aid for information and promotion activities concerning cotton and foodstuffs covered by a quality scheme*

Draft commission regulation no.../...of..., on application of articles 107 and 108 of the treaty to certain categories of State aid in favour of firms operating in the sector of production, transformation and marketing of fishery and aquaculture products is a sector regulation exempting the following categories of aid from the notification requirement:

- *Sustainable development of fishery (Chapter III – Section 1)*
 - *Aid for innovation*
 - *Aid for advisory services*
 - *Aid in favour of partnerships between scientific experts and fishermen*
 - *Aid for the promotion of human capital and social dialogue*
 - *Aid for diversification and new forms of income*
 - *Start-up aid for young fishermen*
 - *Aid for promotion of health and safety*
 - *Aid for mutual aid funds for adverse weather conditions and for environmental emergencies*
 - *Aid for support systems for division of fishery possibilities*
 - *Aid for the creation and implementation of conservation methods*
 - *Aid aimed at limiting the impact of fishery on the marine environment and adapting fishery to protection of the species*
 - *Aid for the protection and restoral of biodiversity and marine ecosystems and for compensation systems in sustainable fishery activities*
 - *Aid to improve energy efficiency and attenuate the effects of climate change*
 - *Aid to promote added value, product quality and use of undesired catches*
 - *Aid for ports, disembarkation points, auction rooms and fishery shelters*
 - *Aid for fishery in internal waters and flora and fauna in internal waters*
- *Sustainable development of aquaculture (Chapter III – Section 2)*
 - *Aid for innovation in the aquaculture sector*
 - *Aid for production investments in the aquaculture sector*



- *Aid for management, replacement and advisory services for aquaculture firms*
- *Aid for the promotion of human capital and Internet connection in the aquaculture sector*
- *Aid for an increase in the potential of aquaculture sites*
- *Aid for the promotion of new operators of sustainable aquaculture*
- *Aid for conversion of eco-management and audit systems and organic aquaculture*
- *Aid for the supply of environmental services by aquaculture*
- *Aid for health measures*
- *Aid for measures relating to animal health and well-being*
- *Aid for aquaculture stock insurance*
- *Measures connected with marketing and transformation (Chapter III - section 3)*
 - *Aid for marketing measures*
 - *Aid for transformation of fishery and aquaculture products*
- *Other categories of aid (Chapter III - Section 4)*
 - *Aid for data collection*
 - *Aid intended to make good the damage caused by certain natural disasters*

These regulations contain an article on transparency of aid, which specifies the method of calculating the GSE for aid granted in the form of loans and guarantees.

For aid in the form of loans, the calculation method is based on the prevailing reference rate at the moment of granting, as indicated in the notice on rates.

For aid in the form of guarantees, the regulations offer two possibilities:

- use of the method based on the “safe-harbour” premiums referred to in the guarantees notice²⁰¹;
- use of a method notified by the Member State to the European Commission.

In conclusion, it may be noted that the aforementioned regulations impose various obligations, including sending summary information to the European Commission within twenty working days of entry into force of the aid measure. There are also common provisions which specify certain obligations, such as the one on the notification threshold, the effect of aid incentives, cumulation and publication and information.

(iv) Aid subject to the notification requirement

If the intended aid measures are not included among those falling within the area of application of the exemption regulations (de minimis and others), it is necessary to notify them to the European Commission.

In these cases, the first aspect to check is whether the measure falls within (or could be made to fall within) the area of application of one of the documents governing evaluation criteria of compatibility of aid subject to notification, such as the Guidelines on regional State aid for 2014-2020²⁰².

The guidelines on the various categories of aid are available on the website of the European Commission, at:

- http://ec.europa.eu/competition/state_aid/legislation/legislation.html

The method of calculating the GSE on aid in the form of a loan and a guarantee may be defined in the notification phase, taking the notices on guarantees and on rates into account.

The notification procedure is governed by regulation (EC) no. 659/1999 and by two notices of the European Commission²⁰³. A further notice specifies the methods of electronic transmission of the notification²⁰⁴.

²⁰¹ Cfr. *supra*, p. 27.

²⁰² Official Journal of European Union n. C 209 of 23.7.2013.

²⁰³ Code of Best Practice for the conduct of State aid control procedures (OJ n. C 136 of 16.6.2009). Notice from the Commission on a simplified procedure for treatment of certain types of State Aid (OJ n. C 136 of 16.6.2009).

²⁰⁴ “Details of arrangement for the electronic transmission of State aid notifications including addresses together with the arrangements for the protection of confidential information” (OJ n. C 237 of 27.9.2005).



In conclusion, regulation (EC) no. 794/2004²⁰⁵ governs certain practical aspects.

b) Risk finance instruments

References:

- General block exemption regulation

- De minimis aid regulations

- Guidelines on State aid to promote risk finance investments (*Official Gazette of the European Union*, no. C 19 of 22.1.2014)

The various deeds are available on the following website:

http://ec.europa.eu/competition/state_aid/legislation/legislation.html

The approach introduced by the Commission for risk finance measures is different to the previous ones. In fact, the aforementioned *Guidelines on State aid to promote risk finance investments*²⁰⁶ do not provide an actual method for determining a “market value” or approximate value deemed as such of a risk finance transaction, but a series of criteria for evaluating compatibility of the aid, in accordance with certain principles, including proportionality of the aid, which involves the aid being limited to the minimum necessary to achieve the objective.

In other words, the notices on guarantees and reference rates and discounting allow the gross subsidy equivalent (GSE) of aid to be determined when said aid is in the form of a loan or a guarantee. The GSE is then used to evaluate compatibility of the aid in terms of proportionality but, as seen, the rules on compatibility of aid are contained in other documents.

There is no method of determining the GSE of risk finance interventions, but criteria which allow it to be concluded that the aid is reduced to a minimum (proportionality of the aid) and other criteria which allows its compatibility with the internal market to be evaluated (admissibility of one of the derogations set forth by the treaty).

The principal characteristics of the documents on the basis of which risk finance instruments can be categorised are discussed below, starting with the de minimis aid regulations (i), then moving on to the general block exemption regulation (ii) and, lastly, the notice on financial instruments (iii).

(i) De minimis aid

The de minimis regulations for aid in the form of guarantees already examined²⁰⁷ provide the possibility of granting aid in the form of capital contributions and risk finance measures. However, the amount of aid (direct subsidy in cash) totals:

- the total amount of the public contribution for aid granted in the form of capital contributions;
- the capital provided for aid granted in the form of risk finance measures, such as equity or quasi-equity investments.

Regulation no. 360/2012 does not mention risk finance, but risk capital: the amount of the aid (direct subsidy in cash) totals the entire capital contribution.

The subsidy equivalent is therefore determined with reference to the “worst-case scenario”, which is total loss of the financing by the public authority.

(ii) General block exemption regulation

The general block exemption regulation provides for a specific category of aid in favour of access of SMEs to finance (Chapter III – Section 3), including risk finance aid.

²⁰⁵ COMMISSION REGULATION (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty (OJ n. L 140 of 30.4.2004) (revisions published on OJ n. L 25 of 28.1.2005 and OJ L 131 of 25.05.2005 and OJ n. L 44 of 15.2.2007; modifications: Commission Regulation (EC) n. 1627/2006 of 24 October 2006 (OJ n. L 302 of 1.11.2006), Commission Regulation (EC) n. 1935/2006 of 20 December 2006 (OJ n. L 407 of 30.12.2006), Commission Regulation (CE) n. 271/2008 of 30.01.2008 (OJ n. L 82 of 25.3.2007), Regulation (EC) n. 1147/2008 (OJ n. L 313 1 22.11.2008, Regulation (EC) n. 257/2009 (OJ n. L 81 15 27.3.2009) and Regulation (EC) n. 1125/2009 (OJ n. L 308 of 24.11.2009)

²⁰⁶ OJ n. C 19 of 22.1.2014.

²⁰⁷ Cfr. *supra*, p. 28.



According to this regulation, risk finance aid schemes in favour of SMEs shall be compatible with the internal market and shall be exempted from the notification requirement, provided the conditions laid down in article 21 and Chapter I of the regulation are satisfied.

The first characterising aspect is connected with the fact that this regulation only applies to aid schemes and not to individual aid.

The article then governs the form which aid to financial intermediaries may take²⁰⁸, which may be of various types (equity or quasi-equity, financial endowment, guarantees or loans), but which must be aimed at intervention of the intermediaries with risk finance in favour of the eligible undertakings.

At the level of independent private investors²⁰⁹, risk finance aid may take one of the forms mentioned for financial intermediaries or the form of tax incentives to private investors who are natural persons providing risk finance directly or indirectly to eligible undertakings.

At the level of eligible undertakings, risk finance aid may take the form of equity, quasi-equity investments, loans, guarantees, or a mix thereof.

Eligible undertakings are undertakings which at the time of the initial risk finance investment are unlisted SMEs and fulfil at least one of the following conditions:

- they have not been operating in any market;
- they have been operating in any market for less than 7 years following their first commercial sale; however, under specific conditions, the risk finance aid may also cover follow-on investments made in eligible undertakings, including after the seven-year period;
- they require an initial risk finance investment which, on the basis of a company plan prepared for the launch of a new product or entry onto a new geographical market, is 50% higher than their annual average turnover over the last five years.

Said article 21 contains other limitations, the principal ones of which are:

- the risk finance measure shall be implemented via one or more financial intermediaries, except for tax incentives to private investors in respect of their direct investments into eligible undertakings;
- financial intermediaries, as well as investors or fund managers shall be selected through an open, transparent and non-discriminatory call, with specific characteristics;
- certain conditions must exist which guarantee profit-driven financing decisions;
- certain conditions must exist which guarantee financial intermediaries are managed on a commercial basis;
- conditions are imposed for the risk finance measures which envisage guarantees or loans in favour of eligible undertakings.

In conclusion, it should be noted that article 21 also sets forth certain simplified conditions for risk finance aid of a limited amount²¹⁰.

Article 22 of said regulation also contains a form of risk finance aid, relating to aid which may be granted to private investors who are natural persons in the form of tax incentives, as compared with investments for risk finance made through an alternative trading platform in eligible undertakings under the conditions of article 21.

Article 24 of the regulation should also be mentioned, which provides for granting aid for scouting costs. Eligible costs are costs for initial screening and formal *due diligence* undertaken by managers of financial intermediaries or investors to identify eligible undertakings pursuant to Articles 21 and 22, which relates to aid for start-ups .

²⁰⁸ “Every financial entity, regardless its form and company assets, included holding funds, private equity funds, public investment funds, banks, micro-finance entities and guarantees funds(annex I of the regulation).

²⁰⁹ “independent private investor” means a private investor who is not a shareholder of the eligible undertaking in which it invests, including business angels and financial institutions, irrespective of their ownership, to the extent that they bear the full risk in respect of their investment; upon the creation of a new company, all private investors, including the founders, are considered to be independent from that company. Gli investimenti effettuati da intermediari finanziari pubblici sono ritenuti svolti da investitori privati indipendenti se lo Stato non esercita un controllo di diritto o di fatto su tali intermediari” (annex I of the regulation).

²¹⁰ Cfr. article 21, paragraph 18.



Although “financial instruments” are not specifically defined and even if they are aimed at achieving a specific objective of environmental protection, it is also worth mentioning here the aid for energy efficiency projects indicated in article 37 of the regulation.

This aid, which is exempted from the notification requirement, must relate to energy efficiency of buildings and may be granted in the form of a loan at a subsidised interest rate to an energy efficiency fund or a financial intermediary, which must be passed on fully to the building owners. The other conditions are specified in said article.

(iii) *Guidelines on State aid to risk finance*

The guidelines on State aid to risk finance are not applied to all undertakings, but their area of application is limited according to the need to intervene in a market bankruptcy relating to the risk finance. The guidelines themselves specify the area of application. The principal conditions may be summarised as follows:

- they are applied exclusively to risk finance schemes. They are therefore not applied to individual risk finance measures of individual undertakings, except in the case of measures supporting a specific alternative trading platform.
- the risk finance aid measures must be implemented through financial intermediaries or alternative trading platforms, except in the case of tax incentives applicable to direct investments in eligible undertakings. A measure which allows the Member State or another public entity to make direct investments in companies without involving said intermediaries does not fall within the area of application of the regulations on State aid for risk finance set forth by the guidelines, nor yet by the general block exemption regulation already examined²¹¹.
- a risk finance measure must be directed at small undertakings with medium capitalisation or at innovative undertakings with medium capitalisation which perform R&D and innovation projects. However, the beneficiary firms must not be listed on a stock exchange or regulated market.
- Risk finance aid measures will not be declared compatible in the complete absence of private investors. Risk finance aid measures will also not be declared compatible if the private investors do not assume a significant risk and/or the flow of benefits is entirely in favour of private investors.
- Excepting the possibility of granting risk finance aid in the form of replacement capital, pursuant to the general block exemption regulation, risk finance aid cannot be used for buy-outs²¹².

Other exclusions are indicated in the guidelines themselves.

Insofar as concerns the finance aid considered, we can list the following:

- risk finance aid destined for undertakings which do not satisfy all the conditions of eligibility for risk finance provided by the general block exemption regulation:
 - small undertakings with medium capitalisation which exceed the thresholds indicated in the definition of SMEs contained in the general block exemption regulation;
 - innovative undertakings with medium capitalisation which perform R&D activities and innovation;
 - undertakings which receive initial investments for risk finance seven years after their first commercial sale;
 - undertakings which require an investment for risk finance of an amount exceeding the limit set forth in the general block exemption regulation;
 - alternative trading platforms which do not satisfy the conditions of the general block exemption regulations;
- measures which, if structured according to different parameters to those set forth in the block exemption regulation, are destined for the same eligible undertakings defined in the regulation:
 - financial instruments with participation of private investors lower than the percentages set forth in the general block exemption regulation;

211 Cfr. *supra*, p. 36.

212 “Buy-out” means the purchase of the controlling stocks or shares of a firm by its own managers in order to acquire its assets and operations.



- financial instruments conceived with parameters higher than the maximums set forth in the general block exemption regulation;
- financial instruments other than guarantees for which financial intermediaries, investors or managers of funds are selected favouring protection against potential losses (protect from risks) with respect to prioritising participation in profits (incentives relating to participation in profits);
- tax incentives to company investors, including financial intermediaries or their managers operating as co-investors;
- the major schemes to which the general block exemption regulation does not apply due to their high balance sheet endowment defined in the regulation itself.



ANNEX IV: REFERENCES AND BIBLIOGRAPHY

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