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# Financial Engineering Instruments and their Assessment Under EU State Aid Rules

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# Financial Engineering Instruments and their Assessment Under EU State Aid Rules

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## **Abstract**

Financial engineering instruments such as guarantees, loans and equity are increasingly used in public funding of enterprises. These instruments have three attractive features: they are repayable, they “leverage” private involvement, and they have a multiplier effect because they generate new income. At the same time, however, they are technically complex and they are subject to state aid rules. Their assessment under EU state aid rules creates two additional problems. First, under certain conditions financial instruments may not contain state aid. This is when public authorities act as “private investors”. This means that state aid cannot be presumed to exist in all financial instruments. It must first be established through market analysis. Second, when state aid is found to be present it is not always possible to quantify it. For this reason the state aid rules that apply to financial instruments differ significantly from other rules. This paper reviews how financial instruments have been assessed by the European Commission and under which conditions the state aid they may contain can be considered to be compatible with the internal market. The paper finds that by and large Member States have succeeded to design measures that have all been approved by the Commission.

**Keywords:** Financial engineering instruments, state aid, risk capital, guarantees, loans, SMEs.

**JEL-codes:** F15, O52.

## Introduction

The purpose of this paper is to review the assessment of financial engineering instruments under the state aid rules of the European Union. Financial engineering instruments are loans, guarantees, equity or other forms of funding where risk is shared between investors and the enterprises in which they invest. Although such financial instruments are complex, they are gaining prominence in public policy towards enterprises, particularly small and medium-sized enterprises [SMEs], mainly for two reasons.

First, they “leverage” limited public support by incentivising the involvement of the private sector. If, for example, every euro provided by the state is matched by a euro from private sources, the total amount that benefits SMEs is doubled. In times of budgetary austerity this leveraging effect is very important to cash-strapped public authorities.

Second, these financial instruments have a “multiplier effect”. Once capital or loans are repaid, they can be used again to support new SMEs. Moreover, they can generate additional income from payments of dividends on equity, interest on loans and premia on guarantees.

Unlike grants which are used in one-off operations to support single companies, financial instruments can be re-used and can increase the total amount of available funding so many more companies can be assisted. These advantageous far outweigh the problems associated with their complexity. During the period 2007-13, EU structural funds have allocated EUR 10.5 billion to operational programmes covering financial instruments.

However, the complexity of financial instruments makes it difficult to assess their compatibility with EU state aid rules. There are two main problems here. First, it is not always evident whether state aid is involved at all. According to Article 345 TFEU, the state may invest in companies or, more broadly, “undertakings” which comprise any entity that engages in economic activities. It cannot be presumed that every time the state makes a capital injection or grants a loan it confers an advantage, in the meaning of Article 107(1) TFEU, to the recipient undertaking.

Article 107(1) prohibits in principle the granting of state aid. But a public measure constitutes state aid only if it provides an advantage that is not available under normal market conditions. To determine whether public investments deviate from normal market conditions, it becomes necessary to compare the terms of investment by the state with the terms that would be acceptable to a private investor under similar circumstances. This is a complex operation which requires extensive market analysis.

Second, even if an advantage can be detected, it is not easy to calculate its magnitude or its grant-equivalent amount. Since state aid is in principle incompatible with the internal market, any public measure that contains state aid must fall into one of the categories of exemption allowed by the Treaty on the Functioning of the European Union. But aid that is in the end

exempted from the overall prohibition must satisfy the criteria of necessity and proportionality. It must be capable of achieving an objective of public policy and must not go beyond the minimum necessary. This means that the amount of aid must be calculated. With financial instruments this is not easy or always possible. The amount of aid is the size of the advantage conferred. But the size of the advantage depends on many factors such as, for example, the credit worthiness of the recipient undertaking, the quality of the collateral it can offer, the risk assumed by the public investors, etc.

For these two reasons, the European Commission has developed special rules for assessing the compatibility of aid in financial instruments. It is important to understand the intricacies of these rules and the difficulties in their application because the intention of the Commission is to give more prominence to financial engineering instruments in the application of structural funds for the period 2014-20.<sup>1</sup>

This paper reviews the relevant rules and analyses seminal cases from the decisional practice of the Commission and the jurisprudence of EU Courts in order to shed light on a relative obscure area of state aid policy. The paper is divided into two parts. Part I examines the rules and practice on injections of risk capital. Part II examines the corresponding rules and practice on public loans and guarantees.

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<sup>1</sup> Proposal for a Regulation of the European Parliament and of the Council 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 covered by the Common Strategic Framework and laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Council Regulation (EC) No 1083/2006, COM(2011) 615 final/2, 14 March 2012.

## PART I: RISK CAPITAL

The assessment of the compatibility of state aid in injections of risk capital is different from the typical state aid practice because there are no eligible costs. Apart from a ceiling for the maximum amount of risk capital that can be invested per annum there are no rates of aid intensity either. Unlike other areas of state aid where the subsidised projects have to fall within well-defined categories, in the risk capital area it is the act of investment that is assessed.

In view of these differences and given the fact that “financial engineering instruments”, including risk capital, will be given more prominence in the actions that will be supported by EU structural funds in the period 2014-20<sup>2</sup>, this paper seeks to shed light on an otherwise under-researched area of state aid policy.

Since the coming into force of the current Risk Capital Guidelines on 1 January 2007,<sup>3</sup> the European Commission has examined about 85 risk capital measures. Of these 85 or so measures, the Commission undertook a detailed assessment in about 20 cases. Only one measure has been found to be incompatible with the internal market. However, the finding of incompatibility was not because the measure infringed state aid rules but rather because it violated fundamental internal market principles, namely the principles of non-discrimination and free establishment.<sup>4</sup> In about another 15 cases, the Commission concluded that no state aid was involved, despite the presence of public funds. This was because the public investments conformed with the private investor principle. Another 40 or so measures have been adopted by Member States on the basis of the general Block Exemption Regulation<sup>5</sup> and therefore have not been subject to any prior assessment by the Commission.

Available statistics reveal that Member State expenditure on risk capital has totalled about EUR 3.5 billion in the period 2006-11.<sup>6</sup> The majority of risk capital measures have been implemented by just a handful of Member States: Germany, France and the United Kingdom. Germany in particular has been very active in inducing investments in newly established companies. Other Member States that have supported risk capital investments are Italy, Spain, the Netherlands, Ireland, Finland, Hungary and Greece. The new Member States as a whole do not seem to be active in risk capital investments.

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<sup>2</sup> Proposal for a Regulation of the European Parliament and of the Council 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 covered by the Common Strategic Framework and laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Council Regulation (EC) No 1083/2006, COM(2011) 615 final/2, 14 March 2012.

<sup>3</sup> OJ C 194, 18.8.2006, p. 2–21, amended in 2010 OJ C 329, 7.12.2010, p. 4–5.

<sup>4</sup> See Commission Decision 2010/13 on scheme C 2/2009 concerning capital investments in Germany.

<sup>5</sup> Regulation 800/2008.

<sup>6</sup> European Commission, DG Competition, Revision of the State Aid Rules for SME Access to Risk Finance, Issues Paper, 22 November 2012.

The paper examines in depth four measures that have been found, in the first place, to contain state aid, and, subsequently, to satisfy the criteria of the balancing test and therefore to be compatible with the internal market. These four measures are representative of the Commission's approach to establishing the compatibility of state aid contained in risk capital investments that use public funds.

In general, the Commission carries out detailed assessment of state aid in two instances: i) when the amount of aid exceeds certain thresholds and ii) when the measure in question is assessed directly on Article 107(3)(c). I hasten to add that detailed assessment should not be confused with the opening of the formal investigation procedure. The latter occurs when the Commission has doubts about the compatibility of a measure, largely because the Member State concerned fails to provide sufficient information. The purpose of the detailed assessment is to determine the necessity of aid, establish the extent of distortion of competition and balance the positive and negative effects of aid. Although there are no publicly available statistics, it seems that the vast majority of measures subject to detailed assessment are approved without any formal investigation.

The reason for the detailed assessment of risk capital measures appears to be different from the reason for the detailed assessment in other state aid areas. The cases that are reviewed in this paper and the cases which are listed in Annex I.1 have been subject to detailed assessment not because Member States intended to grant aid that exceeded pre-defined thresholds but because they wanted to i) use more debt instruments (e.g. loans) than equity, ii) reduce the participation of private co-investors below 50% and iii) provide funding to firms outside assisted areas or beyond their start-up stage. Again, we see that the practice in the risk capital area differs from that in other state aid areas. It is not the amount of aid that is normally the critical issue, as is the case, for example, in R&D subsidies, but the nature of the instruments and specific targets of the risk capital measure.

Part I of the paper is organised as follows. It starts by explaining who the beneficiaries of aid are and then providing a summary of the compatibility criteria as they are elaborated in the Risk Capital Guidelines [RCG]. There are two sets of criteria; those for the standard assessment and additional ones used in the detailed assessment where the balancing tests applies. It continues with a short review of the aims and approach of the balancing test. Then the paper analyses the four representative risk capital measures and explains the reasoning of the Commission. Part I of the paper concludes by identifying the main factors that appear decisive in influencing the Commission's compatibility assessment and the practical application of the balancing test in risk capital cases. In addition, Annex I.1 lists cases that have been subject to detailed assessment. Annex I.2 lists cases where public funding of risk capital instruments has been found not to constitute state aid.

The main finding of the paper is that in contrast to the practice of the Commission in other cases of state aid where it insists in quantitative comparisons of counterfactuals in order to determine the necessity and effects of state aid, in risk capital cases the Commission appears

to be satisfied with ex ante legal constraints imposed on fund managers and investors. In practice, empirical analysis is largely confined to surveys of investor behaviour. Such surveys contain a lot of qualitative information based on investor opinion and preferences instead of hard facts. This is rather surprising because the main purpose of the balancing test and the refined economic approach on which it is founded is to utilise more fact-based economic and quantitative analysis. The reason for this marked difference appears to be that risk capital is provided to enterprises without being linked to specific projects whose impact can be measured.

### **I.1. Existence of state aid**

The purpose of public policy on risk capital is to incentivise investors to provide more funding than normal to SMEs. Therefore, there may be state aid at four different levels: investors, funds, fund managers, SMEs.

Point 3.2 of the Risk Capital Guidelines explains that if there is aid at the level of the investors, then the Commission presumes that at least some aid is passed on to SMEs invested in. This is the case even when “investment decisions are being taken by the managers of the fund with a purely commercial logic.”

It is a general principle of state aid law that aid can be granted directly or indirectly via benefits or inducements that are given to third parties. In case T-93/02, CNCM v Commission, paragraph 95, the General Court found that “the fact that a Member State renounces tax revenue may involve an indirect transfer of State resources, capable of being treated as aid to economic operators other than those to which the tax advantage is accorded directly.” This principle is not confined to tax measures. It applies to any other form of aid. The Commission has to consider aid that is granted both directly and indirectly.

With respect to SMEs, the Commission has found in numerous cases that aid at the level of investors or funds is at least partly passed on to final beneficiaries. In case SA.34582 concerning measures to encourage risk capital investments in newly-created enterprises in Italy, it was stated that “it is consistent Commission practice to consider that where aid is present at the level of the investors, the investment vehicle or the investment fund, it is at least partly passed on to the target SMEs and thus that it is also present at their level. This is the case even where investment decisions are being taken by the managers of the fund with a purely commercial logic.” [paragraph 50]

In this particular case the Commission concluded that “the measure therefore facilitates, through the ... advantage provided to the private investors, the provision of risk capital to SMEs, which would otherwise not be available, or at least not to the same extent, in the absence of the measure. The measure therefore confers an advantage on the investee SMEs.” [paragraph 51]



A similar conclusion was reached in case SA.34006 concerning a venture capital fund in the Italian region of Basilicata. The Commission considered “that where aid is present at the level of the investors, it is at least partly passed on to the target enterprises and thus that it is also present at their level. This is the case even where investment decisions are being taken by the managers of the fund with a purely commercial logic. In the present scheme, Region Basilicata provides via the Fund State resources to a limited number of target enterprises that otherwise would not have found the same amount of finance.” [paragraphs 81-82]

With respect to investment funds and investment managers, point 3.2 of the Guidelines explains that “in general, the Commission considers that an investment fund or an investment vehicle is an intermediary vehicle for the transfer of aid to investors and/or enterprises in which investment is made, rather than being a beneficiary of aid itself.” The same point clarifies that “there is a presumption of no aid if the managers or management company are chosen through an open and transparent public tender procedure or if they do not receive any other advantages granted by the State.”

Overall, the Commission routinely concludes that there is no state aid for funds when they are established for the sole purpose of channeling resources to SMEs and have no other economic activity. The Commission also considers that fund managers receive no aid when they competitively selected or their remuneration is benchmarked at competitive rates. See, for example, cases NN 45/2009, Venture Capital Scheme, Land of Styria; N 406/2009, Clusterfonds, Bavaria; N 722/2009, Risk Capital Aid Scheme, Region Lazio].

By contrast, when risk capital measures favour particular funds or managers, the Commission is of the view that such funds or managers benefit from indirect aid even when the aid is granted to investors. In this instance, there is aid at all levels: funds, managers and final beneficiary SMEs.

In its Decision 2006/638, paragraph 36, on an Italian measure concerning tax incentives for collective investments, the Commission stated the following: “even if specialised investment vehicles do not benefit directly from the tax reduction granted to their investors, they nonetheless receive an indirect economic benefit in so far as the tax reduction on investments in specialised vehicles prompts investors to buy shares [participate] in such vehicles, thereby providing additional liquidity and extra income in terms of entry and management fees”.

It went on in paragraph 39 of the same Decision to add that “a tax advantage provided to investors investing in specialized investment vehicles favours the vehicles themselves as undertakings when they have a corporate form or the undertakings managing such vehicles when they have a contractual form. In particular, the increased demand for shares of specialized investment vehicles leads to an increase in the management and entry fees charged by the vehicles or by the undertakings managing them.” This Decision was confirmed by the General Court in its judgment in case T-424/05, Italy v Commission.

## I.2. Criteria of compatibility of state aid for risk capital

The RCG are applicable to aid schemes only<sup>7</sup> falling under Article 107(1).<sup>8</sup> The Guidelines have two main aims: to explain when state aid is present in risk capital measures and to define criteria for establishing the compatibility of such aid with the internal market. The RCG do not apply to ad-hoc or individual aid, export aid or to schemes not excluding firms in difficulty or firms in the shipbuilding, coal or steel sectors.

In general, an investment instrument contains state aid when the investor does not behave as a “private investor” seeking to earn a return which is commensurate to the level of risk he assumes. In other words, a private investor makes investments on market terms and ignores any public policy objectives.

According to the RCG, state aid may be present at four different levels: the investment fund, the investors, the fund managers or the enterprises in which investments are finally made. If there is state aid at the level of the fund, investors or fund managers, the Commission presumes that there is also state aid for the enterprises invested in, irrespective of whether investment decisions are made on purely commercial grounds. This is because a state measure stimulates the growth in the supply of available capital.

Concerning the compatibility of state aid with the internal market, the RCG define two sets of criteria: those that are used in the “standard assessment” (section 4.3) and those for the “detailed assessment” (section 5). Any risk capital measure that satisfies all of the criteria for the standard assessment is considered to be compatible with the internal market without any further analysis to prove that it fulfils the three fundamental requirements for all types of state aid that is found to be compatible with the internal market: namely that there is actual market failure, that aid is necessary and proportional and that the distortion caused by the aid is limited.

When a measure which has one or more features that deviate from the conditions laid down in the RCG for the standard assessment it is then subject to the detailed assessment. This assessment is based on the principles embodied in the “refined economic approach” used by the Commission since 2005 and which is applied in the form of the so-called balancing test. This test, as its name suggests, balances the positive effects (i.e. well designed objective of common interest) against the negative effects (i.e. distortion of competition) of state aid. A state aid measure is found to be compatible with the internal market only when its positive effects outweigh its negative effects. Below there is a summary of the criteria used in the standard and detailed assessments.

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<sup>7</sup> *Ad hoc* measures are excluded from the scope of the Guidelines. Par. 2.1.

<sup>8</sup> The funding through resources of the European Investment Bank and the European Investment fund is therefore explicitly not covered by the Guidelines, as the funds made available by these bodies do not constitute state resources in the meaning of 107.1 TFEU. Par. 3.2 RCG.

### I.2.1 Standard assessment

The Commission uses a series of indicators to measure whether the incentive effect and the necessity criteria as defined in section 1.3.4 are fulfilled. The guidelines lay down specific safe-harbour thresholds relating to the tranches of investment in SMEs in their early stages of business activity. If these requirements are not met, the Commission will proceed with a detailed assessment of the measure.

Six criteria have to be cumulatively met so that a measure can pass the standard assessment.

1) The maximum level of investment tranches per SME – whether wholly or partly financed through State aid - may not exceed EUR 2.5 million per target SME over each period of twelve months. (4.3.1) The original amount was EUR 1.5 but in 2010 it was raised to EUR 2.5 million per SME.<sup>9</sup> The threshold does not refer to the amount of the aid, but the amount of risk capital provided to the SME.

2) The RCG defines the different phases of development of an SME: seed, start-up and expansion<sup>10</sup>. Investments may be made up to the expansion stage for small enterprises, or for medium-sized enterprises in assisted areas and up to the start-up stage for medium-sized enterprises in non-assisted areas. ( 4.3.2)

3) At least 70% of the budget must be in the form of equity<sup>11</sup> and quasi-equity<sup>12</sup> instruments. (4.3.3)

4) At least 50% of the investments must be provided by private investors or 30% in the case of SMEs in assisted areas. (4.3.4) The private participation includes all funding which is not “state resource” in the meaning of Article 107(1). Financing from the EIB and EIF is considered to be private funding.

5) In order to determine the profit-driven character of the investment decision, the RCG sets up three requirements which have to be met cumulatively. (4.3.5) Investments must be made for profit with significant involvement of private investors. A business plan must establish ex ante viability. A clear and realistic exit strategy must exist for each investment.

6) The management of the measure must be made on a commercial basis, i.e. like the management of the private sector, seeking to maximise the return on the investment. (4.3.6). The Guidelines set out three conditions which have to be met for this criterion to be fulfilled. The manager’s remuneration is linked to performance and there are clearly defined fund objectives and timing of investments. Private market investors are represented in decision-making, e.g. investors’ advisory committee. Best practices and regulatory supervision apply to the management of funds.

Lastly, it is worth pointing out a significant difference between the RCG and the risk capital provisions of the General Block Exemption Regulation 800/2008. Under the RCG, the state may

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<sup>9</sup> Communication from the Commission amending the Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, OJ C 329, 7/12/2010, p.4.

<sup>10</sup> RCG 2.2 (e)-(h).

<sup>11</sup> RCG 2.2(a).

<sup>12</sup> RCG 2.2(c).

contribute to funds which then invest into SMEs or may invest directly with other investors into SMEs. Under the GBER, the state can contribute only to funds which then invest in SMEs.

## **I.2.2 Detailed assessment**

Whenever one or more requirements of the standard assessment are not met, the Commission follows the detailed assessment procedure. The requirements of this type of assessment as enumerated in section 5.2 are not exhaustive, so the Commission does not have to conclude from the presence of one or more elements that the measure is compatible. Depending on the form of the measure, the Commission may check the applicability of these conditions, and the weight attached to them in particular cases. The burden of proof lays with the Member States which have to provide information to demonstrate that the measure is proportional to the level of market failure and that the risk of crowding out private investment is not excessive.

### **(a) Positive effects of aid**

#### 1) 5.2.1 Existence and evidence of market failure

This is shown by equity gap due to high risk, incomplete information or transaction costs.

#### 2) 5.2.2 Appropriateness of the instrument

This is shown by the relative ineffectiveness of other policy measures.

#### 3) 5.2.3 Incentive effect and necessity of aid

i) Commercial management: The fund should be managed by professionals chosen according to a transparent, non-discriminatory procedure, preferably an open tender, with proven experience and a track record.

ii) Presence of an investment committee: There should be an investment committee, independent of the fund manager and composed of independent experts, and preferably also of representatives of investors.

iii) Size of the measure/fund: The budget should be of a sufficient size to take advantage of economies of scale in administering the fund, to diversify risk and to absorb transaction costs

iv) Presence of business angels.

#### 4) 5.2.4 Proportionality

Investors should not be overcompensated, the risk of losses should not be borne entirely by the public sector and the benefits should not flow entirely to private investors. In particular there should be:

ii) Open tender for managers.

ii) Call for tender or public invitation to investors.

### **(b) Negative effects of aid**

#### 1) 5.3.1 Crowding-out

There is crowding out if public funds compete with private funds for the same enterprises. Evidence of non-competition has to be provided.

## 2) 5.3.2 Other distortions of competition

Investments should not be made into inefficient companies and the size of such investments must not be out of proportion in relation to their turnover.

### (c) The “balancing test”

Detailed assessment of state aid is based on the idea of the “balancing test” which was introduced by the State Aid Action Plan of 2005 and has been refined in a Staff Working Paper on “Common Principles for an Economic Assessment of the Compatibility of State Aid under Article 107(3)”.<sup>13</sup>

As the Action Plan put it, “... appreciating the compatibility of state aid is fundamentally about balancing the negative effects of aid on competition with its positive effects in terms of common interest.” Therefore, the balancing test, first, identifies all the possible effects of state aid and, then, compares them in order to determine the overall effect.

The decisional practice of the Commission that I have extensively reviewed elsewhere<sup>14</sup> reveals that, at the risk of not much exaggeration, the single most decisive element in the application of the balancing test is the establishment of a credible, data-based, “counterfactual”. This is a description of what would happen with and without the aid.

By examining counterfactuals, the Commission can determine whether state aid has an incentive effect, i.e. it can influence the behaviour of the beneficiaries, and then calculate how much aid is required in order to bring about the desired change in the behaviour of the aid recipients. These are the tasks of proving the necessity and proportionality of aid. The formula that can accomplish to a large extent both of these tasks is the estimation of the net present value (NPV) or the internal rate of return (IRR) of a project. At one stroke, the NPV or the IRR reveals whether a project would not be undertaken without aid and also how much aid needs to be pumped into a project to make it attractive for an enterprise in order to commit its own money.

Counterfactuals are the bread and butter of balancing tests and measures of NPV or IRR are routinely required by the Commission. With respect to aid for R&D, for example, the Commission focused its detailed assessment on quantitative estimations of profitability and in-

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<sup>13</sup> 18 May 2009. It can be accessed at:

[http://ec.europa.eu/competition/state\\_aid/reform/economic\\_assessment\\_en.pdf](http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf)

<sup>14</sup> P. Nicolaides, *Economic Analysis of State Aid: An Assessment of the Balancing Test and its Application in the Draft Framework on State Aid to Research, Development and Innovation*, “European State Aid Law Quarterly”, 2006; P. Nicolaides, *Compatibility of State Aid and the Balancing Test: Its Role in the Architecture of the System of State Aid Control*, Presented at the Third Annual Conference of the Global Competition Law Centre, College of Europe, Bruges (B) on Economic Analysis of State Aid Rules, 21-22 September 2006; P. Nicolaides and I. Rusu, *The Binary Nature of the Economics of State Aid*, “Legal Issues of Economic Integration”, 2009.

depth analysis of market structures and market players.<sup>15</sup> Yet, the cases which are reviewed below reveal a different picture as far as risk capital is concerned. The quantitative evidence required appears to be paltry by comparison. It is not that the Commission does not require evidence. On the contrary, it demands extensive market surveys of the alleged market failure. However, it appears to be satisfied with general arrangements concerning the amount of capital injected in SMEs and qualitative conditions imposed on the companies invested in.

### **I.3. Cases**

This section reviews four representative cases which established the practice of the European Commission and demonstrate how the Commission assesses in detail risk capital measures. They reveal what appear to be the main concerns of the Commission and the type of evidence that is acceptable to the Commission.

#### **I.3.1. N 700/2007, Finance Wales JEREMIE Fund, UK**

##### **(a) Objective and market failure**

The Finance Wales JEREMIE Fund (hereinafter FWJF) aims at the provision of risk capital support and of loans to small and medium sized enterprises (SMEs) in Wales. The market failure is present up to the expansion phase of SMEs with an investment limit of £2 million. The FWJF provides SMEs with loans from £5000 to £25000 and debt facilities from £25001 to £1 million. All loans are provided under market conditions. The interest charged on loans is set in compliance with the Commission Communication on reference and discount rates. The FWJF is managed by a Holding Fund in line with the Commission's JEREMIE model. This Holding Fund has a dedicated Investor Board to oversee its management. All investment decisions are taken by an independently appointed Investment Committee.

The fund managers are selected through open tender. Fund managers are contracted to generate a set internal rate of return for the funds under their management. Their performance based remuneration is linked to targets set out in the fund management contract.

##### **(b) State aid assessment**

###### ***Existence of state aid:***

With respect to the loans which are provided to SMEs under market conditions, the Commission concludes that they do not constitute state aid. At the level of investors, the Commission finds that there is no state aid because public and private investors share exactly the same upside and downside risks and rewards and hold the same level of subordination, and at least 50 percent of the funding of the measure is provided by private investors, which

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<sup>15</sup> See, for example, Commission decisions on French aid to Siemens & Lohr for metro trains, N674/06; French aid to Alcatel-Lucent for unlimited mobile tv, N 854/2006; Spanish aid to ITP, C9/2007; Swedish aid to Volvo Aero, C33/2008; German aid to RR Deutschland, N195/2007.

are independent from the companies in which they invest. There is also no state aid for the fund and the fund managers. The fund is a vehicle for channelling resources to final recipients while the fund managers are selected according to competitive selection procedures.

Despite finding no state aid for investors, the fund or the fund managers, the Commission concludes that it cannot exclude the presence of an advantage for the target enterprises because only a limited number of SMEs can benefit from the partly public financing of the fund.

***Compatibility of state aid:***

The measure complies with all the criteria for the standard assessment in the RCG except two: i) the maximum tranches (about EUR 2.5 million) exceeds the RCG ceiling of EUR 1.5 million which was in force at the time of the assessment and ii) finance is provided beyond the start-up stage for medium sized enterprises located in non-assisted areas. For these two reasons, the Commission carried out a detailed assessment.

The UK submitted information demonstrating that the market failure was present up to £2 million in the expansion phase of SMEs. This market failure covered medium-sized enterprises located in non-assisted areas. On the basis of this information and because the measure was designed according to EIB/EIF recommendations, the Commission concluded that the evidence showed the necessity of the proposed fund and that the threshold of tranches and the investments into medium-sized enterprises located in non-assisted areas were compatible with the internal market.

### **I.3.2. NN 45/2009, Venture Capital Scheme, Land of Styria, Austria**

**(a) Objective and market failure**

The scheme consisted of two measures. The first measure was the basis for provision of start-up capital in the form and under similar conditions as in case N 403/2002 which was found not to constitute state aid. Under the second measure, seed capital was provided to micro-sized undertakings directly by the StBFG and no participation of private investors was envisaged. The scheme was not organized as a fund with a separate legal personality. The StBFG as the aid granting authority would invest directly into target undertakings. For the start-up investments, gains and losses would be shared equally by the private investors and the StBFG.

The investments under the scheme would be granted to micro- and small-sized enterprises established in Styria. The need of a specific risk capital instrument in Styria was based on the deficiency in access to private equity investments for newly created companies in the early stage of their existence. Investors were reluctant to provide financing to undertakings at the early stage of their existence. The private equity gap in financing at the seed stage was demonstrated by the data on newly created undertakings. In 2007, there were 30,501 new undertakings founded in Austria, of which 3,749 in Styria. Of the Styrian newly established

undertakings only 2 received private equity investment at the seed-stage. Information on the demand for private equity investments at the seed stage showed that in 2007, 35 undertakings in Austria and two undertakings in Styria sought seed capital investments and only 5 (in Styria one) were successful. In 2008, there were 12 (none in Styria) successful candidates of 37 (one in Styria).

### **(b) State aid assessment**

StBFG used state resources and the measure was attributed to the state. For the start-up programme, there was no advantage to investors and therefore no state aid because they invested at least 50% of the funds in eligible enterprises. For the seed capital programme, there may be state aid for investors because StBFG may invest more than 50%.

There was no state aid at the level of the fund because StBFG received no advantage since it acted as a vehicle through which capital would flow to final beneficiaries. Furthermore, no separate fund was established. At the level of the fund managers, there was also no state aid because no fund had been established. For the recipients of start-up capital there was no state aid because there was no state aid at higher level. The Commission pointed out that there might be state aid for the recipients of seed capital because StBFG may invest more than 50% of total equity.

In the assessment of the compatibility of the seed capital programme the Commission proceeded as follows:

1. Maximum level of investment tranches: The limit in the RCG was respected because the maximum investment was EUR 300,000.
2. Restriction to seed and start-up financing: Only seed capital was provided to small enterprises.
3. Prevalence of equity and quasi-equity investment instruments: Only equity finance would be provided.
4. Commercial management: No remuneration was provided to StBFG. However, the requirement of performance-linked incentive was inherent in the exit strategy of the scheme. The selection of the target undertakings was carried out on the basis of purely commercial interests and that the StBFG disposed of appropriate expertise in order to qualify for such selection.

### **(c) Detailed assessment for the seed capital programme which may involve no private investor**

#### ***Positive effects of the aid***

Existence of market failure: There was a gap in private equity financing at the seed stage. Access to private equity capital at the seed stage was even more limited than at the early stage in general due to the higher risk involved. An independent study showed that during the previous five-year period, seed capital was oscillating between EUR 10 million and zero. The investment activity of the Austrian private equity and venture capital funds was below the EU



average. Potential private venture investors fear mainly the high level of risk and uncertainty of revenues of such investments, which further increased at the seed stage.

### ***Negative effects of the aid***

Crowding out private investment: The RCG acknowledge that private investors are reluctant or largely unwilling to provide seed capital. This implies no or very limited risk of crowding-out. Furthermore, there is reduced potential for distortion of competition due to the significant distance from the market of these small-size enterprises. The key argument of the non-existence of risk of the crowding-out effect of the present measure was the fact that of 3,749 newly created undertakings in Styria in 2007 only 2 received private equity investment at the seed-stage. In 2008 the situation further worsened: 2 of 3,977. Furthermore, aid would be modest. The aid was therefore found to be compatible with the internal market.

### **I.3.3. N 406/2009, Clusterfonds, Bavaria, Germany**

#### **(a) Objective and market failure**

The scheme aimed at filling the shortage in private share capital that affects newly established, technology focused micro- and small enterprises at their seed stage. Eligible enterprises were those seated or having an establishment in Bavaria. According to an independent study, only 21% of venture capitalists surveyed were ready to provide seed capital. The German authorities made an estimation of the potential demand and current supply of seed investments in Bavaria and provided documentation to demonstrate that, taking into account regional aspects of the scheme, an equity gap on the seed capital market in Bavaria existed. More than 90% of the potential demand for seed capital in Bavaria was not met by supply.

The German authorities also assessed the effectiveness of alternatives to the notified risk capital instrument. They argued that non-selective instruments, in particular tax advantages, would not provide a sufficient stimulus. Target enterprises would not generate profits in the foreseeable future and such tax instruments would thus not generate an incentive to reduce the tax amount on income received.

Aid in the form of loans and direct grants was unsuitable to address the financing gap in the seed phase, which is characterised by high losses and, as a rule, by the lack of collateral. As such aid is to be granted for specific, individual projects and it could only serve as a supplement to more flexible financing. Besides, such aid would not be available to the extent actually required by the target enterprises, due to budgetary and regulatory-policy reasons.

The measure would be implemented by a Fund established by LfA which is a bank for the support of economic development in Bavaria and is a body governed by public law. LfA is an integral part of the state administration. The Fund's initial capital of EUR 24 million would be provided by LfA. The Fund would be managed by BKG, which is 100% owned by LfA. BKG had

not been selected by an open tender procedure. Hence, public tender rules and provisions did not apply.

The remuneration of BKG consisted of two components. As a first part there would be an annual management fee of 2.5% of the amount accounting for 50% of the money invested by the Fund during the first two years and 2.5% of the total amount of the money invested by the Fund starting from the third year. After five years, the management fee would be calculated on the basis of the money invested, after deduction of repayments and successful sales and completed insolvencies until the end of the previous year. VAT would be added to the management fee. As a performance fee, which was the second part of the remuneration, BKG would be entitled to receive 10% of the profits from successful exits if a hurdle rate of 6% p.a. for the investments of the other owners of the Fund was attained. The management fee was in line with market benchmarks.

### **(b) State aid assessment**

The Fund was endowed with capital provided by public authorities. Private investors may obtain an advantage because it was not certain that they would make at least 50% of investments in recipient companies. The Fund itself acted as an intermediary for the channelling of capital to final beneficiaries. The Fund would not diversify into any other activities than those necessary for the implementation of the notified measure. Therefore, it obtained no advantage and no state aid.

The Fund manager, i.e. BKG, would receive remuneration that was in line with market conditions for fund-management services. According to established Commission practice such remuneration entails no state aid.<sup>16</sup> Furthermore, the selection of BKG without public tender is compliant with the relevant EU law on public procurement because (i) BKG is fully controlled by the state and (ii) carries out the essential part of its activities with the state (i.e. manages state investments).<sup>17</sup>

Targeted enterprises also received state aid because the measure was selective and it could not be excluded that aid at the level of investors would not be passed on to beneficiary enterprises.

### ***Compatibility***

The measure was found compatible with the internal market because it satisfied all the criteria in the Risk Capital Guidelines.

1. Maximum level of investment tranches: The maximum amount of EUR 500,000 per undertaking is below the ceiling of EUR 2.5 million.
2. Restriction to seed-, start-up and expansion financing: The measure was limited to seed capital.

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<sup>16</sup> See N 478/2008 Hannover Beteiligungsfonds; N 696/2007 EFRE-Risikokapitalfonds Brandenburg.

<sup>17</sup> See C-458/03 Parking Brixen.

3. Prevalence of equity and quasi-equity investment instruments: Since silent participation did not exceed 30%, equity and quasi-equity investments would be at least 70%, as required by the RCG.
4. Commercial management: The Fund was be managed commercially. The management's remuneration was linked to performance and investments were made with a clear exit strategy. Private market investors were represented in decision-making. Best practices applied and the Fund was be under regulatory supervision.
5. Participation by private investors: Although the RCG require that at least 50% of the funding must be provided by private investors, the Fund may invest without any private investor. For this reason the Commission applied the balancing test.

### ***Positive effects***

Existence of market failure:

The number of newly established high-technology enterprises was declining on the long run. Financial resources for enterprises in their seed phase were rather limited. Small enterprises could not finance themselves from the operating cash-flows. Access to external financing through banks, which counted for almost 19% of overall finance of high-technology enterprises failed due to stricter requirements regarding creditworthiness. Only 21% of the venture capital providers invested in enterprises in their seed-phase (younger than 1 year). Venture capital providers preferred to invest in enterprises older than 1 year with a turnover of more than EUR 100,000. Moreover, Bavaria lacked a sufficient supply of risk capital.

Incentive effect and necessity of the aid:

The RCG stipulate that the incentive effect of risk capital aid measures plays a crucial role in the compatibility assessment. There is an incentive effect when all the conditions in section 4 of the RCG are present as well. The Commission assessed the following:

Commercial management: The Fund manager operated on a commercial basis but it had not been selected through a competitive procedure.

Presence of an investment committee: Although private investors were represented in decision making, it was not possible to determine its composition beforehand.

Size of the measure/fund: The Fund's size was sufficient and the risk was adequately diversified. There was also no doubt that the Fund's transaction costs could be absorbed.

Presence of Business Angels: Although business angels might not intervene concomitantly with each Fund investment, the measure's aim to involve this category of venture capitalists was to be considered positively.

Proportionality of the aid:

The Commission considered that a transparent, non-discriminatory open tender for the choice of the management company and a public invitation to investors positively influence the assessment of proportionality as they represent a best-practice approach. The Commission found that the aid was proportionate because BKG would be remunerated commercially and that there would be a published invitation to investors.

### ***Negative effects of the aid***

Crowding out private investment:

There would be no investments in cases where private funding was possible. Prior to each investment, the Fund management would scrutinise whether financing from a private venture capital fund or business angel was possible.

The Fund would not act as a lead investor. The Fund investments were targeting a demand that private venture capital funds were not ready to meet. The average investment tranche in Bavarian seed enterprises (in the period 2005-2009) made by private investors (venture capital funds) amounted to EUR 760,000 p.a. The ceiling of the Fund for each investment/enterprise p.a. was EUR 250,000.

The Fund would invest in target enterprises younger than those funded by private investors and at a very early business stage. The Fund's target enterprises must not be older than 1 year to be eligible for the first investment. By contrast, only 8% of private venture capital providers invested in enterprises that were younger than 1 year. The RCG themselves stipulate that the reluctance and near absence of private investors to provide seed capital, implies no or very limited risk of crowding-out.

### **Balancing positive and negative effects of the aid**

The Commission considered positively the fact that the investment was provided in form of equity or quasi-equity to young innovative companies only in their seed-stage. Furthermore the investment tranche was limited to a point that was far below the maximum investment tranche as foreseen in the Guidelines. The scheme tackled a well-identified equity gap on the relevant seed capital market and could be considered as an appropriate measure to encourage private risk capital investment. Even though the Fund's management was not selected through an open tender, the Fund would be managed commercially. The size of the Fund was sufficient and private investors were openly invited on a European level. The measure would apply only in cases where no private investors could be found. In the end the Commission considered that the positive effects prevail.

#### **I.3.4. N 722/2009, Risk Capital Aid Scheme, Region Lazio, Italy**

##### **(a) Objective**

Region Lazio intended to set up a 100% public investment fund in order to make risk capital investments into start-ups and SMEs in Region Lazio with leveraged private funding. Region Lazio planned to establish a revolving fund that would be constituted as separate account fund within FILAS, which was a company established by Region Lazio for the purpose of dealing with risk capital measures and the support of innovation activities. FILAS was a joint stock company, 100% owned by Region Lazio. The fund would be managed by FILAS as a financial intermediary.

A committee would scrutinize proposed investment projects on the basis of their profitability and financial aspects and would check the lawfulness of each investment. This committee was composed by five members. Three of its members were chosen on the basis of an open public tender procedure. The remaining two members would be appointed by Region Lazio.

FILAS for its activities received fees of a maximum of 2% per year of the total amount of the fund for the entire investment period and of a maximum 1% per year of the total amount actually engaged during the divestment period. FILAS would publicise the fund in order to find co-investors interested to invest together with the fund in the SMEs.

The fund would invest in SMEs established in Region Lazio up to their expansion stage, both in assisted and non assisted areas. For this purpose, FILAS would announce a call for projects that would set all the criteria for eligibility for an investee enterprise. The estimated number of investee enterprises ranged between 11 to 50 enterprises.

Under the measure, for the investments in the equity or quasi-equity of an SME, the distribution of the risks and of the profits was asymmetric. According to the Italian authorities, the asymmetric profit distribution in favour of the successful operations was the most appropriate instrument to attract private investors and to develop a risk capital market in Region Lazio, especially since the fund would intervene only on the higher risk segment of the market, and the costs of transaction were primarily under the responsibility of the co-investor.

#### **(b) State aid assessment**

The Commission found that there was state aid for co-investors because of the preferential treatment they received in the distribution of profits.

There was no state aid for the fund that had been established as a separate account within FILAS. Its purpose was only to act as an intermediary vehicle for the transfer of aid and it would not carry out any other function. With respect to the fund manager, the fund management was carried out by FILAS and by the investment committee. In particular, the overall management of the fund was assigned to FILAS and final investment decisions would be made by the investment committee. FILAS was not chosen through an open and transparent public tender. However, the Commission considered that 2% management fee received by FILAS was in line with market remuneration in comparable situations. Furthermore, the Commission had generally accepted a remuneration of 2% as appropriate in Art. 43 of Regulation 1828/2006. With regard to the investment committee, the Commission noted its two-layer structure. On the one hand, three of its members were selected on the basis of an open tender procedure and their remuneration was linked to the investment results according to normal market practice. On the other hand, the remaining two members were civil servants that did not receive any additional remuneration. The Commission concluded that there was no state aid at the level of the fund's management.

At the level of the final beneficiaries, the Commission considers that where aid is present at the level of the investors, it is at least partly passed on to the target enterprises and thus that it is also present at their level. This is the case even where investment decisions are being taken by the managers of the fund with a purely commercial logic.

### **Compatibility of state aid**

The following features of the measure were found to be compatible with the RCG:

1. Maximum level of investment tranches: The maximum amount per undertaking did not exceed EUR 1.5 million
2. Prevalence of equity and quasi-equity investments: At least 70% of funds were in the form of equity or quasi-equity.
3. Profit-driven character of investment decisions: Investments were made only for profit and on the basis of a detailed business plan and a clear and realistic exit strategy. Private investors were significantly involved in investment decisions. And the final decision was made by independent committee.

The following were found not to comply with the conditions of the standard assessment of the RCG and for this reason the Commission carried out a detailed assessment:

1. The measure provided for investments during the expansion stage of medium-sized enterprises outside assisted areas.
2. Participation of private investors: The minimum private participation for high-risk investments in non-assisted areas was only 40% instead of 50%.
3. Commercial management: FILAS's remuneration was not linked to performance. Nor was there an overall agreement at the level of the fund on investment performance.

### **(c) Detailed assessment**

Existence and evidence of market failure: It is difficult for enterprises to find external finance due to high transactions for investors. According to an independent study, enterprises with turnover between EUR 2 and 10 million were not attractive to venture capitalists because they preferred enterprises with turnover between EUR 10 and 100 million.

Geographic market failure: The relevant market failure in Region Lazio was present up to the expansion phase of SMEs, irrespective of whether they were located in assisted or non-assisted areas. Investments in the region accounted for about half of national rates as percentage of GDP.

Appropriateness of state aid instrument: The 100% public fund was necessary to attract investors primarily located in Northern Italy. Initial interviews with venture capitalists indicated that they would want to invest on a deal by deal basis instead of being involved at the level of the fund so as to exercise control on their investments. The measure was part of the regional OP which was assessed positively by the Commission.

Proportionality: The measure did not feature those elements which would automatically imply that it cannot be considered proportionate:

- i. the measure did not provide for the risk of losses being borne entirely by the public sector, as for example in case of a complete loss of the capital invested, both the public and the private investor would lose all their capital;
- ii. the measure did not provide for the benefits of the investments to flow entirely to the private co-investors.

The invitations to co-investors were done through public, transparent and non-discriminatory procedures. The selection of the co-investors would be based on the requirements laid down in the invitation and the procedure would remain open to new entrants during the scheme. This was a first element to help to ensure absence of overcompensation at the level of investors. Both losses and profits were mediated through a pre-determined formula.

Incentive effect and necessity of aid:

1. Commercial management: Only two of the three conditions in the RCG were met [i.e. representation of private investors in decision making and compliance with best practices and regulatory supervision]. However, the absence of performance-based fee for FILAS was due to its public nature, while the fee for the three independent members of the committee was linked to investment performance. Moreover, the fund respected Art 43 of Reg 1828/2006 on financial engineering instruments.
2. Presence of investment committee: The majority of the members of the investment committee were independent professionals.
3. Size of fund: The fund had EUR 20 million to which resources of co-investors were added. This amount was considered sufficient enough to absorb transaction costs.

Negative effects of aid:

1. The fund only invested in parallel with co-investors in order to achieve a leverage effect.
2. No negative effect on private investors was expected because the open structure of the fund allowed the involvement of more co-investors.
3. Inefficient companies would not be kept afloat as investment were made only in enterprises that were likely to be profitable.
4. No or little crowding out effects because the fund invested when co-investors agreed to invest.

On the basis of the aforementioned consideration, the Commission found that the positive effects outweighed the negative effects.

#### **I.4. Evaluation**

The purpose of this section is to identify the factors that appear to be decisive in influencing the Commission's treatment of risk capital measures which are subject to detailed assessment.

As explained earlier, detailed assessment is undertaken in those cases where the measure under consideration deviates from the standard conditions laid down in the RCG. This section concludes with a few observations concerning the application of the balancing test in risk capital as compared to its application in other state aid areas.

#### **I.4.1. Existence and evidence of market failure**

Identified important factors: Surveys of investor opinion expressing their reluctance to invest are the main evidence of equity gap. The Commission also accepts quantitative evidence that shows little investment activity in favour of SMEs in particular regions, relative to national or European averages.

#### **I.4.2. Appropriateness of the instrument**

Identified important factors: Instruments other than state aid are unavailable or less effective in inducing investors to commit funds to SMEs, most often because they cannot reduce risk.

#### **I.4.3. Incentive effect and necessity of aid**

Identified important factors: Investment funds should ideally be managed by professionals chosen through a competitive procedure. Decisions should be made by independent committees involving private investors. The presence of business angels is always a positive element.

#### **I.4.4. Proportionality**

Identified important factors: To avoid overcompensation of managers or investors, managers should be chosen through a competitive procedure and their remuneration should be linked to their performance, while investors should also be selected through an open procedure. Limitations on the amount of profit that private investors can make and allowing for the possibility of loss of capital are positive elements.

#### **I.4.5. Avoiding crowding-out**

Identified important factors: Investments should be made in firms that have been refused funding or are not able to find funding or have secured partial funding from private investors. Investments made on the basis of a credible business plan reduce the likelihood of support of non-viable enterprises.

To recapitulate, the application of the balancing test in risk capital cases seems to focus largely on two factors: i) the views of market participants concerning the prospects of investment in SMEs and ii) the legal obligations and constraints imposed on investors and fund managers.



By contrast, the application of the balancing test in other cases of state aid emphasises a more thorough analysis of counterfactual scenarios, quantitative measures of the profitability of aided projects and analysis of market structures and market players.

This is a surprising difference because the approach in risk capital cases does not at first sight appear to conform with the aim of the refined economic approach, which is to utilise more quantitative methods for evaluating state aid.

Yet, on further consideration, it is an understandable difference. Risk capital is injected in whole enterprises without being limited to a specific project whose profitability can be measured. This probably is also the reason why the RCG are rather unusual among Commission guidelines in not defining a maximum rate of allowable aid intensity, apart from the overall ceiling of EUR 2.5 million.

This finding, however, does not mean that Member States should not pay due attention to thorough analysis of prevailing market conditions and of the impact of the aid they propose to grant. It only means that their risk capital notifications have to be presented in a different format with emphasis on proof of equity gap and on the structure of the aid measure rather than quantitative estimates of needed amounts of aid or market shares.

## **I.5. Conclusions**

Part I of the paper has shed light on a rather obscure area of the Commission's decisional practice and has examined how the Risk Capital Guidelines are applied in practice. On the basis of the measures that have been reviewed, the paper can draw a conclusion which is at first glance surprising but on reflection not so unexpected. This conclusion is that, surprisingly, the Commission has approved all but one risk capital measures. These measures can be quite complex and therefore there are many possibilities for disagreement between the Commission and Member States. This should have led to more negative decisions.

But on reflection, this outcome is not so unexpected because this is exactly the purpose of the guidelines. They are intended to guide Member States to design measures which the Commission will be in a position to approve. Moreover, in most instances there are multiple, formal and informal, meetings between the Commission and national authorities. In the process Member States adjust their measures in order to address the concerns of the Commission and allay its doubts. Of course, as is always the case when one draws conclusions from publicly available information, one never knows how many measures are eventually withdrawn after informal contact and before they are formally notified to the Commission.

However, closer scrutiny of the measures that have been subject to detailed assessment suggests that there may have been other factors at play. These factors are the special nature of state aid in risk capital and the virtual absence from the RCG of quantitative thresholds of compatible aid. With respect to the necessity of aid, it is rather easy for Member States to

demonstrate it by showing the existence of extensive and pervasive market failure in the funding of SMEs. Such failure has been documented at length by EU institutions such as the Commission and by the EIB/EIF. With respect to the proportionality of aid and the avoidance of undue distortion to competition, it has also been rather easy for the Commission and the Member States to avoid unbridgeable disagreements. Simply invested funds have to remain below the maximum allowable tranches. There is no need to measure eligible costs and aid intensities. Undue distortions are avoided by limiting investment to companies not supplied by capital markets. But this is already achieved by the fact that market failure is already shown to exist.

### **Annex I.1: Main risk capital measures for which the Commission completed an in depth assessment**

This list is not exhaustive. It contains the main measures subject to detailed assessment. It does not include subsequent changes or modifications that have also been assessed in detail.

C 36/2005	Investbx United Kingdom
N 758/2006	Régime de capital risqué dans les DOM, France
N 263/2007	Technology fund TGFS, Saxony, Germany
N 521/2007	Cluster Fund Start-up, Risk Capital Scheme, Germany (Bavaria)
N 596a/2007	Investissement dans les PME, France
N 700/2007	Finance Wales JEREMIE Fund, UK
N 395/2007	Start-up Fund VERA, Finland
NN 42b/2007	Venture Capital Trusts United Kingdom
NN 42a/2007	Enterprise Investment Scheme and Corporate Venturing Scheme, UK
N 629/2007	Régime cadre d'interventions publiques en capital-investissement regional, France
N 481/2008	Clusterfonds Innovation, Germany
C 2/2009	Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen, Germany [negative decision without recovery]
N 275/2009	Clusterfonds Bayern, Germany
N 406/2009	Risikokapitalregelung, Clusterfonds Seed GmbH & Co. KG, Germany
NN 45/2009	Neufassung des Venture-Capital-Programms (Styria), Austria
N 722/2009	Risk capital aid scheme, Region Lazio, Italy
SA.31730	Fonds national d'amorçage – Régime cadre d'intervention publique en capital investissement auprès des jeunes entreprises innovantes, France
SA.32520	Risk Capital Scheme High-Tech Gründerfonds II, Germany

**Annex I.2: Risk capital measures involving no state aid**

These measures have been found not to involve state aid because public authorities conformed with the private investor principle. That is, their investments were motivated by profit, a reasonable return was expected and they assumed the same level of risk and reward as private co-investors.

N 403/2002	Austria, Venture Capital Scheme, Land of Styria
N 511/2002	Italy, Fonds capital-investissement (Sardaigne)
N 34/2005	Germany, German Innovation Initiative
N 131/2006	Netherlands, Groeifinanciering
N 194/2006	UK, Screen East Content Investment Fund (CIF)
N 344/2006	Germany, SBG
C 33/2007	Germany, IBG Risk capital fund
N 467/2007	Germany, Creative-Sectors Fund (Berlin)
N 500/2007	Germany, Technology-Venture Capital Fund (Berlin)
N 413/2008	Germany, MoRaKG
N 478/2008	Germany, Hannover Beteiligungsfonds (HBF)
N 481/2008	Germany, Clusterfonds Innovation
N 511/2008	Germany, Risk capital in Brandenburg
NN 45/2009	Austria, Venture Capital Programms des Landes Steiermark
N 151/2010	Germany, Risikokapitalfonds BFB II (Änderung)
SA.31651	Italy, Project Amalattea, Istituto Sviluppo Agroalimentare (N 423/2010) (Lazio)

## Part II: PUBLIC LOANS AND GUARANTEES

The purpose of Part II of the paper is to review the rules on state aid in public loans and guarantees and how they have been enforced in a number of landmark decisions taken by the European Commission. More specifically, Part II examines how the Commission determines the existence of state aid and how it assesses the compatibility of such aid with the internal market.

Since the adoption of the current set of rules on public loans and guarantees in 2008, the Commission has taken about 35 decisions dealing specifically with guarantee measures. It has not been possible to establish how many decisions refer to loans, but they must be more numerous as a result of the measures that have been implemented by Member States on the basis of the Temporary Framework that expired at the end of 2011.

Of the 35 or so decisions concerning individual guarantees and guarantee schemes, a large majority (about 70%) refer to measures for which the Commission has raised no objections. In four cases the Commission initiated the formal investigation procedure. A couple of cases have been closed with a negative decision without recovery, while another case has been concluded with a negative decision coupled with recovery of incompatible aid.<sup>18</sup> This case is analysed in the penultimate section of the paper.

It should also be noted that since 2008, the publicly accessible data base on state aid cases, which is managed by DG Competition, indicates that there have been about 55 or so cases involving a guarantee as an instrument of state aid but having a different primary objective. The vast majority of these cases concern i) rescue and/or restructuring of companies in difficulty, ii) guarantees (mostly unlimited) to state-owned banks and other state-owned entities such as postal undertakings, and iii) export insurance and export guarantees. As far as export insurance and guarantees are concerned, the Commission has not authorised any measure that contains state aid which covers marketable risks for the simple reason that export aid is incompatible with the internal market.<sup>19</sup>

In addition, state guarantees have been at the centre of more than two hundred measures that have been examined by the Commission in the context of the financial crisis and the state support to banks. With the exception of the first rescue case that concerned Northern Rock in

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<sup>18</sup> See case C 6/2008 (ex NN69/2007), Ålands Industrihus Ab, Finland.

<sup>19</sup> See Commission Decision 2008/718 on short-term export-credit guarantees for SMEs with limited export turnover in Hungary, OJ L 239, 6/9/2008. In particular, the Commission observes the following: "(45) Moreover, it is recalled that the Commission has in principle strictly condemned export aid in intra-Community trade, since export subsidies directly affect competition in the market between rival potential suppliers of goods and services. Since it is closely and inseparably linked to the underlying trade transaction, such export aid is likely to adversely affect trading conditions to a considerable extent. In its previous decisions the Commission clearly indicated that guarantees offered at below market price in the context of export contracts within the Community constitute export aid which is incompatible with the common market. Moreover, Member States' support for their exports outside the Community can also affect competition within the Community."

December 2007, which was assessed on the basis of Article 107(3)(c), the state aid that has been approved in all other cases has been based on Article 107(3)(b) TFEU. It is estimated that the total amount of state aid to banks has exceeded EUR 4.5 trillion. From that amount about two thirds are made up by guarantees to creditors and other liabilities of banks. Despite such enormous amounts, guarantees to banks fall outside the scope of this paper because they have been assessed in the context of broader rescue and restructuring plans and not according to the Commission Guarantee Notice.<sup>20</sup> Moreover, EU courts have had the opportunity to review a Commission decision concerning aid to financial institutions only once and the related ruling did not examine in any detail the state guarantees that had been granted.<sup>21</sup>

In addition to presenting the formal rules, Part II of the paper focuses primarily on the various methodologies for determining the amount of state aid in loans and guarantees. The main findings of Part II are as follows. Although the principles concerning the existence of state aid in loans and guarantees are few and fairly easy to define and understand, their application in each particular case can be complicated. This is because the rules can be used both to prove the absence of aid and the existence of aid. In addition, whether state aid exists or not very much depends on the choice of the right market benchmark. Just as in the cases concerning the application of the market economy investor principle or, as sometimes called, the private investor principle, the challenge is to identify the benchmark that conveys a true picture of how private investors would behave. In this respect, the quantification of possible advantages in financial transactions is always tricky. Another reason of the complexity in the application of the rules is that although in general it is the borrower who obtains the benefit of state aid, occasionally state aid may indirectly benefit the lender as well. Therefore, the next section examines how the beneficiaries of aid can be identified.

### **II.1. Existence of state aid: Who benefits?**

A zero- or low-interest loan benefits the borrower, not the lender because the latter forgoes potential revenue. Similarly, a guarantee subsidised by the state benefits the borrower, not the lender, even if the lender is a private bank. This is because the lender merely charges a market rate of interest on the loan, which, among other things, reflects the credit worthiness of the borrower, including the fact that the loan is backed by a state guarantee.

Any lender offering a loan under competitive market conditions would charge a rate of interest that covers its actual and expected costs which are primarily its administrative costs, the

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<sup>20</sup> Official Journal C 155 of 20/6/2008, p. 10.

<sup>21</sup> See joined cases T-29/10 and T-33/10, Netherlands and ING v European Commission. The General Court partly annulled the Commission Decision against which the appeals had been lodged because the Commission failed to appreciate that early repayment of the state funds that had been injected into ING reduced the risk borne by the state and that reduction could justify the payment of interest at a rate lower than that which had been initially agreed and which concerned a longer period of time. This reasoning is relevant to this paper because it shows that risk and compensation or risk and premiums are directly linked.

return it must earn on its capital and a risk premium. Since lending always involves a risk, the rate charged by the lender must include a risk premium in order to compensate for the possibility that the loan may not be repaid. A guarantee by the state reduces that risk but does not eliminate it because even sovereign governments sometimes go bankrupt. So, the risk of the loan and, consequently, the rate of interest charged for that loan are reduced as a consequence of the guarantee. But the lower rate results in lower revenue. Therefore, the benefit from the guarantee is counterbalanced by less revenue.

A numerical example can illustrate this point. What matters to a lender is the expected return on the loan it grants. If the borrower is risky, the lender will charge a higher rate of interest. Suppose that the market rate of interest for the most credit worthy borrower is 3%. Usually, this is the rate at which capital markets lend sovereign governments. If a bank provides a loan to a company, it forgoes the interest of 3% that it would have earned by investing in government bonds. So the bank must charge at least the opportunity cost of the loan which is 3%. But the loan to a company bears additional risk. This translates into additional costs that have to be included in the interest rate. This additional risk is the expected cost from default. If a borrower represents an additional risk of 5% (the extra probability of default), the rate that will be charged by a bank on a loan to that particular borrower would be at least 8% (assuming no other costs such as the administration of the loan and the credit assessment of the borrower). This is because the expected cost of the loan for the bank is 8%. If another bank or a public authority offers to guarantee that the borrower will repay the whole loan (which means that in case of default of the borrower it will have to repay the loan itself), the additional risk is removed. In the end, the lender is indifferent between charging a higher interest rate without guarantee or a lower interest rate with a guarantee. The borrower, of course, is not indifferent. A free guarantee lowers the cost of the loan.

However, the lender too can benefit from a guarantee if it is granted after the loan is provided. If after obtaining a loan, a borrower encounters difficulties in repaying that loan and in response the state grants a free guarantee, then both the borrower and the lender become better off from state aid. The borrower does not have to pay a market rate of premium while the lender also benefits because the probability that the loan becomes non-performing is reduced or even eliminated.

The fact that normally it is the borrower who benefits from guarantees has also been established in the case law of the Court of Justice of the European Union. In a recent case, the Court adopted the opinion of the Advocate-General Juliane Kokott who examined in depth the issue of who benefits from state guarantees.<sup>22</sup> She found that also the lender obtained a benefit because the public guarantee secured a non-performing loan. The case concerned the granting of a guarantee by the Municipality of Rotterdam to a company called RDM Aerospace to enable it to convert old debt into a new loan. The lender was a company called Residex Capital which was also the creditor in the first place. When the borrower was unable to repay the new loan, Residex turned to the Municipality and asked it to honour the guarantee. The

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<sup>22</sup> See case C-275/10, Residex Capital v Gemeente Rotterdam.

Municipality refused to do so, alleging that the guarantee had been granted contrary to EU law on state aid since the aid had not been notified for approval by the Commission and therefore it was null and void.

The Court made the following observations:

“39 In the case where the loan granted by a credit institution to a borrower is guaranteed by the public authorities of a Member State, that borrower normally obtains a financial advantage and thus benefits from aid within the meaning of Article (107(1) TFEU), inasmuch as the financial cost that it bears is less than that which it would have borne if it had had to obtain that same financing and that same guarantee at market prices.

40 However, (...) Residex would also have been liable to procure an economic advantage from the guarantee in question.

41 (...) the financial situation of Aerospace was such that it would not have been able to obtain a loan on the capital markets. As a result, it was only by means of the guarantee provided by the Gemeente Rotterdam that Residex granted Aerospace a loan at a rate that was preferential in comparison with that in force on the market. Furthermore, it is not apparent from the documents before the Court that Residex paid the Gemeente Rotterdam under normal market conditions in consideration for the benefit that it was deemed to draw from the guarantee.

42 In those circumstances (...) it cannot be excluded at the outset that the guarantee in question was granted for the needs of an existing claim of Residex, in the context of a restructuring of Aerospace’s debt. If that were so, Residex would have obtained its own economic advantage by means of that guarantee since (...) the security of its claim increased as a result of being guaranteed by the public authority, with no amendment, moreover, to the conditions of the guaranteed loan.”

The AG explained in more detail in her opinion how the lender, Residex, benefited from the guarantee:

“74 (...) at the time when the municipal guarantee was given, Residex was owed a debt of millions of euros by Aerospace (...) This debt was converted by Residex into a loan to Aerospace, with the guarantee provided by the port authority of Rotterdam playing a significant role in the matter.

75 All of this indicates clearly that the municipal guarantee in this case was given to secure ex post a debt already entered into or in the course of a debt restructuring process, which would mean that Residex procured an economic advantage of its own from the municipal guarantee within the meaning of the law on State aid. Furthermore, there is no indication that Residex had paid the Municipality of Rotterdam a normal market commission for the guarantee in exchange for its advantage under the guarantee. Hence, both Aerospace and Residex would have to be considered beneficiaries of the aid.”

In a very recent decision concerning a state guarantee to Greek company United Textiles, the Commission found that the lending bank, National Bank of Greece, obtained no advantage because the guarantee was given ex ante for a new loan. The Commission commented that



had the guarantee been granted ex post without any adjustment to the terms of the loan, then there could also have been aid to the lender.<sup>23</sup> This confirms that the Commission does not consider that an ex post guarantee necessarily confers an advantage to the lender. An appropriate adjustment to the terms of the loan may offset any such advantage. There appears, however, that the Commission has yet to deal with such a case.

## II.2. Public loans

This section explains how the gross grant equivalent of state aid in loans can be calculated. The loans that fall within the scope of this paper are those which are granted by public authorities to undertakings or those that use state resources in the meaning of Article 107(1) TFEU. As we will see from the cases reviewed in this section, the calculation can be very complex.

A loan which is granted on market terms does not contain state aid. A loan is deemed to be granted on market terms when the rate of interest reflects the credit rating of the borrower and the loan is secured with adequate collateral. If the interest rate charged is lower than the market rate or the so-called “reference rate” which is used as proxy of the market rate (see below) or if the collateral is insufficient, there is state aid in the loan.

This is because the state forgoes revenue which is prima facie selective (because it is given to a particular undertaking) and confers an advantage (because it relieves that undertaking from part or all of the interest it would otherwise pay). As is well known, a public measure constitutes state aid only when all the conditions in Article 107(1) are satisfied. That is, in addition to transfer of state resources, selectivity and advantage, there must also be affectation of trade and distortion of competition. Since the objective of this paper is to examine solely how the existence of advantage is established, the other conditions in Article 107(1) are ignored.

The Commission Communication on Reference and Discounts Rates of 19/1/2008 explains that the gross grant equivalent of the state aid in a low-interest loan is the difference between the rate charged and the market rate that should have been charged multiplied by the amount of the principal and discounted to the point in time that the loan is granted.<sup>24</sup> See Annex II.1 for numerical examples of how to calculate the gross grant equivalent of state aid.

One complication is that loans may contain grace periods; i.e. periods during which the borrower is relieved from the contractual obligation to pay interest and/or re-pay part or the entire principal. Even in this case, however, a loan is free of state aid only when the total amount of interest that is eventually paid takes into account the amount of interest/principal not paid during the grace period. The longer the grace period, the larger the amount of interest that will eventually have to be paid by the borrower to the lender.

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<sup>23</sup> See Commission Decision 2012/541 on state aid granted to United Textiles.

<sup>24</sup> Official Journal C 14, 19/1/2008, p.6.

### II.2.1. Reference rate

The most important element in the calculation of the amount of state aid in a loan is the interest rate that is deemed to correspond to market conditions. The reference rate is a proxy for the market rate of interest and can be used in absence of corresponding market rates. The use of reference rates, calculated as indicated below, ensures that loans do not contain state aid.

The methodology used by the Commission to determine the appropriate reference rate is as follows. The reference rate is the sum of a base rate and a risk margin. The latter depends on the credit rating and the quality of collateral offered by the borrower.

The base rate is the one-year IBOR. The risk margin varies from 60 to 1000 basis points. For instance, for a borrower with good rating (i.e. BBB) and normal collateral, the margin is 100 basis points. This means that the reference rate for such a borrower is the one-year IBOR plus 1%.

It is possible to use a fixed rate for a multi-year loan. However, it is not possible to use a fixed rate for different borrowers because rates have to be determined individually on the basis of the credit rating and collateral that can be offered by each borrower. By contrast, as will be seen in the next section that deals with public guarantees, it is possible to use a fixed rate of guarantee for different borrowers, provided a guarantee scheme is established according to the rules laid down in the Guarantee Notice.

A loan is free of state aid when the interest rate is the market rate or an appropriate reference rate calculated as explained above; i.e. adequately reflecting the credit rating of the borrower and the quality of the collateral. The market/reference rate can be changed during the life of the loan according to terms set in advance.

On the contrary, a loan includes state aid when the interest rate is lower than the relevant market/reference rate or the borrower is unable to offer collateral of sufficient quality. The amount of state aid is the difference between the rate charged and the appropriate market or reference rate, multiplied by the principal of the loan and discounted to the date of granting of the aid. The discount rate must be set as explained immediately below.

In its Decision 2012/268 concerning the German Wine Marketing Company (GfW), the Commission concluded that a public loan to GfW contained state aid because the rate of interest that was charged was lower than the market rate plus the risk premium that should have been charged. The reference rate for Germany at the time was higher than the actual interest rate of the loan.

### II.2.2. Discount rate

The discount rate is used to calculate net present values; i.e. to discount future streams of revenue or expenditure. This rate is determined and adjusted periodically by the Commission and is the one-year IBOR plus 100 basis points.

### II.2.3. Debt-for-equity swap

In a recent case concerning aid implemented by Italy for a company called Legler, the Commission had to consider how to calculate the amount of state aid in a debt-for-equity swap.<sup>25</sup>

The case was complicated by two factors. First, Legler was a company in difficulty in the meaning of the Rescue and Restructuring Guidelines. Second, the public authority which injected the capital into Legler had initially accepted to buy debt owed by Legler to another company (the creditor) which happened to be in liquidation. Legler owed EUR 17 million to the creditor while the public authority paid the creditor only EUR 450,000 which was the estimated market value of the debt. After the purchase of the debt, the public authority converted EUR 14.5 million of the debt into equity.

The creditor obtained no advantage because it sold a claim with nominal value of EUR 17 million for the price of EUR 450,000 which even though it was a much smaller amount it was equivalent to the market value of that claim. The question was whether the conversion of EUR 14.5 million of debt into equity constituted state aid to Legler. The conversion could contain state aid because it relieved Legler from the burden of servicing that portion of its debt. Given the dire financial situation of Legler, the Commission concluded that no private investor would accept to inject capital in the company by converting old debt into new equity.

The fact that the transaction constituted state aid rather than an investment decision was shown by the absence of any prior assessment of the prospects of future profitability of Legler. Italy could not prove that the investment was a better option than the liquidation of Legler.

The next task for the Commission was to quantify the amount of aid. The amount of aid was calculated as follows. The converted amount of debt to equity was equal to 85.3% of the total debt (= 14.5 million / 17 million). That ratio corresponded to EUR 383,850 of the value of the debt (= 0.853 x 450,000). The derived amount was the GGE of the state aid granted by Italy to Legler. It is interesting to note that the nominal value in accounting terms of the debt initially acquired by the public authority was irrelevant because it exceeded by far its actual market value.

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<sup>25</sup> Commission Decision 2012/51.

#### II.2.4. Examples of public loans that do not contain state aid

i. Loan to Polish CRIST shipyard:<sup>26</sup> The loan was granted by IDA, the Polish industrial development agency. The rate of interest was 6.81%, while CRIST was assessed by IDA to be of moderate risk (BB) and the value of the collateral it offered was accepted as “high”. At the time of the granting of the loan, the three-month inter-bank rate in Poland was 3.81%. IDA derived a base rate of 5.1% which was the sum of 3.81% and a margin of 1.2%. The risk premium for CRIST was estimated at 1.8%. Therefore, IDA charged interest at 6.81% [= 5.1 + 1.8]. The Commission’s reference rate for Poland was 4.49%. Although the Commission thought that it was possible that the collateral could also have been classified as “moderate” or “normal”, implying a risk premium of 2.20%, it accepted the Polish rate of 6.81% because it was higher than the rate of 6.69% [= 4.49 + 2.20] that would have applied had the collateral offered by CRIST been indeed moderate or normal. Poland also submitted expert valuations of the credit rating of CRIST and valuations of the real estate that was used to mortgage the loan. The Commission concluded that the Polish government acted as a private investor and the loan contained no state aid.

ii. Loan to Czech airlines CSA:<sup>27</sup> What makes this case unusual is that the loan was granted by a state-owned company that was in liquidation. The Commission established that the state had intervened in the liquidation process to make available part of the proceeds as a loan to CSA. Therefore, the loan was considered to be transfer of state resources. The interest rate charged was 5.51% and was derived by adding a risk premium of 3% point to the three-month inter-bank rate that was at the time 2.51%. Although the credit rating of CSA was “B” (vulnerable financial situation), the level of collateralisation of the loan was 110 % of the loan amount. The collateral used to secure the loan-comprised buildings located at Prague airport, land, inventories and spare parts. The market value of most of the collateral was established by an independent expert. At about the same time, CSA obtained another loan from a commercial bank with 5.10% rate of interest. The Commission Communication on Reference Rates assumes that “high” collateralisation implies a loss given default below or equal to 30%, which corresponds to a value of the collateral of at least 70% of the loan amount. In this case the value of the collateral was 110% of the value of the loan. The Commission, therefore, concluded that the Czech government acted as a private investor and the loan contained no state aid.

#### II.3. Compatibility of state aid in the form of loans

The decisional practice of the European Commission has revealed that an important aspect of the Commission Communication on Reference and Discounts rates of 19/1/2008 can be misunderstood. In a recent decision, SA.31690, concerning subordinated loans in Sachsen-

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<sup>26</sup> Commission Decision SA.33114 on Polish loan to CRIST Shipyard.

<sup>27</sup> Commission Decision 2012/637 on Czech loan to CSA airlines.

Anhalt, the Commission examined a scheme whereby public loans would be offered to SMEs with a low credit rating but without collateral. So in case of default, the loans would be subordinated to the claims of other creditors. The German authorities proposed to add an appropriate risk premium on top of the four percentage points for companies with satisfactory rating (BB) but low-quality collateral. This is the risk premium that, according to the Communication, has to be added to the reference rate.

The Commission did not accept that this method would eliminate advantage for the borrowers. This is because the Communication regards the rates established on the basis of its methodology only as proxies for the market interest rate. The Commission argued that the public authority that was lending the money had a mission to make funding available to companies which could not obtain loans at all. Therefore, the Commission took into account that information and disregarded the rate calculated according to the Communication. It concluded that the loans contained state aid but authorised the scheme on condition that the amount of aid would not exceed the de minimis threshold of EUR 200,000.

If a loan that contains state aid is granted to an undertaking with no obligation on the part of the borrower, it is operating aid. It then has to be appraised according to the rules on operating aid. As is well known, operating aid is normally not allowed because it lacks an incentive effect. In principle it distorts competition without being able to achieve any of the aims of the various derogations allowed by the Treaty.<sup>28</sup>

Operating aid, therefore, is only exceptionally permitted.<sup>29</sup> Operating aid in the form of subsidised loans is only possible when operating is allowed by current state aid rules such as, for example, the Regional Aid Guidelines for Article 107(3)(a) areas. Loans are also possible under certain conditions on the basis of the Guidelines for Risk Capital to SMEs. But these Guidelines require that funding to SMEs is provided at commercial terms. For the sake of completeness, operating aid is also possible under the Environmental Aid Guidelines and the Guidelines on Aid to Maritime Transport, but it is unlikely that loans would be the right instrument because in both cases the aid that can be allowed is in the form of tax exemptions (from environmental taxes and from personal income taxes, respectively).

Of course, the de minimis facility may also be used. The Regulation 1998/2006 on De Minimis Aid does not impose any limitation on form or use of de minimis aid, apart from stipulating that it may not promote exports or the use of domestic products. Therefore, aid in the form of interest subsidies is possible, as long as the total amount of the aid per undertaking, not just per loan, does not exceed EUR 200,000 over a period of three fiscal years and all the other conditions of the Regulation are satisfied.

Unless operating aid satisfies the restrictive conditions of the rules mentioned above, it is incompatible with the internal market. If such operating aid has already been granted illegally

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<sup>28</sup> See T-211/05, Italy v Commission; T-348/04, SIDE v Commission.

<sup>29</sup> See T-211/05, Italy v Commission.

(i.e. without prior notification to the Commission) it must be recovered. In Commission Decision 2012/268 concerning the German Wine Marketing Company (GfW), the Commission also had to assess the compatibility of the aid. It concluded that the aid was not compatible with any of the state aid regulations and guidelines. It also found that the aid could not be exempted directly on the basis of Article 107(3)(c) because the aid merely improved the financial situation of GfW without contributing to the development of an economic activity. In the end the aid was incompatible, but the Commission did not order recovery because in the meantime GfW went bankrupt and the purchaser of its assets acquired them at market prices. This implied that there was no aid to the purchaser. The Commission also examined whether any aid had leaked to wine producers from whom GfW had bought wine but again concluded that they had not benefited from aid because GfW had paid the going market price.

Another interesting aspect of this case is that some time after GfW received the loan it ran into financial trouble and could not repay the loan in full – even at the subsidised interest rate. The public body which had granted the loan then wrote off part of it to make it easier for GfW to repay it. The Commission, therefore, also examined, on the basis of the public creditor principle, whether the write off included aid. It identified the following two options for that public body: either i) to force GfW into liquidation, or ii) write off part of the loan and allow GfW to continue operating so that it would have a better prospect of repaying the remaining loan. The eventual choice between these two options depended on the amount of money that was expected to be generated by each one of them, which in turn depended on, the one hand, whether the loan was secured against collateral and, on the other, the business prospects from continued operations. The Commission was satisfied from the information submitted by Germany that the write off would generate more money in the end because the loan was not secured and the lender could receive only an uncertain amount of revenue from sale of assets after all other creditors were paid.

In order to remove a subsidised public loan from the realm of operating aid, the loan has to be given on condition that the borrower commits to make an investment, hire staff, carry out R&D or undertake an activity that is eligible to receive state aid under any of the Guidelines on state aid or the General Block Exemption Regulation (GBER).<sup>30</sup>

For example, in case N 5/2010, the Commission approved state aid granted by Spanish authorities in the form of a 15-year, interest-free loan without collateral and with a five-year grace period. The reference rate was 3.65%, made up of a base rate of 1.45% and a margin of 2.20%. The discount rate was 2.45% (base rate plus 1.00%). The loan was intended to enable the borrower to carry out research. Therefore the compatibility of the aid included in the loan was assessed and eventually approved by the Commission on the basis of the R&D&I Framework.

In a rare case, the Commission approved a German scheme for subsidised loans to SMEs directly on the basis of Article 107(3)(c) of the Treaty (see Commission Decision on case

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<sup>30</sup> Regulation 800/2008.

SA.30015). Aid for investment in SMEs is allowed under the GBER. The maximum permissible aid intensity is 10% for medium-sized enterprises and 20% for small enterprises.

In case SA.30015, Germany could not use the GBER because Article 5 of the GBER stipulates that only transparent aid can be exempted. In order to be transparent, aid that is included in subsidised loans has to be calculated on the basis of the methodology in the Commission Communication on Reference and Discount Rates. The German scheme used a methodology that deviated from that of the Commission.

According to the German methodology, in order to calculate the aid amount, the market rate of interest was to be determined as follows. The base rate of the loans was the 10-year swap rate because the loans were to be granted for 10 years. On top of that rate, a risk margin was added which was equivalent to the risk of the default reduced by the proportion of the loans that could be recovered. Using information on the performance of more than 200,000 past loans, the German authorities calculated that a risk margin of 2.4%-2.7% had to be added to the base rate.

The German authorities also calculated a hypothetical cost of capital of 1% that was to be considered the required capital remuneration. This was derived from a capital base of 8% of the total amount of loans and a rate of return of 12.5% (i.e.  $0.125 \times 0.08 = 0.01$ ). An administrative cost of 0.5%-0.8% was also added to bring the total margin to 3.9%-4.5%. For reasons of certainty, the German authorities chose the high end of 4.5%.

Since the aid was granted on conditions that otherwise were identical to those of the GBER, the Commission had little difficulty to conclude that the aid could be declared compatible with the internal market. Moreover, the German authorities proposed to grant aid to cover operating costs such as spare parts. Such aid was to be made available in conformity with the requirements of the De minimis Regulation 1998/06.

#### II.4. State guarantees

The Commission Notice of 20/6/2008 on Guarantees explains under which conditions a guarantee contains state aid or not and how the state aid element can be calculated.<sup>31</sup> According to this Notice, an individual guarantee granted by a public authority is deemed **not** to involve state aid when the following four cumulative conditions apply:

1. The borrower is not in financial difficulty.
2. The guarantee is linked to a specific transaction and it is limited in time and amount.
3. The guaranteed amount is less than 80% of the nominal amount of the underlying loan (there is no limitation concerning the ratio of the loan to the cost or value of the project or the size of the borrower).

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<sup>31</sup> Official Journal C 155 of 20/6/2008, p. 10.

4. A market price is paid, depending on the assessed risk in each individual case. Risk depends on the credit rating of the borrower, the quality of collateral, if any, and the amount that can be recovered in case of default.

In the case of SMEs, the Commission accepts the use of safe-harbour annual premiums defined in the Notice to presume the absence of state aid. These premiums vary from 0.4% to 6.3%, depending on the credit rating of the borrower which varies from AAA to B-, respectively.

If any of the above conditions do not hold, then the guarantee is presumed to contain state aid. This is because the authority that grants the guarantee assumes a certain amount of risk. Even if a guarantee is never called, the potential liabilities of that authority increase without a compensatory increase in its revenue. As established in the case law, any advantage granted by means of an additional potential burden for the state is liable to amount to state aid.<sup>32</sup>

The Court of Justice has ruled that to determine whether a guarantee contains state aid it is necessary to consider how a private investor would behave (*Stardust Marine*, C-482/99). In principle, a private investor that offers a guarantee would always charge a premium,  $P$ , that is at least equal and preferably exceeds the expected cost,  $C$ , of the guarantee. The expected cost is, at minimum, equivalent to the amount that is guaranteed,  $A$ , multiplied by the probability of default,  $B$ . In other words,  $P \geq C = (A \times B)$ . If the investor also incurs administrative costs,  $D$ , then those costs must be added to the premium and the formula becomes  $P \geq C = (A \times B) + D$ .

For example, if i) a public authority guarantees a loan of EUR 1 million, ii) the loan has to be repaid at the end of the year, iii) the probability of default during that period is, say, 5%, iv) it incurs administrative costs of EUR 5,000 and v) in case default occurs the borrower has no assets to compensate the lender, then the expected cost to that authority is EUR 55,000 (= (EUR 1 million  $\times$  0.05) + EUR 5,000). If the authority is not to experience an uncompensated increase in its liabilities, the premium it should charge must be at least as high as EUR 55,000.

It follows that the amount of state aid in a guarantee is the difference between the net present value of the appropriate premium that would be charged by a private investor and the premium actually charged or  $S = P_m - P_a$ , where  $S$  is the amount of state aid,  $P_m$  is the market premium and  $P_a$  is the actual premium. Using the example above, if the public authority charges a premium of 1%, the amount of state aid is 45,000 (=  $S = 55,000 - 10,000$ ). The aid intensity is 4.5% (=  $45,000/1,000,000$ ).

For multi-year guarantees, the amount of state aid is the sum of discounted values of future premiums on the outstanding amounts of the underlying loan which is guaranteed at the beginning of each year.

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<sup>32</sup> See, C-200/97, *Ecotrade*; T-204/97, *EPAC v Commission*, T-204/97.



The Notice on Guarantees also defines conditions that establish a presumption that state aid is absent in guarantee schemes. A scheme in this context is a financial instrument that provides for multiple guarantees on a self-sustained basis. That is, the scheme covers its own costs of operation. These conditions are:

1. Borrowers must not be in financial difficulty.
2. Guarantees are granted for specific transactions and are limited in time and amount.
3. Guarantees do not exceed 80% of the underlying loans. This condition does not apply to services of general economic interest (SGEI) where public service obligations are imposed by the public authorities that offer the guarantees and the sole activity of the borrowers is the provision of the services in question.
4. The scheme is self-financed by premiums.
5. Premiums are reviewed and adjusted at least once per year.
6. Premiums must cover normal risk (i.e. default rate) plus administrative costs plus the remuneration of capital, even if there is no separate capital to finance guarantees. The required capital is presumed to be at least 8% of the amount of guarantees, while the risk premium for equity, which is the required rate of remuneration, is presumed to be 4%. Therefore, the remuneration of the capital invested to be considered for the purpose of calculating the gross grant equivalent for guarantees issued within the scheme is 0.32% (8% x 4%).

In case the borrower has no credit rating or history or cannot offer any collateral, the risk premium that should be charged must be at least 3.8%.

If any of the above conditions is not satisfied the Commission will open the formal investigation procedure. This indeed happened in case C 7/2008 concerning a guarantee scheme for working capital loans in Saxony. The German authorities were proposing to offer guarantees of up to EUR 10 million and 80% of the loan, levy a fixed annual premium of just 0.5% of the outstanding guaranteed amount, and charge an one-off administrative fee of 0.5% of the initial amount, up to a maximum of EUR 15,000.

The Commission thought that the premium was possibly too low and doubted that the scheme was self-financing. In the end the notification was withdrawn before the conclusion of the investigation.

By contrast in case SA.31261 concerning a municipal guarantee for a loan for geothermal heat distribution in Germany, the Commission concluded that the guarantee contained no state aid because the German authorities were able to provide a letter from a bank which was willing to offer a guarantee for that loan. The Commission accepted that the premium quoted by the bank was a proper market benchmark and since it was equal to the premium charged by the municipality in question, the state guarantee conferred no advantage to the borrower and therefore contained no state aid.

### II.4.1. Methodologies

The most important aspect of a measure involving guarantees is to establish a methodology for calculating an appropriate premium. This applies to both individual guarantees and guarantee schemes.

With respect to individual guarantees, in case N 197/2007, the Commission approved a methodology for calculating the state aid element in guarantees provided in Germany. The German authorities intended to offer guarantees to enterprises of all sizes, not just SMEs. Therefore, they needed to notify their methodology. The aid would be granted for regional development purposes. Germany proposed to calculate a proxy for the market rate as follows. A basic premium rate was established according to the probability of default based on historic data. The average one-year probability of default was 2%. This rate was increased in the case of multi-year loans because the probability of default would rise as well. As a consequence, the average of one year increased from 2% to 8.9% for 8 years. This adjusted probability was then reduced by the average percentage of recovered assets, which was 20%. Lastly, a margin of 0.25% to 2.5% was added to reflect administrative costs, depending on the complexity of each case.

With respect to guarantee schemes, a good example of how they should be designed is given by the Austrian case N 179/2008 (it is also worth seeing case N 185/2008 which uses a slightly more elaborated methodology, also notified by Austria).

The Austrian measure concerned a methodology for calculating the aid element of guarantees granted to undertakings in a specific sector, namely tourism. The methodology established a hypothetical market premium and compared it to the premium actually charged to establish the grant equivalent of the guarantee. The hypothetical market premium was determined on the basis of the following elements: the probability of default, the expected rate of asset recovery, administrative costs relating to risk assessment, risk monitoring and risk management and the remuneration of adequate capital.

The probability of default was established for each beneficiary of the guarantee (i.e. the borrower) with the help of a rating system that was based on financial data of enterprises in the tourism sector which had been financially successful and those which had been insolvent. According to that data, the risk of default on a guarantee rose in the first two years from 15% to 25%, and then fell again from the fourth year to 10% while no defaulting was observed from the sixth year onwards.

When a default occurs and the guarantee is called, the loss to the guarantor usually does not amount to the full amount of the guarantee. This is because the loss for the guarantor is reduced through seizing and selling the securities which were given as collateral. Such collaterals are (i) material security (mortgages) and (ii) personal security (personal assumption of liability, assumption of debt). The Austrian methodology took into account the recovery

rates for these types of collateral, which were calculated on the basis of historical data. The calculated recovery rate varied from 0% to 35%.

An administration cost rate of 0.39% (in relation to the total outstanding guarantee amount) was calculated on the basis of the total hourly wages incurred in administering guarantees.

As regards the fictional remuneration of capital, a risk premium of 400 basis points was considered. The assumed underlying amount of the capital to be remunerated was taken to be 8% of the outstanding guarantee amount.

Taking all these factors into account, the formula approved by the Commission for determining the market premium was:

$$P (\text{premium}) = L (\text{expected loss}) + A (\text{administrative costs}) + C (\text{remuneration of capital})$$

The expected loss was the outstanding guarantee at the beginning of each year multiplied by the probability of default for the given year and then multiplied by 1 minus the recovery rate; i.e.  $L = G (\text{amount guaranteed}) \times PD (\text{probability of default}) \times (1 - R) (1 - \text{recovery rate})$ .

The amount of gross grant equivalent of state aid was the difference between the market rate of premium and the actual rate of premium charged. For multiple-year guarantees, the grant equivalent was discounted to the moment of granting the guarantees using the applicable reference rate for Austria for discounting.

In case N 182/2010 Italy proposed a method to determine the aid element in guarantees for SMEs. This method was to be used to calculate both de minimis aid and the aid element in working capital loans. The method established a theoretical market premium and compared it with the premium actually charged to establish the grant equivalent of the guarantee. The theoretical market premium was determined so that it covered the probability of losses net of recovery, the (adequate) remuneration of capital and administrative costs.

The gross grant equivalent was the aggregated amount of the yearly differences between this theoretical market premium and the actually paid premium that were discounted to the date of granting the guarantee.

The theoretical market premium of the guarantee was determined as follows:

$$I = D \times Z \times (FR + C + R), \text{ where}$$

I = theoretical market premium of the guarantee;

D = amount of outstanding loan assisted by the guarantee;

Z = percentage of outstanding loan D covered by the guarantee;

FR = risk factor of the scheme (percentage value);

C = administrative costs (percentage value);

R = remuneration of public resources invested under the guarantee scheme (percentage value).

Consequently, in case of a guarantee with duration of less than one year, the gross grant equivalent (GGE) of the guarantees provided by schemes applying the notified methodology was:

$$GGE = D \times Z \times ((FR + C + R) - G), \text{ where}$$

G = premium actually paid by the beneficiary for admission to the guarantee scheme (in percentage terms).

In case of a guarantee duration exceeding 12 months, the differences between the theoretical market premium and the premium actually paid at the end of each period were discounted to their present value using the Commission reference rate. In this case, the gross grant equivalent was:

$$GGE = \sum (I_t - G_t)(1+i)^{-t}, \text{ where}$$

i = reference rate.

$I_t$  = theoretical yearly market premium of the guarantee for the year t, determined according to the first formula, where D is the outstanding debt at year t of the guaranteed loan, calculated conventionally by supposing an amortization rate with annual instalments consistent with rate i;

$G_t$  = yearly premium actually paid by the beneficiary for admission to the guarantee scheme at year t.

Finally, if the duration of a guarantee exceeded 12 months, but the actual premium required for the guarantee was paid by the applicant as a one-off sum at the time the guarantee was granted, then the formula to be applied for determining the GGE was:

$$GGE = (\sum I_t(1+i)^{-t}) - Pu, \text{ where}$$

$Pu = (D \times Z \times G) =$  one-off premium paid at the time the guarantee was granted.

A different approach was followed in case N201/b/2007 concerning a methodology for a guarantee scheme in Hungary. According to the methodology adopted by the Hungarian authorities, the starting point was the amount of annual revenue from guarantee premiums that was needed to ensure a certain level of after-tax profit on equity employed. The formula that was notified was as follows:

$$R \text{ (revenue from premiums)} + I \text{ (investment income)} = P \text{ (profit)} + E \text{ (expenses)} + L \text{ (losses minus recovery)} \text{ or } R = P + E + L - I$$

where  $P = (\text{amount of equity} \times \text{bank base rate}) / (1 - \text{tax rate})$ .

Premiums were then calculated according to the probability of default. The derived amount of state aid was the difference between the market premium as determined by the formula above and the premium actually charged.

In case SA.33022 Denmark notified a methodology for calculating a transparent amount of state aid in guarantees covering loans aimed at financing expansion of business. The guarantees cover 75% of loan up to DKK 10 million (EUR 1.33 million) and 65% of a loan between DKK 10 million and DKK 25 million (EUR 3.35 million).

The calculation methodology uses a single premium and a single risk factor irrespective of the risk class of borrowing SMEs. The aid element is the difference between the theoretical market premium and the premium actually paid. The basis for the theoretical premium is the guaranteed sum multiplied by the risk factor. This basic premium is reduced by the proportion of expected recovered assets and then increased by a consideration for adequate remuneration of capital and administrative costs. More specifically, the individual items in the formula used by the Danish authorities are as follows:

**V:** The total loan volume amounts to DKK 1438 million (EUR 192 million). The total loan volume is estimated based on capital demands in the market and the availability of guarantees.

**G:** The total guarantee volume amounts to DKK 1037 million (EUR 138 million) and is estimated on the basis of the total loan amount multiplied by the guarantee percentages (i.e. 75 % & 65 %). That is, DKK 1438 million  $\times$  0.72 = DKK 1037 million under the assumption that the average loan amounts to DKK 14 million (EUR 1.86 million).

**D:** The expected default rate of 12% is an estimate based on historic numbers and forward looking projections, and takes into account expected recoveries.

**P:** Premiums actually paid by the borrower include 2% fee charged on the guaranteed amount plus the borrower will pay a yearly premium of 1.25% of the depreciated guarantee amount.

**R:** The expected revenue from premiums is DKK 80 million (EUR 11 million) with a view that the premiums actually paid by the borrowers can secure that the long term total costs of the scheme are fully covered by the premiums.

**A:** The administrative costs are set at DKK 11 million (EUR 1.5 million), which corresponds to 1.06 % of the total value of the guarantee scheme.

**F:** The loan default payments amount to DKK 125 million (EUR 17 million), i.e.: the expected loss rate of 12% is multiplied by the total amount of the guarantees to be issued of DKK 1037 million (DKK 1037 million  $\times$  0.12 = DKK 125 million). All payments on loan defaults include expected recoveries.

**K:** The capital return amounts to DKK 27 million (EUR 4 million). The capital yield is based on a risk premium of 4% per annum of an amount equal to 8% of the granted guarantees (as indicated in Guarantee Notice). It is derived as follows: DKK 27 million = DKK 1037 million  $\times$  0.08  $\times$  0.04  $\times$  8 years).

The above can be summarized as follows:

Loans covered by guarantees	DKK 1438 million
Total guarantee undertakings	DKK 1037 million
Expected default rate (over lifetime of guarantees)	12%
Expected income from premiums, current value	DKK 80 million

Costs:

Administrative costs	DKK 11 million
Payments on defaulting guarantees	DKK 125 million
Capital return	DKK 27 million
<u>Total costs</u>	<u>DKK 162 million</u>

The market premium is calculated as follows. The total cost of DKK 162 millions is divided by total guarantee amount of DKK 1037 million, which is 0.1562 or 15.6%. This is the total required market rate for a guarantee for the loan of the average amount of DKK 14 million and the average duration of 8 years. The yearly market premium equals to 3.5% of the outstanding guarantee amount for a given year.

The rate of aid intensity is derived as follows. First, the annual amount of state aid is calculated as the difference between the market premium of 3.5% and the rate of 1.25% that will be actually charged. The amount of aid for each of the 8 years is then discounted and summed up. This discounted sum, which is DKK 733287, is expressed as a percentage in relation to the outstanding guaranteed amount of the average loan of DKK 14 million in the first year. That is,  $733,287/10,100,000 = 7.26\%$

Finally, a scheme developed by the Netherlands should also be mentioned here because the Commission conclusion was that it contained no state aid. The measure was approved in decision N 639/2009 and later modified and approved in decision SA.33051. Only the original version is explained here because the modification has not change the substance of the measure.

The guarantee covers up to 80% of the loan on a pari passu basis for shipbuilding projects. The underlying loans are issued for up to 100% of the cost of constructing a ship. Collateral is the ship itself. Recovery of losses can be up to 80% of the value of the ships when sold. The fees for guarantees are set at a level that cover the costs (estimated ex ante) of the guarantee scheme. Moreover, the fee paid by shipyards for a guarantee is the higher of (i) a fee based upon the shipyard's rating at the time the guarantee is issued (**method 1**) and (ii) the fee based upon the state's own assessment (**method 2**).

Under **Method 1** the fee is made of three elements: the normal risk of guarantees (which is based upon the shipyard's ratings and the corresponding probability of default), administrative costs and the remuneration of capital. In order to ensure that the measure is self-financing the following factors were taken into account:

The probability of default is drawn from Standard & Poor's calculations of default for different risk classes.

The loss in case of default was initially estimated to be 75% and later revised to 50%. The latter means that in case of default 50% of the guaranteed sum is expected to be recovered so that the cost of default is the probability multiplied by 50%.

For capital costs, 0.8% of the guaranteed amount is charged (10% over 8% of the guaranteed amount).

For administrative costs for each project, 1.0% is charged in the first year, 0.3% for each subsequent year.

The probability of default is assumed to be in accordance with the methodology set out in BIS working paper 207.

The annual fee is the sum of the various costs: the expected cost of default (= probability of default multiplied by 50%) plus capital costs of 0.8% and administrative costs of 1% (first year) or 0.3% (second or any subsequent year).

Under **Method 2** the projects are assessed on the basis of 13 different criteria developed by the state. The 13 criteria are as follows:

Yard	Ranges
1. Track record shipyard	-5 to 5
2. Qualification management	-2 to 2
3. Liquidity	-3 to 3
4. Profitability	-3 to 3
5. Margin on construction project	-5 to 5
6. Liquidity planning during construction	-3 to 3
7. Exchange rate risk	-2 to 0
8. Type of ship	-2 to 2
Client	
9. Track record client	-5 to 5
10. Experience with type of ship	-3 to 3
Supplier	
11. Casco construction	-4 to 4
12. Duration of construction period	-3 to 3
13. Pass on of raw material costs to client	0 to 2

The sum of the scores of these 13 criteria, ranging from -40 to 40, is then linked to the annual fee which ranges from 0.8% to 4.5%.

### 100% guarantees

According to the Guarantee Notice, the guaranteed amount should not exceed 80% of the underlying loan. The only exception is for providers of services of general economic interest (“SGEI”) on whom public service obligations (“PSO”) are imposed by the public authority that offers the guarantee and the borrower has no economic activity outside the defined SGEI. In these cases, the Commission has to examine, in addition to the other conditions laid down in the Notice, whether (i) they concern genuine SGEI or PSO, (ii) the guarantee is offered by the same authority that imposes the PSO and (iii) the borrower carries out no activity other than the SGEI.

In case SA.31261 mentioned above concerning the imposition of a public service obligation to supply geothermal energy in Germany, the Commission concluded that all three additional requirements were satisfied.

### Unlimited guarantees<sup>33</sup>

The 2008 Notice on Guarantees explains that public guarantees may be linked to the status of an undertaking itself and imply coverage of losses by the state. More specifically, there is aid in the form of a guarantee where more favourable funding terms are obtained by undertakings whose legal form rules out bankruptcy or other insolvency procedures or provides an explicit state guarantee or coverage of losses by the state. The fact that there is no explicit contract is not relevant.

In the case of La Poste, the Commission in Decision 2010/605 found that French law did acknowledge the granting of implied guarantees, and in particular the existence of a state guarantee deriving from the status of publicly owned establishment.<sup>34</sup> Since the guarantee was an essential component of its relationship with the state, La Poste enjoyed more favourable borrowing terms that it would have obtained had it been assessed only on its own credit worthiness.

When the General Court recently ruled on the appeal lodged by France against Commission Decision 2010/605, it reiterated that “an unlimited State guarantee enables its recipient inter alia to obtain more favourable credit terms than what it would have obtained on its own merits alone and, therefore, eases the pressure on its budget.”<sup>35</sup> Consequently, it agreed with the Commission that the unlimited guarantee conferred an advantage which constituted state aid even though the Commission was not able to quantify the amount of the aid. In other words, it was not possible to calculate the amount of the market premium that La Poste should have paid to the state. The Court also concurred with the view of the Commission that a guaranteed does not have to be granted through an explicit assignment to a particular undertaking, but may also be implicitly granted through a broader legal arrangement which allows for compensation by the state of the creditors of undertakings a certain legal status.

A similar conclusion was reached by the Commission in its Decision 2005/145 on state aid to EDF where the Commission took the view that EDF was not subject to administration or compulsory liquidation proceedings, and therefore could not be declared bankrupt. That was deemed to be equivalent to a general guarantee covering all its liabilities. That type of guarantee could not be the subject of any remuneration according to the rules of the market. The guarantee, which was unlimited in scope, time and amount, constituted state aid.

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<sup>33</sup> In a rather unusual and unique case, the Commission found that a so-called “indemnification guarantee” constituted incompatible state aid. Such a guarantee was granted by the Greek state during privatization proceedings to the prospective purchaser of a state-owned shipyard. The purpose of the guarantee was to offset fully any liability of the purchaser in relation to any hidden state aid that could be detected after the sale and which would be determined by the Commission to be incompatible with the internal market. The Commission’s grounds for the finding of incompatibility was that the Greek state was seeking to nullify the effectiveness of Article 107(1) TFEU. In a subsequent appeal, the decision of the Commission was endorsed by the General Court in case T-384/08, *Elliniki Nafpigokataskevastiki v European Commission*.

<sup>34</sup> OJ L274, 19/10/2010.

<sup>35</sup> T-154/10, *France v Commission*, paragraph 108.



In two other related cases the Commission examined unlimited guarantees granted to the Institute Francais du Petrole (IFP). IFP carries out research on petroleum products and processes and disseminates the results of its research through publications and training. In its Decisions 2009/157 & 2012/26, the Commission concluded that IFP was a research organisation in the meaning of the R&D&I Framework. Therefore, it did not carry out economic activity and any public funding it received, including the unlimited guarantee, was not state aid. However, the Commission was concerned about direct aid to the commercial activities of IFP and indirect aid to the creditors and clients of IFP.

The Commission found that there was both direct and indirect state aid for the following reasons. First, the unlimited guarantee meant that no creditor of IFP could lose its money. Therefore, banks would be willing to provide finance at very low rates to IFP. As a result, the activities of IFP which were in competition with other undertakings could derive a selective advantage. Second, other creditors never faced the prospect of seeking to recover their money in case of default because IFP could never default. Third, suppliers of IFP were certain that they would always be paid and, as a result, charged lower prices to IFP, which resulted in benefits for IFP's commercial activities outside research. Fourth, clients of IFP would prefer to do business with IFP because they would never lose their money. Even if IFP could not complete a research project satisfactorily, the client was indemnified. In dealing with other providers of similar research services, clients who wanted to obtain the same level of security would have to buy a performance bond from a financial intermediary. Not only suppliers and clients avoided certain costs, they also obtained an advantage in relation to similar companies doing business with enterprises providing services competing with those of IFP.

It is interesting here that the Commission equated the unlimited guarantee to a factoring contract with a factoring fee varying between 0.7% and 2.5% of the turnover covered.

In the end the Commission found that state aid was compatible with the internal market because it did not exceed what was allowed by the R&D&I Framework.

In all cases, the Commission ordered France to end the unlimited guarantees. These decisions followed the precedent established by its treatment of state guarantees for public banks in Germany. The difference was that the aid for the German banks was existing and, therefore, the Commission had to propose appropriate measures for its abolition without recovery.<sup>36</sup>

#### **II.4.2. Compatibility of state aid in the form of guarantees**

If a guarantee contains state aid, the same issues as those considered in the case of operating aid in loans apply here too. Operating aid is not normally allowed unless it can exceptionally be authorised under conditions specified in the relevant Guidelines (e.g. for regional investment in Article 107(3)(a) areas).

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<sup>36</sup> See case E 10/2000.

De minimis Regulation 1998/2006 makes an explicit reference to guarantees. It is possible to provide de minimis aid in the form of a guarantee without having first to calculate the gross grant equivalent of the aid included in the guarantee. This is permitted only when the aid is granted in the framework of a scheme (i.e. no ad-hoc measures), the guaranteed part of the loan does not exceed EUR 1.5 million per undertaking and the guaranteed amount does not exceed 80% of the underlying loan.

If state aid in a guarantee is not to be regarded as operating aid or de minimis aid, it must be linked to an eligible activity and must comply with the GBER or the relevant Guidelines. This is also because the Notice on Guarantees does not provide any compatibility criteria of its own.

## **II.5. Combined loans and guarantees**

A guarantee always enables the borrower to obtain funds at a lower rate of interest. This is because the guarantee reduces the risk for the lender. The lower interest represents a gain for the borrower which, however, is partly or wholly offset by the premium it has to pay to the guarantor.

The gross grant equivalent of the state aid amount is the difference between the market rate of interest without the guarantee and the interest rate obtained by means of the state guarantee, net of the premium, if any, that has been paid for the guarantee.

The Commission was confronted with this situation in case N 63/2010 concerning a state guarantee for the construction of Murcia International Airport in Spain. The Spanish government granted a guarantee covering 100% of a EUR 200 million loan. The duration of the loan was five years. Since the guarantee covered more than 80% of the underlying loan, there could be no presumption that there was no state aid, even if the beneficiary did pay a premium.

The Commission's main problem was to establish the market rate of interest that would have applied to SCAM, the airport operator, which was a newly established special purpose vehicle without a credit history. Because the rating of SCAM was believed not to be above "weak", it was graded at "B" with "low" collateral. On this basis, the Commission derived the corresponding market rate and calculated the amount of aid in the loan. From this amount it then subtracted the premium already paid by SCAM and discounted it to obtain the net present value of the aid, which came to EUR 26.5 million.

In case N 541/2009 Sweden proposed to grant a state guarantee to Saab Automobile to enable it to obtain a EUR 400 million loan from the EIB. The guarantee was divided into two separate guarantees. The first guarantee, guarantee A, covered 82.8% of the loan, i.e. EUR 331.2 million. Saab would pay a premium amounting to 323 basis points per annum for the first two years, i.e. 3.23% of the installments received by Saab. After this period of two years, Saab would pay a premium amounting to 380 bps (3.80%) p.a. for the remainder of the validity of the

guarantee. The second guarantee, guarantee B, covered the remaining 17.2% of the loan, i.e. EUR 68.8 million. For this, Saab would pay a premium of 1248 bps per annum, i.e. 12.48% of the amount covered by the guarantee. Sweden argued that guarantee A involved compatible state aid, while guarantee B was free of aid.

The problem for the Commission was that it could not identify a corresponding market premium for that kind of loan. The Commission determined a plausible market premium using values for risk-adjusted return on capital in the automotive sector with evidence concerning the quality of the collateral (presumed to be high), a credit rating of Caa, the corresponding default rates provided by Moody's for the Caa category and Moody's historical series on expected recovery rate corresponding to the senior secured ranking of guarantee B. On this basis, the Commission accepted that the fee paid for guarantee B was at least as high as the margin for a similar non-guaranteed loan, and that guarantee B therefore did not involve state aid.

With respect to guarantee A, it was found to be compatible with the internal market because it was granted in compliance with the Temporary Framework for State Aid to counter the effects of the financial crisis 2008-10.

Occasionally, the credit rating of the borrower is so low or the collateral it can offer is so poor that there is no market player willing to either offer a guarantee or a loan. Because the borrower cannot secure a guarantee it cannot obtain a loan either. Under these circumstances there is state aid in both the guarantee and the underlying loan.<sup>37</sup> In this case, the whole amount of the loan is the GGE of state aid.

This typically happens when the borrower is a company in difficulty in the meaning of the Rescue and Restructuring Guidelines. Without outside injection of capital or new loans, the company will eventually go bankrupt. In a number of recent decisions the Commission has found that the amount of state aid in loans to companies in difficulty corresponds to the totality of the guaranteed amount of the loan.<sup>38</sup>

## **II.6. Recovery of incompatible aid in loans and guarantees**

If state aid is found to be incompatible with the internal market, Regulation 659/99 obliges the European Commission to instruct the Member State concerned to recover the aid and charge interest on the amount of incompatible aid since the date it was granted.

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<sup>37</sup> See C-288/96, *Germany v Commission*; and the opinion of Advocate-General Jaaskinen in case C-106/09 P, *European Commission v Government of Gibraltar and United Kingdom*, paragraph 161.

<sup>38</sup> See Commission Decision 2012/541 on state aid granted by Greece to United Textiles; Commission Decision 2012/51 on aid implemented by Italy for Legler; Commission Decision 2010/359 on aid implemented by Italy for Ixfin.

During the past decade or so, some of the most prominent cases involving guarantees referred to unlimited coverage of all liabilities of state banks and state-owned entities such as postal undertakings. Since in many cases, the guarantees had been granted before the establishment of European Economic Community, they were deemed to constitute “existing aid”. This meant that the Commission could only request their abolition without recovery.

Recently, however, there has been one interesting case of incompatible aid where recovery was ordered. The case concerned the injection of capital and the granting of guarantees to Ålands Industrihus (ÅI) which is a 100% state-owned property developer located on the Finnish island of Åland.

The Commission calculated the amount of state aid in the public guarantees and the private loans that were extended at a lower rate of interest as a result of the guarantees following the approach that is laid down in the Commission Communication on Reference and Discount Rates and the Commission Notice on Guarantees.

ÅI was not an undertaking in difficulty (in the meaning of the Rescue & Restructuring Guidelines) but it barely made any profit. As a result, the Commission concluded that no private investor would be willing to inject capital in the company. Although it was not in difficulty it could not provide a return to match the sum of the return on the riskless alternative (which was the 2-year Finnish government bond) and the additional risk borne by investors in ÅI. With respect to the capital injections, the total amount of the injections had to be recovered.

With respect to guarantees and loans, there was state aid because the guarantees covered 100% of the loans. Not only is this contrary to the Guarantee Notice, it also not in conformity with the behaviour of a private investor. This is because no private investor would offer a 100% guarantee because it would provide perverse incentives to the borrower to default.

In calculating the premium that should have been charged to ÅI, the main difficulty and issue of contention between the Commission and the Finnish authorities was the credit rating of ÅI. The Commission concluded that although ÅI could offer a normal collateral, its credit rating was weak. The problem was that no market premium could be found for that kind of risk. So, the market premium could not be compared to the premium actually charged. Therefore, the amount of state aid and, consequently, the amount that had to be recovered was the difference between the market rate of interest on the loans without the guarantee and the cost of the loans at the lower rate plus the guarantee premium that was actually charged.

Two more aspects of this case are worth mentioning. First, the actual premium was made up of two components: the annual premium on the outstanding amount of the loans plus an one-off payment made up front. The Commission considered only the annual premium presumably because the one-off payment would be made irrespective of whether the annual premium was at market rate or below market rate.

Second, the reason for the incompatibility of state aid was that it did not comply with any of the guidelines on state aid or the General Block Exemption Regulation. Although the capital injections, loans and guarantees aimed to enable ÅI to undertake particular projects, no strict limits as to the uses of these funds were imposed on ÅI, no check was performed on the necessity of aid, nor was the aid intensity prevented from breaching the thresholds allowed by the various guidelines or the GBER.

## II.7. Conclusions

Part II of the paper has analysed the rules concerning the measurement of state aid in public loans and guarantees and reviewed the decisional practice of the European Commission. The principles are few and simple. The granting of a public loan or guarantee involves state aid as long as the corresponding interest rate or premium is below the rate that would be charged by the market for the same risk. In the case of guarantees, the amount of aid is the difference between the two rates, while in the case of loans, the amount of the aid is the difference between the two rates multiplied by the principal. The benefit from subsidised loans or guarantees normally goes to the borrower, not the lender. If the borrower is in financial difficulty normally the whole amount of the loan is the amount of state aid.

There are, however, important complications. If there is aid in a guarantee, there is also aid in the guaranteed loan because the interest rate charged would normally be lower. This is despite the fact that the public authority that grants the guarantee does not forgo any resources when the loan is provided by a private financial institution. If the guarantee is granted after a loan becomes non-performing or the borrower encounters difficulties in repaying the loan and the terms of the loan are not adjusted accordingly, then the guarantee also involves state aid to the lender.

The most important complication is the establishment of a credible methodology for calculating the amount of state aid or for proving the absence of state aid. The various cases reviewed in this paper reveal that public authorities have a choice of different methodologies. However, irrespective of which methodology is chosen, the risk probabilities, default rates and recovery factors have to be established on the basis of actual experience. This requires measurement of market data. Even though these are past data, they can still provide a credible foundation for forecasting future default rates and recovery factors.

If state aid is involved in loans or guarantees, public authorities must also ensure that it is compatible with the internal market. Apart from the possible procedural requirement of notification to the Commission, the problem with this kind of aid is that it has to be linked to a project such as, for example, investment, training or research. Otherwise it will be considered to be operating aid with all the consequences which are attached to such aid. This is because operating aid is allowed only in exceptional circumstances.

## **Annex II.1: Numerical Examples of the Gross Grant Equivalent of State Aid**

For all cases below, it is assumed that the borrower is an SME. It borrows EUR 1 million for one year. The loan is repaid in full in a single payment including interest at the end of the year. The market (or reference) rate of interest is 5%. The credit rating of the borrower is BBB and it can offer a normal collateral.

On the basis of these assumptions and according to the Commission Communication on Reference and Discount Rates, the margin that should be added for a loan to this undertaking is 1%. According to the Commission Notice on Guarantees, the premium that should be charged for an individual guarantee is 0.8%.

### **Example 1: Loan at a preferential rate**

The market rate of interest that should be charged is 6% (= 5% + 1%).

If the actual interest rate that is charged is, say, 2%, the amount of state aid is EUR 40,000 (60,000 – 20,000).

### **Example 2: Free guarantee**

If the premium that is actually charged is 0 and the guarantee covers only 80% of the loan, then the amount of state aid included in the guarantee is EUR 6,400 (= (1,000,000 x 0.8 x 0.008) – 0).

### **Example 3: Free guarantee that facilitates a loan at a preferential rate**

Since a free public guarantee reduces the risk borne by the lender, the loan may be granted without the risk premium of 1%. In this case the amount of state aid is EUR 16,400 (= 6,400 + (1,000,000 x 0.01)).

### **Aid intensity**

If the undertaking is using the loan to make an investment of EUR 1 million, the aid intensity of the combined low-interest loan and free guarantee is 1.64% (= 16,400/1,000,000). This aid is in principle compatible with the internal market as the aid intensity is below the maximum rates permitted by the General Block Exemption Regulation (10% for medium-sized enterprises or 20% for small enterprises).