Making financial instruments work for cities

CSI EUROPE

STATE AID AND FINANCIAL INSTRUMENTS

THEME PAPER 2

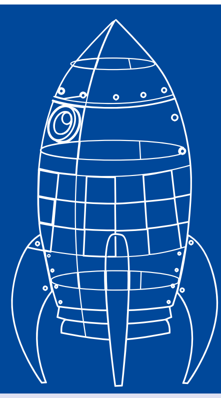
The CSI Europe network was established under the URBACT programme with a mission to make financial instruments work for cities. This series of Theme Papers introduces the key issues for successful implementation of financial instruments to support urban development through loans and other investments instead of grants.

KEY MESSAGE

- The use of European Structural Investment Fund (ESIF) resources, whether by grant or investment through a Financial Instrument (FI), must comply with the State aid rules
- Cities are in the business of providing State aid so they should make sure they are the experts and use flexibilities to their full potential
- The General Block Exemption Regulation (GBER) provides a safe and fast way to secure State aid compliance and should be the "first resort" when considering products to be offered by FIs.
- Other options include "no aid investments" and a FI specific notification, both of which can be effectively used to support FIs, subject to market needs ;

WHAT IS STATE AID?

The State aid rules are set out in the European Treaty and prevent Member States from subsidising "undertakings" where it gives them an advantage in a competitive market. As urban development is a competitive market , the use of European Structural Investment Fund (ESIF) resources, whether by grant or investment through a Financial Instrument (FI), must comply with the State aid rules.



PATHWAYS TO COMPLIANCE

This paper describes four ways in which FIs established to support urban development can ensure compliance: "No-aid"; De-minimis; GBER; and Notification.

The ESIF Common Provisions Regulation requires that FIs comply with the State aid rules and any FI will be required to demonstrate compliance through audit and other monitoring processes. The pathways to compliance for urban development funds have been informed by the experience of JESSICA funds established in the previous programme.

This means that once a City and/or Managing Authority has identified its priority areas for investment, it should seek to design the measures to be provided by FIs to meet these needs by reference to the State aid pathways to compliance.

For example, a FI for energy efficiency schemes in housing may be able to adopt the de-minimis off the shelf model if it is seeking to tackle apartment blocks in multiple ownership. On the other hand if the blocks are owned by one or more large landlords, this option may not be available and the GBER flexibilities should be considered instead.

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STATE AID – PATHWAYS TO COMPLIANCE

DE-MINIMIS

The de-minimis exemption authorises small amounts of aid up to €200,000. This has been used by FIs to provide loans to fund renewal of apartment blocks in multiple ownership,where a single loan is shared between the owners each of whom receive support below the de-minimis limit.

In Lithuania this has been used successfully to support over €200 million investment in FIs to invest in refurbishing housing and this has been used to develop an off the shelf model.

The Lithuanian model allows a mix of grant and low cost loan to be provided to home owners through UDFs established at three banks with a presence on the High Street. Home owners work with a government agency who assists in aggregating the demand to provide a single proposition that allows the owners of a block to apply through a single administrator for loans to secure the renovation of the building.

NO AID

Investments by FIs at the "market rate" are compliant with the State aid rules. Compliance can be demonstrated either by investing on the same terms and interest rate as private investors or by using the Reference Rate published by the Commission.

In Manchester, the Evergreen FI has provided over £50 million of investment to urban development projects on a "no aid" basis, typically at rates above 5%.

For example, Evergreen invested in a Science and Innovation project called Citylabs by way of a syndicated loan where it provided 50% of the senior debt alongside a major UK private sector bank. Under the terms of the loan, the FI enjoyed the same interest rate and rights under the agreement as the private sector bank and is therefore demonstrated to be at market rate and therefore does not constitute State aid.

GENERAL BLOCK EXEMPTION REGULATION (GBER)

A new version of GBER was published in May 2014 which included specific provision for FIs. It has specific exemptions that allow FIs in Assisted Areas to make sub-commercial loans. It also has specific exemptions that can be used by all FIs to support investment in priority sectors such as low carbon and innovation.

For example in Portugal, GBER provides a framework for delivering competitive financial products that are transparent and address market failures.

Under the Portugal scheme, the amount of aid is calculated using the gross grant equivalent. Investments with an aid level is higher than the de-minimis threshold, use the regional aid intensity levels permitted under the GBER as a cap to determine the interest rate applicable to the project.

NOTIFICATION

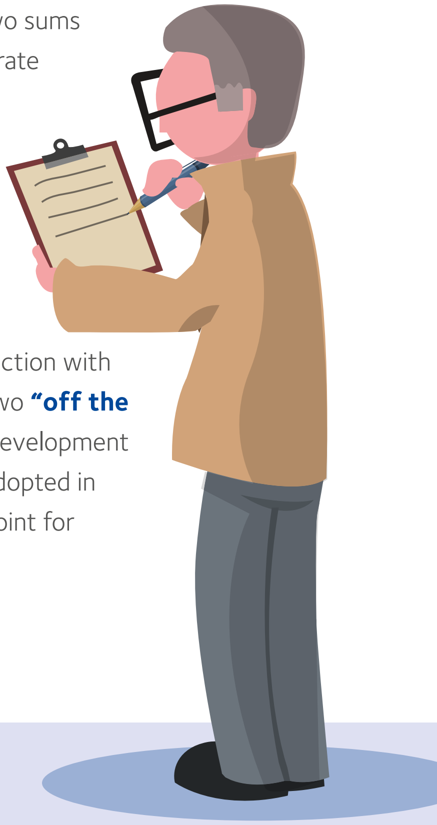
The State aid rules allow notification of measures to the Commission for approval. This has been used to establish FIs to make sub-commercial loans, offer priority returns and provide support as a mixture of grant and loan. This option will only be available where the other State aid pathways are not suitable.

For example in Chester an FI with the benefit of a notified scheme was able to provide a loan of £4 million at zero interest alongside an ERDF grant to support an urban development project to deliver new offices.

This investment was authorised using procedures in the Northwest JESSICA notification that relies on the independence of the competitively procured private sector fund manager to the fund. It also requires a further independent expert to verify that the developer recipient only receives a “fair rate of return” (including its profit) to ensure aid is kept to a minimum.

STATE AID FACTS

- **No-aid** can be demonstrated by showing market investors have invested in the project on the same terms (pari passu) as the FI. Alternatively, where there is no market comparison, the "market rate" can be calculated by using **the reference rate** that is published annually by the Commission;
- The **de-minimis** rules are set out in Regulation 1407/2013 and permit grants of up to €200,000 or loans of up to €1 million to be made to any single undertaking over a rolling three year period;
- **GBER** was published by the Commission in May 2014 and contains specific provisions that allow FIs to make sub-commercial loans in Assisted Areas. To take advantage of this flexibility the governance of the FI must comply with the terms set out in GBER;
- Alternatively investment by FIs at below market rate can be made under the other provisions in GBER, for example which permit support of **low carbon** projects.
- The **notification** procedure needs to be undertaken by Member States and the lead ministry may not be the same as the Managing Authority. The process involves a series of preliminary discussions around draft "non-papers". Once terms are agreed, a formal paper is submitted for consideration and, if the Commission approve the notification it is likely they will issue a formal letter approving the arrangement. The process typically takes around a year.
- A lot of the features of the early notified schemes are now found in the GBER model and therefore, in the future, it is likely that notified schemes will be limited to those which cannot take advantage of GBER such as, for example FIs that are **operating outside assisted areas**;
- When calculating the amount of aid provided under a FI it is essential that the value of the "aid" can be correctly identified. To do this the **"gross grant equivalent"** (or GGE) needs to be calculated. This is done by calculating the amount of interest that would have been paid under the applicable reference rate and comparing it to the amount of interest actually paid. The difference between the two sums is the GGE of the interest rate discount. The GGE may then be used to demonstrate compliance with the de-minimis and GBER rules as applicable.
- The Commission, in conjunction with the EIB, have developed two **"off the shelf"** models for urban development funds that can either be adopted in full or provide a starting point for funds adapted to suit the local context.



FURTHER INFORMATION

This paper is intended to be a guide to some of the relevant issues arising in connection with financial instruments and State aid. As it is a highly technical and complex area it is essential that Cities and Managing Authorities seeking to promote an FI obtain their own expert advice.

Further information on State aid can be obtained from the Commission's web site at: http://ec.europa.eu/regional_policy/thefunds/fin_inst/index_en.cfm

Further information on CSI Europe project, please visit: http://urbact.eu/en/projects/metropolitan-governance/csi-europe/homepage/

CASE STUDY

The steps taken and issues considered in relation to the notification of the Northwest JESSICA fund are described in our Case Study which can be found on our website.