

Review of access to Finance Review – Stage 2 Review

Assessment of State Aid element of the Review

1. Introduction

1.1 The purpose of this Report is to provide a review of the comments made by Professor Dylan Jones-Evans within his report headed "Access to Finance Review – Stage 2 Review" ("the Review") in the context Finance Wales activities in providing loan finance and the application of the EU State aid rules to the provision of such loan finance.

1.2 The contents of this Report relate to State aid compliance issues only in the context of the Review and have been produced by Eversheds for the benefit only of its client, Finance Wales, and Eversheds' duty of care in respect of the contents of this Report apply only in respect of Finance Wales. Should Finance Wales disclose this Report to any third party, the legally privilege nature of this Report is likely to be lost and Eversheds shall owe no duty of care to any such third party.

2. Executive Summary

2.1 It is considered that the Review appears to be incomplete in terms of its assessment of the State aid rules and how they apply to loans made by Finance Wales. In particular, the Review does not reflect that:

2.1.1 Use of methodology set out in the Reference Rate Communication only provides for a proxy for the market rate in the absence of an actual market rate; and

2.1.2 the methodology set out in the Reference Rate Communication is not applicable in circumstances where the risks in terms of the loan are abnormally high. This is the case, in particular, where the loan is subordinated in any way and also potentially where there is no security provided.

2.2 The review does not seem to appreciate that use of the General Block Exemption Regulation is not a given in terms of justifying subsidised loans by Finance Wales and that any aid would need to be in compliance with the requirements of the General Block Exemption Regulation and, in particular, will need to be applied as against relevant eligible costs in order to be permitted. Whilst this is not an issue in terms of use of De Minimis aid Block Exemption, de minimis aid is a finite resource for any entity and may have already been utilised or may be needed at a later date by relevant entities to cover costs that cannot otherwise be justified in State aid terms.

2.3 The review does not seem to appreciate that in a number of cases (in particular, the Finance Wales JEREMIE Fund) it is not within Finance Wales' purview to simply change the basis, unilaterally, on which funds are applied to the end recipients.

2.4 Whilst reference is made to State aid advice being sort it is unclear if this was on a generic basis or linked specifically to the actual funds and the nature of the deals that Finance Wales undertakes. Our view is that the review seems to be based on what the general State aid principles are rather than advice specific to their application to the nature of the deals that Finance Wales undertakes

3. **The cost of borrowing and the EU reference rate**

3.1 The provisions of the Review included suggestions that Finance Wales can lend (without the risk of granting State aid) at a rate of no less than those calculated in accordance with the methodology set out within the Communication from the Commission on the revision of the method for setting the reference and discount rates. ("the Reference Rate Communication")¹. This is considered to be an incomplete assessment of how the State aid rules apply to loans by public bodies and, in particular, does not take into account the fact that the reference rate provides for a "proxy" for the market rate in the absence of there being a market rate rather than operating as a definitive rate for lending by public bodies in all circumstances.

3.2 The State aid rules and, in particular, the application of the so called market economy investor principle/market economy lender principle (MEIP/MELP) operate on the basis that aid issues will not arise if public funds are applied on the same basis as those that would be offered by a prudent private sector investor/lender motivated by profit, if presented with the same circumstances. It is, therefore, considered that if the market rate is actually higher than that based on use of the reference rate methodology then simply relying on the reference rate (as a proxy for the market rate) raises the potential for such a loan still to contain elements of State aid. This point is recognised in guidance² issued by the Department of Business of Innovation and Skills, in the response of the Question "*What is the Commission reference rate? Is there aid when I use the reference rate?*" where it is stated that :-

"the Commission's reference rate was put in place for member states to be used as a proxy for the market rate. However, particularly in light of recent economic crisis and credit freeze, you should consider whether the

¹ Communication from the Commission on the revision of the method for setting the reference and discount rates OJ C 14, 19.1.2008, p. 6–9

² BIS State aid: Frequently asked questions. May 2012

reference rate genuinely reflects the rate which would be available to the beneficiary on the market. If you provide finance on better terms than would have been available on the market then there will still be aid to them, regardless of the reference rate.

*Therefore the reference rate plus the appropriate margin based on the credit rating of the company offered, as set out in the reference rate communication, is considered as a **minimum rate** rather than a definitive guide to the rate which should be used”.*

3.3 It is considered that this guidance is consistent with MELP as if use of the reference rate methodology provides for a rate which is demonstrably lower than that which would be offered by the market (in comparable circumstances) then there would be a clear benefit to the recipient entity as a result of the application of State resources (in the form of the state loan).

3.4 It is also noted within the Review that reference is made (at footnote 44) to an article written by Professor Nicolaides³ and within that article Professor Nicolaides expressly states (within the first paragraph of section ii.2.1 – Reference rate) the following:-

“the Reference Rate is a proxy for the market rate of interest and can be used in the absence of corresponding market rates”.

This clearly indicates that a rate calculated using the reference rate methodology should only be relied upon in State aid terms where there is no corresponding market rates. This in turn suggests that if there is such a corresponding rate then that rate rather than the rate calculated using the reference rate methodology should be used in order to demonstrate no benefit to the recipient entity

3.5 In addition to a rate calculated using the reference rate methodology only amounting to a proxy for the market rate (in the absence of any corresponding market rate of interest), it is considered that the methodology is only relevant in calculating the proxy rate in limited circumstances where the loan terms are standard in nature and, in particular, where there is no element of subordination in respect of the public sector loan against any other private sector debt.

3.6 The EC within a number of State aid decisions⁴ have expressly indicated that the Reference Rate Communication cannot directly be applied for the assessment of subordinated loans and that it is of the opinion that it only applies to senior debt. Within these decisions, the EC has expressly referred to “subordinated loans constitute a special situation” and that special situations are caught by the

³ Financial Engineering Instruments and their Assessment under EU State aid Rules – Phedon Nicolaides

⁴ State aid N 689/09 – Germany KfW loan scheme "Capital for jobs and investments and N55/2008 - GA/ERDF subordinated loan scheme for Brandenburg

introductory sentence relating to loan margins within the Reference Rate Communication, which underlines that “the following loan margins are to be applied ***in principle*** depending on the rating of the undertaking concerned and the collateral offer”. The qualification “in principle” allows the Commission to deviate from the grid in justified circumstances”.

- 3.7 It is considered that the reference to “special circumstances” and “justified circumstances” is intended to cover circumstances where public loans made carry additional risk (e.g. are subordinated) and will potentially cover not only loans that are made on a subordinated basis but also those that can be regarded as containing unusual terms which would increase the risk for the lender over that covered by standard lending conditions. It is considered such special circumstances could include where no security is offered. This conclusion is based on the definition of debt instruments under the EC Risk capital Guidelines⁵ which refers to them as :

“loans and other funding instruments which provide the lender/investor with a predominant component of fixed minimum remuneration and are at least partly secured”

- 3.8 As a result it is considered simplistic to argue that lending at a rate based on the use of the methodology set out in the Reference Rate Communication can be relied upon by Finance Wales in all circumstances in relation to loans that they provide in order to demonstrate that such loans contain no aid.
- 3.9 It is noted at paragraph 2 of page 39 of the Review that reference is made to the following feedback provided by an SME:-

“I am surprised to see that the offer on the table is more expensive in interest rates compared to the existing High Street overdraft in place, that personal security is required and are the same if not more stringent as those for the Bank...”

Whilst the details of this example are not known, it is possible that the Finance Wales’ loan was subordinated in some way to the existing bank debt and therefore the use of the Reference Rate Communication to calculate the interest rate would not be relevant. It would be entirely consistent with commercial lending principles for a subordinated debt (being at greater risk) to be provided at a higher rate than any senior debt.

⁵ Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises (Text with EEA relevance) *OJ C 194, 18.8.2006, p. 2–21*

4. **Use of the General Block Exemption Regulation and the De Minimis Aid Block Exemption Regulation.**

4.1 A theme throughout section five of the Review is the view that Finance Wales could simply reduce interest rates on the loans they provide, with such interest rate subsidies being justified under either the General Block Exemption Regulation (“GBER”) or the De Minimis Block Exemption Regulation. Whilst it is clear that loans by Finance Wales at subsidised rates are potentially capable of being provided under these Block Exemption Regulations, it is considered that the references in the Review as to how this can be achieved are not complete in nature.

4.2 In respect of the terms of the GBER, any aid (i.e. interest rate subsidy) in order to fall within the safe harbour provided by the GBER must comply with its general provisions as well as those specific to the relevant measure being relied upon to justify the aid within the GBER. In terms of specific measures funding can, as a general rule, only be applied as against specific eligible costs. On this basis, in order for Finance Wales to be able to provide subsidised loans in compliance with the GBER, the relevant recipients and Finance Wales must be able to demonstrate that the loans (and the subsidies entailed in the same) will be applied as against such eligible costs. Without such evidence it is not possible for such an interest rate subsidy to be justified in State aid terms on the basis of compliance with the GBER.

4.3 It should be noted that the GBER does not provide for a carte blanche approach in terms of the provision of State aid with such aid being required to be targeted towards specific areas. For example, the Regional Investment and employment aid and SME investment and employment aid measures require that funding only be applied towards “initial investment costs” (as defined within the GBER). Other measures such as those relating to environmental aid and R&D aid are even more specific in terms of eligible costs to which aid must be applied. Whilst the Review refers to SMEs located in assisted areas it does not refer to the need for any aid to be applied as against relevant eligible costs.

4.4 It is therefore not simply a case of stating that Finance Wales can provide subsidised loan based on the GBER, as there would always be a question as to whether the proposed use of the loan complies with the requirements of the GBER in general and the specific measure in the GBER being relied upon. The fact that an SME is located in an assisted area does not mean it is automatically capable of receipt of a subsidised loans from Finance Wales as it will be dependent on whether the aid is applied/capable of being applied towards eligible initial investment costs.

4.5 In terms of application of De Minimis aid, in accordance with the De Minimis aid block Exemption, whilst there are no restrictions in terms of costs as against

which aid may be applied, it is considered that again the approach taken within the Review does not provide the full picture. In particular, the Review does not seem to take into account the possibility that SMEs may already have utilised some or all of their De Minimis entitlement at the point in time that the Finance Wales loan is given or alternatively may still require that De Minimis allocation to enable them to receive funding for costs which would otherwise not be capable of being funded under any other State aid rules (this would particularly be the case in relation to operating aid).

- 4.6 It is also noted that reference is made within the Review to De Minimis aid not being required to be cumulated with any aid other than De Minimis said (see footnote 46). This is factually incorrect as paragraph 11 of the De Minimis Block Exemption Regulation expressly states the following:-

“in order to avoid circumvention of maximum aid intensity provided in different community instruments, De Minimis aid should not be cumulated with State aid in respect of the same eligible costs if such cumulation would result in an aid intensity exceeding that fixed in these specific circumstances in each case by a block exemption regulation or decision adopted by the Commission”.

This wording is also mirrored within the GBER (Article 7(3)).

This therefore requires that evidence be obtained in advance of any subsidised loan being offered not only as to any de minimis aid previously received/committed to be being received but also any other aid already received/committed to be received on the basis of approved State aid schemes/other Block Exemptions in relation to costs which any Finance Wales loan would be applied base on de minimis aid.

- 4.7 A further point that does not seem to be addressed within the Review is that there may be a number of circumstances in which Finance Wales is precluded from providing subsidised loans on the basis of existing State aid decisions and/or its relationship with third parties. By way of example, reference is made at various points within the Review to the Finance Wales JEREMIE Fund and loans provided by Finance Wales under that Fund. This Fund is subject to an existing State aid approval⁶ and within that approval it is expressly stated (at paragraph 20) that all loans will be provided under normal market conditions. The provision of subsidised loans would amount to a significant change to the basis on which the EC approved the Finance Wales JEREMIE Fund.

⁶ N700/2007 Finance Wales JEREMIE Fund

- 4.8 In addition, the basis on which the Finance Wales JEREMIE Fund operate needs to be in compliance with the basis on which the ERDF funding is required to be applied based on the relevant ERDF application and offer letter. The offer letter would undoubtedly require the ERDF funds to be applied in a manner consistent with the requirements of the State aid decision and therefore would not allow Finance Wales to provide loans (without variation) other than on commercial terms. The changes to this position would require approval not only from the European Commission (via WEFO) in terms of the basis on which any ERDF funds and match funding are applied through the fund, but also the European Investment Bank (“the EIB”) which provided 50% of the funding towards the Finance Wales JEREMIE Fund as a whole. Finance Wales is, therefore, due to the basis on which the Finance Wales JEREMIE Fund was set up and approved unable to simply unilaterally start providing subsidised loans because by doing so it would be in breach of various obligations it holds in relation to operation of the Finance Wales JEREMIE Fund. Changes to the basis on which funds are applied, if not approved in advance, would be inconsistent with the basis on which it was approved (in terms of both the State aid and ERDF rules) and potentially obligations held to other funders (i.e. the EIB)

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