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Financial Instruments and their Proportionality and Consistency under EU Law

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by

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09/2012 - 07/2013	**Hertie School** (Berlin) **Master of Public Policy (MPP)** ▪ Master Thesis with the German Bundestag: "The German Multi-annual Contract LuFV for Railway Infrastructure in a Cross-European Comparison"
09/2011 - 07/2013	**London School of Economics and Political Science** (London) **Master of Public Administration (MPA)**
09/2007 - 08/2010	**Maastricht University** (Maastricht) Erasmus semester: Universidad Autónoma de Madrid (Madrid) **Bachelor of Laws (LL.B.)**, European Law School, top 3% of students 2007/2008 ▪ Bachelor Thesis: "Mutually Assured Destruction Inevitable? – The Relationship between the ECJ and the German FCC", awarded with the Bachelor Thesis Award of the Montesquieu Institute 2011

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Summary of the Thesis

Financial instruments have witnessed an increasing uptake by the European Union (EU) and Member States to finance public policy objectives not just since the Covid-19 crisis, e.g. to support young and innovative SMEs in need of risk finance. Next to grants and tax exemptions, they provide an alternative tool under EU state aid law in the form of equity, quasi-equity, loans, and guarantees. They are implemented via financial intermediaries, such as banks and financial institutions, are repayable, and leverage private sector investment. As market interventions, they may create undue advantages at different levels, i.e. at that of investors, financial intermediaries and their fund managers, as well as beneficiary undertakings. As such, they are liable to distort the market, so that state aid law applies. However, the latter applies only to those instruments implemented and managed at Member State level, while those at EU level must be 'consistent with state aid law'. The Commission strives to ensure this through terms and conditions of special agreements with implementing bodies of the European Investment Bank.

Thereby, the principle of proportionality is of critical importance to state aid law, since it warrants that aid measures as market interventions are suitable, necessary, and non-disproportionate. Specifically, financial instruments must be suitable to the desired goal, necessary or least restrictive as a means, and not disproportionate to avoid market distortions. If this principle is applied inconsistently, i.e. with contradictions and not as one set of rules, legal certainty and efficiency suffer to the detriment of stakeholders. The overarching research question of this thesis is thus whether the European Commission and the legal framework of financial instruments both inside and outside state aid law ensure their proportionate application in a consistent manner in accordance with the case law of the EU Courts. The thesis addresses this question to provide improvements to the overall state aid framework of financial instruments under the urgency of the Commission's review of state aid rules. Therefore, legal texts of primary and secondary, binding and non-binding nature, the applicable case law of the EU Courts, and relevant Commission decisions were consulted, compared, and analysed.

The findings of this thesis are, firstly, that inconsistencies among the plethora of legal texts exist (chapter IV). Secondly, that it is difficult to consistently identify and quantify the advantage and risks of financial instruments in a market environment of young and innovative SMEs that is inherently risky and prone to information asymmetries (chapter V). Thirdly and importantly, that the Commission fails to adhere to the requirements of the EU Courts on proportionality in its case law on state aid: Instead of the required effects-based approach, including the balancing of positive and negative effects of financial instruments, the Commission merely applies a formalistic checklist.

Hence, the findings suggest that neither in its compatibility assessment of its decisions (chapter VI) nor in its design of financial instruments at the EU level (chapter VII) does the Commission provide tools to analyse the correspondence between the aid amount and the extent of the respective market failure or impact of the aid. Instead, it checks whether certain limitations to the aid amount, market mechanisms, and accountability methods (chapter VIII) are applied to the relevant instrument to minimise market distortions. Since the Commission does not possess tools to quantify the aid, let alone conduct the balancing exercise, the thesis recommends the introduction of so-called manifest negative effects, which are applied in other state aid areas and are apt to solve these inconsistencies: Based on the EU Courts' requirements on proportionality, they indicate with legal certainty to stakeholders which potential negative effects are disproportionally distortive, rendering the relevant instrument incompatible with the internal market.

Impact of the Thesis

The objective of the thesis is to assess the legal framework of financial instruments, in the form of equity, quasi-equity, loans, and guarantees, on its consistency with the requirements of the proportionality principle established by the EU Courts. Thus, it is intended to reveal potential improvements in light of its review by the Commission and its heightened use during the Covid-19 crisis. Financial instruments are, next to grants and tax exemptions, a tool of state aid for attaining certain policy goals. They are implemented via financial intermediaries, such as public and private banks, have the task to leverage private investment to achieve the policy goal in question, and are, unlike grants, repayable. In particular, the thesis benchmarks legal texts and decisions of the Commission against the requirements of the EU Courts. The latter lay down in their case law that state aid must be proportionate, i.e. be suitable to achieve European policy goals, the least restrictive alternative, and not excessively harmful to markets and competition in the EU. In light of these requirements, the thesis thus aims to highlight potential contradictions to ensure an improved, more consistent and certain legal framework through its upcoming review by the Commission.

The comparison and analysis of the legal sources reveal that there are inconsistencies and contradictions among the plethora of legal texts, and importantly, between the legal approach of the Commission and the requirements of the EU Courts. Therefore, the thesis provides legal solutions in form of a list of 'manifest negative effects', i.e. effects that automatically indicate that the financial instrument at hand causing them is prone to distort markets excessively. This would be in line with the EU Courts' requirements, since such a list of excessive effects is already available in other areas of state aid. Moreover, the thesis reveals the areas of contradictions in the legal texts and decisional practice of the Commission, so that they may be removed to ensure the clearer and more efficient use of financial instruments. It is assumed that the more consistent the less ambiguous the legal framework is, and hence the clearer the rules the more efficient and less costly the design of instruments may be.

This may help stakeholders in the field of financial instruments and risk finance aid: Member States, their implementing bodies, financial intermediaries and institutions, investors, industry associations, NGOs, and aid recipients, could profit from insights as to how to assess and design legal financial instruments that are suitable to achieve certain European policy goals, that are necessary and least restrictive compared to alternative means, and that do not distort competition and markets disproportionately. In particular, Member State bodies, financial intermediaries, and investors have an interest in ensuring that aid measures be in accordance with EU law and do not have to be returned otherwise. The social impact of a consistent framework of financial instruments is their efficient and proportionate use of taxpayers' money and its achievement of European public policy goals, be they economic, social, cultural, or scientific. This is because the thesis's elaborations may provide an overview, insights, and guidance to stakeholders and practitioners in the use of financial instruments for these different areas.

To disseminate the findings among stakeholders, copies of the thesis may be distributed to the Commission as the competent authority of state aid law, Member State authorities, promotional banks as financial intermediaries, and other practitioners. The research results could also be integrated into a conference on state aid law.

Table of Contents

Table of Abbreviations

CAPM	Capital Asset Pricing Model
CDR	Commission Delegated Regulation, Commission Delegated Regulation (EU) No 480/2014 of 3 March 2014 supplementing Regulation (EU) No 1303/2013 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 et al.
CPG	Capped Portfolio Guarantee instrument
CPR	Common Provisions Regulation, Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund et al.
ECJ	European Court of Justice
EFG	Equity Facility for Growth instrument
EFSI	European Fund for Strategic Investments
EIB	European Investment Bank
EIF	European Investment Fund
ESI funds/ESIF	European Structural and Investment Funds
EU Courts	The Court of Justice of the European Union, including the Court of Justice and the General Court
FAFA	Financial and Administrative Framework Agreement between the Commission and EIF/EIB
FR	Financial Regulation, Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union
GBER	General Block Exemption Regulation, Commission Regulation (EU) No 651/2014 of 17 June 2014
IFE	InnovFin Equity Facility for Early Stage instrument
InnovFin	EU Finance for Innovators
LGF	Loan Guarantee Facility instrument
MEIP	Market Economy Investor Principle
RFG	Risk Finance Guidelines, Communication from the Commission — Guidelines on State aid to promote risk finance investments (2014/C 19/04)
RSL	Risk Sharing Loan instrument

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Regulation (EU) No 1291/2013 of the European Parliament and of the Council of 11 December 2013 establishing Horizon 2020 - the Framework Programme for Research and Innovation (2014-2020) and repealing Decision No 1982/2006/EC.

Regulation (EU) No 1295/2013 of the European Parliament and of the Council of 11 December 2013 establishing the Creative Europe Programme (2014 to 2020) and repealing Decisions No 1718/2006/EC, No 1855/2006/EC and No 1041/2009/EC.

Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union, amending Regulations (EU) No 1296/2013, (EU) No 1301/2013, (EU) No 1303/2013, (EU) No 1304/2013, (EU) No 1309/2013, (EU) No 1316/2013, (EU) No 223/2014, (EU) No 283/2014, and Decision No 541/2014/EU and repealing Regulation (EU, Euratom) No 966/2012.

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Summary Boxes

I. Introduction: Relevance, Questions, and Methods

1. The Covid-19 Crisis and the Review of the Legal Framework on Financial Instruments

The Covid-19 crisis triggered an unprecedented amount of government support programmes for companies in need throughout Europe. Next to the provision of direct grants, the use of financial instruments in the form of loans, guarantees, and equity finance has grown to fight the negative economic consequences of the 'Great Lockdown' and its aftermath. For instance, the Organisation for Economic Co-Operation and Development (OECD) found that loan guarantees were the 'preferred instrument deployed throughout the current crisis', which countries use 'to support liquidity in the system and to encourage lending'.[1]

The European Union (EU) alone provided EUR 360 billion in loans, a sum that nearly matches the EUR 390 billion in direct grants support.[2] Additionally, Member States set up national programmes delivering financial instruments, amounting in the billions of euros.[3] Although grants were the most favoured instrument (representing more than 26 per cent of the total sector-specific budget in the form of 66 measures), guarantees were widely granted (almost 21 per cent of the total sector-specific budget in the form of twelve measures), followed by capital injections and loans (21 per cent and almost 1.7 per cent of the total sector-specific budget in the form of four and five measures, respectively).[4] For instance, Germany alone made available through its 'Economic Stabilisation fund' EUR 600 billion, including equity, loans, and guarantees.[5] This is

[1] The OECD, Covid-19 Government Financing Support Programmes for Businesses, 2020, available at: https://www.oecd.org/finance/COVID-19-Government-Financing-Support-Programmes-for-Businesses.pdf, p. 13, last access: 06.01.2021.
[2] The European Council, Infographic Next Generation EU, https://www.consilium.europa.eu/en/infographics/ngeu-covid-19-recovery-package/, last access: 06.01.2021.
[3] The OECD, Covid-19 Government Financing Support Programmes for Businesses, 2020, available at: https://www.oecd.org/finance/COVID-19-Government-Financing-Support-Programmes-for-Businesses.pdf, pp. 33-58, last access: 06.01.2021.
[4] Jan van Hove, The European Parliament, Impact of State Aid on Competition and Competitiveness during the Covid-19 Pandemic: An Early Assessment, 2020, p. 28, https://www.europarl.europa.eu/RegData/etudes/STUD/2020/658214/IPOL_STU(2020)658214_EN.pdf, last access: 16.01.2021.
[5] The OECD, Covid-19 Government Financing Support Programmes for Businesses, 2020, available at: https://www.oecd.org/finance/COVID-19-Government-Financing-Support-Programmes-for-Businesses.pdf, p. 41, last access: 06.01.2021,
and European Commission, Aid No. SA.56814, Commission decision, 08.07.2020.

mirrored by hundreds of Commission decisions (almost 400 by January 2021) on the compatibility of these rapid help measures under EU law since the virus's impact in March 2020.[6]

Yet, the increased uptake of financial instruments is relatively new and was fostered by crisis measures, as state aid commonly implies the application of direct grants or tax exemptions.[7] Since 2014, Member States have established 700 financial instruments with contributions of more than EUR 23 billion, while grants still build the bulk of state aid provided by Member States.[8] This is still a small number relative to grants and tax exemptions, however.

Financial instruments are defined as Member State or EU measures in the form of equity finance, loans, and guarantees to facilitate the funding of economic and political objectives, and are implemented by a financial intermediary, such as financial institutions, if they are set up as risk finance aid under EU law.[9] Thereby, the very rationale behind interventions in financial markets and the use of financial instruments is deemed the existence of market failures, e.g. financing gaps in the provision of venture capital.[10]

Financial instruments have several advantages over conventional direct funding in the form of grants: They provide a leverage effect of private capital on funds, may combine different forms of public and private resources to support public policy objectives, and render this support sustainable due to their revolving nature.[11]

[6] European Commission, State Aid Rules and Coronavirus, https://ec.europa.eu/competition/state_aid/what_is_new/covid_19.html, last access: 02.11.2020.
[7] European Commission, State Aid Scoreboard 2019, https://ec.europa.eu/competition/state_aid/scoreboard/state_aid_scoreboard_2019.pdf, last access: 26.08.2020, p. 20.
[8] Fi Compass, Country Data, Source: Cohesion Policy Open Data Platform, data from before 01.01.2019, https://www.fi-compass.eu/fisiyc, last access: 02.11.2020.
[9] Article 2 Nr 71 of Commission Regulation (EU) No 651/2014: 'financial instruments may take the form of loans, guarantees, counter-guarantees as well as hybrid, mezzanine, and equity finance', and Article 21 (10) and (13) of Commission Regulation (EU) No 651/2014.
[10] The OEDC and the European Commission, The Theory and Practice of Financial Instruments for Small and Medium-sized Enterprises, 2017, https://www.oecd.org/cfe/regional-policy/Brown_When-to-use-financial-instruments.pdf, p. 9, last access: 22.05.2020.
[11] Preamble of Regulation (EU) No 1303/2013.
In particular, advantages are that this form of instrument may be targeted and less state aid is needed, that risks are mitigated, and that involvement of intermediaries is possible. Disadvantages may be the danger of crowding out, the full risk transfer to the state, and other market distortions. - Ex-ante assessment methodology for financial instruments in the 2014-2020 programming period, General Methodology covering all thematic objectives, Volume I, p.76.

Category	Equity	Debt	
Type	Equity (e.g. venture capital, seed, early stage)	Loans	Guarantees
Definition	Provision of capital to unlisted companies in return of shares	Lending of capital to be repaid	Provision of collateral for an underlying loan

Source: Claudia Gloazzo, The Financial Accountability of Financial Instruments in Cohesion Policy. Distinctive Features?, European Structural and Investment Funds Journal, Vol. 6 No. 2, 2018, p.103.

For instance, via the financial instrument schemes, the EU institutions and Member States promote the availability of financing options for SMEs, especially start-ups and innovative companies, with the aim of boosting their growth.[12] Financial instruments and risk finance are apt to encourage 'experimentation and innovation in the economy', 'mak[ing] it easier for promising start-ups to grow and challenge incumbents, speed[ing] up the reallocation of resources towards the highest productivity firms, and ultimately contribut[ing] to accelerated economic growth and job creation'.[13]

Thus, for companies to gain easy and reliable access to funding in the EU, financial instruments are an especially favourable solution, providing advantageous financing conditions.[14] They generally entail aid granted by a Member State to undertakings, which may influence market conditions within the EU. As such, they trigger the application of the EU competition law on state aid with its rationale to prevent any distortion of the internal market. Distortions are due to inherent uncertainty of market interventions, particularly present in risky business environments targeted by financial instruments.[15] Therefore, state aid law of the EU provides a framework for achieving public and economic policy goals and the mitigation of internal market distortions.

Regarding the application of state aid law, financial instruments are, compared with grants, more complex and involve several actors in their set up and management: not only Member States, their implementing authorities, and final recipients, but also funds, fund managers, investors, and financial intermediaries, so that state aid may exist at their different levels. What adds to the legal complexity of financial instruments is that inconsistencies of their framework become apparent

[12] European Commission, SME access to finance, www.ec.europa.eu/growth/access-to-finance_en, last access: 10.02.2021.
[13] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 375.
[14] See, for instance, European Commission Communication, Guidelines on State aid to promote risk finance investments (2014/C 19/04), para. 36.
[15] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 196,
and European Commission Communication, Guidelines on State aid to promote risk finance investments (2014/C 19/04), para 3.

between their application at the EU level, on the one hand, and at the Member State level, on the other – they even lack a consistent definition that is applicable at both levels (see Chapter III).

The framework of state aid rules on financial instruments is complex and broad for other reasons. It is complex, since it consists of different layers of hard law and soft law: Over the years, a plethora of legal texts of Commission regulations, codes, and guidance documents have developed, which vary in their binding and non-binding, or possibly quasi-binding, nature. It is broad, since it encompasses different areas of application, such as the European Structural and Investment funds (ESI funds) for economic, social, and territorial cohesion at the level of Member States as well as funding programmes in different subject areas at the EU level.

To review and streamline its state aid framework, the Commission set out an ambitious reform in the Communication of State Aid Modernisation (SAM) in 2012.[16] Its aim was twofold: Firstly, it was intended to facilitate the implementation of state aid by Member States to foster investment, economic growth, and job creation more rapidly.[17] Secondly, it aimed to concentrate state aid control through the Commission itself only on such cases that are most liable to distort competition.[18] This reform appears to be a success, as '97 per cent of all state aid measures are now implemented by Member States without the need for prior approval by the Commission'.[19]

However, numerous rules and the plethora of legal texts adopted under the SAM, including those on financial instruments, were due to expire by the end of 2020.[20] Therefore, the Commission prolonged the validity of those rules until the end of 2021 and 2023, respectively, and yet more importantly, evaluates those and other state aid rules under a 'fitness check' in line with its Better Regulation Guidelines.[21]

[16] European Commission Communication, European State Aid Modernisation (SAM), 08.05.2012, COM(2012) , 209 final.
[17] European Commission Communication, European State Aid Modernisation (SAM), 08.05.2012, COM(2012) , 209 final; and European Commission, State Aid Scoreboard 2018, http://ec.europa.eu/competition/state_aid/scoreboard/state_aid_scoreboard_2018.pdf, last access: 11.05.2019.
[18] European Commission Communication, European State Aid Modernisation (SAM), 08.05.2012, COM(2012) , 209 final; and European Commission, State Aid Scoreboard 2018, http://ec.europa.eu/competition/state_aid/scoreboard/state_aid_scoreboard_2018.pdf, last access: 11.05.2019.
[19] The European Commission, Press release: State Aid: Commission prolongs EU State aid rules and adopts targeted adjustments to mitigate impact of coronavirus outbreak, 02.07.2020, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1247, last access: 26.08.2020.
[20] For an overview, see The European Commission, Press release: State Aid: Commission to prolong EU State aid rules and launch evaluation, 07.01.2019, http://europa.eu/rapid/press-release_IP-19-182_en.htm, last access: 11.05.2019.
[21] The European Commission, Press release: State Aid: Commission to prolong EU State aid rules and launch evaluation, 07.01.2019, http://europa.eu/rapid/press-release_IP-19-182_en.htm, last access: 11.05.2019.

This review of state aid rules may be a critical juncture and lends an urgency to the concern of this thesis: from a legal perspective, this thesis strives to assess the consistency of the current 2014-2020 state aid rules on financial instruments to deliver insights as to whether, and if so how, the framework ought to be revised. According to the Commission, its fitness check is intended to 'provide a basis for decisions, to be taken by the Commission in the future, about whether to further prolong or possibly update the rules', which includes the identification of 'overlaps, gaps, inconsistencies, and/or obsolete measures that may have appeared over time, and considering the cumulative impact of EU legislation and activities'.[22]

The final report of the fitness check based on a stakeholder consultation was released by the end of 2020, which is considered a 'mid-term review' or an 'implementing evaluation' to 'examine whether everything is on track' or changes are required.[23] It found that SAM rules overall are 'broadly fit for purpose', as a whole effective, appropriate to meet the EU's needs, to a certain extent efficient, and deliver an 'EU added value' to stakeholders on the internal market.[24] Importantly, with regard to the many texts' consistency, the Commission found that the rules 'form a rather coherent package, albeit some technical alignments may be necessary'.[25]

The fitness check confined itself to legislation on financial instruments at Member State level. However, it did not analyse whether the latter is consistent with the Commission's rules applicable for financial instruments at the EU level – and, more importantly, whether the overall legal framework and decisional practice of the Commission pertaining to financial instruments is consistent with the requirements of the EU Courts in their case law, particularly in terms of the important principle of proportionality. Without any research in the field of financial instruments so far other than the fitness check report and given the complexity of financial instruments and their legal framework, the following question of consistency merits closer investigation: Do the rules of the different legal texts and the decisional practice of the Commission present

[22] The European Commission, Press release: State Aid: Commission to prolong EU State aid rules and launch evaluation, 07.01.2019, http://europa.eu/rapid/press-release_IP-19-182_en.htm, last access: 11.05.2019.
[23] European Commission, Staff Working Document, Fitness Check of the 2012 State aid modernisation package, railways guidelines and short-term export credit insurance, 30.10.2020, SWD(2020) 257 final, p. 9.
[24] European Commission, Staff Working Document, Fitness Check of the 2012 State aid modernisation package, railways guidelines and short-term export credit insurance, 30.10.2020, SWD(2020) 257 final, Executive Summary, pp. 2, 3.
[25] European Commission, Staff Working Document, Fitness Check of the 2012 State aid modernisation package, railways guidelines and short-term export credit insurance, 30.10.2020, SWD(2020) 257 final, p. 116.

contradictions that may impede legal certainty and economic efficiency, especially in relation to the EU Courts' requirements on proportionality?

The general principle of proportionality is of particular importance for the following reasons: State aid is taxpayers' money, and as such, under good governance, its use must be proportionate and its legal restrictions be applied in a consistent manner for it not to be wasted or creating detrimental effects. Thus, as market interventions, financial instruments must be suitable and necessary means to achieve the objective sought, so that distortions caused by the aid measure remain limited. The proportionality principle therefore allows to 'judge measures by the relationship between the objective pursued and the methods used' and rests on the rationale of 'the increasing intensity of interference with liberty to be matched by an increasing weight of reasons justifying the interference'.[26]

The importance of proportionality in the realm of EU law is highlighted by the recent judgment of the EU Courts in *Weiss* on the Public Sector Purchase Programme of the European Central Bank, where the Courts made clear that every EU act 'should be suitable for attaining the legitimate objectives pursued by the legislation at issue and should not go beyond what is necessary to achieve those objectives'.[27] Together with the principle of consistency, the proportionality principle ensures predictability and legal certainty and hence the legitimacy of the law.[28]

Although there is a growing number of research papers and analyses on the economic aspects of financial instruments in the European context, there are none on the legal framework of financial instruments and its relation to principles of EU law.[29] Hence, the overarching concern of the thesis is this very framework and its relation to the overriding principles of proportionality and consistency. Without any existent research on this subject matter, the question of whether

[26] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 441 citing J Schwarze, European Administrative Law, Sweet & Maxwell, 2006, pp. 664, 665, and
Robert Alexy, A Theory of Constitutional Rights, Oxford University Press, 2002, p. 231.
[27] Case C-493/17, Weiss and Others [2018] EU:C:2018:1000, para. 72, citing case C-62/14, Gauweiler and Others [2015] EU:C:2015:400, para. 67.
Importantly, the German Federal Constitutional Court in its judgment of May 2020 heavily criticised the EU Courts for failing to consider the economic effects of the programme and thus to adhere to the proportionality principle in the very judgment of *Weiss*. – BverfG, Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15 -, paras.167-179.
C-331/88, The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health ex parte Fedesa et al [1990] ECR I-4023, para. 13.
[28] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 162.
[29] See, for instance, the platform for advisory services on financial instruments under the European Structural and Investment Funds 'fi-compass', www.fi-compass.eu.

financial instruments adhere to those principles becomes increasingly relevant, as we face the critical juncture described above: On the one hand, we witness a growing popularity of financial instruments as state measures, even heightened through the Covid-19 crisis, and, on the other, the EU legislator's effort to review their framework for 'better regulation' alongside their increasing uptake. The thesis therefore aims to reveal flaws and lacunae of the complex framework and to provide insights as to how the latter may be revised and improved, so that the law on financial instruments becomes more consistent, certain, and understandable, and their use more effective and efficient in the end.

2. Relevant questions posed and structure of the thesis

State aid law, as a pillar of EU competition law, is concerned with the control of Member States' interventions through state resources, which grant certain undertakings selectively an advantage and thereby threaten to or distort the internal market.[30] Thus, it is connected to the general principle of proportionality under EU law, which requires that EU and Member State measures must be appropriate and necessary in achieving a legitimate objective, whereby the benefits outweigh the costs of the respective intervention.[31] Translated to state aid law, this means that Member States' aid measures must be appropriate and necessary in order to achieve a legitimate objective and minimise distortions of competition. In the context of financial instruments, this often means that they must be an appropriate and necessary means to the end of tackling market failures, e.g. a funding gap.

As will be elaborated on, the legal field of financial instruments let sprout different legal texts of binding and non-binding nature applicable both at Member State and EU level as well as the decisional practice of the Commission. This complex legal framework lends itself as fertile ground for an analysis of how these state interventions are in proportion to the ends of tackling market failures and minimising market distortions. And crucially, whether this is done in a consistent manner.

[30] Article 107 (1) TFEU.
[31] Case C-331/88, The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health ex parte Fedesa et al [1990] ECR I-4023, para. 13.

The concept of consistency, in its wide understanding, implies both 'the absence of contradictions between rules producing the same result on the same facts or raising similar legal issues', as well as the 'making sense as a set', i.e. being related as a set in a rational and logic manner, instrumentally and intrinsically.[32] This thesis will follow this wide understanding of the term 'consistency', analysing both *ex negativo* the absence of contradictions, i.e. the similar application of principles and rules, as well as *ex positivo* the overall 'making sense' as a legal framework comprising legal texts, EU Courts' judgments, and Commission decisions on financial instruments.

Under the urgency of reviewing the rules of the 2014-2020 programme period, the **central question of this thesis** is framed as follows: How do the binding and non-binding legal texts, the EU Courts, and the Commission ensure the use, i.e. the design and implementation, of financial instruments in accordance with the principles of proportionality and consistency, or put differently:

- **Are financial instruments, in secondary legislation and Commission acts and guidelines inside and outside state aid law, compliant with the principles of proportionality and consistency?**

Several sub-questions will address this overarching question. The **first sub-question** is covered in chapter II and reads as:

- What are the principles of proportionality and consistency under EU law?

This is the theoretical foundation of the thesis and a yardstick to evaluate whether the EU Courts' requirements are reached in the field of financial instruments.

Chapter III will cover the **second sub-question**, which reads as:

- What are financial instruments and what are their different types and rationale?

[32] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.141, and
Neil McCormick, Coherence in Legal Justification, in W Kravietz et al., Theorie der Normen, Duncker & Humblot, 1984, pp. 41-42.

Building on the theoretical foundations of chapters II and III, chapter IV will focus on the content of the legal framework on financial instruments. The thesis's elaboration on the development of state aid rules on risk finance aid as well as on the legal framework of risk finance aid during the 2014-2020 programme period will show that this very framework is rather fragmented, consisting of different legal texts. Why this may be problematic in terms of consistency will also be analysed through the **third sub-question**:

- What is the legal framework of financial instruments and are the provisions for financial instruments in the General Block Exemption Regulation (GBER), the Common Provisions Regulation (CPR), and the Financial Regulation (FR) consistent or do they reveal ambiguities and contradictions?[33]

As chapter IV will explain, state aid comprises the element of an advantage. Chapter V will elaborate on how an advantage through financial instruments may emerge and how it may be found and measured. For instance, aid may address certain market risks. Financial instruments imply, particularly in the form of risk finance measures aimed at young, innovative SMEs, inherent risks amid information asymmetries stemming from the lack of credit history and the uncertainty around the soundness of business plans, for instance.[34] Measuring and pricing these inherent risks may thus be especially difficult. However, the exercise of measuring the aid element of an advantage, and hence calculating and pricing risks, may be an obligatory element of the so-called market economy investor principle (MEIP), the application of which may exclude the presence of aid. The thesis will therefore investigate the following **fourth sub-question** in chapter VII:

- How may an advantage through financial instruments arise and may this aid element be consistently measured and removed through the application of the MEIP?

This question explores how financial instruments contain an advantage. It will be addressed by analysing the conditions of the market economy investor principle (MEIP) laid down by the EU Courts as well as relevant decisions of the Commission on risk finance measures involving the

[33] Commission Regulation (EU) No 651/2014, Commission Regulation (EU) No 1303/2013, and Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union.
[34] European Commission Communication, Guidelines on State aid to promote risk finance investments (2014/C 19/04), introduction, recital 3.

MEIP. This analysis will reveal the approach of the Commission towards the application of the MEIP in practice. It also discusses whether measurement and calculation methods are suitable for financial instruments and risk finance measures amid information asymmetries, and consistent with the EU Courts' requirements.

This thesis will refer to the term 'financial instrument' in accordance with the rules on risk finance measures, including equity, quasi-equity, loans, and guarantees, being implemented through a financial intermediary and leveraging participation by private investors.[35] The thesis' main assessment of proportionality and consistency will rest on the different peculiarities of financial instruments: they imply no underlying identifiable costs, they may be managed and implemented at both EU and Member State level, implying that state aid law may apply or not, they must be implemented by financial intermediaries and leverage private funding, and they imply inherent risk amid information asymmetries.

Contrary to state aid in the form of grants, financial instruments and 'risk finance measures have no underlying identifiable costs, therefore they are not subject to a maximum intensity rate measured as a percentage of the aid amount relative to the eligible costs' in terms of proportionality.[36] It is thus problematic to assess how financial instruments affect markets and competition, i.e. what their potential of market distortion is.

Thus, financial instruments are subject to absolute maximum amounts instead. EU Courts elaborated on the principle of proportionality, including necessity and the balancing of positive and negative effects, in order to assess the potential of market distortions and the lawfulness of state aid in general. Given the problem to assess the potential of market distortions by financial instruments in particular due to their lack of identifiable costs, these principles become even more relevant, so that the **fifth sub-question** posed by this thesis in chapter VI is thus:

- Is the Commission's decisional practice on financial instruments consistent with the requirements of the EU Courts on proportionality under state aid law, including necessity and the balancing of positive and negative effects?

[35] Article 21 of Commission Regulation (EU) No 651/2014.
[36] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.

Thus, the principle of proportionality, including necessity and the balancing of positive and negative effects, of the EU Courts will serve as a benchmark for analysing whether the Commission adheres to or deviates from this principle in its decisions. Moreover, the analysis will reveal whether a consistent logic along the lines of the Courts' requirements on proportionality is discernible. This is relevant since the Commission enshrined this principle in the 'common assessment principles' of its Risk Finance Guidelines. This is also relevant given that it is the sole authority competent 'to assess the compatibility of state aid with the internal market'.[37] It therefore 'cannot control itself', but is subject to the EU Courts' conditions under the proportionality principle.[38]

Regarding their second feature, implementation and management of financial instruments may occur at both Member State and EU level. The sixth sub-question thereby relates to the legal framework of financial instruments implemented and managed exclusively at the EU level: Given that there is no involvement or discretion at the level of Member States in this case, they do not fall under the scope of state aid law. Yet, as market interventions, EU financial instruments are liable to distort the internal market in general. Thus, the thesis poses the following **sixth sub-question** in chapter VII:

- How do the Commission and the EIB/EIF prevent or minimise market distortions by financial instruments at the EU level and are these rules consistent with state aid rules applicable to financial instruments implemented and managed at the Member State level as well as with the EU Courts' requirements on proportionality?

There appears to be no study on how EU institutions, such as the Commission and the EIB, ensure that financial instruments implemented and managed at the EU level prevent the distortion of competition, given that they do not fall under the scope of state aid rules. Hence, the sub-question will analyse which rules, standards, or policies the Commission and other EU institutions apply. That is to ensure that financial instruments implemented and managed at EU level be

[37] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.13.
[38] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.13.

'consistent with state aid rules', as required by law, and to prevent the distortion of competition in the light of the proportionality principle.

These rules will be compared to state aid rules, in particular to those of the GBER and the common assessment principles applied by the Commission in its Risk Finance Guidelines. They will also be critically assessed with regard to the case law of the EU Courts and its requirements on the proportionality principle for state aid, which were established in chapter VI. An analysis of so-called 'off-the-shelf instruments', designed by the Commission as ready to use instruments for Member States for being free of state aid or compatible instruments, will add to answering this sub-question. This will discuss whether their provisions are consistent with those of EU financial instruments, which are designed by the Commission, and the EU Courts' proportionality requirements, too.

Moreover, regarding their third feature, financial instruments under risk finance aid must be implemented through a financial intermediary in accordance with Article 21 (13) GBER and paragraph 20 of the Risk Finance Guidelines.[39] Thus, if a public authority provides funding directly to an undertaking, it is not considered a risk finance measure under the GBER or the Risk Finance Guidelines – hence, it requires 'a different legal basis'.[40] These financial intermediaries thus serve as agents of public authorities, which may have their own agenda and different interests than their principal (the so-called principal-agent problem).

Therefore, financial intermediaries must be held accountable, so that several rules aim at intermediaries via incentives and performance measures. What is more, under Article 21 (15) GBER, financial intermediaries may co-invest own resources with the aim to align interests with the public investor. However, this co-investment might lead to the crowding out of investment by other private investors and may imply a trade-off between co-investing's inherent goal of profit seeking and the very achievement of the public policy objective under the risk finance measure. The **seventh and final sub-question** in chapter VIII is thus:

[39] European Commission, Communication from the Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04).
[40] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.

- Are the accountability rules for financial intermediaries at both the EU and the Member State level consistent and are they apt to achieve public policy objectives and to minimise market distortions?

In the end, this thesis strives to reveal a basis for enhancing the legal consistency and legal certainty of the legal framework on financial instruments with regard to the inherent requirements of the proportionality principle. The thesis will first outlay the concepts of the principles of proportionality and consistency (chapter II), followed by the elaboration on the concept of financial instruments, their different types, and rationale (chapter III).

Moreover, it will discuss the overall legal framework of state aid and financial instruments (chapter IV) and the meaning of the aid element of advantage for financial instruments and the tool of 'removal' through the market economic investor principle (chapter V). The analysis of legal consistency consists of the comparison of the EU Courts' requirements of the MEIP and relevant Commission decisions on its application.

With regard to the application of the proportionality principle in the context of financial instruments, the analysis of legal consistency will rest on the following comparisons. Firstly, of different legal texts of the overall legal framework on financial instruments and risk finance measures (chapter IV on the legal framework). Secondly, of EU Court cases and Commission decisions (chapter VI on the compatibility assessment). Thirdly, of the legal texts and rules applicable to financial instruments implemented and managed at the EU level and those applicable to financial instruments implemented and managed at the Member State level (chapter VII on the rules of state aid law and those for 'state aid consistency' as well as chapter VIII with its focus on the respective accountability rules).

3. Methods and sources

In general, the case law of the EU Courts and Commission decisions, which can be found on their respective websites, the secondary legislation, i.e. the legal framework on financial instruments

and risk finance measures, also available on the Commission's website, and a wide array of literature and guidance (by the Commission and its bodies) were consulted.[41]

With regard to chapters II, III, and IV, concerning the legal framework of financial instruments, relevant provisions of the EU Treaties on state aid and the EU Courts' case law as well as secondary legal sources, in particular the legal texts of the Commission on financial instruments, were selected and analysed. Academic literature complemented this, including standard reference books and journal articles in the field of state aid law and adjacent areas.

For chapter V on the MEIP, the relevant case law of the EU Courts and the legal texts of the Commission on the MEIP were consulted. To analyse and compare the Commission's decisional practice with the requirements of the EU Courts and the Commission's own (soft law) provisions in terms of assessment methods used, relevant and detailed Commission decisions were selected.

Regarding chapter VI on the Commission's compatibility assessment and the EU Court's requirements under the proportionality principle, landmark cases by the EU Courts on the application of proportionality tests under state aid law were analysed. To contrast them with the Commission's decisional practice, three extensive, detailed, and relatively recent Commission decisions were consulted and discussed: The decisions analysed were selected from a plethora of decisions on financial instruments previously consulted based on their extensive compatibility assessment. Moreover, they were selected based on their recent publication, so that the current Risk Finance Guidelines and their compatibility assessment applied, except for Commission decision SA.34660. The latter was selected as it lends itself as a textbook example for the Commission's approach to guarantees in specific as well as to the compatibility assessment during the 2007-2013 programme period in general.

For chapter VII on financial instruments designed by the Commission, with particular regard to financial instruments at the EU level, the Commission's own terms and conditions (the Financial and Administrative Framework Agreement (FAFA) and Delegation Agreements) were analysed and compared with the provisions of state aid law and the EU Courts' requirements on

[41] European Commission, State Aid Overview, https://ec.europa.eu/competition/state_aid/overview/index_en.html, last access: 30.10.2020.

proportionality. The former were found and are available by request via the register of Commission documents on the Commission's website.[42]

Concerning chapter VIII on accountability mechanisms for financial intermediaries, the provisions of the legal texts for financial instruments under state aid law as well as the Commission's terms and conditions for financial instruments at the EU level were consulted and compared.

The following chapter II elaborates on the principles of proportionality and legal consistency, the latter's consequences for legal certainty and economic efficiency, which are intended to serve as a theoretical basis for benchmarking the consistency of state aid rules with the EU Courts' case law. This aims to investigate the overall research question of whether the EU Treaties and secondary legislation, the EU Courts, and the Commission ensure the proportionality of financial instruments in a consistent manner.

Additionally, in order to enrich the theoretical deductions drawn from the analysis of this thesis and to receive practical insights from the experience and expertise of policy makers, expert interviews were conducted, following a Bayesian logic of interference.[43] This means, three policy experts from the field of financial instruments based on reputation and functional roles, namely a legal practitioner of a private firm, another of a European institution, as well as a politician responsible for the funding of German SMEs at the German Ministry of Economics, were selected and interviewed, as they possess privileged perspectives that are apt to refine prior knowledge and insights more significantly, highlighting the relevance of expert interviews thus.[44] Therefore, semi-structured interviews with open-ended questions around the main topics of the thesis's chapters were conducted (see Appendices), so that the conversations could flow naturally, validate the answers given, and refine the analysis of the thesis.[45] The insights gained from the interviews are cited at the relevant parts of the thesis.

[42] European Commission, Register of Commission documents, https://ec.europa.eu/transparency/regdoc/index.cfm?fuseaction=search&language=en, last access: 30.10.2020.
[43] James Mahoney, Mechanisms, Bayesianism, and Process Tracing, New Political Economy 21 (5), 2016, pp. 493-99.
[44] Oisín Tansey, Process Tracing and Elite Interviewing: A Case for Non-probability Sampling, Political Science & Politics 40 (04), 2007, pp. 766, 767.
[45] Beth Leech, Asking Questions: Techniques for Semistructured Interviews, Political Science & Politics 35 (4), 2002, pp. 665-68, and Uwe Flick, An Introduction to Qualitative Research, SAGE, 2014, pp. 156ff.

II. The Principles of Proportionality and Consistency in EU Law

The consistency of the framework of financial instruments under EU state aid law and the requirements of the EU Courts on the principle of proportionality are the concern of this thesis. Thus, the thesis analyses whether the legal framework of financial instruments provides for the proportionate design and implementation of these in a consistent manner and whether the Commission adheres to the principles of proportionality and consistency in accordance with the EU Courts' requirements. Regarding the latter, the thesis investigates whether the Commission in its decisional practice of the assessment of Member State measures and in its own rules on financial instruments set up at the EU level adheres to the Courts' proportionality requirements. In the following, firstly, the principle of proportionality (section 1) and, secondly, the principle of consistency will be elaborated on (section 2). These will serve as the theoretical basis for analysing the legal frameworks of both Member State financial instruments and EU financial instruments as well as Commission decisions on the former. Hence, this chapter will address the following sub-question:

- What are the principles of proportionality and consistency under EU law?

1. The principle of proportionality

The proportionality principle may be the 'most important general principle in the field of EU economic law due to the absence of a thorough system of EU administrative law', as 'it judges measures by the relationship between the objective pursued and the methods used'.[46] A principle of law is 'an ideal of reason and/or of justice, which… is presumed to form the basis of the very institution of law' and as part of the reasoning of the court 'can form the basis of expectations as to how the court will solve similar cases in the future'.[47] This serves the predictability and legal certainty and hence the legitimacy of the law.[48] As a general principle of law, 'it is inherent in a

[46] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 441 , citing J Schwarze, European Administrative Law, Sweet & Maxwell, 2006, pp. 664, 665.
[47] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 159.
[48] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 162.

series of infinite applications of the law' and 'perceived as having some universal quest', so that it is present in national and international systems of law.[49]

Today, the principle is explicitly stated in the EU Treaties, namely in Article 5 (4) TEU: 'Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties. The institutions of the Union shall apply the principle of proportionality as laid down in the Protocol on the application of the principles of subsidiarity and proportionality.' Moreover, it is present 'in an array of Treaties' Articles', e.g. in Articles 12 and 69 TFEU as well as in Articles 276 and 296 TFEU.[50]

The proportionality principle may be considered a 'conflict rule', as 'it is applied in judicial procedures to manage disputes involving an alleged conflict between two rights claims, or between a rights provision and a state/public interest', the latter of which applies to the area of state aid law.[51] The principle serves as a framework for determining 'whether and/or to what extent rights can be limited by governmental intervention (such as legislation) that is motivated by public interests'.[52] It may be invoked to challenge actions of both the EU and Member States.[53] The proportionality principle is derived from the laws of the Member States (*Verhältnismäßigkeit* in German law and various general principles of French administrative law) and, together with supremacy, direct effect, and state liability, forms one of the core general principles in EU law.[54]

1.1. The development of proportionality in EU administrative law and its elements

At the European level, its development hailed from the constitutional review of public acts, i.e. the 'review of the legality of secondary EU law and of the compatibility with EU law of national law that falls within the scope of EU law'.[55] Vis-à-vis the doctrines of supremacy and direct effect, the proportionality principle may be regarded as a counterpart, as it concerns 'the establishment

[49] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 159.
[50] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.617.
[51] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 164.
[52] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 440.
[53] Paul Craig, EU Administrative Law, Oxford Scholarship, 2018, p. 642.
[54] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 442.
[55] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 443.

of limits of EU law' and the 'balancing between different rights and principles in EU law' rather than claims to EU level competence (as do the former).[56] The proportionality principle was recognised by the EU Courts early on 'as being a principle of fundamental nature for the EU legal order'.[57] The EU Courts stated that the proportionality principle 'is amongst the unwritten general principles of Community law because it is widely shared across the legal orders of the Member States'.[58]

In EU law, the proportionality principle applies to acts at both the EU and the Member State level and its test reviews the consistency with EU law.[59] At the EU level, the review concerns secondary measures and their compatibility with the EU Treaty rules, while at the Member State level, the implementation of EU measures as well as the compatibility of national measures with EU law are assessed.[60] At the EU level, the first application of the proportionality test may be found in the case *Internationale Handelsgesellschaft* in the context of the common agricultural policy and fundamental rights, where the Court did not explicitly mention the term proportionality in its reasoning, but applied the test of necessity and appropriateness to the EU measure.[61]

At the Member State level, the Court assessed in the case *Cassis de Dijon* for the first time whether a national measure invoking an exception to EU law was proportionate and held that minimum alcohol content requirements of German law were not.[62] Since then, the EU Courts highlighted the importance of the proportionality principle in their case law, which requires 'that acts of the EU institutions be appropriate for attaining the legitimate objectives pursued by the

[56] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, pp. 444, 445.
[57] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.618,
and case C-25/70, Einfuhr und Vorratsstelle für Getreide und Futtermittel (Frankfurt) v Köster, Berodt u. Co. [1970] I-1161.
[58] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.619,
and case C-108/63, Officine elettromeccaniche A. Merlini v High Authority ECSC [1963] para. 3.
[59] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 445.
[60] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 445.
[61] Case C-11/70, Internationale Handelsgesellschaft bH v Einfuhr- und Vorratsstelle für Getreide und Futtermittel [1970] ECR 1125, para. 12.
[62] Case C-120/78, Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein (Cassis de Dijon) [1979] ECR 649, paras. 12-14.

legislation at issue and do not exceed the limits of what is appropriate and necessary in order to achieve these objectives'.[63]

The constitutional theorist Robert Alexy described proportionality as the 'law of the balancing', which 'requires the increasing intensity of interference with liberty to be matched by an increasing weight of reasons justifying the interference'.[64] The proportionality test is thus understood to comprise three rules: 'first, the value of interference of the individual interest; second, the value of satisfying the public interest; and, third, whether the importance of satisfying the public interest can justify the detriment to the individual's right'.[65] This is considered a 'weighted test', since values may be assigned, ranging from light to intermediate and serious, the ranking of which may render balancing decisions more rational.[66]

The Court elaborated in the case *Fedesa* on the proportionality principle and its elements: 'The Court has consistently held that the principle of proportionality is one of the general principles of Community law. By virtue of that principle, the lawfulness of the prohibition of an economic activity is subject to the condition that the prohibitory measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question; when there is the choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued.'[67]

Thus, in *Fedesa*, the four elements of proportionality in its broad sense were outlined, under which the first three steps form the necessity test and the fourth step forms the balancing test under proportionality in the strict sense: under the proportionality principle, there must be

(i) an appropriate (or suitable) measure (the so-called suitability or appropriateness test, which refers to the relationship between the means and the end),

[63] Case C-8/55, Fédération Charbonnière [1956] ECR 1956 I-302, para. 311, case C-491/01, British American Tobacco [2002] ECR 2002 I-11550, para. 122, case C-343/09, Afton Chemical, [2010] ECR 2010 I-7062, para. 45, case C-293/12, Digital Rights and Others [2014] EU:C:2014:238, para. 46.
[64] Robert Alexy, A Theory of Constitutional Rights, Oxford University Press, 2002, p. 231.
[65] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 441.
[66] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 441.
[67] Case C-331/88, The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health ex parte Fedesa et al [1990] ECR I-4023, para. 13.

(ii) in pursuit of a legitimate objective (the test of legality is sometimes not counted as a separate step),

(iii) that is the least restrictive measure among the appropriate measures (the so-called necessity test or least restrictive means test),

(iv) and that is not manifestly disproportionate in terms of a costs versus benefits balance (the so-called proportionality test *stricto sensu* or manifestly disproportionate test).[68]

Importantly, not all steps are applied in practice and the 'least restrictive means' and the 'manifestly disproportionate test' are often applied alternatively rather than complimentarily, and even if proportionality in the strict sense is applied, 'an explicit balancing of costs versus benefits is rare'.[69] The 'manifestly disproportionate test', on the other hand, represents a broader and less strict test, leaving 'a relatively wide margin of discretion to the authorities', the measures of which are under review.[70] The use of the different kinds of proportionality tests 'is as varied as it is widespread', and according to de Búrca, 'the way the proportionality principle is applied by the Court of Justice covers the spectrum ranging from a very deferential approach to quite a rigorous and searching examination of the justification for a measure which has been challenged'.[71]

Sauter argues that EU institutions are usually subject to the so-called 'manifestly disproportionate test' as opposed to Member States, which are subject to the so-called 'least restrictive means test'.[72] As stated, under the broad concept of proportionality, necessity and proportionality in the narrow sense as balancing are inter-linked.[73] This stands in contrast as to how the proportionality test is often applied in practice, where 'proportionality in the narrow sense is often skipped and

[68] Case C-331/88, The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health ex parte Fedesa et al [1990] ECR I-4023, para. 13
and Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 448,
and Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 165.
[69] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 448.
[70] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 448.
[71] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 464,
and Gráinne de Búrca, The Principle of Proportionality and its Application in EC Law, Yearbook of European Law, 1993, p. 111.
[72] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 445.
[73] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 447.

necessity generally forms the substance of the test at the national level, whereas only a mild form of balancing is applied at the EU level instead'.[74]

As Sauter, Tridimas finds that EU measures are generally reviewed under the manifestly disproportionate test, while Member State measures are under the least restrictive means test.[75] This limited judicial review in favour of the EU legislature and executive may be due to an 'integration bias' of the EU Courts, according to him.[76] Thus, as to EU measures, the Court will declare them non-compliant, 'if it finds them manifestly inappropriate to achieve the goal proposed'.[77] It may be derived that the Courts apply the proportionality test *stricto sensu* whenever they find it suitable to 'promote the desired outcome'.[78] Thus, 'the proportionality principle is interpreted weakly, providing great leeway for arguments supportive of public interest' or European (market) integration.[79] A measure would hence be considered non-compliant only, if it were found to be manifestly inappropriate.[80] In sharp contrast, as to Member State measures, the Court takes a stricter approach and declares these non-compliant, if it finds that the Member State (authority) did not select the least restrictive alternative.[81]

Whether the proportionality assessment is conducted *stricto sensu* through the manifestly disproportionate test or through the least restrictive means test is thus connected to the constitutional question of the distribution of competences between the EU Courts and the Commission. The Commission 'as the initial decision-maker develops the general policy' in the area of state aid, whose 'decisions are subject to judicial review' by the EU Courts.[82] The latter are 'mindful of the complex evaluations of social and economic data involved, and they will not, therefore, substitute their view for that of the Commission', which possesses wide discretion.[83]

[74] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 447.
[75] Takis Tridimas, The General Principles of EU Law, 2nd edn, Oxford University Press, 2006, p. 138.
[76] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, pp. 452, 465.
[77] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 172.
[78] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 172.
[79] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, pp. 180, 181.
[80] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 180.
[81] Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 172.
[82] Paul Craig and Gráinne de Búrca, EU Law – Text, Cases, and Materials, Oxford University Press, 2008, p. 1084.
[83] Paul Craig and Gráinne de Búrca, EU Law – Text, Cases, and Materials, Oxford University Press, 2008, p. 1084.

[84] Therefore, the judicial review by the EU Courts is limited, as they confine their review 'to determining whether the rules governing procedure and the requirement for a statement of reasons have been complied with, whether the facts are accurately stated and whether there has been any manifest error of assessment or any misuse of powers'.[85] The core idea behind this reasoning is that 'where the Treaties explicitly or implicitly accord a broad discretion to the legislative institutions or the administration, the Courts should be wary of the substituting their judgment for that of the primary decision-maker under the guise of proportionality'.[86]

In the assessment of proportionality, the EU Courts thus take into account the 'relative expertise, position, and overall competence' of the Commission as the primary decision-making authority, so that they would not 'substitute their judgment for that of the administration'.[87] Thus, the EU Courts are inclined to 'apply the [proportionality] concept less intensively' and 'will only overturn the policy choice if it is clearly or manifestly disproportionate', and importantly, 'this is more especially so where the policy choice required the weighing of complex variables'.[88]

This serves as a strong argument in favour of the application of the manifestly disproportionate test in the area of state aid law and financial instruments. As it will be seen, the EU Courts require the Commission to conduct their proportionality assessment *stricto sensu*, i.e. the Commission must assess the balance of positive and negative effects of the aid measure in question, if the negative effects (manifestly) outweigh the negative ones, next to its necessity and suitability. The EU Courts in turn are required to review whether the Commission indeed conducts such a proportionality test *stricto sensu* vis-à-vis both Member States and EU institutions implementing and managing financial instruments at the EU level (e.g. the European Investment Fund).

Sauter also brings into play the 'degree to which a certain policy domain has been harmonised – or pre-empted by the EU level', i.e. 'the degree to which a common policy exists and/or the degree to which the Member States have acceded to a common regime corresponds to the reduction of

[84] Thus, the Commission can develop its substantive policy through formal legislation (e.g. Commission Regulations), informal rule-making (e.g. guidelines and notices), as well as through individual decisions (which it may structure through guidelines). - Paul Craig and Gráinne de Búrca, EU Law – Text, Cases, and Materials, Oxford University Press, 2008, p. 1085.
[85] Case T-171/02 Regione Autonoma della Sardegna v Commission [2005] ECR II-2123, para. 97.
[86] Paul Craig, EU Administrative Law, Oxford Scholarship, 2018, p. 653.
[87] Gráinne de Búrca, The Principle of Proportionality and its Application in EC Law, Yearbook of European Law, 1993, p. 111, and Paul Craig, EU Administrative Law, Oxford Scholarship, 2018, p. 644
[88] Paul Craig, EU Administrative Law, Oxford Scholarship, 2018, p. 644.

scope for independent action, even in pursuit of a legitimate objective', so that 'in the absence of harmonisation, the LRM [least restrictive means] test is unlikely to be applied to the action of the Member States'.[89]

1.2. Proportionality as a principle of economic efficiency

In the context of competition law, Portuese recognises the principle of proportionality, and especially proportionality *stricto sensu* and its cost benefit analysis, as a principle of economic efficiency incorporated into law.[90] This is the case as 'the proportionality principle requires balancing divergent values as to minimise the administrative burden of a proposed regulation inflicted on the society with respect to any other potentially proposed regulation'.[91] The cost benefit analysis can be described 'as being the aim to maximise the present value of all benefits less that of all costs, subject to specified constraint' and its rationale 'lies in the idea that things are worth doing, if the benefits resulting from doing them outweigh their costs'.[92] It means a calculation 'carried by public authorities so that the regulations these authorities enact are economically justified' and the cornerstone of welfare economics.[93]

The necessity test may be regarded as an effectiveness test, since 'the means chosen are accepted only because they contribute to the effective realisation of the ends', the less restrictive means test as 'tackl[ing] superfluous regulatory means that would… incur superfluous costs', which both strive for the minimisation of costs only.[94] In contrast, the proportionality test *stricto sensu* may be considered 'encapsulating the cost benefit analysis' as an 'economic efficiency test' for striving for 'the maximisation of net benefits' (aggregate benefits minus aggregate costs).[95]

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[89] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 453.
[90] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.613.
[91] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.617.
[92] Amartya Sen, The Discipline of Cost-Benefit Analysis, The Journal of Legal Studies, 2000, p. 934,
and Alan Prest et al., Cost-Benefit Analysis: A Survey, Economic Journal, 1965, p. 685.
[93] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.614.
[94] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.620.
[95] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.620.

In the wording of the Courts, the necessity test means that 'in order to establish whether a provision of Community law complies with [the principle of proportionality], it must be ascertained whether the means which it employs are suitable for the purpose of achieving the desired objective…', the less restrictive means test 'when there is a choice between several appropriate measures, recourse must be had to the least onerous', and the proportionality test *stricto sensu* that 'the disadvantages caused must not be disproportionate to the aims pursued'.[96]

Being an analytical tool, however, it is criticised for falling short of solving 'the problem of quantification of both costs and benefits' and for implying the 'bias against the benefits of the regulation because they are more problematically quantified than the respective costs of the regulation'.[97] In the context of law, 'a legal rule shall be more detailed, more burdensome as long as the marginal benefit of this additional legal prescription is greater than the marginal cost associated with this legal move, so that this legal outcome entails the greatest net benefits from a utilitarian viewpoint'.[98] The cost benefit analysis in the legal area in general and with regard to financial instruments in particular thus means 'weighing the benefits against the costs of a state intervention' for 'correcting market failures'.[99] With regard to Member State measures, 'the marginal costs of national measures must not be greater than [their] marginal benefits for the obtainment of optimal regulations, otherwise the national measures are struck down by the Court'.[100]

1.3. The highlighted importance of proportionality in EU and national law

The importance of proportionality in the realm of EU law is highlighted by the recent judgment of the EU Courts in *Weiss* on the Public Sector Purchase Programme (PSPP) of the European Central Bank, where the Courts made clear that every EU act 'should be suitable for attaining the legitimate objectives pursued by the legislation at issue and should not go beyond what is

[96] Case C-84/94, United Kingdom of Great Britain and Northern Ireland v Council [1996] I-5755, para. 57;
joined cases C-254, 255, 269/94, Fattoria autonoma tabbachi et al v Ministerio dell' Agricolture e delle Foreste et al [1996] ECR I-4235, para. 55; and case T-13/99, Pfizer Animal Health SA v Council [2002] II-03305, para. 12.
[97] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.616.
[98] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.616.
[99] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.615.
[100] Aurelien Portuese, Principle of Proportionality as Principle of Economic Efficiency, European Law Journal, vol. 19 no. 5, 2013, p.630.

necessary to achieve those objectives'.[101] However, and importantly, the German Federal Constitutional Court in its judgment of May 2020 came to the conclusion that the EU Courts did not adhere to the requirements of the proportionality principle in *Weiss*: 'This view [of the EU Courts] manifestly fails to give consideration to the importance and scope of the principle of proportionality (Article 5 (1) second sentence and Article 5 (4) TEU)… given that it completely disregards the actual effects of the PSPP.'[102]

Moreover, it heavily criticised the EU Courts, since 'the view of proportionality is rendered meaningless, given that suitability and necessity of the PSPP are not balanced against the economic policy effects – other than the risk of losses – arising from the programme… and that these adverse effects are not weighed against the beneficial effects the programme aims to achieve'.[103] Thus, the German Federal Constitutional Court highlighted the importance of the weighing of negative and positive effects of EU acts for the fulfilment of the proportionality requirements. For failing to fulfil these requirements in *Weiss*, the German court came to the conclusion that the EU Courts even acted *ultra vires*, since the judgment caused 'a structurally significant shift in the order of competences to the detriment of Member States' as 'Masters of the Treaties'.[104]

Given this renewed emphasis on the importance of the proportionality principle under EU law, the thesis will investigate which approach the EU Courts in their case law and the Commission in its decisions take on the proportionality of financial instruments and risk finance aid and if the latter's approach is consistent with that of the EU Courts. In particular, it will analyse, if the Commission applies different approaches, mechanisms, and methods at both the EU level and the Member State level to ensure that financial instruments are proportionate and minimise market distortions. Chapter VI will therefore enquire, if the Commission's compatibility assessment in its decisions is in accordance with the requirements of the EU Courts. Chapter VII

[101] Case C-493/17 Weiss and Others [2018] EU:C:2018:1000, para. 72, citing case C-62/14 Gauweiler and Others [2015] EU:C:2015:400, para. 67.
Importantly, the German Federal Constitutional Court in its judgment of May 2020 heavily criticised the EU Courts for failing to consider the economic effects of the programme and thus to adhere to the proportionality principle in the very judgment of *Weiss*. – BverfG, Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15 -, paras.167-179.
C-331/88 The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health ex parte Fedesa et al [1990] ECR I-4023, para. 13.
[102] BverfG, Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15 -, para. 119.
[103] BverfG, Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15 -, para. 133.
[104] BverfG, Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15 -, paras. 154 and 157.

will analyse, if the Commission's approach to its rules applicable to financial instruments at the EU level towards 'consistency with state aid rules' is different than its approach to financial instruments at the Member State level. Chapter VIII will investigate, if accountability rules for financial instruments as tools of proportionality are consistent.

This thesis thus poses the following questions: How strictly is the proportionality principle applied, respectively? Is it the same test for both financial instruments implemented and managed both at the Member State level and the EU level, respectively? And is it applied in a consistent manner? The following section will elaborate on the principle of consistency.

2. The principle of consistency

The second principle of importance for this thesis is the principle of consistency under EU law. Historically, the principle of consistency in EU law stems from the field of external relations, aiming to prevent contradictions in the interaction within the dual-system between 'the supranational external relations of the European Community and the distinct intergovernmental foreign policies of the European Political Cooperation'.[105] However, with the ratification of the Treaty of Lisbon, two provisions have found entry at the Treaty level, requiring consistency to be achieved 'both more generally as between all EU policies (both internal and external) as well as more specifically in the field of external relations' (Article 7 TFEU and Article 21 (3) TEU, respectively):[106] The Treaty of Lisbon refers in several provisions to 'consistency' 'as a main objective or as a path to achieve legal certainty and coherence'.[107] [108] It appears that the Treaty of Lisbon has elevated the principle of consistency 'to standing as one of the central regulatory principles of EU cooperation'.[109]

[105] Christian NK Franklin, The Burgeoning Principle of Consistency in EU Law, Yearbook of European Law, Vol. 30, No. 1, 2011, pp.43 and 83.
[106] Christian NK Franklin, The Burgeoning Principle of Consistency in EU Law, Yearbook of European Law, Vol. 30, No. 1, 2011, p.83.
[107] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, Vrije Universiteit Amsterdam, 2013, https://research.vu.nl/en/persons/ester-herlin-karnell/publications/?page=1, last access: 12.05.2019.
[108] First and foremost, Article 7 TFEU stipulates that the EU 'shall ensure consistency between its policies and activities, taking all of its objectives into account and in accordance with the principle of conferral of powers'.
[109] Christian NK Franklin, The Burgeoning Principle of Consistency in EU Law, Yearbook of European Law, Vol. 30, No. 1, 2011, p.84.

Consistency implies that two rules 'produce the same result on the same facts or raise similar legal issues'.[110] Instead of the term consistency, different language versions of EU legal texts use the term coherence ('*Kohärenz*', '*samenhang*', '*cohéherence*').[111] Coherence may be defined as follows: 'The coherence of norms is a matter of their "making sense" by being rationally related as a set, instrumentally or intrinsically, either to the realisation of some common value or values; or to the fulfilment of some common principle or principles'.[112] In contrast to this definition *ex positivo* of the term coherence, the term consistency is often defined *ex negativo* in EU law as the absence of contradictions.[113] This means, a differentiation may be made between a narrow and a wide definition of consistency, the former meaning the mere absence of contradictions and the latter the presence of positive connections, respectively.[114]

Furthermore, its notion may be 'concerned with the symmetry of all components of a given legal system', i.e. the wide definition of consistency, which may also be labelled 'strategic consistency', representing 'consistency and "a single vision of justice" or, in other words, integrity'.[115] Thus, the broad interpretation of consistency may be considered synonymous with the broader notion of coherence, as it is understood in the English language.[116] As opposed to the narrow definition of consistency (i.e. two rules either contradict each other or not), academia agrees that its broad definition may be fulfilled in degrees, e.g. normative coherence may be 'used to evaluate the various arguments put forward in an attempt to justify single decisions'.[117] This evaluation implies a weighing or balancing of arguments coherence is based upon: 'it is arguably the sum of this balancing out of relevant justificatory arguments that may be said to lead to a sufficient degree

[110] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.141.
[111] Julian Langer and Wolf Sauter, The Consistency Requirement in EU Internal Market Law: Last Refuge of the Unimaginative or Legal Standard for Rational Administration?, TILEC Discussion Paper, 2016, p.2, https://papers.ssrn.com/abstract=2815893, last access: 12.05.2019.
[112] Neil McCormick, Coherence in Legal Justification, in W Kravietz et al., Theorie der Normen, Duncker & Humblot, 1984, pp.41-42.
[113] Geert de Baere, Constitutional Principles of EU External Relations, Oxford University Press, 2008, p.251;
and Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.141.
[114] Geert de Baere, Constitutional Principles of EU External Relations, Oxford University Press, 2008, p.251;
and Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.141.
[115] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.142.
[116] Christian NK Franklin, The Burgeoning Principle of Consistency in EU Law, Yearbook of European Law, Vol. 30, No. 1, 2011, p.47.
[117] Christian NK Franklin, The Burgeoning Principle of Consistency in EU Law, Yearbook of European Law, Vol. 30, No. 1, 2011, p.48.

of coherence being achieved or not'.[118] The factors that are 'deemed capable of contributing towards the achievement of a sufficient degree of coherence… may naturally vary from one case to another'.[119]

2.1. The principles of consistency and legal certainty and their relation to economic efficiency

In the context of EU law, consistency may be further defined as 'vertical consistency based on clear competence delimitation and conflict prevention/resolution between the EU and Member States' legal orders' as well as differences the implementation as opposed to 'horizontal consistency based on cooperation between the institutional actors involved in EU decision making'.[120] Thus, consistency 'is reflected in the notions of loyalty and primacy' with regard to vertical consistency 'as well as in the broader principles of good administration and good governance related to openness, transparency, and accountability to democratic institutions' with regard to horizontal consistency.[121] Furthermore, the notion of consistency is 'anchored in the judicial interpretation of the CJEU', a lack of which would result in legal uncertainty and thus have an adverse effect on, for instance, the rights of private and legal persons, fair competition, and the functioning of the internal market.[122]

The principle of legal consistency is thus related to the principle of **legal certainty**: both principles are concerned with the correct management of (legal) expectations in order to 'build confidence in the overall legal system', i.e. they aim for 'legal effectiveness and a transparent, predictable, and coherent legal framework', from which 'legal subjects may draw expectations'.[123] Hence, both principles entail predictability as their aim and call 'for choosing the right legal rules to a factual situation that is predictable'.[124] As such, legal certainty may 'entail a requirement for legal

[118] Christian NK Franklin, The Burgeoning Principle of Consistency in EU Law, Yearbook of European Law, Vol. 30, No. 1, 2011, p.48.
[119] Christian NK Franklin, The Burgeoning Principle of Consistency in EU Law, Yearbook of European Law, Vol. 30, No. 1, 2011, p.48.
[120] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.142.
[121] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.142.
[122] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.143.
[123] Pablo Martín Rodríguez, The Principle of Legal Certainty and the Limits to the Applicability of EU Law, Cahiers de Droit Europeen, 2015, p.118.
[124] Aurelien Portuese et al., The Principle of Legal Certainty as a Principle of Economic Efficiency, European Journal of Law, European Journal of Law and Economics, 2017, vol. 44, issue 1, No 7, p.132.

coherence', e.g. 'legal coherence requires the withdrawal of a meaningless act or of an act in contradiction with other provisions'.[125]

In terms of the nexus between predictability of legal acts and **economic efficiency**, 'legal uncertainty by legal inconsistency or legal unintelligibility increases reliance costs', i.e. 'when laws are poorly written or when they are hardly understandable, economic actors refrain from relying optimally on these laws and thus bear some ex post costs of interpretation that are greater than the saved costs of drafting ex ante'.[126] Thus, 'precise legal rules (creating greater ex ante drafting costs) may be preferred from an efficiency viewpoint over vague standards (creating greater repeated ex post litigation and correction costs)'.[127] Therefore, with regard to the drafting of legal acts, the EU Courts require that 'legal acts must be written using a language that must clearly and coherently detail the elements of fact and law necessary to implement and understand the legal provisions'.[128] Thus, from the (economic) perspective of legal subjects, 'the requirement of clarity [and consistency] in legal language [and drafting] increases predictability in legal relationships for individuals, but also reduces the asymmetric information that may arise between law-maker and those subject to the laws enacted'.[129]

In order to enhance the so-called 'productive efficiency' of EU laws by the EU legislator, the ECJ sets 'the procedural and formal conditions laid out in terms of clarity, consistency, and non-retroactivity of EU law'.[130] Hence, in the context of legal drafting, the principle of consistency may be interpreted 'not only as consistency of content (i.e. coordination and avoidance of contradictions), but also as consistency of logic (consolidation) and goals'.[131] Regarding the latter, consistency is paramount for the adoption of 'smart' EU regulation vis-à-vis enterprises and industry.[132] Hence, the Commission undertakes 'fitness checks' in order to assess 'whether the

[125] Aurelien Portuese et al., The Principle of Legal Certainty as a Principle of Economic Efficiency, European Journal of Law, European Journal of Law and Economics, 2017, vol. 44, issue 1, No 7, p.135.
[126] Aurelien Portuese et al., The Principle of Legal Certainty as a Principle of Economic Efficiency, European Journal of Law, European Journal of Law and Economics, 2017, vol. 44, issue 1, No 7, p.138.
[127] Aurelien Portuese et al., The Principle of Legal Certainty as a Principle of Economic Efficiency, European Journal of Law, European Journal of Law and Economics, 2017, vol. 44, issue 1, No 7, p.138.
[128] Case C-55/69, Cassella Farbwerke Mainkur AG v Commission [1972] para. 63.
[129] Aurelien Portuese et al., The Principle of Legal Certainty as a Principle of Economic Efficiency, European Journal of Law, European Journal of Law and Economics, 2017, vol. 44, issue 1, No 7, p.142.
[130] Aurelien Portuese et al., The Principle of Legal Certainty as a Principle of Economic Efficiency, European Journal of Law, European Journal of Law and Economics, 2017, vol. 44, issue 1, No 7, p.149.
[131] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.146.
[132] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.146.

regulatory framework for a policy sector – as opposed to an individual piece of legislation – is fit for purpose and to identify excessive administrative burdens, overlaps, inconsistencies or obsolete measures'.[133]

Thus, in terms of excessive burdens and economic efficiency, 'the need for clear and precise laws lowers information costs for those subject to these laws', which are, in the case of state aid rules on financial instruments, the Member States and their authorities implementing financial instruments, investors, and undertakings as final recipients of the aid vis-à-vis the EU legislator.[134]

2.2. The principle of consistency in the EU Treaties

In the Treaties, Article 7 TFEU contains the first reference to consistency, stipulating that the EU 'shall ensure consistency between its policies and activities, taking all of its objectives into account and in accordance with the principle of conferral of powers'. With regard to the conferral of powers and the EU's necessity to act based on a specific legal basis and thus intra vires, Article 7 TFEU 'therefore aims at tackling complexity and legitimacy gaps, the permanent features of multi-level governance'.[135] Importantly, while Article 7 TFEU presents the destination of the consistency principle, i.e. that the EU 'shall ensure consistency between its policies and activities', 'but provides no particular instructions on how to reach it'.[136] Thus, consistency may be considered a symbolic concept of 'making the EU more relevant and comprehensive to its citizens'.[137]

Importantly, the EU Courts in the case *Front Polisario v Council* interpreted consistency *ex negativo*: 'The supposed inconsistency with of an act with the policy of the European Union in a given area necessarily implies that the act concerned is contrary to a provision, rule or a principle which governs that policy', and by referring to Article 7 TFEU, 'that fact alone… would be sufficient

[133] The European Commission, https://europa.eu/rapid/press-release_MEMO-12-974_en.htm, last access: 18.08.2019.
[134] Aurelien Portuese et al., The Principle of Legal Certainty as a Principle of Economic Efficiency, European Journal of Law, European Journal of Law and Economics, 2017, vol. 44, issue 1, No 7, p.149.
[135] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.145.
[136] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.166.
[137] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.166.

to lead to the annulment of the act concerned, without it being necessary to rely on Article 7 TFEU'.[138]

Moreover, in the case of *Uno di noi*, the EU Courts had to judge on whether the funding of a biotechnological invention that is not patentable under EU law (*in casu* human embryos) violates the principle of consistency, as the applicants stated: '… they argue that the Commission, by suggesting that the European Union should fund research projects that were precluded from patentability under Article 6 of Directive 98/44/EC… grossly disrespects the principle of the duty of consistency enshrined in Article 7 TFEU.'[139] However, the EU Courts made clear that 'contrary to the applicants' claims, the Commission's reasoning is in no way inconsistent, in view of the fact that the question of whether scientific research involving the use (and destruction) of human embryos may be financed by EU funds is clearly separate from the question, dealt with in Directive 98/44… of whether or not a biotechnological invention involving that use is patentable.'[140] Thus, the EU Courts clarified that the principle of consistency requires differentiation, i.e. the EU act of financing projects regarding a subject matter that is curtailed by certain EU rules (here: no patentability) does not violate the principle of consistency, as the subject matters of financing and patentability are separate legal questions.[141]

In the same vein as Article 7 TFEU, Article 13 TFEU stipulates that the EU institutional framework 'shall aim to promote its values, advance its objectives, serve its interests, those of its citizens and those of the Member States, and ensure the consistency, effectiveness and continuity of its policies and actions'. Article 7 and 13 TFEU do not only provide that consistency is relevant as to the EU acting intra vires, 'but that it also forms a significant aid in the drafting and negotiation of EU legislative proposals'.[142] In recent case law, the EU Courts again made clear that the EU, including its institutions, such as the Commission, may incur non-contractual liability under Article 340 (2) TFEU, if a number of conditions are fulfilled: 'The unlawfulness of the conduct alleged against the EU institution, the fact of damage and the existence of a causal link between the

[138] Case T-512/12, Front populaire pour la libération de la saguia-el-hamra et du rio de oro (Front Polisario) v Council of the European Union [2015] ECLI:EU:T:2015:953, para. 153.
[139] Case T-561/14, European Citizens' Initiative One of Us (Uno di Noi) v Commission [2018] EU:T:2018:210, para. 160.
[140] Case T-561/14, European Citizens' Initiative One of Us (Uno di Noi) v Commission [2018] EU:T:2018:210, para. 174.
[141] Case T-561/14, European Citizens' Initiative One of Us (Uno di Noi) v Commission [2018] EU:T:2018:210, para. 174.
[142] Esther Herlin-Karnell et al., The Rise and Expressions of Consistency in EU Law: Legal and Strategic Implications for European Integration, The Cambridge Yearbook of European Legal Studies, Volume 15, 2012-2013, p.145.

conduct of the institution and the damage complained of'.[143] Regarding the first condition, EU Courts require the establishment of a 'sufficiently serious breach of a rule of law intended to confer rights on individuals', which means a high legal hurdle to prove EU institutions' unlawful conduct, as can be seen in the case *Ledra Advertising*.[144]

2.3. The principle of consistency and its meaning in this thesis

In light of the fitness check and the economic efficiency of EU law, this thesis will refer to the notion of 'consistency' in its broader understanding, including both the absence of contradictions between rules producing the same result on the same facts or raising similar legal issues (i.e. the similar application of principles and rules), as well as the making sense of the framework of state aid law on financial instruments, comprising legal texts, EU Courts' judgments, and Commission decisions. A third layer of understanding may be even added to the broad concept of consistency, namely that both the elements of the absence of contradictions and of the 'making sense as a set' 'should serve a clearly identifiable objective and/or set of principles', i.e. a 'goal-oriented or teleological approach' in the light of the proportionality principle and its consistent application, lending legitimacy and effectiveness to EU law.[145]

With regard to the consistency of the legal framework of financial instruments, this thesis assumes that the less ambiguous the legal framework is, the clearer the rules and the more efficient and less costly the design of instruments may be, in particular for practitioners and stakeholders of financial instruments, such as managing authorities. Importantly, if financial instruments are designed in a way consistent state aid rules, the risk of declaration of incompatibility with the internal market by the Commission decreases, of course.

Taking into account the particular features of financial instruments, the concept of consistency in conjunction with proportionality will serve as an analytical 'red thread' throughout this thesis as to whether the overall legal regime and the Commission's decisional practice on financial instruments and risk finance aid live up to the consistent standards required by the EU Courts as

[143] Joined cases C-8/15 P to C-10/15 P, Ledra Advertising et al v European Commission [2016] ECLI:EU:C:2016:701, para. 64, and case C-611/12 P, Giordano v European Commission [2014] EU:C:2014:2282, para. 35.
[144] Joined cases C-8/15 P to C-10/15 P, Ledra Advertising et al v European Commission [2016] ECLI:EU:C:2016:701, para. 65.
[145] Wolf Sauter, Coherence in EU Competition Law, Oxford Studies in European Law, 2016, pp. 9, 10, 14.

regards the proportionality of financial instruments – or whether a piecemeal approach of contradicting and ambiguous legal texts and Commission decisions works to the detriment of a consistent application of proportionate financial instruments.

III. Introduction to Financial Instruments: Rationale and Types

This chapter will first elaborate on the definition, rationale, and premises for intervention of financial instruments (section 1), followed by the differentiation of direct grants and financial instruments as tools of state aid (section 2). Finally, the different types of financial instruments and their characteristics will be explained (section 3). Thus, this chapter will address the following sub-question question:

- What are financial instruments and what are their different types and rationale?

1. Definition, rationale, and premises for intervention of financial instruments

1.1. Definition

The term **financial instrument** is defined in Article 2 (29) of the Financial Regulation, which is applicable to the general budget of the EU and therefore to financial instruments that are implemented and managed at the EU level. It states that '"financial instrument" means a Union measure of financial support provided from the budget to address one or more specific policy objectives of the Union which may take the form of equity or quasi-equity investments, loans or guarantees, or other risk-sharing instruments, and which may, where appropriate, be combined with other forms of financial support or with funds under shared management or funds of the European Development Fund (EDF)'.[146]

The legal texts on state aid, which are applicable to financial instruments implemented and managed by Member States, such as the GBER, the Risk Finance Guidelines, and the CPR, however, merely define the term 'risk finance' instead of the term 'financial instrument' itself. Thus, the GBER defines '**risk finance investment**' as 'equity and quasi-equity investments, loans including leases, guarantees, or a mix thereof to eligible undertakings for the purposes of making new investments' under Article 2 (71) GBER. What becomes clear from Article 21 (3) GBER, moreover, is that '**risk finance aid**' appears to entail an even broader concept covering both

[146] European Parliament and Council Regulation (EU, EURATOM) 2018/1046 on the financial rules applicable to the general budget of the Union, OJ-L 193/30.07.2018.

financial instruments and fiscal instruments: equity, quasi-equity, financial endowment to provide risk finance investment directly or indirectly to eligible undertakings, loans, guarantees, as well as tax incentives for investors who are natural persons.[147] Fiscal instruments are based on the tax system, i.e. they represent tax incentives.[148] Furthermore, and importantly, Article 21 (10) and (13) GBER attach to risk finance aid the conditions of leveraging private investment and the implementation through financial intermediaries, respectively. The RFG in section 2.3. (xxiv) re-iterates the definition of the GBER that risk finance investment means 'equity and quasi-equity investments, loans including leases, guarantees, or a mix thereof, to eligible undertakings' as well as the conditions of implementation through financial intermediaries and of leveraging private investment under its recitals (20) and (23).

The currently valid CPR does not contain any definition of financial instruments.[149] At best, it provides an indirect definition through its elaborations on the features of financial instruments under the CPR in recitals (35) to (45), which are in line with the definition under the GBER and RFG. However, the proposal of the CPR 'valid for the next multi-annual financial framework for the period of 2021-2027' provides a definition of financial instruments under Article 2 (15), which states that these 'mean a structure through which financial products are provided', and Article 2 (16) indirectly defines financial product through referring to the definition under Article 2 of the Financial Regulation.[150]

Thus, while the term 'financial instrument' covers the same financial products under its definition of the FR for financial instruments at EU level and its definition under state aid law for financial instruments at Member State level, it does not translate into the same legal concept, since financial instruments under risk finance aid applicable at the Member State level imply their implementation through financial intermediaries and the leveraging of private investment.

[147] Article 21 (2), (3), and (4) of Commission Regulation (EU) No 651/2014.
[148] Article 21 (4) of Commission Regulation (EU) No 651/2014.
[149] Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund, OJ L 347, 20.12.2013, p. 320–469.
[150] Proposal for Regulation (EU) No 2018/0196 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and financial rules for those and for the Asylum and Migration Fund, the Internal Security Fund and the Border Management and Visa Instrument, https://eur-lex.europa.eu/resource.html?uri=cellar:26b02a36-6376-11e8-ab9c-01aa75ed71a1.0003.02/DOC_1&format=PDF, last access: 26.08.2020.

Thus, aid in the form of financial instruments falls only under risk finance measures in the meaning of the state aid rules on risk finance, if it is not provided directly to a final recipient, but implemented through a financial intermediary (Article 21 (13) of the General Block Exemption Regulation (GBER) and paragraph 20 of the Risk Finance Guidelines), and if it leverages private investor participation (Article 21 (10) GBER, except for guarantees).[151] In the same vein, there may be aid in the form of financial instruments, which is not intended to be a risk finance measure in the meaning of Article 21 GBER or the Risk Finance Guidelines, however, e.g. if no intermediary or leverage of private funding is involved.[152] The right definition is not legal sophistry, but entails legal implications for aid measures that are intended to be financial instruments.[153] A consistent definition may be recommended, applicable to all of the legal texts relevant for financial instruments, which could list the forms of financial instruments as a point of departure, while adding the connection to tax incentives and, more importantly, under which conditions a financial instrument may function as a risk finance measure.

Following the different meanings of financial instruments, depending at which level, they are implemented, Member State or EU level, this thesis will understand financial instruments in the meaning of risk finance aid applicable under state aid rules, implying that they leverage private investment and are implemented through financial intermediaries.

1.2. Rationale and premises for intervention

The overarching **rationale** of financial instruments, particularly in the context of the Cohesion policy of the EU, is the facilitation of access to finance 'through the use of repayable instruments', which 'contributes to sustainable economic growth and employment' by leveraging private funding.[154] They encourage venture capital funds and business angels to invest, which in turn

[151] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.
[152] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.
[153] The consequences of not falling under the definition of risk finance aid are, that the gross grant equivalent of aid embedded in the financial instrument must be calculated, the recipient undertaking must conduct an investment that is eligible to receive aid under current state aid rules, and since financial instruments are repayable, the supported investment projects must be capable of generating sufficient revenue to return at minimum the equity or loan (must be commercially viable), and before the granting authority starts using instruments, it must have requisite know how to assess creditworthiness. - Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.
[154] Fiona Wishlade and Rona Michie, Financial Instruments in 2014-20: learning from 2007-13 and adapting to the new environment, 2014, p.1.

'help firms to invest more, grow more quickly, sustain longterm [sic] performance, obtain higher valuations at exit and bring radical innovations to market faster'.[155] However, 'the European venture capital market has struggled for years with the perception of being a smaller, less successful cousin to the US market'.[156] For instance, the size of US funds is larger than that of their EU counterparts and this 'gap has not narrowed much over time', so that 'their larger size allows US funds to make twice as many investments as European funds, and to invest larger amounts in each portfolio business on average'.[157]

Three premises for intervention underlying this rationale may be discerned. Firstly, since loans, guarantees, equity, and quasi-equity have different features with different advantages and disadvantages, they may be 'adjusted to particular market segments', and may especially provide 'capital to riskier market areas not being serviced previously'.[158] Thus, they may be **designed to address particular market imperfections**, which are due to information asymmetry (e.g. the lack of recipients' credit history) and the lack of regard for positive externalities and wider social benefits (e.g. a lack of investment in R&D constrains the development of new technology benefitting society as a whole).[159] [160] Market failures thus arise in the forms of asymmetric information and adverse selection, monitoring costs, thin or incomplete markets, funding gaps for specific company types, market failures in entrepreneurship, and government failures.[161]

Secondly, financial instruments have a **revolving nature** and may, as **repayable instruments**, improve the quality of investments due to **commercial, profit-seeking** considerations stemming

[155] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 375, referring to Paul Gompers et al., The Venture Capital Revolution, Journal of Economic Perspectives, vol. 15 (2), 2001, pp. 145-168, and Thomas Hellmann et al., The Interaction between Product Market and Financing Strategy: The Role of Venture Capital, Review of Financial Studies, vol. 13 (4), 2000, pp. 959-984.
[156] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 377.
[157] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, pp. 378, 379.
[158] Fi-Compass, Financial Instrument Products, https://www.fi-compass.eu/sites/default/files/publications/ESIF-factsheet-FI-products.pdf, last access: 19.05.2021, pp. 16, 18.
[159] Fiona Wishlade and Rona Michie, Financial Instruments in 2014-20: learning from 2007-13 and adapting to the new environment, 2014, p.1.
[160] The most common sources of market failure may be summarised into nine categories, according to a study conducted for the European Parliament: positive or negative externalities 'that arise where market players do not internalise the whole benefit or cost of their actions', public goods that could result in free rider problems, imperfect and asymmetric information, split incentives arising from different goals and incentives of two parties, unstable markets 'due to non-rational behaviour', government and regulation failure, incomplete property rights and difficulties of enforcement, inequality issues, and incomplete markets and underproduction of merit goods.
- The European Parliament, Financial Instruments: Defining the Rationale for Triggering their Use, October 2017, https://www.ceps.eu/system/files/IPOL_STU%282017%29603787_EN.pdf, p.30, last access: 12.01.2019.
[161] The OEDC and the European Commission, The Theory and Practice of Financial Instruments for Small and Medium-sized Enterprises, 2017, https://www.oecd.org/cfe/regional-policy/Brown_When-to-use-financial-instruments.pdf, pp. 9-14, last access: 22.05.2020.

from the obligation to repay the investment and the due diligence involved in assessing investment proposals, which is often supported by private sector expertise.[162] They are apt to improve the project quality partly through due diligence and, in the context of state aid provisions, the support by private sector expertise is hence complemented by the supply of business plans, monitoring reports, and best practice documentation.[163]

Thirdly, based on their revolving nature, financial instruments may increase the cost-effectiveness of public funds, since repayments may be re-invested and create a mechanism for mobilising private sector finance, i.e. they create a **leverage effect** enabling them to release public and private sector resources.[164] Hence, financial instruments may also facilitate the establishment of public-private partnerships.[165] Another feature of financial instruments, from a legal perspective, is that different levels may (illegally) benefit from aid: investors, financial intermediaries, and final recipients, i.e. undertakings. The legal implications of these different levels will be part of this thesis.

Article 209 of the Financial Regulation (FR) lays down the principles and conditions applicable to financial instruments implemented through the EU budget.[166] Article 209 (1) FR states that they 'shall be used in accordance with the principles of sound financial management, transparency, proportionality, non-discrimination, equal treatment and subsidiarity, and in accordance with their objectives'. According to Article 209 (2) FR, financial instruments must fulfil the following conditions: (a) address market failures or sub-optimal investment situations and provide support in a proportional manner to final recipients that are deemed economically viable, (b) achieve additionality by preventing the replacement of potential support and investment from other public and private sources (crowding-out), (c) not distort competition in the internal market and be consistent with State aid rules, (d) achieve a leverage and multiplier effect, with target range of values based on an ex ante evaluation, by mobilising a global investment exceeding the size of

[162] Fiona Wishlade and Rona Michie, Financial Instruments in 2014-20: learning from 2007-13 and adapting to the new environment, 2014, p.1.
[163] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.27.
[164] Fiona Wishlade and Rona Michie, Financial Instruments in 2014-20: learning from 2007-13 and adapting to the new environment, 2014, p.1, and
The European Parliament, Financial Instruments: defining the rationale for triggering their use, October 2017, https://www.ceps.eu/system/files/IPOL_STU%282017%29603787_EN.pdf, p.26, last access: 12.01.2019.
[165] Gianni Carbonaro, The Role of Financial Instruments in PPP Blended Projects, in European Structural and Investment Funds Journal, Vol. 6, Number 2, 2018, p.111.
[166] Article 209 of Regulation 2018/1046 on the financial rules applicable to the general budget of the Union (ex Article 140 (2) of Regulation No 966/2012).

the Union contribution, including, where appropriate, the maximisation of private investment, (e) be implemented in a way to ensure that there is a common interest of the implementing entities or counterparts involved in the implementation in achieving the policy objectives through, e.g. co-investment, risk sharing requirements, or financial incentives, while preventing a conflict of interests with other activities of the entities or counterparts, (f) provide for remuneration of the Union that is consistent with the sharing of risk among financial participants and the policy objectives of the financial instrument, (g) where remuneration of the implementing entities or the counterparts involved in the implementation is due, provide that such remuneration is performance-based and comprises administrative fees, and where appropriate, policy related incentives, and finally (h) be based on ex ante evaluations.

From an **institutional point of view**, financial instruments may be apt for both 'thousands of quite standardised transactions' as well as 'measures comprising of only a few operations and complex arrangements and compliance issues', highlighting their feature that the specific context matters.[167] Moreover, due to the involvement of the expertise from the private sector, they are apt to partially compensate for weak public administrative capacity as well as to help develop weak financial markets (e.g. through co-financing schemes or the facilitation and expansion of business angel networks and regional venture capital markets).[168]

2. Grants versus financial instruments

In the wider discussion of financial instruments, alternative economic policy instruments in the form of grants merit further explanation. Traditionally, the public sector has applied a wide set of grant instruments, constituting 'transactional forms of support designed to promote certain aspects within companies aimed at improving business performance'.[169] The following section will cover the differences between financial instruments and grants and their history.

[167] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, pp.30,31.
[168] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, pp.30,31.
[169] The OECD and the European Commission, The Theory and Practice of Financial Instruments for Small and Medium-sized Enterprises, 2017, https://www.oecd.org/cfe/regional-policy/Brown_When-to-use-financial-instruments.pdf, p. 23, last access: 22.05.2020.

Although direct grants remain by far the most used aid instrument by Member States, when looked at the evolution of expenditure by aid instrument from 2009 to 2018, representing 61 per cent of the total expenditure, their use of financial instruments has steadily increased over the years to around 5 per cent of total expenditure (in comparison, tax advantages are at 31 per cent).[170] However, another surge in the application of financial instruments may be expected, considering the measures notified in the wake of the Covid-19 crisis in 2020 and 2021.[171]

The Financial Regulation (FR) defines a 'grant' as 'a financial contribution by way of donation', which may be awarded, as financial instruments, either under direct management by the EU or under shared management by Member State authorities (the FR is applicable only to the former).[172] The term 'financial contribution' implies that grants consist not only of money, but may also take the form loans or guarantees.[173] Although the FR applies to grants awarded under direct management by the EU, its concept will be used for the term 'grant' throughout this thesis, pertaining to grants awarded both by the EU and by Member States.

Thus, the fundamental **difference between a traditional grant and the** 'unconventional' measure of a **financial instrument,** is that the latter are **repayable**: the recipient is expected to repay the principle plus a certain profit to the grantor.[174] This includes the remaining claim of the granting authority on the amount transferred to the recipient as well as an inherent risk due to the uncertainty of the actual repayment.[175] Financial instruments **imply no identifiable underlying costs** as such, and are therefore, unlike grants, subject to absolute maximum amounts rather than 'maximum intensity rates measured as a percentage of aid relative to eligible costs'.[176]

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[170] The European Commission, State Aid Scoreboard 2019, https://ec.europa.eu/competition/state_aid/scoreboard/state_aid_scoreboard_2019.pdf, last access: 30.05.2020, p. 20.
[171] Website of the European Commission, https://ec.europa.eu/competition/state_aid/what_is_new/covid_19.html, last access: 30.05.2021.
[172] Articles 2 (33) and 180 of Regulation 2018/1046 on the financial rules applicable to the general budget of the Union (ex Article 140 (2) of Regulation No 966/2012).
[173] Jacobine van den Brink, Requirements under EU Law on the Allocation of scarce European Subsidies, in Willemien den Ouden et al., Scarcity and the State I. The Allocation of Limited Rights by the Administration, Cambridge: Intersentia, 2016, p.130.
[174] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.122.
[175] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.122.
[176] Article 2 (26) GBER defines 'aid intensity' as 'the gross aid amount expressed as a percentage of the eligible costs, before any deduction of tax or other charge'.
Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.

Another difference is that, financial instruments, unlike grants, are **managed and implemented by** fund managers or, more generally, **financial intermediaries** (such as private or state owned banks) rather than by public administrations.[177] Therefore, fund managers receive remuneration, which may consist of management costs and fees.[178] While the former is reimbursed against evidence of expenditure, the latter consists of an agreed price or compensation for services rendered.[179]

Financial intermediaries must be selected through an open, transparent, and non-discriminatory call, according to Article 21 (13) (a) GBER and paragraph 20 of the Risk Finance Guidelines. In contrast, Article 216 of the Financial Regulation allows financial instruments to be directly implemented by the Commission pursuant to Article 62 (1) (a) of the Financial Regulation, rendering direct management possible for financial instruments implemented at the EU level. So far, this is not problematic in terms of consistency. However, Article 38 (4) (d) CPR also allows managing authorities to undertake implementation tasks directly in the case of financial instruments consisting solely of loans or guarantees.

To a certain extent, this contradicts the requirement of indirect implementation via financial intermediaries of the GBER and the Risk Finance Guidelines for risk finance measures, since this leaves merely two options in order to prevent a violation of this requirement: Either direct implementation is avoided altogether or state aid excluded through the fulfilment of the *de minimis* requirements or the market economy investor principle.[180] This is unsatisfactory, since the first possibility, the *de minimis* requirement, sets strict limits to the amount of the funding, which may be far too low for the public policy objective sought, and the second possibility defeats the very purpose of the use of financial instruments by Member States (if market forces worked, no aid would be required).[181] A revised, more consistent provision could stipulate the standard

[177] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.60.
[178] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.60.
[179] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.60, and
the European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, para. 2.2., p.3.
[180] A third option may be that the GGE is calculated and the loan is granted to support investment.
- Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.
[181] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.

case of indirect implementation and allow for the exception of direct implementation through Member State authorities under certain conditions and for certain forms of financial instruments.

From an economic perspective, **grants and financial instruments play different roles**, yet with overlapping purposes.[182] On the one hand, grants are apt to address a range of market imperfections, e.g. the undersupply of public goods or merit goods, externalities such as training or research and development or information asymmetries resulting in insufficient access to capital.[183] On the other hand, financial instruments may only be used for purposes with the 'potential to generate revenue or savings that may be used to repay the original outlay', limiting their use to certain market imperfections, where the private sector may not be willing or able to invest, i.e. those related to externalities (e.g. long-term loans for energy efficiency investment resulting in cost savings and environmental benefits) or information asymmetries (e.g. loans to support training of individuals lacking credit history, equity investment in start-up companies with significant capital requirements and high risk investments).[184]

However, grants may be used primarily, even for revenue generating and savings projects, 'where there is a need for an incentive effect to persuade organisations to undertake initiatives that they would not do otherwise', and may be more efficient 'where there is a small number of small-scale projects involving recipients such as social enterprises who are unused to market-based products'.[185] However, financial instruments under risk finance aid target young, innovative SMEs and leverage private funding, including equity funding from business angels. Thus, it may make more sense to implement grants rather than financial instruments in such cases, where the risk is considered too high, so that any returns of the respective financial instrument may be anticipated to be either too low or highly unlikely at all.[186]

There is the presumption that non-grant instruments facilitate a more effective use of public funding vis-à-vis grants, as the availability of the latter could encourage 'rent seeking' behaviour.[187] Thereby, it is argued that the public actor as the principal 'has little control over the

[182] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.25.
[183] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.25.
[184] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, pp.25, 26.
[185] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.25.
[186] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.28.
[187] Rona Michie and Fiona Wishlade, Between Scylla and Charybdis: Navigating Financial Engineering Instruments through Structural Funds and State Aid Requirements, IQ-Net Thematic Paper No. 29(2), 2011, p.20.

expenditure of the funding' and 'its effective use within the recipient undertaking', and that the latter has 'little skin in the game', so that it 'may be less inclined to maximise the return from the expenditure than if the activities undertaken entailed the use of internal firm resources'.[188] In contrast, the necessity to repay funding of non-grant instruments could encourage recipient undertakings to be 'more "careful" with public money'.[189] There are several studies hinting at unintended consequences altering firms' behaviour, e.g. skewing the firms' reliance towards public sector sources of revenue to the detriment of private revenue sources.[190] 'Repeated aid measures' could result in companies' 'aid mentality that harms productive efficiency'.[191]

In its Risk Finance Guidelines, also the Commission poses the 'general presumption' that financial instruments were less distortive than direct grants and therefore constituted a more appropriate instrument.[192] However, it does not back up this presumption. One explanation may rest on their design, according to the European Parliament: For instance, financial instruments are 'accompanied by procedures to ensure that those instruments are not crowding out private finance, but rather are complementing it'.[193] However, there appears to be no empirical evidence so far that financial instruments incentivise companies more than grants or that projects backed by financial instruments were more successful in terms of efficiency and effectiveness. Thus, studies and evaluations should investigate the reliability of this presumption.

Both grants and financial instruments may be used for the European Structural and Investment Funds under the framework of the Common Provisions Regulation (CPR), which 'sets out a Common Strategic Framework as a strategic guide for the ESI funds at European level, requires Member States to draft one common document for the ESI funds at national level: the Partnership Agreement, [and] defines common standards for all their programmes'.[194]

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[188] The OEDC and the European Commission, The Theory and Practice of Financial Instruments for Small and Medium-sized Enterprises, 2017, https://www.oecd.org/cfe/regional-policy/Brown_When-to-use-financial-instruments.pdf, p. 23, last access: 22.05.2020.
[189] Rona Michie and Fiona Wishlade, Between Scylla and Charybdis: Navigating Financial Engineering Instruments through Structural Funds and State Aid Requirements, IQ-Net Thematic Paper No. 29(2), 2011, p.20.
[190] The OEDC and the European Commission, The Theory and Practice of Financial Instruments for Small and Medium-sized Enterprises, 2017, https://www.oecd.org/cfe/regional-policy/Brown_When-to-use-financial-instruments.pdf, pp. 23-24, last access: 22.05.2020.
[191] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.29.
[192] Risk Finance Guidelines, para. 92.
[193] The European Parliament, Financial Instruments: defining the rationale for triggering their use, October 2017, https://www.ceps.eu/system/files/IPOL_STU%282017%29603787_EN.pdf, p.9, last access: 12.01.2019.
[194] European Commission, European Structural and Investment Funds 2014-2020 – Official Texts and Commentaries, 2015, https://ec.europa.eu/regional_policy/sources/docgener/guides/blue_book/blueguide_en.pdf, p. 16, last access: 14.03.2020.

In accordance with Article 37 (7) CPR, financial instruments may be combined with grants (as well as with interest rate subsidies and guarantee fee subsidies), for which state aid rules apply and separate records shall be maintained for each form of support.[195] The combination of support 'may cover the same expenditure item provided that the sum of all forms of support combined does not exceed the total amount of the expenditure item concerned' in accordance with Article 37 (9) CPR. The same paragraph stipulates that 'grants shall not be used to reimburse support received from financial instruments' and that financial instruments 'shall not be used to pre-finance grants'.

When looked at the expenditure of the state aid schemes by policy objective under the ESI funds as of 2018, the three largest state aid schemes with the policy objective of the promotion of SMEs including risk capital as of 2018 encompassed EUR 1107.7 million (UK venture capital scheme, SA.49923), EUR 279.1 million (German grant and guarantee scheme, SA.49191), and EUR 214.8 million (German grant and guarantee scheme, SA.52163).[196]

There may also be aid in the form of a financial instrument, which, however, does not meet the conditions of the GBER and the Risk Finance Guidelines. Consequentially, it does not formally fall under the concept of risk finance measure (either for not being implemented through a financial intermediary or for not leveraging private investor participation in accordance with Article 21 (10) and (13) GBER), but may be considered a repayable grant.[197] As such, the consequences for such a grant are that 'the gross grant equivalent (GGE) of the aid embedded in the financial instrument must be calculated'; the final recipient must carry out an investment, which is 'eligible to receive aid under the current state aid rules'; since financial instruments are per se repayable, 'the supported investment projects must be capable of generating sufficient revenue to pay back, at minimum, the equity or loan', i.e. the project must be commercially viable; and finally, 'before

[195] Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund, OJ L 347, 20.12.2013, p. 320–469.
[196] The European Commission, State Aid Scoreboard 2019, https://ec.europa.eu/competition/state_aid/scoreboard/state_aid_scoreboard_2019.pdf, last access: 30.05.2020, p.47.
[197] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.

the granting authority starts using such instruments, it needs to have the requisite know-how to assess the creditworthiness' (for calculating the GGE).[198]

3. Types of financial instruments

Financial instruments comprise a range of different types. In the following, these types and their characteristics will be explained in order to gain a better understanding of their different use as well as of their advantages and disadvantages. The Financial Regulation, applicable to the general budget of the EU, stipulates in its Article 2 (29) that a financial instrument 'means a Union measure of financial support provided from the budget to address one or more specific policy objectives of the Union which may take the form of equity or quasi-equity investments, loans or guarantees, or other risk-sharing instruments'. Moreover, in accordance with the Commission Regulation (EU) No 651/2014 (GBER), financial instruments are divided into four main financial products: loans, guarantees, equity, and quasi-equity.[199] The financial product to be applied depends on factors such as market failures, suboptimal investment solutions, the investment needs that are to be addressed, as well as acceptable levels of risk, reward, and ownership.[200] Member States may tailor these financial products according to their requirements and capabilities.[201]

From a practical point of view, the choice of the financial product depends on a number of factors, as interviews with Managing Authorities conducted by Wishlade et al. for the Commission showed:[202] First and foremost, the outcome of the ex-ante assessment is decisive for the choice of a product, as it indicates the effectiveness and performance of measures and the investment strategy. Second, the experience or administrative capacity of the respective Managing Authority plays a significant role. Third, in some cases, the choice is left to the EU level, as the Commission provides 'certainty on the programme' – in particular, compliance with state aid law is not

[198] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.126.
[199] Article 21 (2) of Commission Regulation (EU) No 651/2014.
[200] Interreg Europe, What are Financial Instruments?, https://www.interregeurope.eu/innova-fi/news/news-article/5490/what-are-financial-instruments/, last access: 26.05.2019.
[201] Interreg Europe, What are Financial Instruments?, https://www.interregeurope.eu/innova-fi/news/news-article/5490/what-are-financial-instruments/, last access: 26.05.2019.
[202] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.90.

required – and the European Investment Bank provides management expertise. Finally, specific objectives or the demand is decisive for the choice.

In the following, the different products and their characteristics will be explained. According to Article 2 (40) FR and the Commission Guidance for Member States on Financial Instruments, a **loan** is defined as an 'agreement, which obliges the lender to make available to the borrower an agreed sum of money for an agreed period of time and under which the borrower is obliged to repay that amount within the agreed time'.[203] The interest charged on the loan comprises the market rate plus a risk premium, which reflects the likelihood of a lender retrieving the money and which varies in relation to the borrower's credit history and expected cash flow.[204] The risk premium may be decreased through collateral by the borrower providing assets, receivables, or investments as security.[205]

Being the most widely used and simple form of support, the advantages of loans are that they are not particularly difficult to administer (thus, there are limited management costs), that a defined repayment schedule renders budgeting easier, that the lending mechanism is intelligible (thus, the need for capacity building and the risk for misunderstandings are reduced), and that they preserve the equity of the final recipient, as there is no shift of ownership.[206] The disadvantages of loans are that they are funded products and thus more initial resources than un-funded products, such as guarantees, that the probability of default may be difficult to establish, and that there are limited additional benefits other than financial ones, as know-how is not transferred.[207]

A **guarantee** is defined by Article 2 (34) FR and the Commission as a 'written agreement to assume responsibility for all or part of a third party's debt or obligation or for the successful performance by that third party of its obligations if an event occurs, which triggers such guarantee, such as a

[203] European Commission, Guidance for Member States on Financial Instruments – A Glossary, https://ec.europa.eu/regional_policy/sources/docgener/informat/2014/guidance_glossary.pdf, p. 4, last access: 19.05.2021.
[204] Fi-Compass, Financial Instrument Products, https://www.fi-compass.eu/sites/default/files/publications/ESIF-factsheet-FI-products.pdf, p.7, last access: 02.11.2020.
[205] Fi-Compass, Financial Instrument Products, https://www.fi-compass.eu/sites/default/files/publications/ESIF-factsheet-FI-products.pdf, p.7, last access: 02.11.2020.
[206] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.31; and Fi-Compass, Financial Instrument Products, p.7.
[207] Fi-Compass, Financial Instrument Products, https://www.fi-compass.eu/sites/default/files/publications/ESIF-factsheet-FI-products.pdf, p.7, last access: 02.11.2020.

loan default'.[208] There are several subcategories of guarantees: for a direct guarantee, the guarantor issues an agreed amount of debt to cover the lender's losses in the event that the final recipient defaults.[209] Guarantees may be capped either on a loan-by-loan basis, where an agreed percentage of the loss incurred will be covered by the guarantor.[210] Or they may be capped at the level of the loan portfolio, where losses incurred will be covered until an aggregate value reaches the agreed percentage of the total value of the loan portfolio.[211] A first loss default or portfolio guarantee means that first the guarantor covers the losses of a loan portfolio. Thereby, the lender remains exposed to the losses greater than the capped amount of the guarantee as opposed to the proportional sharing of risks by both the lender and the guarantor.[212] Moreover, an uncapped guarantee has the advantage of reducing the capital required for the lending bank.[213]

What is more, the so-called multiplier is the ratio between the amount of resources for covering expected and unexpected losses and the amount of new loans disbursed to financial recipients (e.g. a multiplier of 4 means the fund can provide four times that in amount in loans).[214] The so-called capped amount is the maximum liability under the capped guarantee and is calculated as the product of the total portfolio volume (aggregate amount of the underlying transaction), the guarantee rate (maximum portion of the value of each loan covered by the guarantee), and the guarantee cap rate (maximum portion of the total portfolio covered by the guarantee).[215]

Guarantee funds are an important source of support for new businesses due to their several advantages: they can preserve the equity of final recipients, as there is no claim on the ownership.[216] Moreover, final recipients may benefit from lower or no guarantee fees, collateral requirements, and/or risk premiums, as the Member State provides the security.[217] There may be high leverage effects, since private investors are more prone to invest, as the overall risk and the

[208] European Commission, Guidance for Member States on Financial Instruments – A Glossary, https://ec.europa.eu/regional_policy/sources/docgener/informat/2014/guidance_glossary.pdf, p. 4, last access: 19.05.2021.
[209] Fi-Compass, Financial Instrument Products, p.10.
[210] Fi-Compass, Financial Instrument Products, p.10.
[211] Fi-Compass, Financial Instrument Products, p.10.
[212] Fi-Compass, Financial Instrument Products, p.10.
[213] Fi-Compass, Financial Instrument Products, p.10.
[214] Fi-Compass, Financial Instrument Products, p.11.
[215] Fi-Compass, Financial Instrument Products, p.12.
[216] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.31; and Fi-Compass, Financial Instrument Products, p.13.
[217] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.31; and Fi-Compass, Financial Instrument Products, p.13.

investment risk for third party lenders is reduced.[218] What is more, guarantees as unfunded products require less initial support.[219] The disadvantages are that they merely represent a risk reserve rather than providing liquidity, that it may be difficult to estimate the appropriate cap level, and that there is no transfer of expertise to the final recipients.[220]

Equity investment is defined by Article 2 (25) FR as the 'provision of capital to a firm, invested directly or indirectly in return for total or partial ownership of that firm and where the equity investor may assume some management control of the firm and may share the firm's profits'.[221] The financial return of equity is dependent on the growth and profitability of the business.[222] The types of equity investment may vary according to the stage of a company's development (investments may be described by the relevant phase: pre-seed, early stage including seed and start-up, growth, and expansion) and to the investment model.[223] The riskier an investment is, the higher the expectation of higher than average returns.[224]

While their use by the public sector has gained momentum over the recent years, equity instruments are still less widely used than other forms of financial instruments.[225] The advantages of equity are that potential returns are higher than those of debt instruments, that the investor may play an active role in project management and access shareholder information, that it may stimulate investment by the local private equity industry in riskier areas, that the company may benefit from the investor's management expertise, and that public investors may influence the configuration and mission of a company.[226] The disadvantages are that there is inherent insolvency risk for all the invested capital, that it forms a time-consuming and cost-intensive investment, that high set-up and operational costs render it a more difficult investment to administer, that it allows only long-term financing as returns are feasible only then, that the

[218] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.31; and Fi-Compass, Financial Instrument Products, p.13.
[219] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.31; and Fi-Compass, Financial Instrument Products, p.13.
[220] Fi-Compass, Financial Instrument Products, p.13.
[221] European Commission, Guidance for Member States on Financial Instruments – A Glossary, https://ec.europa.eu/regional_policy/sources/docgener/informat/2014/guidance_glossary.pdf, p. 3, last access: 19.05.2021.
[222] Fi-Compass, Financial Instrument Products, p.3.
[223] Fi-Compass, Financial Instrument Products, p.15.
[224] Fi-Compass, Financial Instrument Products, p.15.
[225] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, pp.32, 33.
[226] Fi-Compass, Financial Instrument Products, p.16.

establishment of the process may be difficult, and that it may be less attractive to final recipients as it entails the obligation to yield control.[227]

Finally, **quasi-equity** investment is defined in Article 2 (52) FR as 'a type of financing that ranks between equity and debt, having a higher risk than senior debt and a lower risk than common equity' and that 'quasi-equity investments can be structured as debt, typically unsecured and subordinated and in some cases convertible into equity, or as preferred equity'.[228] Quasi-equity is also called mezzanine capital and, depending on the level of ownership acquired and the risk exposure as to insolvency, may be classified closer to equity or debt capital.[229] Examples are subordinated loans with a lower repayment priority than senior loans, convertible bonds, which is structured as a debt claim but may be converted into equity at the discretion of the investor, and preferred stocks, which entitle the holder to a fixed-rate dividend to be paid before holders of ordinary shares receive their dividend.[230]

The advantages of quasi-equity products are that they entail higher returns for co-investors compared to pure debt products, that they address the specific risk capacity of a particular market segment, and that they may induce the local private equity industry to invest also in riskier areas previously not serviced.[231] The disadvantages, on the other hand, are that they are more difficult to administer entailing higher set-up and operational costs, that they deliver returns only in the long-run, that ancillary services may come only at the expense of the company, and that they may be less attractive to final recipients than debt products due to a loss of control when bonds are converted into equity, for instance.[232]

[227] Fi-Compass, Financial Instrument Products, p.16.
[228] European Commission, Guidance for Member States on Financial Instruments – A Glossary, https://ec.europa.eu/regional_policy/sources/docgener/informat/2014/guidance_glossary.pdf, p. 5, last access: 19.05.2021.
[229] FI Compass, Financial Instrument Products, p.17.
[230] FI Compass, Financial Instrument Products, p.17.
[231] FI Compass, Financial Instrument Products, p.18.
[232] FI Compass, Financial Instrument Products, p.18.

IV. The Legal Framework of Financial Instruments and Risk Finance Aid

1. Introduction to the rules of financial instruments and risk finance aid

State aid law, as a part of EU competition law, is concerned with the control of Member States' interventions through state resources, which grant certain undertakings selectively an advantage and thereby threaten to or distort the internal market.[233] State aid control forms one of the central components of EU law. Its task is inherent to the establishment of the internal market and the promotion of competitiveness.[234] Hence, its *raison d'etre* is the very prevention of a race to the bottom in the Member States' granting of subsidies.[235] The provisions on state aid can be found in section two of the first chapter of title VII of the TFEU and form part of the rules on competition. Contrary to the rules on trusts and on the abuse of a dominant market position, the addressees of the state aid rules are not undertakings but Member States.

This chapter will elaborate on the legal framework of financial instruments and risk finance aid. Firstly, it will discuss the concept of state aid and its cumulative criteria with reference to financial instruments (sections 2, 3, and 4). Secondly, it will elaborate on the evolution of the rules on risk finance aid, with particular regard to the programme periods of 2007-2013 and 2014-2020 (section 5). Thirdly, the notification exemptions towards the Commission under the General Block Exemption Regulation (GBER) will be explained (section 6). Finally, the Risk Finance Guidelines with its important compatibility assessment criteria and their relation to the proportionality principle will be elaborated on (section 7).

The EU internal market, comprising a free trade area, a customs union, and a single market, is based on the idea of free trade and overall welfare gains resulting from free competition.[236] The internal market therefore guarantees the five freedoms of products, services, establishment, capital, and persons, which are enshrined in Articles 45, 49, 56, and 57 TFEU. These fundamental market freedoms rest on the twin principles of free movement and non-discrimination on the grounds of nationality, the latter requiring out-of-state products, services, private and legal

[233] Article 107 (1) TFEU.
[234] Case C-369/07, Commission v Greece [2009] ECR I-5703, paras. 118-119.
[235] Case C-720/79, Philipp Morris BV v European Commission [1980] ECLI:EU:C:1980:209, para 25.
[236] Catherine Barnard, The Substantive Law of the EU – The Four Freedoms, Oxford University Press, 2011, pp. 3-17.

persons, and capital 'to enjoy the same treatment as their in-state equivalents', and in turn guaranteeing the free movement of them within the EU.[237]

State aid law is not opposed to the fundamental market freedoms, 'but based on them', so that 'granting undue advantages is also [a] violation of the fundamental market freedoms'.[238] Violations of both market freedoms and state aid law presuppose a 'discriminatory action by a Member State and not merely by a private undertaking'.[239] This is in contrast to the other rules of EU competition law: Articles 101 and 102 TFEU on the prohibition of cartels and other agreements and of the abuse of market power, respectively, involve private restrictions of competition and relate to undertakings as addressees.[240]

Exceptions to the fundamental market freedoms may thus not have a discriminatory character.[241] By granting a selective benefit, however, state aid is an inherently discriminatory act by Member States, potentially distorting competition and the internal market.[242] The functioning of the internal market renders control of such discriminatory acts by state actors therefore necessary, which translates into a general ban on state aid.[243] Thus, only under certain exceptions to this rule may state aid be granted pursuant to Article 107 (3) TFEU.[244]

Therefore, Articles 107 and 108 TFEU establish the 'diligent control' of state aid.[245] All measures that meet the five cumulative criteria of Article 107 (1) TFEU must be notified to the Commission in accordance with Article 108 (3) TFEU.[246] Thus, 'the Commission is in charge of ensuring' that the general ban is respected, that 'state aid complies with EU rules', and that 'exemptions are

[237] Case 48/75 Royer [1976] ECR 497, para. 12, case 118/75 Watson and Belman [1976] ECR 1185, para. 9;
and Catherine Barnard, The Substantive Law of the EU – The Four Freedoms, Oxford University Press, 2011, pp. 17, 18;
and Paul Craig and Gráinne de Búrca, The Evolution of EU Law, Oxford University Press, 2011, p. 499.
[238] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 2.
[239] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 2.
[240] Andreas Bartosch, EU-Beihilfenrecht – Kommentar, C.H. Beck Verlag, 2016, p. 1,
and Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 5.
[241] Andreas Bartosch, EU-Beihilfenrecht – Kommentar, C.H. Beck Verlag, 2016, p. 2.
[242] Cases C-21/88, Du Pont de Nemours [1990] ECR I-889, para. 19; C-156/98, Germany v Commission [2000] ECR I-6857, paras. 83-85; C-225/91 Matra v Commission [1993] ECR I-3203, para. 41;
and Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, pp.2, 5.
[243] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.5.
[244] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.5.
[245] Andreas Bartosch, EU-Beihilfenrecht – Kommentar, C.H. Beck Verlag, 2016, p. 2.
[246] Cases C-280/00, Altmarkt Trans [2003] ECR I-7747, para. 74; C-428/99 France v Commission (Stardust) [2002] ECR I-4397, para. 68.

applied equally across the EU'.[247] The EU Courts regularly express the criteria of Article 107 (1) TFEU through the following formula:

'Thus, first, there must be an intervention by the State or through State resources. Second, the intervention must be liable to affect trade between Member States. Third, it must confer an advantage on the recipient. Fourth, it must distort or threaten to distort competition.'[248]

Hence, while Article 107 TFEU contains the criteria (paragraph 1) and exceptions (paragraphs 2 and 3), Article 108 TFEU stipulates the procedural rules on the compatibility assessment by the Commission. Moreover, Article 109 TFEU provides the legal basis for Council regulations on a proposal by the Commission and, in particular, the determination of conditions under which Article 108 (3) TFEU shall apply as well as of the categories of aid exempted from this procedure.

Together with the legal basis of Articles 107 and 108 TFEU, this chapter will elaborate on the legal framework of financial instruments and risk finance aid, including the GBER, the Risk Finance Guidelines, and the elements of the market economy investor principle. This chapter will set out and explain Article 107 (1) TFEU and its cumulative conditions for state aid to be considered present and their relevance for financial instruments. Secondly, it will elaborate on Article 108 TFEU, which lays down the Commission's role, as well as Article 109 TFEU, which provides the basis for Council regulations on a proposal by the Commission. Thereafter, the chapter will cover the concept of *de minimis* aid. After the development of state aid law on financial instruments and risk finance, this chapter will elaborate on the framework of legal codes, both binding and quasi-binding, the GBER, and the Risk Finance Guidelines.

As will be seen, the legal framework applicable to financial instruments and risk finance aid consists of a plethora of legal texts due to the complexity of their nature, as aid elements may be found at different levels and as they may apply under different circumstances (e.g. under different EU programmes as well as under shared management with Member States or direct management through the EU). Thus, this chapter will pose the following question:

[247] Doris Hildebrand, The Role of Economic Analysis in EU Competition Law: The European School, Wolters Kluwer, 2016, p. 487.
[248] Cases T-266/02, Deutsche Post v Commission [2008] ECR II-1233, para. 70; Case C-280/00, Altmark Trans [2003] ECR I-7747, paras. 74, 75; and Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 83.

- What is the legal framework of financial instruments and are the provisions for financial instruments in the General Block Exemption Regulation (GBER), the Common Provisions Regulation (CPR), and the Financial Regulation (FR) consistent or do they reveal ambiguities and contradictions?[249]

2. Article 107 (1) TFEU: The Applicability of State Aid Law

Article 107 TFEU is the central provision on state aid stipulating that any aid granted by the State or through State resources in any form whatsoever, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, is, in so far as it affects trade between Member States, incompatible with the internal market. Article 107 (1) TFEU does not apply where the State acts by 'exercising public power' or where entities act 'in their capacity as public authorities', i.e. where the activity forms part of the essential functions of the State or is connected with those functions by its nature, its aim, and the rules to which it is subject.[250]

The notion of state aid encompasses aid granted in any form whatsoever: while the most common form of granting aid is in the form of financial grants, more than 25 per cent of aid takes the form of exemptions from taxes or social security.[251] The notion of aid encompasses a wider definition than that of a subsidy, since it entails both, *ex positivo*, benefits and, *ex negativo*, interventions mitigating charges that are normally included in the budget of an undertaking.[252]

Thus, in order to qualify as state aid, a measure needs to fulfil the following criteria cumulatively: (i) the measure forms an intervention by the state through state resources, (ii) which grants the recipient an advantage, (iii) on a selective basis, (iv) where the recipient is an undertaking, and (v) competition has been or may be distorted and the intervention is likely to affect trade between

[249] Commission Regulation (EU) No 651/2014, Commission Regulation (EU) No 1303/2013, and Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union.
[250] Case C-118/85, Commission v Italy [1987], paras. 7 and 8; Case C-30/87, Corinne Bodson v SA Pompes funèbres des régions libérées [1988], para. 18; Case C-364/92, SAT Fluggesellschaft mbH v Eurocontrol [1994], para. 30.
[251] State Aid Scoreboard, 2019, and Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.15.
[252] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.15.

Member States.[253] It is the task of the Commission, checked by the EU Courts, to determine which measures are covered by the notion of Article 107 (1) TFEU based on objective factors and without discretion.[254] In the following, the criteria will explained in more detail, with particular regard to their relevance for financial instruments.

2.1. State aid must involve State resources and be imputable to the State

In order to fulfil this criterion, the aid measure must be granted directly or indirectly through State resources, on the one hand, and be imputable or attributable to the State, on the other.[255] This criterion is very relevant for financial instruments, since they may be implemented at both the Member State level and the EU level, whereby Member States may or may not have a certain discretion and control. If they do, state aid law applies.

The EU Courts made clear that 'the prohibition contained in Article [107 (1) of the Treaty] covers all aid granted by a Member State or through State resources without its being necessary to make a distinction whether the aid is granted directly by the State or by public or private bodies established or appointed by it to administer the aid'.[256]

With regard to **imputability**, 'if a public authority grants an advantage to a beneficiary, the measure by definition is imputable to the State, even if the authority enjoys legal autonomy from other public authorities'.[257] According to the EU Courts and the Commission, 'the same applies, if a public authority designates a private or public body to administer a measure conferring an

[253] Often, these five criteria are summarised in four criteria only: (i) the measure must involve the use of state resources, (ii) confer an advantage to certain enterprises, (iii) distort competition, and (iv) affect trade to an extent contrary to the common market – see e.g. Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.732.
[254] Case C-83/98P, France v Ladbroke Racing Ltd. and Commission [2000] I-3271, para 25; Case C-487/06P, British Aggregates Association v Commission [2008] ECR I-10515, para 111-112; Case C-89/08P, Commission v Ireland [2009] ECR I-11245, para 72; Cases C-71/09P, C-73/09P, C-76//09P, Comitato Venezia vuole vivere v Commission [2011] ECR I-4727, para 132; Case C-194/09P, Alcoa Transformazioni srl v Commission [2011] ECR I-6311, para 125; Case T-67/94, Ladbroke Racing v Commission [1998] ECR II-1, para 52; Case T-613/97, Ufex v Commission [2000] ECR I-4055, para 67; Case T-198/01R, Technische Glaswerke Ilmenau GmbH v Commission [2002] ECR II-2153, para 76; Case T-152/99, Hijos de Andrés Molina SA v Commission [2002] ECR II-3049, para 159; Case T-274/01, Valmont Nederland NV v Commission [2004] ECR I-3145, para 71; Case T-266/02, Deutsche Post AG v Commission [2008] ECR II-1233, para 71; Cases T-268/08, T-281/08, Land Burgenland v Commission [2012] EU:T:2012:90, para 76.
[255] Case C-482/99, France v Commission (Stardust) [2002] ECLI:EU:C:2002:294, para 51.
[256] Case 78/76 Steinike & Weinling v Germany [1977] EU:C:1977:52, para. 21.
[257] Case T-358/94, Air France v Commission [1996] ECLI:EU:T:1996:194, para. 62,
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 39.

advantage'.[258] Moreover, 'imputability may be less evident if the advantage is granted through public undertakings'.[259] In such cases, 'it is necessary to determine whether the public authorities can be regarded as having been involved in a certain way in adopting the measure'.[260]

Highly relevant for financial instruments and their feature of intermediaries, 'in the context of the analysis of State aid cases imputability becomes an element to be checked with particular care when the aid is granted to the beneficiary through an intermediate body…' after the EU Courts' highlighting in the case *Stardust Marine*.[261]

In this case, the EU Courts provide a list of indicators for establishing whether a measure is imputable: '(a) the fact that the body in question could not take the contested decision without taking account of the requirements of the public authorities; (b) the presence of factors of an organic nature, which link the public undertaking to the State; (c) the fact that the undertaking, through which aid was granted, had to take account of directives issued by governmental bodies; (d) the integration of the public undertaking into the structures of the public administration; (e) the nature of the public undertaking's activities and their exercise under normal market conditions; (f) the legal status of the undertaking regarding the autonomy, which that legal form confers on it (the mere fact that a public undertaking has been constituted in the form of a capital company may not be regarded as sufficient reason to exclude imputability); (g) the degree of supervision that the public authorities exercise over the management of the undertaking; (h) any other indicator showing the involvement of the public authorities in adopting the measure in casu or the unlikelihood of their not being involved, taking account of the measure's scope, content, or conditions'.[262]

[258] Case T-358/94, Air France v Commission [1996] ECLI:EU:T:1996:194, para. 62,
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 39.
[259] The concept of public undertakings is defined in Commission Directive 2006/111/EC, of 16 November 2006, on the transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings: Article 2b states that "'public undertakings' means any undertaking over which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it".
[260] Case C-482/99, France v Commission (Stardust) [2002] EU:C:2002:294, para. 52,
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 40.
[261] Nicola Pesaresi et al., EU Competition Law, Volume 4, State Aid, Claeys & Casteels Publishers, 2016, p. 246,
and Case C-482/99 France v Commission (Stardust) [2002] EU:C:2002:294.
[262] Case C-482/99, France v Commission (Stardust) [2002] EU:C:2002:294, paras. 55 and 56; and also Case C-482/99, Opinion of Advocate General Jacobs of 13 December 2001, France v Commission (Stardust), paras. 65-68.

The case of **national promotional banks**, being 'large entities carrying out financial, development, and promotional activities' with a mandate by a Member State at central, regional, or local level, is a special one.[263] While 'it is likely that that decisions approving the establishment and/or remit of national [promotional] banks will continue to be assessed directly under the Treaty', for aid measures managed by these banks, 'the risk finance State aid rules, as well as the start-up aid provisions of the new GBER, will likely be the primary legal base'.[264]

They typically act as financial intermediaries and channel loans and other financial instruments to SMEs, for instance, thereby implementing public policy objectives, and as such, their decisions may be attributed to the Member State.[265] For being state owned, their resources are in any case considered state resources.[266] However, 'their decision-making autonomy implies that not all measures implemented by them are necessarily for the pursuit of public policy objectives', so that the presence of imputability depends on 'whether their decisions are made independently or whether they can be attributed to the state'.[267] In turn, if the promotional bank acts on behalf of the Member State and implements public policy objectives mandated by it, it grants state aid.

With regard to the criterion of **state resources**, the aid must result in a burden on public financial resources, whilst advantages not granted via state resources do not fall within the scope of Article 107 (1) TFEU.[268] Crucially for financial instruments, there need not be an actual or immediate transfer of resources from the State to the beneficiary: aid may be deferred to a future contingency, for instance, through a guarantee which may entail an additional burden for its implementation, but which comprises a real economic risk potentially resulting in a burden on the State budget.[269] Accordingly, a positive transfer of funds does not necessarily have to be

[263] Website of the European Investment Bank, https://www.eib.org/en/about/partners/npbis/index.htm#, last access: 22.05.2020.
[264] Nicola Pesaresi et al., EU Competition Law, Volume 4, State Aid, Claeys & Casteels Publishers, 2016, p. 688.
[265] Phedon Nicolaides, State Aid Hub, 1) The European Commission does not have to identify individual beneficiaries in its recovery decisions 2) revision of the GBER, http://stateaidhub.eu/blogs/stateaiduncovered/post/9534, last access: 09.07.2019.
[266] Phedon Nicolaides, State Aid Hub, 1) The European Commission does not have to identify individual beneficiaries in its recovery decisions 2) revision of the GBER, http://stateaidhub.eu/blogs/stateaiduncovered/post/9534, last access: 09.07.2019.
[267] Phedon Nicolaides, State Aid Hub, 1) The European Commission does not have to identify individual beneficiaries in its recovery decisions 2) revision of the GBER, http://stateaidhub.eu/blogs/stateaiduncovered/post/9534, last access: 09.07.2019.
[268] Cases C-399/10P, C-401/10P, Bouygues SA v Commission EU:C:2013:175 [2013] para. 99.
[269] Case C-387/92, Banco Exterior de Espana SA v Ayuntamiento de Valencia [1994] ECR I-877, para. 14; Case C-6/97, Italy v Commission [1999] ECR I-2981, para 16; cases T-204/97 and T-270/97, EPAC v Commission [2000] ECR II-2267, para. 80.

present, since also the loss or foregoing of Member State revenue (e.g. through a tax exemption) fulfils this criterion of state resources.[270]

The concept of state resources is broad, as it covers all public funds - their source and destination are not decisive – and implies financial assistance granted by regional and local authorities.[271] Thus, measures need not be financed directly by the state in order to qualify as state aid, which also comprises aid granted by public authorities and public bodies, including intra-State entities.[272]

The origin and property of the resources are not relevant, provided that, before being directly or indirectly transferred, these resources come under public control and are thus available to national authorities.[273] Thus, 'the transfer of state resources in the meaning of Article 107 (1) TFEU applies, if the state controls the resources and the decision to transfer them may be attributed to the state'.[274] Control means 'that the state has discretion to determine how resources may be used'.[275] Insofar as there is control by the Member State over the resources, it is irrelevant whether this control is exerted by the State on a temporary or permanent basis.[276] Attribution means that the State takes the decision directly or indirectly via bodies regarding the execution of the transfer.[277]

Hence, and highly relevant for financial instruments and their management, the case law of *PreussenElektra* shows that 'the notion of control is key in deciding whether a given resource can be considered a State resource', so that 'not only public funds can be State resources; also private funds can be considered State resources'.[278]

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[270] Case C-83/98 P, France v Ladbroke Racing Ltd and Commission [2000] ECLI:EU:C:2000:248, paras. 48 to 51, and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 51.
[271] Case C-173/73, Italy v Commission [1974] ECR 709, per Advocate General Warner, at p.727; Case C-248/84, Germany v Commission [1987] ECR 4013, para 17; Case C-88/03, Portugal v Commission [2006] ECR I-7115, para 55; Cases T-211/04 and T-215/04, Government of Gibraltar v Commission [2008] ECR II-3745, para. 79; Cases T-267/08 and T-279/08, Région Nord-Pas-de-Calais v Commission [2011] ECR II-1999, para. 108.
[272] Case C-78/76, Steinike und Weinlig v Germany [1977] ECR 595, paras. 21-22; Case C-290/83, Commission v France [1985] ECR 439, para 14; Case T-358/94, Air France v Commission [1996] ECR II-02109, para. 62.
[273] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.7, and Cases C-206/06, Essent Netwerk Noord [2008], para. 70, C-83/98, France v Ladbroke Racing Ltd and Commission [2000], para. 50, T-358/94, Air France v Commission [1996], paras. 65 and 66.
[274] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.7.
[275] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.7.
[276] Case C-83/98P, France v Ladbroke Racing Ltd. and Commission [2000] I-3271, paras 8 and 50.
[277] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.7.
[278] Nicola Pesaresi et al., EU Competition Law, Volume 4, State Aid, Claeys & Casteels Publishers, 2016, p. 217, and case C-379/98 PreussenElektra [2001] EU:C:2001:160.

If regulation leads to financial redistribution only among private entities without any further involvement of the State, i.e. 'if the money flows directly from one private entity to another without passing through a public and private body designated by the state to administer the transfer', there is no transfer of state resources present.[279] However, if the money transits through an intermediary designated to channel them to the beneficiaries, State resources are present.[280] As long as the Member 'State continues to strictly monitor the entity', it is irrelevant whether this intermediary is a public or private entity.[281]

On the other hand, if advantages granted by a State do not entail a financial burden on the State, they are in principle not covered by Article 107 (1) TFEU.[282] With regard to financial instruments, **funding stemming directly from the EU** cannot constitute state aid, since it does not result in a burden on the state budget.[283] Therefore, resources stemming from the EU (e.g. ESI-funds), from the European Investment Bank or the European Investment Fund, from international financial institutions (e.g. the International Monetary Fund or the European Bank for Reconstruction and Development) will not be regarded as state resources, if national authorities have no discretion as to the use of these resources.[284] Thus, if EU funding is combined with a financial instrument entailing state aid, only the latter's compliance with state aid provision will be examined. Similarly, state measures required to be taken under an obligation of EU law are not considered to be imputable to the Member State, since the latter thereby has no discretion or acts within the admissible margin of discretion.[285]

[279] Case C-82/77, Openbaar Ministerie (Public Prosecutor) of the Kingdom of the v Jacobus Philippus van Tiggele [1978] ECLI:EU:C:1978:10, paras. 25 and 26; Case C-379/98, PreussenElektra AG gegen Schleswag AG, Beteiligte: Windpark Reußenköge III GmbH und Land Schleswig-Holstein [2001] ECLI:EU:C:2001:160, paras. 59-62,
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 61.
[280] Case C-206/06, Essent Netwerk Noord [2008] ECLI:EU:C:2008:413, paras. 69-75.
[281] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 64: It is noteworthy that several consecutive measures of State intervention may be considered one single intervention for being so closely linked with each other by their chronology, their purpose, and the circumstances of the recipient undertaking at the time, that they are inseparable. - Cases C-399/10P and C-401/10P, Bouygues SA v Commission EU:C:2013:175, paras 103-104; Case C-15/14P, Commission v MOL [2015] EU:C:2015:362, para 97; Case T-1/12 France v Commission EU:T:2015:17, paras 33-34.
[282] Case C-345/03 BV Pearle v Hoofdbedrijfschap Ambachten [2004] ECR I-7139, para 36.
[283] Case C-213-215/81, Norddeutsches Vieh- und Fleischkontor v BALM [1982] ECR 3583, paras. 22-23,
and Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 174.
[284] Case C-213-215/81, Norddeutsches Vieh- und Fleischkontor v BALM [1982] ECR 3583, paras. 22-23,
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 60.
[285] Case T-58/10, Phoenix-Reisen GmbH v Commission [2012] EU:T:2102:3, para 8; case T-351/02, Deutsche Bahn AG v Commission [2006] ECR II-1047, para. 102.

However, this does not apply where EU law simply allows for certain national measures and the Member State enjoys discretion (i) as to whether adopt the measures in question or (ii) in establishing the characteristics of the concrete measure that are relevant in terms of State aid rules.[286] Thus, if **EU funding is managed at Member State level**, it is under the control of the State and hence falls under Article 107 (1) TFEU: For instance, all ESI funds are considered state resources, albeit emanating from the EU budget, since they are under the responsibility of managing authorities, i.e. public bodies appointed by the Member State 'for the explicit purpose of designing and implementing operational programmes and ensuring that EU funds are spent efficiently and effectively'.[287] For discharging their responsibilities, managing authorities possess the legal powers 'to determine eligible beneficiaries and terms of funding' conferring to them the control over the use of EU funds.[288]

By contrast, EU funds that are not under the control of Member States are not considered to be state resources and thus fall outside the scope of Article 107 (1) TFEU.[289] **Funding from the EU budget managed at the EU level** does not fall under Article 107 (1) TFEU, since it is neither granted by a Member State nor through State resources, as the EU budget is based on 'own resources' and decided upon by the European Parliament and the Council, the two arms of the budgetary authority, not being under the control of the Member States.[290]

In nuce, if 'EU resources are transferred through a channel, fund, or body, over which the State can exercise control', they are regarded as state resources.[291] In contrast, if EU resources are awarded directly to undertakings without being transferred through a state-controlled channel, fund, or body, they do not fall under the scope of Article 107 (1) TFEU.[292] If a Member State

[286] Case C-272/12 P, Commission v Ireland and Others [2013] ECLI:EU:C:2013:812, paras. 45 to 53.
[287] Case C-206/06, Essent Netwerk Noord [2008] ECLI:EU:C:2008:413, paras. 69-75,
and Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.10.
[288] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.10.
[289] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.9.
[290] Case C-213-215/81, Norddeutsches Vieh- und Fleischkontor v BALM [1982] ECR 3583, paras 22-23,
and Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.11.
[291] Case C-206/06, Essent Netwerk Noord [2008] ECLI:EU:C:2008:413, paras. 69-75,
and Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.11
[292] Case C-82/77, Openbaar Ministerie (Public Prosecutor) of the Kingdom of the v Jacobus Philippus van Tiggele [1978] ECLI:EU:C:1978:10, paras. 25 and 26,
and Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.11.

returns EU funding to an EU institution to manage it at the EU level without the Member State's discretion how the funding is invested in its territory, no state resources are involved.[293]

Accordingly, the so-called General Block Exemption Regulation (GBER), exempting certain categories of aid from the notification requirement for being compatible with the internal market, stipulates under Article 8 (2) on the cumulation of aid that Union funding centrally managed by EU institutions, agencies, joint undertakings, or bodies that are not directly or indirectly under the control of Member States will not be considered for the determination of the notification thresholds. Moreover, under its recital 26, the GBER states that Union funding managed by EU bodies does not constitute state aid.

In accordance with the case law, the Commission Guidelines on Risk Finance reiterate the exemption of Union resources under paragraph 169 of point 3.9. on cumulation. Moreover, paragraph 60 of the Notice on the Notion of State Aid states that Union funding managed at the EU level does no constitute state aid, and recital 13 of the *de minimis* Regulation states that it does not constitute state resources, respectively. The Introduction to Analytical Grids on State Aid to Infrastructure of the Commission also states in paragraph 6 that recourses 'awarded directly by the Union, the EIB or by the EIF, with no discretion on the part of the national authorities… do not constitute state resources'.[294] It appears that all these legal texts are consistent, insofar as EU funding managed at the EU level is considered not to represent state aid.

2.1.1. EU programmes for financial instruments at EU and Member State level and the applicability of state aid law

Strongly related to the conditions of imputability to the Member State and the presence of state resources, this section will elaborate on the different programmes of the EU, which entail the setting up and management of financial instruments at the EU and the Member State level, respectively. As the Commission states, 'financial instruments are a way of deploying EU

[293] The European Commission, Explanatory Note accompanying the proposal for the targeted GBER revision, footnote 2, http://ec.europa.eu/competition/consultations/2019_gber/note_en.pdf, last access: 09.07.2019.
[294] The European Commission, Introduction to Analytical Grids, http://ec.europa.eu/competition/state_aid/modernisation/intro_grid_en.pdf, last access: 16.07.2019.

budgetary resources' as well as Member State resources in a range of activities, such as participation in equity funds, guarantees to local banks lending to a large number of final beneficiaries, and risk-sharing with financial institutions to boost investment in large infrastructure projects.[295]

From a legal point of view, it is important to distinguish at which level financial instruments are set up and managed, since this will decide whether state aid law applies or not: If financial instruments are set up and managed at the EU level, they do not fall under the scope of Article 107 (1) TFEU (section 5 of this chapter will further elaborate thereupon), as they are not imputable to a Member State nor considered state resources. In contrast, if they are set up at EU level, but managed at the Member State level, they do fall under the scope of Article 107 (1) TFEU, as the Member State possesses control over the resources and imputability is given. The differences in the applicability of state aid law will be discussed in the following, depending on the respective programmes to be set up and managed at Member State and EU level.

With their main focus in the areas of research and innovation, digital technologies, support of the low-carbon economy, sustainable management of natural resources, and small businesses, the **European Structural and Investment Funds** (ESI funds) are designed to 'invest in job creation and a sustainable and healthy European economy and environment' and are set up and implemented at the Member State level.[296] The ESI funds comprise the European Regional Development Fund (ERDF), the European Social Fund (ESF), the Cohesion Fund (CF), the European Agricultural Fund for Rural Development (EAFRD), and the European Maritime and Fisheries Fund (EMFF).

The ESI funds legal foundation is the Common Provisions Regulation (CPR) stipulating the general conditions relevant for all funds.[297] Special conditions relating to the individual funds are laid down in the ERFD, ESF, CF, EAFRD, and the EMFF Regulation, respectively.[298] Although being set up at the EU level and channelling over half of the EU funding, the funds are managed by the

[295] The European Commission, Financial Instruments, https://ec.europa.eu/info/business-economy-euro/growth-and-investment/financing-investment/innovative-financial-instruments_en, last access: 10.09.2017.
[296] The European Commission, Management of Funds, https://ec.europa.eu/info/funding-tenders-0/european-structural-and-investment-funds_en#howthefundsaremanaged, last access: 20.01.2018.
[297] Regulation (No) 1303/2013 of the European Parliament and of the Council laying down common provisions on the ERFD, ESF, CF, EAFRD, EMFF.
[298] For the individual Regulations on ERFD, ESF, CF, EARFD, and EMFF please consult the Commission's website: http://ec.europa.eu/regional_policy/en/information/legislation/regulations/, last access: 26.02.2018.

Member States themselves, and, by means of partnership agreements (see Chapter II of the CPR), in collaboration with the European Commission, 'setting out how the funds will be used during the funding period 2014-2020'.[299] The investment areas are jobs, growth, and investment, the digital single market, energy Union and climate, the internal market, the economic and monetary Union, justice and fundamental rights, and migration.

Member States may provide **contributions of ESI funds to financial instruments**, which are **established at EU level**, i.e. EU financial instruments under direct or indirect Union management. If the Member State does not attach any conditions to the use of these ESI funds, such contributions are regarded neither as state resources nor as imputable to the state.[300] Thereby, a regional condition does not evoke the presence of state aid, so that the contributing Member State may attach the condition that the ESI funds' contributions may only be invested in its own territory, since the ESI funds are 'allocated to Member States in accordance with rules that have already determined in which Member State's territory those funds may be invested' in the first place.[301] Thus, this condition would not render the resources imputable to the Member State.

Consequently, it is the responsibility of the Commission to design EU central financial instruments in a way that they are consistent with state aid law, which is explained in point 3.1.2 of the Commission Staff Working Document on ESI funds: 'The legal framework governing Union financial instruments, including the agreements with the entrusted entities, has been designed by the Commission with a view to ensuring consistency with state aid law' and 'the different financial instruments have to be designed to be state aid consistent.'[302] Therefore, at the EU level, the Commission ensures consistency with state aid law and the non-distortion of competition in the design of EU financial instruments through setting up of delegation agreements with the EIB/EIF (see chapter VII). For instance, for Horizon 2020 and COSME, the Commission designs the

[299] The European Commission, Management of Funds, https://ec.europa.eu/info/funding-tenders-0/european-structural-and-investment-funds_en#howthefundsaremanaged, last access: 20.01.2018.
[300] Case C-206/06, Essent Netwerk Noord [2008] ECLI:EU:C:2008:413, paras. 69-75, case C-213-215/81, Norddeutsches Vieh- und Fleischkontor v BALM [1982] ECR 3583, paras. 22-23,
and European Commission, Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.3.
[301] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.3. with footnote 13:
'Article 70 CPR imposes on Member States to support operations in a given programme area. The breakdown of the funds made available by Member State is determined by a methodology contained in Annex VII of the CPR and set out in the Commission Implementing Decision 2014/190/EU.'
[302] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.2.

regulation and implementation rules, in particular the delegation agreements and term sheets, in such a way as to achieve consistency.[303] The concept of 'state aid consistency' and its comparison with state aid rules of the GBER and the RFG will be elaborated on in chapter VII.

The **EIB group's** (both EIB and EIF) **investment of own resources at its own risk** is considered private financing in nature under state aid rules and hence does not constitute state aid pursuant to Article 107 (1) TFEU.[304] Thus, if EIB/EIF own resources are invested at full own risk, they need not be taken into account for the calculation of the *de minimis* threshold, for notification thresholds, or for calculating aid intensities.[305] In contrast, if a Member State contributes by providing guarantees or any other support to the investment of the EIB group, the EIB/EIF is not investing at full own risk and hence its investment may not be considered private in nature.[306]

Thus, if Member States contribute financial support of ESI funds and **national co-financing to EU financial instruments**, such co-financing involves state resources and is imputable to the state and hence may constitute state aid.[307]

Resources of the **European Fund for Strategic Investments (EFSI)** do not qualify as state resources and hence do not constitute state aid.[308] Since EFSI resources are outside the scope of the Financial Regulation on the EU budget, they are not even required to possess state aid consistency of Article 209 (2) (c) FR.[309] Consequently, if **EIB group own resources are covered by an EFSI guarantee**, no state aid control is required.[310] In contrast, if projects or investment platforms supported by the EFSI are co-financed with ESI funds or national public resources, this additional

[303] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.2.
[304] Case C-213-215/81, Norddeutsches Vieh- und Fleischkontor v BALM [1982] ECR 3583, paras. 22-23, and Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.4.
[305] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.4.
[306] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.4.
[307] European Commission, Introduction to Analytical Grids, http://ec.europa.eu/competition/state_aid/modernisation/intro_grid_en.pdf, para. 7, last access: 05.05.2019.
[308] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.5.
[309] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.5.
[310] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.5.

financing is subject to state aid rules.[311] However, if Member States return ESI funding back to the EU level without attaching conditions as to the use thereof, state aid rules do not apply.[312]

Importantly, the CPR on ESI funds, modified by Financial Regulation 2018/1046, introduces under Articles 38 (1) (c) and 39a CPR the option to **combine ESI funds with EFSI funding**, which has not been possible before (next to the existing options of contribution from an ESI fund programme to an EU level instrument and contribution from an ESI fund programme to a financial instrument set up at national, regional, trans-national or cross border level managed by a managing authority).[313] Article 39a CPR lays down the rules applicable to the ESIF financial instruments when combined with EFSI funding: inter alia, the purpose of the combination must be to leverage additional private funding, ESI funding may not exceed the threshold of 25 per cent (40 per cent for less developed regions, if there is a justified ex ante assessment), and that the implementation options are similar to those available under the responsibility of a managing authority. According to the Commission, for the ESIF stream of funding, the rules of the ESIF legal framework apply (Title IV of the CPR and the relevant delegated and implementing acts), while the EFSI stream falls under the EFSI Regulation (EU) 1017/2015.[314] Moreover, the Commission clarifies that 'the two streams of funding do not need to be combined at the same time'.[315]

What is more, **Horizon 2020** is the largest EU Research and Innovation programme hitherto with nearly EUR 80 billion of funding available over seven years (2014 to 2020) in addition to private investment that this fund aims to attract.[316] Striving to drive economic growth and create jobs,

[311] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.5.
[312] European Commission, Introduction to Analytical Grids, http://ec.europa.eu/competition/state_aid/modernisation/intro_grid_en.pdf, para. 7, last access: 01.06.2019.
[313] European Commission, Financial Instruments – Overview of Changes in Title IV of the CPR following the Omnibus Regulation, 05.03.2019, https://www.fi-compass.eu/sites/default/files/publications/Financial%20instruments%20-%20Overview%20of%20the%20changes%20in%20Title%20IV%20of%20the%20CPR%20following%20the%20Omnibus%20regulation.pdf, last access: 30.05.2019, p 5.
[314] European Commission, Financial Instruments – Overview of Changes in Title IV of the CPR following the Omnibus Regulation, 05.03.2019, https://www.fi-compass.eu/sites/default/files/publications/Financial%20instruments%20-%20Overview%20of%20the%20changes%20in%20Title%20IV%20of%20the%20CPR%20following%20the%20Omnibus%20regulation.pdf, last access: 30.05.2019, pp. 6,7.
[315] European Commission, Financial Instruments – Overview of Changes in Title IV of the CPR following the Omnibus Regulation, 05.03.2019, https://www.fi-compass.eu/sites/default/files/publications/Financial%20instruments%20-%20Overview%20of%20the%20changes%20in%20Title%20IV%20of%20the%20CPR%20following%20the%20Omnibus%20regulation.pdf, last access: 30.05.2019, p.7.
[316] Regulation (EU) No 1291/2013 of the European Parliament and of the Council of 11 December 2013 establishing Horizon 2020 - the Framework Programme for Research and Innovation (2014-2020) and repealing Decision No 1982/2006/EC, and European Commission, Horizon2020, https://ec.europa.eu/programmes/horizon2020/en/what-horizon-2020, last access: 02.11.2020.

the programme entails several sections or pillars. Under the 'Industrial Leadership' pillar, one goal is to support and facilitate access to risk finance for innovative SMEs, especially in the start-up phase or after diversifying into new markets.[317] The 'EU Finance for Innovators' or 'InnovFin' is the concept under which the EU promotes a range of tailored debt and equity products and advisory services, i.e. financial instruments established at the EU level.[318] The Horizon2020 financial instrument will be analysed in chapter VII.

Thereby, 'the **European Investment Bank** (EIB) and the **European Investment Fund** (EIF) play a crucial role as entrusted entities in implementing each financial instrument facility on behalf of and in partnership with the Commission'.[319] The EIB provides loans to medium and larger companies, or guarantees to banks lending to them, while it also provides a range of technical assistance and advisory services.[320] The EIF provides guarantees to banks lending to SMEs and invests in venture capital funds providing start-ups and fast-growing firms with equity.[321] As explained above, if a financial instrument is set up at the EU level and managed by the EIB or EIF, it does not fall within the scope of Article 107 (1) TFEU, so that state aid law does not apply, as the aid is not imputable to the Member State and does not consist of resources of the Member State.

Under the programme for the Competitiveness of Enterprises and Small and Medium-sized enterprises (**COSME**), the EU has set up 'a budget of over EUR 1.4 billion to fund financial instruments that facilitate access to loans and equity finance for SMEs, where market gaps have been identified'.[322] The Commission envisages mobilising 'up to EUR 35 billion in financing from financial intermediaries via leverage effects', whereby 'the financial instruments are to be

[317] European Commission, Horizon2020, https://ec.europa.eu/programmes/horizon2020/en/what-horizon-2020, last access: 02.11.2020.
[318] The European Investment Bank, http://www.eib.org/products/blending/innovfin/products/index.htm, last access: 10.09.2017.
[319] European Commission, Horizon2020, https://ec.europa.eu/programmes/horizon2020/en/what-horizon-2020, last access: 02.11.2020.
[320] European Commission, Horizon2020, https://ec.europa.eu/programmes/horizon2020/en/what-horizon-2020, last access: 02.11.2020.
[321] The European Commission, https://ec.europa.eu/programmes/horizon2020/en/h2020-section/access-risk-finance, last access: 10.09.2017.
[322] Regulation (EU) No 1287/2013 of the European Parliament and of the Council of 11 December 2013 establishing a Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014 - 2020) and repealing Decision No 1639/2006/EC.
and European Commission, https://ec.europa.eu/growth/access-to-finance/cosme-financial-instruments_en, last access: 10.09.2017.

managed by the EIF in cooperation with financial intermediaries in EU countries'.[323] Being set up and managed at the EU level, state aid rules do not apply.

Two facilities are part of the COSME budget. Firstly, the **Loan Guarantee Facility** (LGF) funds guarantees and counter-guarantees for financial intermediaries (e.g. guarantee organisations, banks, leasing companies) to support them in providing loan and lease finance to SMEs.[324] It also includes the securitisation of SME debt-finance portfolios. Secondly, the **Equity Facility for Growth** (EFG) is 'dedicated to investments risk finance funds that provide venture capital and mezzanine finance to expansion and growth stage SMEs, in particular to those operating across borders'.[325] Both facilities, the LGF and the EFG, are established and managed at the EU level, so that they do not fall under the scope of Article 107 (1) TFEU and state aid rules do not apply. The LGF and EFG instruments will be analysed in chapter VII.

Another programme is the **EU Programme for Employment and Social Innovation** (EaSI), a financing programme 'to promote a high level of quality and sustainable employment, guaranteeing adequate and decent social protection, combating social exclusion and poverty, and improving working conditions'.[326] This programme is managed directly by the Commission and combines three EU programmes formerly managed separately between 2007 and 2013. Hence, being established and managed at the EU level, its financial instruments do not fall under the scope of Article 107 (1) TFEU. Under its Microfinance and Social Entrepreneurship axis, the programme provides microcredits and microloans for vulnerable groups and micro-enterprises. Furthermore, the EIF is the entrusted entity to implement the EaSI Guarantee, which entails a budget of EUR 96 million available for interested microcredit providers and social enterprise to facilitate funding from entrepreneurs.[327]

[323] The European Commission, https://ec.europa.eu/growth/access-to-finance/cosme-financial-instruments_en, last access: 10.09.2017.
[324] The European Commission, https://ec.europa.eu/growth/access-to-finance/cosme-financial-instruments_en, last access: 10.09.2017.
[325] The European Commission, https://ec.europa.eu/growth/access-to-finance/cosme-financial-instruments_en, last access: 10.09.2017.
[326] Regulation (EU) No 1296/2013 of the European Parliament and of the Council of 11 December 2013 on a European Union Programme for Employment and Social Innovation ("EaSI") and amending Decision No 283/2010/EU establishing a European Progress Microfinance Facility for employment and social inclusion,
and European Commission, http://ec.europa.eu/social/main.jsp?catId=1081, last access: 10.09.2017.
[327] The European Commission, http://ec.europa.eu/social/main.jsp?catId=1084&langId=en, last access: 10.09.2017.

Under the Creative Europe Programme, the **Cultural and Creative Sector Guarantee Facility** entails EUR 121 million as insurance to financial intermediaries offering financing to cultural and creative sector initiatives.[328] The programme envisages creating EUR 600 million in loans and other financial products through leverage effects. The guarantee scheme is managed by the EIF on behalf of the Commission and is set to benefit SMEs active in the cultural and creative sectors in the EU, Iceland, and Norway.[329] Thus, being established and managed at the EU level, Article 107 (1) TFEU does not apply.

There are also funds combining several EU resources, such as the Pan-European Venture Capital Fund-of-Funds, which consists of resources from Horizon 2020's InnovFin Equity scheme, EFSI, and COSME.

The **InvestEU** programme, which will be applicable from 2021 to 2027, will combine the EFSI with 13 existing financial instruments (including COSME and EaSI instruments) in order to facilitate 'simplified and streamlined investment support' by the EU.[330] Its planned budget comprises more than EUR 15 billion.[331] Since these instruments are implemented and managed at the EU level, state aid rules will not apply. As this thesis concerns existing programmes, it will not cover the new rules of the InvestEU programme.

[328] Regulation (EU) No 1295/2013 of the European Parliament and of the Council of 11 December 2013 establishing the Creative Europe Programme (2014 to 2020) and repealing Decisions No 1718/2006/EC, No 1855/2006/EC and No 1041/2009/EC.
[329] The European Commission, https://ec.europa.eu/programmes/creative-europe/cross-sector/guarantee-facility_en, last access: 10.09.2017.
[330] The European Commission, https://ec.europa.eu/commission/priorities/jobs-growth-and-investment/investment-plan-europe-juncker-plan/whats-next-investeu-programme-2021-2027_en, last access: 02.11.2020.
[331] The European Commission, Proposal for a Regulation establishing the InvestEU Programme, COM(2018) 439 final, 2018/0229 (COD), p. 10, https://eur-lex.europa.eu/resource.html?uri=cellar:319a131d-6af6-11e8-9483-01aa75ed71a1.0002.03/DOC_1&format=PDF, last access: 02.11.2020.

In sum, the following overview of point 3.1.6. of the Commission Staff Working Paper depicts the above-noted remarks:

Types of resources:	National public resources	ESI funds resources (in shared management)	Directly/indirectly managed Union funds (e.g. Horizon2020, COSME or ESI funds in direct/indirect management)	EIB group own resources (without any risk coverage or other support from EU or national public resources)	EIB group own resources covered by EFSI guarantee
State resources present?	**Yes** Need for compliance with state aid rules	**Yes** Need for compliance with state aid rules	**No** Consistency with state aid rules ensured by the Commission at the level of the instrument	**No** No state aid requirements	**No** No state aid requirements

If different types of the above-mentioned resources are combined, the application of state aid rules is required to be verified separately for each part.

In conclusion, it is thus crucial for the applicability of Article 107 (1) TFEU whether a financial instrument is set up and managed at the EU or Member State level. On the one hand, if a financial instrument is set up at the EU level, but the relevant Member State has any discretion as to its use, Article 107 (1) TFEU and state aid rules apply. On the other hand, if a financial instrument is set up at the EU level and managed without any discretion of the Member State, Article 107 (1) TFEU does not apply and mere 'state aid consistency' is required. There remain ambiguities regarding the concept of entrusted entities and the new Article 39a CPR on investment platforms, for instance, which should be clarified in order to enhance the consistency of state aid law on financial instruments.

2.1.2. Financial Instruments implemented by entrusted entities

As explained above, resources stemming from the EU budget are considered state resources and imputable to the state, if national authorities of Member States possess discretion on the use of these resources.[332] By contrast, if national authorities have no discretion and the EU resources are managed directly or indirectly by the EU or its bodies (or by international organisations), these

[332] Case C-482/99, France v Commission [2002] ECR I-4397, para 51,
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 45.

resources are regarded neither as state resources nor as imputable to the state.[333] Thus, they do not fall under the scope of Article 107 (1) TFEU.

Since the vast majority of ESI funds relevant for cohesion policy are under shared management, Member States typically possess discretion regarding the use of funding and eligibility criteria.[334] Therefore, ESI funds and the national public (co-)funding are considered state resources and imputable to the state.[335] Thus, financial instruments managed by or under the responsibility of a managing authority in accordance with Article 38 (1) (b) CPR are subject to state aid rules.[336]

According to the Commission Staff Working Document on the Guidance on State aid and EFI funds, **EU funding implemented by an entrusted entity** (including the EIB or the EIF), 'under a mandate from the European Commission or any other EU institution or entity in direct or indirect management, where national authorities may not decide about the use of resources' hence, does not constitute state aid: neither does it qualify as state resources nor is it imputable to the state.[337] The Regulation laying down the rules for the establishment and implementation of the Union budget (the 'Financial Regulation') prescribes that Union financial instruments must comply with non-distortion of competition and consistency with state aid rules in Article 209 (2) (c): 'Financial instruments… shall not distort competition in the internal market and be consistent with state aid rules'.[338]

Therefore, the Commission designed the legal framework governing Union financial instruments, including the agreements with the entrusted entities, with a view to ensure consistency with state aid law.[339] However, the Commission's elaborations on the non-applicability of state aid law on entrusted entities reveals ambiguities: the concept for the use of entrusted entities is enshrined in Article 21 (17) GBER, which means that their use implies the existence of state aid and that entrusted entities do carry out instructions of Member States. This contradicts the concept of

[333] C-213-215/81, Norddeutsches Vieh- und Fleischkontor v BALM [1982] ECR 3583, paras. 22-23, and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 45.
[334] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.10.
[335] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.10.
[336] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.10.
[337] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.2.
[338] Article 209 of Regulation 2018/1046 on the financial rules applicable to the general budget of the Union (ex Article 140 (2) of Regulation No 966/2012).
[339] Article 2 (23) CPR and Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.2.

'entrusted entities' of Article 38 (4) (b) CPR, which may exclude the falling under state aid rules under the conditions described above. The legislator ought to clarify this ambiguity.

An entrusted entity is defined by the CPR, the GBER, and the Risk Finance Guidelines 2014-2020 as 'the EIB, the EIF, and international financial institution in which a Member State is a shareholder, a financial institution established in a Member State aiming at the achievement of public interest under the control of a public authority, a public law body, or a private law body with a public service mission'.[340] The CPR, modified by Financial Regulation 2018/1046 (the so-called Omnibus Regulation), distinguishes between entrusting entities through the direct award of a contract (Article 38 (4) (b) CPR) and entrusting another body governed by public or private law (Article 38 (4) (c) CPR). For the former case, Article 38 (4) (i) – (iii) CPR states that directly entrusted entities may be the EIB, an international financial institution in which a Member State is shareholder, and – by recognising the importance of promotional banks for financial instruments – 'a publicly-owned bank or institution, established as a legal entity carrying out financial activities on a professional basis'.

Such a publicly owned bank or institution must fulfil the following conditions pursuant to Article 38 (4) (iii) CPR: there is no direct private capital participation (with a certain exception), it operates under a public policy mandate given by the relevant authority of a Member State at national or regional level, it carries out development activities contributing to the ESI funds' objectives in regions, policy areas, or sectors, for which access to funding from market sources is not generally available or sufficient, it operates without primarily focussing on maximising profits, but ensures a long-term financial sustainability, it ensures that the direct award of contract does not provide any direct or indirect benefit for commercial activities, and is subject to the supervision of an independent authority.

If the financial instrument is managed by an entrusted entity, the latter may not co-invest with the Member State and is thus considered a mere vehicle to channel the financing and not a beneficiary of aid, as long as it is not overcompensated.[341] Otherwise, if the entrusted entity does

[340] European Commission, Communication from the Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), Section 2.3. definitions.
[341] Communication from the Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), Section 2.1.2., para. 39.

provide funding or co-invests with the Member State in a similar manner to financial intermediaries, the Commission will assess whether it receives state aid.[342] The reasoning of the Commission is the following: if an entrusted entity co-invests, it 'acts in its own capacity as a financial institution by taking risk on its own balance sheet, and is no longer subject to the risk finance rules on entrusted entities, but must respect the risk finance rules on financial intermediaries'.[343] Moreover, the Commission highlights that the notion of an entrusted entity refers to its role when acting on behalf of the Member State, rather than 'the process of selecting such institution, i.e. entrustment does not necessarily imply an appointment', so that a Member State 'may select or appoint a financial institution to act as its entrusted entity'.[344] In contrast, financial intermediaries must be selected through an open, transparent, and non-discriminatory call as per Article 17 (13) b GBER.

What the **concept of an entrusted entity** is, however, is far from clear. As explained, the definition of Article 2 (79) GBER provides that it may mean 'the European Investment Bank and the European Investment Fund, an international financial institution in which a Member State is a shareholder, or a financial institution established in a Member State aiming at the achievement of public interest under the control of a public authority, a public law body, or a private law body with a public service mission' as well as that 'he entrusted entity can be selected or directly appointed in accordance with the provisions of Directive 2004/18/EC on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts'. Article 14 (b) GBER requires that the entity provide for a due diligence process to ensure a commercially sound investment strategy, including a risk diversification policy to achieve economic viability and an efficient scale in terms of size and territorial scope of the portfolio and investments. However, it does not elaborate further on it.

The Common Provisions Regulation provides in its Article 38 (4) (b) CPR the same scope of eligible institutions as the GBER, namely the EIB (Article 2 (23) CPR defines the 'EIB' as comprising the EIB, the EIF, and any other subsidiary of the EIB), international financial institutions in which a Member State is a shareholder, or financial institutions established in a Member State aiming at the achievement of public interest under the control of a public authority, or a body governed by

[342] Risk Finance Guidelines, Section 2.1.2., para. 39.
[343] The European Commission, The General Block Exemption Regulation – Frequently Asked Questions, 2016, pp. 32, 33.
[344] The European Commission, The General Block Exemption Regulation – Frequently Asked Questions, 2016, pp. 32, 33.

public or private law. The CPR, hence applicable to ESI funds financial instruments only, in addition states that entrusted entities may further entrust part of the implementation to financial intermediaries under Article 38 (5) CPR, that they are obliged to open fiduciary accounts in their name and on behalf of the managing authority or set up the financial instrument as a separate block of finance within the financial institution under Article 38 (6) CPR, and that terms and conditions shall be set out in certain funding agreements under Article 38 (7) CPR. Apart from that, however, the CPR does not elaborate further on the concept of entrusted entities.

The Risk Finance Guidelines elaborate further on the relation between entrusted entities and financial intermediaries in paragraph 39: If entrusted entities do not co-invest with Member States in the risk finance measure, the Commission will regard entrusted entities as vehicles to channel the financing and not as beneficiaries of aid, as long as they are not overcompensated.[345] In case an entrusted entity provides funding or co-invests in a manner similar to financial intermediaries, however, the Commission will assess whether it receives state aid.[346] However, contrary to what is stated in the explanatory publication of the Commission on the GBER (it does not provide an answer to the question, but simply refers to the RFG), the GBER itself does not cover the situation where the entrusted entity co-finances and manages the fund.[347] In its publication, at least, the Commission clarifies that the concept of entrusted entity is only applicable to Article 21 GBER, thus excluding Article 22 GBER on start-up aid, since the latter provision 'does not require aid to be deployed via intermediated financial products'.[348]

The Commission provides guidance in its Notice on the selection of bodies implementing financial instruments, which is done by managing authority, and, in particular, on Article 7 of Directive 2014/24/EU on public procurement as well as on Article 7 of Commission Delegated Regulation (EU) No 480/2014 (hereinafter: CDR).[349] The Notice provides information on the thresholds for the applicability of the public procurement directive (Article 4), choice of the procedure, the use

[345] Risk Finance Guidelines, para. 39.
[346] Risk Finance Guidelines, para. 39.
[347] The European Commission, General Block Exemption Regulation (GBER) – Frequently Asked Questions, March 2016, website of the German Ministry of the Economy, https://www.bmwi.de/Redaktion/DE/Downloads/B/beihilfenkontrollpolitik-kom-zusammenstellung-faq-agvo.pdf?__blob=publicationFile&v=5, last access: 17.07.2019, p. 33.
[348] The European Commission, General Block Exemption Regulation (GBER) – Frequently Asked Questions, March 2016, and website of the German Ministry of the Economy, https://www.bmwi.de/Redaktion/DE/Downloads/B/beihilfenkontrollpolitik-kom-zusammenstellung-faq-agvo.pdf?__blob=publicationFile&v=5, last access: 17.07.2019, p. 34.
[349] European Commission, Notice on Guidance for Member States on the selection of bodies implementing financial instruments, 2016/C 276/01, 29.07.2016.

of framework agreements to avoid the need for contract modifications and to manage changes in the scope of the tasks to be entrusted, contract modifications, which are possible without new procurement procedures, and further guidance on the public procurement procedures.

Importantly, the Notice elaborates on the designation of the EIB, the EIF, and international financial institutions: they may be entrusted in accordance with Article 38 (4) (b) (i), (ii) CPR and be contracted by the managing authority directly without a public procurement procedure of Directive 2014/24/EU: Where a contract is directly awarded by a managing authority to the EIB/EIF for the implementation of a fund of funds, the EIB/EIF is required to select it on the basis of its internal rules and procedures, which must also comply with the general principles of the EU Treaty, as well as adhere to the requirements of Article 7 (3) CDR.[350] The concept of a 'fund of funds' is defined by Article 2 (27) CPR as a fund set up with the objective of contributing support from (a) ESI fund programme(s) to several financial instruments. This means that a fund of fund is 'a pool of capital provided by multiple partners to invest in venture capital funds, which in turn invest in start-ups', for instance.[351] For international institutions, Article 7 (1), (2), (3) CDR applies.

In accordance with the requirements of Article 12 of Directive 2014/24/EU, a contracting authority may conclude a public contract with a controlled legal person per 'in house award'. The cumulative conditions are: (i) no direct private capital participation in the controlled legal person, (ii) control over in-house entity, and (iii) the controlled legal person must carry out more than 80 per cent of its activities in the performance of tasks entrusted to it by the controlling contracting authority (measured via turnover or an appropriate alternative activity-based measure). Moreover, inter-administrative cooperation is possible under the conditions of Article 7 (1) and (2) CDR and Article 12 (4) of Directive 2014/24/EU.

Article 7 CDR lays down the criteria to be applied by the managing authority, when selecting bodies implementing financial instruments. Article 7 (1) and (2) CDR apply to the selection of bodies implementing financial instruments (except for the selection of the EIB and the EIF) regardless of the amount of the contract and regardless of the selection procedure of the bodies

[350] European Commission, Notice on Guidance for Member States on the selection of bodies implementing financial instruments, 2016/C 276/01, 29.07.2016, points 3.2, 3.3, and 3.4.
[351] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 14.

concerned, while Article 7 (3) CDR applies to the selection of financial intermediaries by the bodies implementing a fund of funds.[352] The criteria of Article 7 (1) (a) to (f) and Article 7 (2) first paragraph CDR and their minimum set of selection criteria relate to the legal, financial, economic, and organisational capacity of the body to be entrusted. Article 7 (2) (a) to (f) CDR and its minimum set of award criteria relate to the subject matter of the contract on the implementation of the financial instrument, e.g. robustness and credibility of the methodology, terms and conditions applied in relation to support provided to final recipients, and own resources of the implementing body.

Chapter VII will elaborate further on financial instruments set up and managed at the EU level and the corresponding concept of 'consistency with state aid law'.

2.2. The grant of an advantage

Another condition that must be fulfilled so that state aid law of Article 107 (1) TFEU applies is the presence of an advantage: An **advantage** is defined as any economic benefit, which an undertaking could not have obtained under normal market conditions, i.e. in the absence of State intervention.[353] This criterion is effects-based: What is decisive is the effect of the measure in question on undertakings rather than the cause or the objective of the State intervention, as the EU Courts made clear in their case law.[354] Thus, 'whenever the financial situation of an undertaking is improved due to state intervention on terms differing from normal market conditions', an advantage is considered to be present.[355] Therefore, the Commission will compare the financial situation of the undertaking following the measure 'with its financial situation if the measure had not been taken'.[356] The exact form of the measure is not relevant either: not only granting positive economic advantages, but also relief from economic burdens constitutes an

[352] European Commission, Notice on Guidance for Member States on the selection of bodies implementing financial instruments, 2016/C 276/01, 29.07.2016, point 3.7.
[353] Case C-39/94, SFEI and Others [1996] ECLI:EU:C:1996:285, para. 60.
[354] Case 173/73, Italy v Commission [1974] ECLI:EU:C:1974:71, para. 13.
[355] According to the Commission, 'the term 'State interventions' does not only refer to positive actions by the State but also covers the fact that the authorities do not take measures in certain circumstances, for example to enforce debts. See for example Judgment of the Court of Justice of 12 October 2000, Magefesa, C-480/98, ECLI:EU:C:2000:559, paragraphs 19 and 20' - Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 67.
[356] Case C-173/73, Italy v Commission [1974] ECLI:EU:C:1974:71, para. 13.

advantage.[357] An advantage may be conferred also indirectly, i.e. if 'the measure is designed in such a way as to channel its secondary effects towards identifiable undertakings or groups of undertakings'.[358]

The concept of advantage is very relevant for financial instruments with regard to the so-called market economy investor principle (MEIP). According to that principle, where a Member State intervenes in the market, its measures constitute the grant of an economic advantage, where it does not act in the same way as a private operator under normal market conditions – or put differently, 'to determine whether a public body's investment constitutes State aid, it is necessary to assess whether, in similar circumstances, a private investor of a comparable size operating in normal conditions of a market economy could have been prompted to make the investment in question'.[359] If the MEIP test is positive, however, no advantage is assumed to be attributable to the intervention by the Member State, since the recipient could have benefitted in the same way from the mere functioning of the market.[360]

For financial instruments, an advantage, and thus aid, may be present at different levels: at the level of investors, of the financial intermediary and/or its manager, and of the final beneficiaries, i.e. the undertakings in which the investment is made. Regarding **the level of investors**, for instance, 'where a measure allows private investors to carry out risk finance investments into a company or set of companies on terms more favourable than public investors investing in the same companies', there may be an advantage present (e.g. in the form of preferential returns or reduced exposure to losses).[361]

However, aid may be excluded, if the investment is effected *pari passu* between public and private investors, i.e. under the same terms and conditions for both (i.e. same risks and rewards and same level of subordination), where both types of investors intervene simultaneously (i.e. co-

[357] Case C-280/00, Altmark Trans [2003] ECLI:EU:C:2003:415, para. 84,
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 68.
[358] Case C-156/98, Germany v Commission [2000] ECLI:EU:C:2000:467, paras. 26, 27,
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 116.
[359] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 74: See, for instance, cases C-142/87, Belgium v Commission ('Tubemeuse') [1990] ECLI:EU: C:1990:125, para. 29; C-305/89, Italy v Commission ('ALFA Romeo') [1991] ECLI:EU: C:1991:142, paras. 18 and 19; T-16/96, Cityflyer Express v Commission [1998] ECLI:EU: T:1998:78, para. 51; joined cases T-129/95, T-2/96 and T-97/96, Neue Maxhütte Stahlwerke and Lech-Stahlwerke v Commission [1999] ECLI:EU:T:1999:7, para. 104.
[360] Case T-244/08, Konsum Nord ekonomisk förening v Commission [2011] ECR II-444, para 62.
[361] European Commission, Risk Finance Guidelines, para. 36.

investment via the same transaction), and where the intervention of the private investors is of real economic significance (i.e. 30 per cent private investment).[362] An advantage of investors may take 'the form of preferential returns (upside incentive) or reduced exposure to losses in the event of underperformance of the underlying transaction compared to the public investors (downside protection)'.[363]

Regarding aid at **the level of financial intermediaries**, the Commission considers them a vehicle for the transfer of aid rather than a beneficiary, in general.[364] However, if one of the MEIP requirements is not adhered to, they may be considered to receive aid.[365] If they effect direct investments or co-invest, an advantage is excluded, if the transfer is in line with the MEIP.[366] If the financial instrument is managed by an entrusted entity, the Commission considers this entity a vehicle to channel the financing and not to be a beneficiary of aid, if it is not overcompensated.[367] If the entrusted entity provides funding or co-invests, the Commission will assess whether it receives aid.[368]

If the financial intermediary or the fund manager is selected via an open, transparent, non-discriminatory, and objective procedure, or the remuneration reflects current market levels in comparable situations, the Commission presumes aid to be excluded.[369] If such a procedure was not applied, an advantage will only be excluded, if the management fee is capped, the overall remuneration reflects normal market conditions and is linked to performance, the financial intermediaries are managed commercially with investment decisions taken in a profit-oriented manner, the private investors are selected through an open, transparent, non-discriminatory, and objective selection process on a deal-by-deal basis, and mechanisms are in place to prevent interference by the State.[370]

[362] European Commission, Risk Finance Guidelines, paras. 31-34.
[363] European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.12.
[364] European Commission, Risk Finance Guidelines, para. 37.
[365] European Commission, Risk Finance Guidelines, para. 37.
[366] European Commission, Risk Finance Guidelines, para. 38.
[367] European Commission, Risk Finance Guidelines, para. 39.
[368] European Commission, Risk Finance Guidelines, para. 39.
[369] European Commission, Risk Finance Guidelines, para. 40.
[370] European Commission, Risk Finance Guidelines, para. 41.

Regarding aid at the **level of 'final beneficiaries'** or '**final recipients'** the Commission considers that, where aid is present at the level of the investors, the financial intermediary, or its managers, the aid is at least partly passed on to the undertakings, regardless of whether investment decisions were being taken by the fund managers with a purely commercial logic.[371] Regarding loans and guarantees, they are considered to be free of state aid, if they fulfil the conditions of the Reference Rate Communication or section 3 of the Notice on Guarantees, respectively.[372]

2.3. On a selective basis

With regard to **selectivity**, this criterion comprises a comparison between undertakings that are favoured by the aid measure and comparable undertakings that are not favoured (in the same manner): measures are selective, even if the number of eligible beneficiaries is large, since 'neither a large number of eligible undertakings (which can even include all undertakings of a given sector), nor the diversity and size of the sectors to which they belong, provide grounds for concluding that a State measure…' is not selective.[373] The comparability between these undertakings means a comparable legal and factual situation, considered in the light of the objective pursuit by the measure in question.[374]

De jure selectivity relates to 'the legal criteria for granting a measure that is formally reserved for certain undertakings only', e.g. having a certain size or companies newly incorporated or listed.[375] *De facto* selectivity relates to cases, where although 'the formal criteria for the application of the measure are formulated in general and objective terms, the structure of the of the measure is such that it effects significantly favour a particular group of undertakings' and may be the 'the result of conditions or barriers imposed by Member States preventing certain undertakings from

[371] European Commission, Risk Finance Guidelines, para. 44.
[372] European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.13.
[373] Case C-75/97, Belgium v Commission [1999] ECLI:EU:C:1999, para. 32, and
Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 118.
[374] Case C-143/99, Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH v Finanzlandesdirektion für Kärnten [2001] ECR I-8365, para. 41.
Thus, where an undertaking is not comparable to any other undertaking in a comparable legal and factual situation, any economic advantage granted would not be considered selective. - Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.7.
[375] Case T-211/05, Italy v Commission [2009] ECLI:EU:T:2009:304, para. 120, case C-458/09 P, Italy v Commission [2011] ECLI:EU:C:2011:769, paras. 59, 60, and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 121.

benefitting from the measure', e.g. a tax measure being applicable only to investments exceeding a certain threshold.[376] Comparability may not be confused with the undertakings being in competition, which relates to the separate criterion of the distortion of competition. Moreover, there may be territorial selectivity: A measure is not selective, if it applies to the entire territory of a Member State.[377] Hence, a general measure that benefits all undertakings within the Member State does not fall under Article 107 (1) TFEU.[378] The comparison of Member States' territories as such is inadmissible.[379]

Financial instruments, in contrast to 'general economic, tax, or social policy measures, which are effectively open to all undertakings operating in a Member State on an equal basis', favour only certain undertakings that fall within the category of eligible final recipients provided by the relevant programme of a financial instrument.[380] Risk finance measures, due to the criteria of Article 21 (5) GBER, for instance, favour only certain types of undertakings (i.e. young undertakings), rendering these measures selective.

2.4. The recipient is an undertaking and the notion of production of goods

The scope of the State aid rules encompasses advantages granted to certain undertakings or production lines. According to the Court of Justice, **undertaking** means 'every entity engaged in an economic activity, regardless of the legal status of the entity and the way in which it is financed'.[381] Thus, 'the classification of a particular entity as an undertaking depends on the nature of its activities', which implies three consequences.[382] Firstly, the status of the entity under national law is not decisive, since the only relevant criterion is whether it conducts an economic

[376] Joined cases C-182/03 and C-217/03, Belgium and Forum 187 v Commission [2006] ECLI:EU:C:2006:416, para. 122; joined cases T-92/00 and T-103/00, Ramondin SA and Ramondín Cápsulas SA v Commission [2002] ECLI:EU:T:2002:61, para. 39, and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, paras. 121, 122.
[377] Case C-143/99, Adria-Wien Pipeline GmbH v Finanzlandesdirektion für Kärnten [2001] ECR I-8365, para 35.
[378] Case C-143/99, Adria-Wien Pipeline GmbH v Finanzlandesdirektion für Kärnten [2001] ECR I-8365, para 35; case T-233/04, Netherlands v Commission [2008] ECR I-591, para 85.
[379] Case T-308/00, Salzgitter [2004] II-1933, para 81.
[380] The European Commission, European Social Fund financial instruments and State Aid, fi-compass, https://www.fi-compass.eu/sites/default/files/publications/European%20Social%20Fund%20and%20State%20aid_0.pdf, p.8, last access: 12.05.2019.
[381] Case C-41/90, Klaus Höfner and Fritz Elser v Macrotron GmbH [1991] ECR I-1979, para 21.
[382] Joined Cases C-180/98 to C-184/98, Pavlov and Others [2000] ECLI:EU:C:2000:428, para. 74; case C-222/04, Cassa di Risparmio di Firenze SpA and Others [2006] ECLI:EU:C:2006:8, para. 107; and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, paras. 7-10.

activity.[383] Secondly, 'the application of the State aid rules does not depend on whether the entity is set up to generate profits', since 'non-profit entities can also offer goods and services on the market' (as the defining criterion of 'economic activity').[384] Thereby, the notion of 'production of goods' is broad: it does not only cover the very production of goods, but also the provision of services for remuneration and thus all sectors of the economy.[385] Thirdly, 'the classification as an undertaking is always relative to a specific activity': where an entity conducts both economic and non-economic activities, only with regard to the former the entity will be considered an undertaking.[386]

With regard to financial instruments, the Commission states that 'the presence of state aid must be verified for all actors involved in financial instruments' and that 'it should therefore be checked for all actors whether they qualify as "undertakings", unless the presence of state aid can be excluded on the basis of other requirements of Article 107 (1) TFEU'.[387] Regarding fund managers and investors, they 'normally qualify as "undertakings", because they carry out an economic activity'.[388] Interestingly, if a fund manager merely manages the financial instrument and does not co-invest, the Commission considers it a mere 'vehicle' rather than an 'undertaking'.[389]

Final recipients do not qualify as undertakings, if they are **individuals**, who are not engaged in an economic activity or in activities, which are not regarded as economic in nature.[390] Importantly, however, the Commission considers natural persons in the capacity of **business angels** to be undertakings, if they have a professional quality, i.e. by applying an active role, due diligence, and risk management strategies, going beyond the activities of normal shareholders (see chapter

[383] European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.10.
[384] Joined Cases 209/78 to 215/78 and 218/78, Van Landewyck [1980] ECLI:EU:C:1980:248, para. 88,
and European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.11.
[385] Case C-66/02, Italy v Commission [2005] ECR-I-10901, para. 95, and
Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 187.
[386] Case T-128/98, Aéroports de Paris v Commission [2000] ECLI:EU:T:2000:290, paras. 107-109,
and European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.11.
[387] European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.11.
[388] European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.11.
[389] Commission decision SA.37824 and Commission decision SA.36904, para. 71 (b).
- European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.11, footnote 21.
[390] European Commission, Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 Programming Period, 2017, SWD(2017) 156 final, p.11.

VI).[391] For the compatibility assessment under the Risk Finance Guidelines in these cases, the Commission will regard such natural persons pursuing economic activities qualifying to be undertakings as 'corporate investors' under the Risk Finance Guidelines.[392] In a similar vein, the general block exemptions (GBER) for risk finance aid recognise corporate investors who are natural persons providing risk finance to undertakings and benefitting from tax exemptions as potential recipients of aid at the level of independent private investors.[393]

In most cases, final recipients do qualify as undertakings, and with regard to financial instruments, the Commission generally considers that aid is present and the advantage at least partially passed on to undertakings, where aid was found to be present at the level of investors, the financial intermediary or its manager.[394]

2.5. Competition must or may be distorted and trade must be affected

Another criterion is that the aid must **distort or threaten to distort competition** by favouring certain undertakings: The mere threat of distortion suffices to fulfil this criterion.[395] Anti-competitive practices on the part of the recipient need not be proven.[396] For the assessment of state aid, the point of departure is the competitive position existing within the internal market before the adoption of the measure in question.[397] This pre-existing competitive position is the result of numerous factors having varying effects on production costs, such as investment costs, operating costs, and taxation, so that 'the unilateral modification of a particular factor of the cost of production… may have the effect of disturbing the existing equilibrium'.[398] Aid that mitigates

[391] Aid No. SA.46308, Commission decision, 25.08.2016, para. 24.
[392] Aid No. SA.46308, Commission decision, 25.08.2016, para. 55, footnote 21.
[393] Article 21 (3) of Commission Regulation 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Article 107 and 108 of the Treaty, OJ L 187 26.6.2014, p. 1.
[394] European Commission, Risk Finance Guidelines, para. 44.
[395] Case C-301/87, France v Commission [1990] ECR I-307, para 33; Case C-494/06P, Commission v Italy [2009] ECR I-3639, para 49; Case T-214/95, Vlaams Gewest v Commission [1998] ECR II-717, para 54; Case T-288/97, Regione Autonoma Friuli Venezia Giulia v Commissio [2001] ECR II-1169, paras 49-50; Case T-35/99, Keller SpA v Commission [2002] ECR II-261, para 85; Cases T-239/04 and T-323/04, Italy v Commission [2007] ECR II-3265, para 127; Case T-238/09, Sniace SA v Commission [2011] ECR II-430, para 77.
[396] Cases T-231/06 and T-237/06, Netherlands v Commission [2010] ECR II-5993, para 123.
[397] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.77.
[398] Case C-173/73, Italy v Commission [1974] ECR 709, para 17;
and Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.77.

costs of an undertaking it would normally have to bear for the operation of its daily business processes, so-called operating costs, is considered to distort competition.[399]

It is not necessary to identify the relevant product market and the relevant geographic market before a distortion of competition may be established.[400] While the relevant market needs to be identified, it is sufficient for the Commission to merely establish that the measure in question is apt to affect trade between Member States and distorts or threatens to distort competition without the need for a detailed analysis of the sector in question.[401] With regard to the Commission's assessment, it suffices to deliver a qualitative analysis, while a quantitative analysis is not necessary.[402]

For State aid to be present, the measure must also **affect trade between Member States**. The notion of trade encompasses the entire trade of products and services between Member States.[403] There is a considerable overlap between the effect on trade between Member States and the distortion of competition, so that, in practice, they are often treated jointly in the assessment of State aid.[404]

The EU Courts consider an effect on trade to be present, 'where State financial aid strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade'.[405] The aim of Article 107 (1) TFEU is 'to prevent trade between Member States from being affected by benefits granted by the public authorities, which, in various forms, distort or threaten to distort competition by favouring certain undertakings or the production of certain goods'.[406] In particular, it is thus necessary to consider whether State aid is present, if an undertaking's position is strengthened vis-à-vis other international undertakings offering comparable products

[399] Case C-86/89, Italy v Commission [1990] ECR I-3891, para 18.
[400] The identification need not be as detailed as it must be in cases of competition law.
- Case C-730/79, Philip Morris v Commission [1980] ECR 2671, paras 10-11.
[401] Case 730/79, Philipp Morris v Commission [1980] ECR 2671, para 12; Cases C-62 and 72/87, Exécutif Régional Wallon v Commission [1988] ECR 1573, para 18; Case C-494/06P, Commission v Italy and Wam [2009] ECR-3639, para 50.
[402] Case T-214/95, Het Vlaams Gewest v Commission [1998] ECR II-717, para 67.
[403] Andreas Bartosch, EU-Beihilfenrecht, C.H. Beck Verlag, 2016, p.114.
[404] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.83.
[405] Case 730/79, Philip Morris v Commission [1980] ECR 2671, para 11; Case C-494/06P, Commission v Italy [2009] ECR I-3639, para 51.
[406] Case C-173/73 Italy v Commission [1974] ECR 709, para 13; Case C-310/85, Deufil GmbH v Commission [1987] ECR 901, para 8; Case C-387 Banco Exterior de Espana SA v Ayuntamiento de Valencia [1994] ECR I-877, para 12; Case C-39/94, SFEI v La Poste [1996] ECR I-3547, para 58; Cases T-116/01 and T-118/01, P&O European Ferries (Vizcaya) SA v Commission [2003] ECR II-2957, para 18, and Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.83.

or services in other Member States.[407] If the Commission fails to examine the effect of the aid, however, the ECJ will annul the Commission decision.[408] For instance, if the production costs of undertakings competing with undertakings in other Member States are modified due to a State measure, trade between Member States is necessarily affected.[409]

Hence, for the concept of 'effect', it is decisive whether there is an impact or, at least, the possibility of an impact on trade between Member States.[410] Therefore, it is sufficient to examine whether the measure at hand is liable to affect trade; an actual effect need not be proven.[411] The measure's very circumstances may be sufficient to demonstrate that the measure may be capable of affecting trade.[412] On the contrary, 'if a measure benefits products, which are not subject to any competition, or where trade is affected only at the national level', it will not fall under Article 107 (1) TFEU.[413]

With regard to financial instruments, they are regarded as not affecting trade and competition and hence to be free of state aid, if their total amount of aid does not exceed a certain ceiling

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[407] Cases T-81/07 to T-83/07, KG Holding NV v Commission [2009] ECR II-2411, para 79.
Accordingly, Quigley states that as soon as 'it is foreseeable that exports will be directed to other Member States, the Commission is obliged to examine whether there is an effect on trade by virtue of the grant of the aid'.
- Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.83.
[408] Cases C-447-449/93, AITEC v Commission [1995] ECR II-1971, paras 139-140.
[409] Case C-173/73, Italy v Commission [1974] ECR 709, para 18; Case C-126/01, Ministre de l'économie, des finances et de l'industrie v GEMO [2003] ECR I-13769, para 42.
This may be the case even if the beneficiary undertaking is itself not involved in exporting: if the domestic production remains constant or increases, this may result in foreign undertakings' decreased chances of exporting their products to the market of the Member State granting the aid.
- Case C-102/87, France v Commission [1988] ECR 4067, para 19; Cases C-278/92-280/92, Spain v Commission [1994] ECR I-4103, para 40; Case C-75/97, Belgium v Commission [1999] ECR I-3671, para 47; Case C-156/98, Germany v Commission [2000], ECR I-6857, para 33; Case C-310/99, Italy v Commission [2002] ECR I-2289, para 84; Case T-288/97, Regione Autonoma Friuli Venezia Giulia v Commission [2001] ECR II-1169, para 51; Case T-152/99, Hijos de Andrés Molina SA v Commission [2002] ECR II-3049, para 220; and Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, pp.83-84.
[410] Case C-66/02, Italy v Commission [2005] ECR I-10901, para 112.
[411] Case C-301/87, France v Commission [1990] ECR I-307, para 33; Case C-372/97, Italy v Commission [2004] ECR I-3679, para 44; Case C-298/00P, Italy v Commission [2004] ECR I-4807, para 49; Cases C-442/03P and C-471/03P P&O European Ferries (Vizcaya) SA v Commission [2006] ECR I-4845, para 110; Case C-222/04, Ministero dell'Economia e delle Finanze v Cassa di Risparmio di Firenze SpA [2006] ECR I-289, para 140; Case C-494/06P, Commission v Italy [2009] ECR I-3639, para 49.
[412] Cases C-296 and 318/82, Netherlands and Leeuwarder Papierwarenfabriek v Commission [1985] ECR 809, para 24.
The very liberalisation of a sector, which a beneficiary undertaking adheres to, indicates the real or potential effect of the aid on competition and trade. - Cases C-409/00, Spain v Commission [2003] ECR I-1487, para 75; and C-66/02, Italy v Commission [2005] ECR I-10901, para 116.
[413] Case C-40/75, Produits Bertrand v Commission [1976] ECR 1, per Advocate General Reischl, at p.16; Case 730/79, Philip Morris v Commission [1980] ECR 2671, per Advocate General Capotorti, at p.2697; Case C-142/87, Belgium v Commission [1990] ECR I-959, per Advocate General Tesauro at p.1001;
and A. Petersen, State Aid and European Union: State aid in the light of trade, competition, industrial and cohesion policies, in I. Harden ed., State Aid: Community Law and Policy, Cologne, 1993, p.22.
Accordingly, where a measure aims at undertakings providing only local services, it is not likely to affect trade between Member States. - See, for instance, SA.37432, Czech public hospitals; SA.33149, Kiel information services; SA.38035, Bad Nenndorf rehabilitation clinic; SA.38208 UK golf clubs (2015).

over a period of time per single undertaking and if they fulfil the other criteria of the *de minimis* Regulation (see section 4 of this chapter).[414] Otherwise, the Commission finds that 'state aid is almost always presumed to have a potential effect on competition, when the State grants a financial advantage to an undertaking in a liberalised sector, where there is, or could be, competition', and regarding the effect on trade, that 'it is sufficient that a product or service [of the final recipients] is tradeable between Member States'.[415] Therefore, if a measure fulfils the requirements of *de minimis*, it will be considered not to affect trade and competition and to be free of state aid thus. Distortion of competition and the effect on trade between Member States are present in the case of financial instruments in general, since the investment of capital is an activity subject to intensive trade between states.[416] In sum, from the case law of the EU Courts it appears that 'the production of effects on trade and the distortion of competition are a normal consequence of the granting of aid which fulfils the other requisites of Article 107 (1)'.[417] This is the case, unless 'the aided company operates only in a non-liberalised market', or 'there are no competitors established within the EU', or 'the aid is *de minimis*', or 'the aided company's activity is purely local', representing only 'a small share of all state aid situations', however.[418]

3. Article 107 (2) and (3) TFEU, Articles 108 and 109 TFEU

The prohibition of State aid under Article 107 (1) TFEU is neither absolute nor unconditional, as itself states that aid shall be prohibited save as provided in the TFEU.[419] Thus, certain categories of aid are declared to be compatible with the internal market by **Article 107 (2) TFEU**.[420] Measures that form part of these categories must nonetheless be notified to the Commission in advance

[414] Commission Regulation (EU) No 1407/2013, recitals (1) and (3).
[415] The European Commission, European Social Fund financial instruments and State Aid, fi-compass, https://www.fi-compass.eu/sites/default/files/publications/European%20Social%20Fund%20and%20State%20aid_0.pdf, p.8, last access: 12.05.2019.
[416] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 733.
[417] Manuel Fontaine Campos, The Evolution of the "Effects on Trade" and "Distortion of Competition" Requirements under the EU State Aid Regime, in: Sofia Oliveira Pais, Competition Law Challenges in the Next Decade, Peter Lang Internationaler Verlag der Wissenschaften, 2016, p. 211.
[418] Manuel Fontaine Campos, The Evolution of the "Effects on Trade" and "Distortion of Competition" Requirements under the EU State Aid Regime, in: Sofia Oliveira Pais, Competition Law Challenges in the Next Decade, Peter Lang Internationaler Verlag der Wissenschaften, 2016, pp. 211, 212.
[419] Case C-78/76 Steinike und Weinlig v Germany [1977] ECR 595, para 8; Case C-301/87, Commission v France [1990] ECR I-307, para 15; Case C-39/94, SFEI v La Poste [1996] ECR I-3547, para 36; and Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.193.
[420] Being an exception to Article 107 (1) TFEU, its provisions must be interpreted narrowly. - Case C-156/98, Germany v Commission [2000] ECR I-6857, para 49.

pursuant to Article 108 (3) TFEU before they are implemented.[421] Article 107 (2) TFEU concerns the following categories:

a) aid having a social character,
b) damage caused by natural disasters and exceptional occurrences,
c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany.

Under **Article 107 (3) TFEU**, certain categories of aid may be considered compatible with the internal market: (a) aid for seriously underdeveloped areas, (b) aid for projects of common European interest or for remedying serious disturbances in the economy, (c) aid to facilitate the development of certain economic activities or areas, where such aid does not adversely affect trading conditions and competition to an extent contrary to the common interest, (d) aid for culture and heritage conservation, where such aid does not adversely affect trading conditions and competition to an extent contrary to the common interest, and (e) other categories to be specified by decision of the Council on a proposal from the Commission.[422]

Unlike Article 107 (2) TFEU, Article 107 (3) TFEU does not compel the Commission to find aid to be compatible with the internal market, but grants it certain discretion to consider it so or not, which involves the assessment of economic and social factors within the EU as a whole.[423] Thus, the Commission weighs the possibly contradictory interests of the aid's objectives against the EU's overall interest of undistorted competition, so that aid should be limited to the minimum necessary.[424] Hence, the overarching criteria for of any measure are the achievement of a public interest objective, its appropriateness and necessity to achieve the objective, its proportionality, and the limitation of distortion and negative effects on trade and the internal market. These criteria can be found in the common assessment principles of the Commission in its assessment of compatibility with the internal market (see chapter VI).

[421] Case T-308/00, Salzgitter AG v Commission [2004] ECR II-1933, para 74.
[422] Like Article 107 (2) TFEU, the provisions of Article 107 (3) TFEU must be interpreted narrowly. The exceptions under Article 107 (2) TFEU and Article 107 (3) TFEU are quite distinct, as those categories under the former are automatically compatible with the internal market, if the relevant conditions are satisfied. In practice, the categories of Article 107 (3) TFEU are, however, far more relevant compared to the very limited categories of Article 107 (2) TFEU.
- Kelyn Bacon, European Union Law of State Aid, Oxford University Press, 2017, p.93.
[423] Case 730/79, Philip Morris v Commission [1980] ECR 2671, para 24.
[424] Case T-349/03, Corsica Ferries France sas v Commission [2005] ECR II-2197, para 317.

A textbook example for the application of financial instruments, including equity, guarantees, and sub-commercial loans, based on Article 107 (3) (c) TFEU, for instance, provides Commission decision SA.34660 on revolving Urban development funds addressing socio-ecological and socio-economic urban market failures, which will be discussed in chapter VI.

Article 108 TFEU defines the role of the Commission to review all systems of aid existing in the internal market in cooperation with the Member States as well as the procedure, under which the Commission may find state aid to be incompatible with the internal market. However, Article 108 TFEU merely defines a framework of the procedure, which is complemented by Council Regulation (EU) No 2015/1589, which lays down detailed rules for the application of the procedure. Before a Member State sets up or alters any of the aid forms falling within the categories of Article 107 (3) TFEU, it must inform the Commission in sufficient time to enable it to submit its comments. According to Article 108 (2) and (3) TFEU, the Commission has the power to block the aid project or require its amendment. Moreover, Article 108 (4) TFEU mandates the Commission 'to adopt regulations relating to the categories of state aid that the Council has, pursuant to Article 109, determined may be exempted from the procedure' of Article 108 (3) TFEU.

As indicated before, **Article 109 TFEU** provides the legal basis for Council regulations on a proposal by the Commission and, in particular, the determination of conditions in which Article 108 (3) TFEU shall apply and of the categories of aid exempted from this procedure: Council Regulation (EU) No 1588/2015 on certain exemptions from the notification procedure and Council Regulation (EU) No 2015/1589 laying down detailed rules for the application of Article 108 (3) TFEU were adopted on the basis of Article 109 TFEU.

4. De minimis aid

4.1. Case law and different lines of argumentation

As elaborated above, Article 107 (1) TFEU applies and state aid is considered present, if all of its criteria are fulfilled. Regarding the criterion of trade effects, there are two lines of argumentation on the so-called *de minimis* aid, where both the EU Courts and the Commission have been

ambiguous in their respective approach to this issue.[425] The first line of argumentation states that *de minimis* aid affects competition involving intra-State trade only to a minor degree, so that it falls outside the scope of Article 107 (1) TFEU.[426] Moreover, even if aid fell within its scope, it may be treated similar to aid that is *de minimis* and may thus not be notified due to its 'minor importance'.[427] The second, stricter line of argumentation states that 'all State aid that has an effect, no matter how small, on competition involving intra-State trade falls within the scope of Article 107 (1) TFEU' and may only be considered 'permissible in so far as it is declared compatible with the internal market by the Commission or the Council'.[428]

In *France v Commission*, the EU Courts regarded aid that did not 'substantially affect trade between [Member] States' as permissible.[429] Due to the fact that this aid had not been notified to the Commission, it may be deduced that the EU Courts tended to the line of argumentation that *de minimis* aid does not affect trade, is not covered under the scope of Article 107 (1) TFEU, and thus does not require notification.[430] However, the EU Courts held that for aid to be regarded as substantially affecting trade, the circumstances of the case rather than the quantity of aid were decisive, 'so that even aid of a relatively small amount may be liable to affect trade between Member States, where there is strong competition in the sector', for instance.[431] In *Belgium v Commission*, both the EU Courts and the Commission stated 'that there is no threshold, below which intra-EU trade' may be considered not to be affected, so that a *de minimis* principle thus did not exist.[432] Be this as it may, the Commission bases its *de minimis* Regulation on the presumption that *de minimis* aid does not affect competition and hence does not fall under the scope of Article 107 (1) TFEU, as it will be explained in the following.[433]

[425] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.91.
[426] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.91.
[427] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.91.
[428] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.91.
[429] Case C 47/69, France v Commission [1970] ECR 487, para 16.
[430] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.92; and case C-40/75, Societé des Produits Bertrand v Commission [1976] ECR 1, per Advocate General Reischl at p.17; case C-42/93, Commission v Spain [1994] ECR I-4175, per Advocate General Jacobs, p.4182.
[431] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.92; and case C-259/85, France v Commission [1987] ECR 4393, para 24; case C-303/88, Italy v Commission [1990] ECR I-1433, para. 27; cases C-278/92-280/92, Spain v Commission [1994] ECR I-4103, paras. 41, 42; case C-156/98, Germany v Commission [2000] ECR I-6857, para. 32; case C-310/99, Italy v Commission [2002] ECR I-2289, para. 86; case C-278/00, Greece v Commission [2004] ECR 3997, paras. 69, 70; cases C-393/04 and C-41/05, Air Liquide Industries Belgium SA v Ville de Seraing [2006] ECR I-5293, para. 36; case T-14/96, BAI v Commission [1999] ECR II-139, para. 77.
[432] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.93; and case C-142/87, Commission v Belgium [1990] ECR I-959, para. 43.
[433] Commission Regulation (EU) No 1407/2013, recitals (1) and (3).

4.2. Regulations No 1407/2013 and No 1588/2015 on de minimis aid

The enabling power of Article 2 of the Council Regulation (EU) No 1588/2015 states that the Commission may adopt a regulation to entail the *de minimis* rule. With this mandate, the Commission may decide that certain aid does not fulfil all the criteria of Article 107 (1) TFEU and is therefore exempt from the notification requirements of Article 108 (3) TFEU.[434] Based thereupon, the current regulation is Commission Regulation (EU) No 1407/2013. The EU Courts made clear that Member States, which strive to apply the *de minimis* block exemption, must provide the Commission with requisite evidence that the conditions for its application are met.[435] This Regulation states that the total of any *de minimis* aid granted, irrespective of its form or its objective pursued, may not exceed EUR 200,000 over any period of three years.[436] If this threshold is exceeded, the *de minimis* aid will not be considered separately from other aid granted to the same beneficiary by the Commission, but as a whole.[437]

As stated, recitals (1) and (3) of the *de minimis* Regulation explain that *de minimis* aid does not affect competition and hence does not fall under Article 107 (1) TFEU. However, the wording of its Article 3 (1) defining *de minimis* aid is ambiguous: on the one hand, it lays down that *de minimis* aid does not fall under Article 107 (1) TFEU, while it also states that *de minimis* aid is exempted from the notification requirement of Article 108 (3) TFEU, if it fulfils the requirements of the Regulation, on the other hand. If it were not to be considered state aid, it would not have to be exempted from the notification requirement in the first place. This ambiguity may stem from the facts that the legal basis of the *de minimis* Regulation is Article 108 (4) TFEU, which allows for exemptions of the notification requirement, and that the text of Article 2 of the Council Regulation (EU) No 1588/2015 also contains this wording. Moreover, under the rules applicable for ESI funds, the bodies implementing financial instruments may not receive any state aid, under which the Commission appears to comprise also *de minimis* aid.[438]

[434] Article 2 (1), Council Regulation No 994/98.
[435] Case T-527/13, Italy v Commission [2015] EU:T:2015:429, para 21.
[436] Commission Regulation (EU) No 1407/2013, Article 3 (2).
[437] Cases T-394/08, T-408/08, T-454/08, Regione autonoma della Sardegna v Commission [2011] ECR II-6255, para 312.
[438] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.4.

With regard to the **expiration date**, a few inconsistencies may be detected in the different legal texts on financial instruments: Firstly, the limited duration of the *de minimis* Regulation, i.e. 31 December 2020, conflicts with the eligibility period under the ESI fund rules, as Article 65 (2) CPR stipulates the date of 31 December 2023, and with the life cycle of financial instruments.[439] Even if the duration of *de minimis* Regulation were extended for two years as part of the fitness check, the duration until 31 December 2022 would still conflict with the eligibility period of the CPR.[440] Secondly, the limited duration of the GBER conflicts with the longer life cycle of financial instruments, which may also be the case, if it were extended for another two years until 31 December 2022.[441] The European Court of Auditors recommended in its report that the Commission should provide guidance on the continuance of financial instruments into following programme periods and, in general, the de-coupling of financial instruments' lifespans from programme lifecycles may be recommended, so that funds may 'be rolled forward with a fresh injection of funding based on a re-assessment of the finance gap, but without requiring closure and re-procurement'.[442] A solution could be to widen the transitional provision of Article 58 (4) GBER, which hitherto states that 'at the end of the period of validity of this Regulation, any schemes exempted under this Regulation shall remain exempted during an adjustment period of six months'.[443]

5. The development of the rules on risk finance aid

This section will elaborate on the development of EU state aid rules on risk finance beginning with the Risk Capital Action Plan in the late 90s, followed by the 2007-2013 programme period, and closing with the 2014-2020 programme period. It will discuss the shifting approaches and priorities of the Commission in assessing the compatibility of financial instruments with the internal market. In the end, and connected with the further analysis of the 2014-2020 legal

[439] European Commission, State Aid Survey, fi-compass, final report, November 2018, point 5.7.4.
[440] The European Commission, State Aid – 2 Year Extension for de minimis Regulation, https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-6622705_en, last access: 11.07.2019.
[441] The European Commission, State Aid – 2 Year Extension for General Block Exemption Regulation, https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-6622730_en, last access: 11.07.2019.
[442] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.121,
and Fiona Wishlade, Financial Instruments in ESIF: Past, Present and Future Conditional, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.98.
[443] European Commission, State Aid Survey, fi-compass, final report, November 2018, p. 23, point 6.6.3.

framework of this thesis, it will elaborate on potential improvements for the development of the legal framework beyond 2020.

5.1. Risk Capital Action Plan 1998 and Commission Communication 2001

The Commission has developed a favourable stance towards risk capital support beginning in the late 1990s. Following the **Risk Capital Action Plan of 1998** (RCAP), that championed risk capital markets providing equity finance to SMEs and high-growth companies for the sake of job creation within the EU and that designated six categories of barriers to the creation thereof, the Commission stated in its **2001 Communication** that the promotion of risk capital may be justified when there is evidence of a market failure.[444] The 2001 Communication based this on the RCAP's aims of promoting a culture of entrepreneurship, easing fiscal constraints on equity, fostering market integration, and easing regulatory constraints including limitations on investments by certain types of financial institutions and administrative procedures for setting up companies.[445]

The 2001 Communication set out for the first time how the Commission would apply the state aid definition of former Article 87 (1) of the EC Treaty (now Article 107 TFEU) to risk capital measures.[446] Moreover, it provided criteria, under which the Commission would authorise such measures that did constitute state aid, even if they were not compatible with other legislation adopted by the Commission.[447] However, the Commission also stated the imperative of controlling public funding to risk capital measures for three inherent risks: the risk that advantages to the beneficiaries (investors or enterprises) create undue distortion of competition, the risk of 'dead-weight' or lack of incentive effect, and the risk of 'crowding out', i.e. the discouraging of other potential investors from providing capital.[448]

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[444] Commission Communication, Risk capital: a key to job creation in the Union, http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=LEGISSUM:l24195&from=GA, last access: 19.12.2017;
and European Commission, Communication, State aid and risk capital, 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017.
[445] European Commission, Communication, State aid and risk capital, 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[446] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section II.1.
[447] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section II.1.
[448] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section III.1.

In the 2001 Communication, the Commission differentiates between the levels of the investors, the financial intermediaries, and enterprises as potential beneficiaries of aid.[449] At the level of the investors, the Commission finds an advantage 'where the measure allows investors to participate in the equity of a company on terms more favourable than public investors' (i.e. on conditions more favourable than market terms) or 'than if they had undertaken such investments in the absence of the measure'. It makes clear that this is the case 'even if the investor is persuaded by the measure to confer an advantage on the company', since the fact that due to the existence of a market failure no investor would otherwise make an investment was itself not sufficient to rebut the presumption of an advantage.[450] The Commission reasons that the investors were being offered more advantageous terms to compensate those investments for the factors that cause market failure.[451] However, if the advantage was 'limited to the amount necessary to overcome the factors which cause the market failure', the measure 'may be considered compatible with the Treaty' because of its limited effect, according to the Commission.[452]

At the level of the financial intermediary, the Commission states that it tended to the view that a fund was a vehicle for the transfer of aid to investors rather than an aid beneficiary itself.[453] However, in certain cases, 'notably measures involving transfers in favour of existing funds with numerous and diverse investors, the fund may have the character of an independent enterprise'.[454] If it could not be proven that the investment was made on terms, which would be acceptable to a normal economic operator in a market economy, aid was considered to be present.[455]

At the level of the enterprises invested in, the Commission re-iterates its main test, namely whether the enterprise has received the investment on terms, which would be acceptable to a

[449] Commission Communication, "State aid and risk capital", 2001/C 235/03, section IV.
[450] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[451] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[452] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section III.1.
[453] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[454] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[455] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.

private investor in a market economy.[456] It states that this is the case, for instance, when the investment is made on *pari passu* terms.[457] If this was not the case, an important indicator could instead be the fact that investment decision were taken by commercial managers of risk capital funds with an interest to ensure a maximum return for the fund.[458] The Commission would also take into account 'the possibility that any advantages accorded to investors… are passed on to the enterprises invested in', when the investments were not made by the fund *pari passu* with a private investor.[459] The Commission makes clear that if the risk capital measure 'has reduced the risks and/or increased the rewards of investors' then they were considered no longer to be operating as a normal economic operator.[460]

The 2001 Communication also mentions that *de minimis* aid does not constitute state aid, but that *de minimis* rule for risk capital measures was handicapped by difficulties of calculation (outlined in its section V) and by the fact that measures might provide aid not only to the target enterprise but also to other investors.[461] However, if a scheme provided public capital of EUR 100,000 or less to each enterprise over a three year period, then it was certainly *de minimis* aid in accordance with Commission Regulation (EC) No 69/2001 on *de minimis* aid, according to the Commission.

As the principal basis for authorising risk capital measures under former Article 87 (3) (a), (c), and (d) of the EC Treaty (now Article 107 TFEU), the Commission names market failure.[462] The main causes of this market failure were 'imperfect information, the risk-averse nature of investors and lending institutions, and the limited guarantees that SMEs are in a position to offer'.[463] However, the Commission cautions that it did not consider a general risk capital market failure in the European Community to be present, but that it did accept that there were 'market gaps for some

[456] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[457] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[458] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[459] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[460] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section IV.5.
[461] Difficulties of calculation might relate to the establishing of a grant equivalent of equity capital or of a link with eligible costs. – Commission Communication, "State aid and risk capital", 2001/C 235/03, section V.
[462] Commission Communication, "State aid and risk capital", 2001/C 235/03, section VI.
[463] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section VI.1.

types of investments, at certain stages of enterprises' lives and possibly for certain activities' and 'difficulties in regions qualifying for assistance'.[464] For tackling these gaps and difficulties, the Commission refers to already existent State aid frameworks back then, which could be applied to risk capital measures where possible.[465]

Therefore, the Commission put emphasis on the fact that it required the provision of evidence of market failure 'before being prepared to authorise risk capital measures, which fall outside the scope of existing rules'.[466] The exception were risk capital measures being fully or partially financed through state aid that contain a certain maximum of aid in regions qualifying for assistance, since for small transactions the presence of a market failure was more convincing due to the proportionally higher transaction costs.[467]

For the case it does find market failure to be present, the Commission elaborated on criteria for assessing a measure's compatibility at each level in its 2001 Communication.[468] The criteria were expressed in the form of 'positive and negative elements', whereby not all elements had equal weight, listing the more important ones first: The applicability and the weight attached to the elements were dependant on the form of the measure. [469]

The Commission's assessment was to take into account regional specificities and an overall test of proportionality. This means that the Commission analysed whether the aid measure was devised to meet and sought to ensure that any distortion be minimised, i.e. measures had to be 'just sufficient to ensure that market investors provide capital and which result in investment decisions being taken on a commercial basis and on terms as close as possible to those which would prevail in the normal economy'.[470] Thus, the presence of a market failure had to be

[464] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section VI.1.
[465] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section VI.1.
[466] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section VI.1.
[467] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section VI.1.
[468] Commission Communication, "State aid and risk capital", 2001/C 235/03, section VIII.
[469] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section VI.1.
[470] Commission Communication, State aid and risk capital, 2001/C 235/03, section VI.6.

demonstrated first, as outlined above, and only then the criteria could be applied under the overall test of proportionality, according to section VIII of the Communication:[471]

Firstly, the 'restriction of investments or failing that of a majority of funds invested (i) to small or even micro-enterprises and/or (ii) to medium-sized enterprises in their start-up or other early stages or in assisted areas' would be regarded as a positive element. The access to finance for medium-sized enterprises beyond their start-up or early stages should be subject to a limit per enterprise on total funding through the measure, according to the Commission. Restriction to certain smaller transaction sizes or to a given level of demonstrated market failure would also be regarded as a positive element. Thus, the limitation to certain sizes of enterprises or enterprises in certain stages is recognisable.

Secondly, measures should be focused on risk capital market failure, whereby a measure's provision 'for the delivery of finance to enterprises principally in the form of equity or quasi-equity' would be regarded positively. If measures provided 'significant amounts of finance in other forms or would not have a significant incentive effect' (i.e. 'where it will support risk capital investments which would have happened even in the absence of the measure'), this would be regarded negatively. For instance, this could be the case, if measures provided 'further finance to an enterprise, which had already received one aided injection of capital'. Thus, the preference of equity and quasi-equity over other forms of financial instruments and the concept of the incentive effect are recognisable.

Thirdly, decisions to invest should be profit-driven, i.e. 'a link between the investment performance and the remuneration of those responsible for the investment decisions' would be a positive element. This would be assumed to be met 'by measures under which all the capital invested in the target enterprises' was provided by market economy investors, who 'also make the investment decision with the aid being solely an incentive for them to do so', i.e. an incentive effect, and by 'other measures with significant involvement of market economy investors' capital being invested on a commercial basis (that is, only for profit) directly or indirectly in the equity of the target enterprises'. Thus, the concepts of incentive effect, the significant involvement of a

[471] Commission Communication, "State aid and risk capital", 2001/C 235/03, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52001XC0821(01)&from=EN, last access: 19.12.2017, section VIII.

private investor, and the investment on a commercial basis are recognisable. The Commission states that it considered the provision of at least 50 per cent of the fund's capital to constitute a 'significant involvement', or 30 per cent in assisted areas. Furthermore, the Commission regarded in the context of commercially driven decisions positively (i) an agreement between a professional fund manager and participants in the fund, whereby the manager's remuneration is linked to performance and the setting out of the objectives of the fund and proposed timing of investments, (ii) the representation of market investors in decision-making, and (iii) the application of best practice and regulatory supervision in the management funds. If no such element were present, this would be regarded negatively.

Fourthly, the level of distortion of competition between investors and between investment funds should be minimised. Therefore, the Commission considered positively 'a call for tender for the establishment of any 'preferential terms' given to investors' or an availability in the form of a public invitation to investors at the launch of a fund or a scheme that remained open to new entrants over an extended period. By contrast, 'the absence of any such check against overcompensation to investors' or a measure where 'the risk of losses is borne entirely by the public sector and/or where the benefits flow entirely to the other investors' would be considered negatively.

Fifthly, the Commission could 'accept a sectoral focus where this has a commercial as well as a public policy logic'. However, the Commission was less favourable towards a sectoral focus in sensitive sectors suffering from overcapacity, excluding aid in the shipbuilding sector, for instance.

Sixthly, the Commission considered positively 'the existence for each investment of a business plan containing details of product, sales, and profitability development and establishing the ex-ante viability of the project'. By contrast, where measures provided no 'exit mechanism' for the direct or indirect public involvement, this was considered negatively.

Finally, the Commission listed the avoidance of the cumulation of aid measures to a single enterprise: if a measure provided aid (other than *de minimis* aid) to the enterprises invested in, the Commission might 'request commitments from a Member State to assess and limit other

forms of state aid to enterprises funded by the risk capital measure'. For such measures, the Member State had to propose to the Commission a reasonable evaluation of the aid element for examination and approval in terms of the cumulation rules.

5.2. The SAAP, the 'refined economic approach', and the 'balancing test': The 2007-2013 Programme Period and the Risk Capital Guidelines 2007-2013

Following the **State Aid Action Plan of 2005 (SAAP)**, in which the Commission stated that 'state aid policy safeguards competition in the Single Market and it is closely linked to many objectives of common interest', the Commission introduced certain general block exemptions (the GBER) to focus on the 'most distortive types of aid' and a new set of Guidelines on state aid to promote risk capital investments as of 18 August 2006.[472] The SAAP was the first step 'towards the implementation of a more economic, effect-based approach in state aid and state aid control'.[473] Its aim was to introduce less and better targeted state aid, a refined economic approach, more effective procedures, better enforcement, higher predictability, enhanced transparency, and a shared responsibility between the Commission and Member States.[474] The Guidelines were prepared by the Commission 'in the light of the experience gained in the application' of the 2001 Communication, for which comments from public consultations of Member States and stakeholders had also been taken into account.[475] [476]

The Commission stated that according to its experience and the comments received the 2001 Communication had 'generally worked well in practice', but 'also revealed a need to increase flexibility in the application of the rules and to adjust the rules to reflect the changed situation of

[472] European Commission, State Aid Action Plan – Less and better targeted state aid: a roadmap for state aid reform 2005-2009, 07.06.2005, pp. 5, 10.
[473] Doris Hildebrand, The Role of Economic Analysis in EU Competition Law: The European School, Wolters Kluwer, 2016, p. 487.
[474] European Commission, State Aid Action Plan – Less and better targeted state aid: a roadmap for state aid reform 2005-2009, 07.06.2005, pp. 5, 6.
[475] European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.2.
[476] Regarding the revision of the Communication on risk capital, the Commission stated in its SAAP that 'the aim of the review will be to contribute to a culture of entrepreneurship and further stimulate investment in the form of risk capital, in particular in favour of start-ups and young, innovative SMEs, where this can properly address identified market failures. In particular, the Commission will focus on the need to further increase the flexibility of the rules to take into account diversity, especially as regards the level of the safe-harbour investment tranches for which the so-called 'equity gap' is presumed to exist' - European Commission, State Aid Action Plan – Less and better targeted state aid: a roadmap for state aid reform 2005-2009, 07.06.2005, p. 9.

the risk capital market'.[477] Moreover, 'for some types of risk capital investments in some areas it was not always possible to fulfil conditions' of the 2001 Communication, so that risk capital could not be adequately supported with state aid measures, and experience showed a low overall profitability of aided risk capital funds.[478]

Hence, following the SAAP, new Guidelines were designed in 2006 for the period of 2007 to 2013 to adopt a more flexible approach to better target risk capital measures to the relevant market failure and to set out a refined economic approach for the assessment of the compatibility of risk capital measures.[479] While the 2001 Communication had its focus already on a refined economic approach, the new 2006 Guidelines were intended to 'fine-tune' some of the criteria and, in particular, 'to ensure that profit-driven and professional investment decisions are strengthened in order to further encourage private investors to co-invest with the state'.[480]

As indicated, the SAAP 'aimed to align state aid policy with the general economic policy objectives of the Lisbon Strategy, to respond to the 2004 enlargement of the EU and to focus on correcting market failures…'.[481] In light of the aim of 'achieving less and better targeted state aid, the Commission aimed to apply a **refined economic approach**'.[482] The use of this refined economic approach was intended as 'a means to ensure a proper and more transparent evaluation of the distortions to competition and trade associated with state aid measures' and to 'help investigate the reasons why the market by itself does not deliver the desired objectives of common interest and in consequence evaluate the benefits of state aid measures in reaching these objectives'.[483] Therefore, the analysis of market failures was considered one key element in order 'to evaluate better whether state aid could be justified and acceptable, would represent the most appropriate

[477] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.2.
[478] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.2.
[479] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.2.
[480] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.2.
[481] European Commission, State Aid Action Plan – Less and better targeted state aid: a roadmap for state aid reform 2005-2009, 07.06.2005, p. 6,
and Wolf Sauter, Coherence in EU Competition Law, Oxford Studies in European Law, 2016, p. 215.
[482] Wolf Sauter, Coherence in EU Competition Law, Oxford Studies in European Law, 2016, p. 215.
[483] European Commission, State Aid Action Plan – Less and better targeted state aid: a roadmap for state aid reform 2005-2009, 07.06.2005, p. 6.

solution, and how it should be implemented to achieve the desired objective without distorting competition and trade to an extent contrary to the common interest'.[484]

The strengthening of the economic approach translated into the establishment of a **'balancing test'** between 'the potential positive effects of the measure in reaching an objective of common interest against its potential negative effects in terms of distortion of competition and trade' in the new Guidelines.[485] This test comprised three steps, the first two relating to the positive effects and the last one to the negative effects:

1. 'Is the aid measure aimed at a well-defined objective of common interest, such as growth, employment, cohesion, and environment?
2. Is the aid measure well designed to deliver the objective of common interest, i.e. does the proposed aid address the market failure or another objective?
    i. Is the aid measure an appropriate policy instrument?
    ii. Is there an incentive effect, i.e. does the aid measure change the behaviour of firms and/or investors?
    iii. Is the aid measure proportional, i.e. could the same change in behaviour be obtained with less aid?
3. Are the distortions of competition and the effect on trade limited, so that the overall balance is positive'?[486]

This 'balancing test' comprises the different steps of the proportionality principle (see chapter II), as there must be an appropriate measure in relation to a legitimate objective that is least restrictive and not manifestly disproportionate in the sense that the overall balance of the positive and negative effects of the measure must be positive (costs versus benefits balance).

The Commission re-iterated the reasons for and risks of state aid measures for the risk capital markets it had already outlined in its 2001 Communication. In particular, it again explained the

[484] European Commission, State Aid Action Plan – Less and better targeted state aid: a roadmap for state aid reform 2005-2009, 07.06.2005, p. 6.
[485] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.3.
[486] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.3.1.

principal basis for authorising risk capital measures, namely the market failure. As it was the case in its 2001 Communication and as it is the case in the 2014-2020 Guidelines, the Commission maintains its presumption that no general market failure exists with regard to the financing of SMEs.[487] Therefore, it still requires the demonstration of a specific market failure, which the measure to be declared compatible was or is aimed to tackle.[488] Moreover, the Commission maintained that failures 'of the business finance markets to provide the necessary equity and debt financing' were due to information asymmetries. [489]

Next to establishing a concrete market failure, it emphasised the importance of the appropriateness of the instruments, the incentive effect and necessity of the measures, and the proportionality of aid as underlying conditions in the compatibility assessment of measures. As it had outlined in its 2001 Communication, it would assess whether state aid was present at three different levels: aid to investors, aid to an investment fund, and aid to enterprises in which the investment is made.

Based on then Article 87 (3) (c) EC Treaty, the Commission would declare a risk capital measure compatible on the basis of the balancing test, if it concluded that 'the aid measure leads to an increased provision of risk capital without adversely affecting trading conditions to an extent contrary to the common interest'. [490] Therefore, the Commission introduced in these new Guidelines a two-tier test to be applied when it was in the possession of a notification: it first undertook a rapid assessment, and second, for certain types of measures that did not fulfil all the foregoing conditions, it would undertook a more detailed assessment of the risk capital measure.[491]

Firstly, in order to ensure that the incentive effect, the necessity of the aid, and the proportionality of it are present in a risk capital measure, the 'rapid assessment' criteria were applied. The underlying rationale was the targeting of a specific market failure, for the existence

[487] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.3.2.
[488] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 1.3.2.
[489] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 744.
[490] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.1.
[491] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.1.

of which there had to be sufficient evidence.[492] Where there was an investment vehicle involved, the detailed assessment was applied automatically. The first criterion related to the **maximum amount of the measure**: the risk capital measure had to provide for tranches of finance not exceeding EUR 1.5 million per target SME over each period of twelve months. The second criterion related to the **size and stage of the target enterprise**: the measure had to 'be restricted to provide financing up to the expansion stage for small enterprises or for medium-sized enterprises located in assisted areas'.[493] In non-assisted areas, the measure had to be restricted 'to provide financing up to the start-up stage for medium-sized enterprises'.[494] Thus, the 2006 Guidelines were more restrictive with regard to both the maximum amount of aid and the eligible target enterprises compared to the 2014-2020 ones.

The third criterion related to the **prevalence of equity and quasi-equity instruments**, i.e. the 2006 Guidelines were also more restrictive with regard to the types of financial instruments, since a risk capital measure had to provide at least 70 per cent of its total budget in the form of equity and quasi-equity investment instruments.[495] Thereby, the Commission had regard to the economic substance of the instrument rather than to its name and the qualification attributed to it by investors.[496] In particular, the Commission took into account 'the degree of risk in the target enterprise borne by the investor, the potential losses borne by the investor, the predominance of profit-dependent remuneration versus fixed remuneration, and the level of subordination of the investor in the event of the enterprise's bankruptcy'.[497] Moreover, it could take into account the prevalent domestic legal, regulatory, financial, and accounting rules applied to the instrument, if those were consistent and relevant for the qualification.[498]

[492] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.1.
[493] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.1.
[494] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.2.
[495] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.3.
[496] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.3.
[497] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.3.
[498] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.3.

The fourth criterion related to the **participation by private investors**: at least 50 per cent (or at least 30 per cent in assisted areas) of the 'funding of the investments made under the risk capital measure had to be provided by private investors'.[499] Like the fourth criterion, the fifth criterion was geared towards the newly emphasised economic approach of the 2006 Guidelines: the investment decisions had to possess a profit-driven character.[500] According to the Commission, this was the case where the motivation to effect the investment was based 'on the prospects of a significant profit potential and constant assistance to target companies for this purpose'.[501] Therefore, three conditions had to be met: the measures had to have significant involvement of private investors (as it was already demanded by the fourth criterion) providing investments on a commercial basis (i.e. only for profit), a business plan had to exist for each investment containing the details of product, sales, and profitability development and establishing the ex-ante viability of the project, and a clear and realistic exit strategy had to exist for each investment.[502]

In line with the more economic approach, the sixth criterion of the rapid assessment part required the **demonstration of a commercial management** of the risk capital measure: the management had to behave 'as managers in the private sector seeking to optimise the return for their investors', for which three conditions had to be met: there had to be an 'agreement between the fund manager and the participants in the fund providing that the manager's remuneration is linked to performance and setting out the objectives of the fund and proposed timing of investments', private market investors had to be represented in decision-making (e.g. through an investors' or advisory committee), and best practices and regulatory supervision had to be applied to the management of funds.[503] The last criterion of the first part covered the Commission's possibility to accept a sectoral focus for risk capital measures.

[499] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.4.
[500] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.5.
[501] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.5.
[502] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.5.
[503] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.6.

If at least one of the criteria above was not satisfied, the Commission would undertake the **detailed assessment**, under which the analysis of compatibility of the measure would be based on a number of positive and negative elements.[504] Thereby, 'no single element [was] determinant, nor [could] any set of elements be regarded as sufficient on its own to ensure compatibility', since the elements' applicability and weight were dependent on the form of the measure at hand.[505] Member States had to provide all elements and the evidence they considered relevant.[506] The Commission made clear that the level of evidence had to be proportionate to the seriousness of the market failure tackled and the risk of crowding out private investment. Thus, the detailed assessment showed the Commission's focus on the economic approach and the emphasis of the burden of proof to demonstrate a market failure by the Member State. However, unlike the 2014 Guidelines, the 2006 Guidelines required that Member States provide only in certain situations additional evidence of the relevant market failure.[507]

Hence, the first positive element stated by the Commission was the **existence and evidence of a market failure**. Therefore, the Member State had to provide evidence based on a study 'showing the level of the equity gap with regard to the enterprises and sectors targeted by the risk capital measure'.[508] The information to be provided related to 'the supply of risk capital and the fundraising capital as well as the significance of the venture capital industry in the local economy' for periods of three to five years preceding the implementation of the measure and – remarkably

[504] The types of risk capital measures subject to the detailed assessment were (i) measures providing for investment tranches beyond the threshold of EUR 1.5 million per target SME over each period of twelve months, (ii) measures providing finance for the expansion stage for medium-sized enterprises in non-assisted areas, (iii) measures providing for follow-on investments into target companies that already received aided capital injections beyond the thresholds, (iv) measures providing for a participation by private investors below 50 per cent in non-assisted (or 30 per cent in assisted) areas, (v) measures providing seed capital to small enterprises which foresaw less or no private participation by private investors and/or predominance of debt instruments as opposed to equity or quasi-equity, (vi) measures involving an investment vehicle, and (vii) costs linked to the first screening of companies in view of the conclusion of investments up to the due diligence phase. - The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2.

[505] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.1.
and Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 743.

[506] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.

[507] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.1,
and Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 744.

[508] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.7.

stricter than the 2014 Guidelines that do not require it – also for the future on the basis of reasonable projections, if available.[509]

The Commission recommended that the evidence include the 'development of the fundraising over the past five years, the current overhang of money, the share of government aided investment programs in the total venture capital investment over the preceding three to five years, the percentage of new start-ups receiving venture capital, the distribution of investments by categories of the amount of the investment, and a comparison of the number of business plans presented with the number of investments made by segment'.[510]

For measures that targeted SMEs in assisted areas, the Commission had a stricter approach requiring additional evidence proving that the regional specificities justified the features of the measure.[511] Recommended elements were the estimation of the additional site of the equity gap caused by the peripherality and other regional specificities, in particular in terms of the total amount of risk capital invested, number of funds or investment vehicles present in the territory or at a short distance, availability of skilled managers, number of deals, and average and minimum size of deals if available, specific local economic data, social and/or historic reasons for an underprovision of risk capital in comparison with the relevant average data and/or a situation at national and/or Community level as appropriate, and any other relevant indicator showing an increased degree of market failure.[512]

The second positive element in the balancing test is the **appropriateness of the instrument**, namely whether and to what extent the state aid in the field of risk capital could be considered an appropriate instrument to encourage private risk capital investment.[513] As described above, this element contains an impact assessment of the proposed measure and whether other policy

[509] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 4.3.7.
[510] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.1.
[511] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.1.
[512] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.1.
[513] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.2.

options were considered and the advantages of using a selective instrument had been established and submitted to the Commission.[514]

The third positive element was the **demonstration of an incentive effect and the necessity of aid**, for which the sub-elements of a commercial management, the presence of an investment committee, and the size of the measure/fund, and the presence of business angels were considered positively.[515] As regards the commercial management, the Commission would consider it positively that the measure or fund were managed by professionals from the private sector or by independent professionals selected via a transparent, non-discriminatory procedure.[516] As regards the investment committee, its presence and being independent of the fund management company and composed of independent experts form the private sector and independent experts selected via a transparent, non-discriminatory procedure were considered positively.[517] The larger the size of the measure, the more stable the budget and the more diversified and resilient it was considered to be.[518] Interestingly, the Commission did not elaborate on the reason it considered the involvement of business angels positively.

The final positive element of **proportionality** required that the aid amount is limited to the minimum necessary. The Commission stated that the measure could not be considered proportionate 'in the absence of any mechanism to check that investors were not overcompensated or where the risk of losses is borne entirely by the public sector, and/or where the benefits flow entirely to the other investors'.[519] The Commission furthermore stated that an open tender for managers and a call for tender or public invitation to investors would be considered positively, since it would limit the cost level at the minimum necessary and minimise the distortion of competition.[520]

[514] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.2.
[515] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.3.
[516] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.3.
[517] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.3.
[518] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.3.
[519] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.4.
[520] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.4.

According to the Commission, it 'balanced' these positive elements with potential negative effects in terms of distortion of competition and the **risk of crowding-out private investment**.[521] The negative effects had to be analysed at each of the three levels, where aid might be present. The first effect related to crowding-out: the Commission required specific evidence especially 'for larger investment tranches in target SMEs, for follow-on investments, or for financing of the expansion stage in medium-sized enterprises in non-assisted areas or for measures with low participation by private investors or measures involving an investment vehicle'.[522] The Member States were required 'to provide evidence concerning the targeted segment, sector, and/or industry structure', whereby 'the number of venture capital firms, the targeted enterprises in terms of size, growth stage, and business sector, the average deal size and possibly the minimum deal size, and the total amount of venture capital available were relevant elements'.[523]

The second effects were those stemming from **other distortions of competition**, e.g. the measure could have had the effect of keeping inefficient firms or sectors afloat, or cause an over-supply to inefficient enterprises.[524] In its analysis, the Commission examined, in particular, the overall profitability of the firms over time and prospects of future profitability, the rate of enterprise failure targeted by the measure, the maximum size of the investment tranche envisaged as compared to the turnover and costs of the target SMEs, and the over-capacity of the sector benefiting from the aid.[525]

In the end, the Commission would 'balance the effects of the risk capital measure and determine whether the resulting distortions adversely affect trading conditions to an extent contrary to the common interest', whereby an overall assessment of the criteria's relative importance would be made.[526] However, as will be discussed in chapter VI, the Commission did and does not conduct

[521] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.3.1.
[522] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.3.1.
[523] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.3.1.
[524] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.3.2.
[525] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.3.2.
[526] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.4.

a proper balancing exercise, but merely checks the market mechanism it calls 'positive effects' mentioned above. This means that the Commission in practice does not apply the proportionality test *stricto sensu* with its balancing of positive and negative effects of the relevant aid measure.

Accordingly, under the 2006 Guidelines, the Commission did not show 'particular ardour when carrying out the negative-effect test', as 'meeting the standard criteria on profit-orientation and commercial management seemed to be sufficient indication for the absence of any undue distortions of competition'.[527] Thus, the Commission never investigated the negative effects in detail under the 2006 Guidelines.[528] However, the 'stronger distortive potential of the risk finance aid' under the 2014 Guidelines (due to the inclusion of mid-caps and SMEs up to 7 years after their first commercial sale potentially developing more significant market power due to the aid) and the stricter approach of the cumulative assessment principles might result in a likewise 'more strict [sic] application of the negative-effects test in detail'.[529] That this is not the case, will be discussed in chapter VI. Thereby, the more detailed and varied criteria of risk finance aid under the 2014 Guidelines do not necessarily contrast with the Commission's decisional practice, as it merely uses them as a checklist of a formalistic assessment rather than quantifying and balancing negative effects.

In sum, the 2006 Guidelines were considered to have made 'a material impact with the Commission applying the framework in a total of 109 decisions', where 'all but one of these decisions concerned aid schemes' and '104 involved measures that were assessed by the without proceedings being opened'.[530] Of the latter, 'the vast majority were approved unconditionally while the remaining three were considered not to be aid'.[531] In comparison, 54 schemes were 'registered under the risk finance measures in the 2008 GBER'.[532]

[527] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 751.
[528] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 751.
[529] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 751.
[530] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 384.
[531] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 384.
[532] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 384.

5.3. The 2014-2020 Programme Period and the Risk Finance Guidelines 2014-2020

The Commission launched a **public consultation in July 2012** asking various stakeholders (Member States, public authorities, registered and non-registered organisations, and citizens) for feedback on the risk capital state aid rules.[533] The consultation revealed that the basic principles of these Guidelines, in particular the focus on proven market failures and on the leverage of private investment and commercial management, were well founded.[534] The simple safe-harbour rules and the appropriate flexibility under the detailed assessment were also appreciated.[535] However, most of the stakeholders requested 'a simplification of the framework' and emphasised 'the need to address a number of shortcomings including risks of undue restrictiveness and over-deterrence as well as risks of undue permissiveness and under-deterrence'.[536] Therefore, reform was required with regard to 'both the scope of the rules and the design of appropriate compatibility criteria of the GBER and the Guidelines'.[537]

The **Commission's Issues Paper** envisaged to abolish the distinction between the standard and detailed assessment and to broaden the scope of the GBER that were until then subject to standard scrutiny.[538] Thus, the scope of the GBER was to be extended for a broader framework of SME access to risk finance in terms of financing forms and instruments as well as the abolishment of the differentiation between assisted and non-assisted areas, as this should correspond to financial market realities.[539] While the concept of 'risk capital' covered only equity and quasi-equity finance, the concept of 'risk finance' is broader and thus covers also aid measures that contain loans and guarantees.[540]

[533] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.2.
[534] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.2.
[535] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.2.
[536] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.11.2012, p.2.
[537] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.2.
[538] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.3.
[539] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.3.
[540] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.122.

Changes introduced for the 2014-2020 Programme period:

- **Broadened scope and types of measures**: changed term from 'risk capital' to 'risk finance' signifying that the new rules include the implementation of aid measures that contain also loans and guarantees rather than equity only.
- **Typical and standard measures were largely moved into the new GBER** for Member States to implement them without prior notification for the sake of simplification, while the measures with a potentially higher distortive effect remain to be notified for individual assessment under the Guidelines.
- **New eligibility criteria address a wider set of enterprises** affected by market failures, are more objective, easier to verify, and promote the endogenous growth of SMEs.
- **Increased flexibility in terms of permissible aided investments by introducing the concept of total financing**, which allows for higher upfront investments.
- **Amplification of the eligible forms** of aided investments.
- **The flat minimum private investment ratios** of 30 per cent in assisted and 50 per cent in non-assisted regions **were replaced by ratios modulated in accordance with the inherent riskiness of the target enterprise** along its development stage.
- Introduction of **evaluation plans** to be conducted in cases of larger aid schemes that are likely to have the most significant impact on the internal market.
- The Commission shifted the focus of its refined economic approach even more on the demonstration of a specific market failure through the **requirement of an ex-ante assessment.**

Source: author

In light of the responses summarised in the Issues Paper and the case experience developed since 2006, the Commission elaborated a set of new risk finance rules and adopted the Risk Finance Guidelines in January 2014. Moreover, it adopted the new GBER with its new Article 21 on risk finance aid in June 2014. The main objectives of the reform were the simplification and reduction of regulation in general, the better reflection of prevailing market failures, an increased flexibility in terms of permissible amounts and sequencing of the financing, and the expansion of eligible forms of aid.[541] Thus, for the 2014 Guidelines, a framework of 'clear conditions under each of the relevant assessment principles acting as "filters" to ensure that the aid targets a material market failure, is an appropriate instrument, has an incentive effect, and is proportionate, while negative effects remain limited' was envisaged in the Issues Paper.[542] In terms of the modernisation in 2014 and the broadened scope and types of measures, the Commission **changed the term from risk capital to risk finance** signifying that the new rules include the implementation of aid measures that contain also loans and guarantees rather than equity only.[543]

[541] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.691.
[542] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.3.
[543] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.123.

With regard to the objectives, firstly, the **typical and standard measures were largely moved into the new GBER** for Member States to implement them without prior notification for the sake of simplification, while the measures with a potentially higher distortive effect remain to be notified for individual assessment under the Guidelines.[544]

Secondly, in order to broaden the scope of the eligible undertakings, the **new eligibility criteria address a wider set of enterprises** affected by market failures, are more objective, easier to verify, and promote the endogenous growth of SMEs.[545] Therefore, the scope of the eligible target enterprises was extended as follows. While, the new GBER rules cover three newly defined categories of eligible undertakings, namely SMEs before their first commercial sales, SMEs within seven years from their first commercial sales, and more established SMEs under certain conditions, the eligibility criteria for notified measures were radically extended, since the new Guidelines cover SMEs, small midcaps with up to 499 employees, and innovative midcaps with up to 1,500 employees. This extension takes into account that enterprises of those sizes may face similar market failures and the alignment of the Guidelines with similar EU financial instruments, such as Horizon 2020.[546]

Thirdly, the new rules provide for an **increased flexibility in terms of permissible aided investments by introducing the concept of total financing**, which allows for higher upfront investments.[547] The investment thresholds of the 2006 Guidelines were criticised by the stakeholders for being too inflexible and not reflecting the true nature of the size of the funding gaps that affected innovative and growth-oriented SMEs.[548] Thus, the Issues Paper envisaged an overall investment cap covering both equity and debt finance over a certain period of time.[549] The 2014 regime accordingly aims to align the thresholds with market realities: risk finance measures in the amount of EUR 15 million or less per SME are exempted in the GBER, which may

[544] About two thirds of the risk capital decisions were adopted under the standard assessment procedure: between 18.08.2006 and 02.08.2013, the Commission adopted 99 risk capital decisions, 65 of which were adopted based on the standard assessment procedure. - Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.691.
[545] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.691.
[546] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.692.
[547] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.692.
[548] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.4.
[549] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.4.

be regarded as a one-off aid covering the entire development circle of target enterprises.[550] Thus, the annual investment tranches were replaced by the total financing amount of EUR 15 million per SME under the GBER. Member States may provide for notified measures with a higher total financing amount under the Guidelines. Thus, while they do not impose any specific cap, a market failure has to be demonstrated convincingly.

Fourthly, **the new rules amplified the eligible forms of aided investments**. Although under the former rules it was possible to provide a higher ratio of debt to equity than the 30/70 rule, this was difficult: This restrictive approach required the notification of the measure, the detailed assessment, and was limited to small companies receiving seed capital.[551] Therefore, the 2014 Guidelines allow a wider range of financial instruments to be selected and combined with each other on the basis of free choice, as the stakeholders envisaged it in the Issues Paper.[552] Thus, with regard to the ratio of the different forms of funding, the 2014 Guidelines do not contain any requirements, so that the forms may be equity, quasi-equity, loans, guarantees, and other hybrid forms (e.g. leases or counter-guarantees), which also means the extension of eligible intermediaries beyond the venture capital industry, namely i.e. now covering any type of private finance providers, e.g. lenders such as banks.[553]

Fifthly, **the flat minimum private investment ratios** of 30 per cent in assisted and 50 per cent in non-assisted regions **were replaced by ratios modulated in accordance with the inherent riskiness of the target enterprise along its development stage**.[554] The rationale behind the new 10-40-60 per cent ratios is that the more established the enterprises become, the more attractive to private investors they become, so that the more private investment may be expected and required.[555] Thus, instead of the differentiation between assisted and non-assisted areas, the 2014 Guidelines tailor the private participation ratio according to the inherent riskiness of the development stage of the beneficiary.[556] This means a potential economic alignment with market realities and a legal alignment with the refined economic approach of demonstrating specific

[550] The European Commission, A new rule book for Risk Finance State aid, Competition Policy Brief, 2014, http://ec.europa.eu/competition/publications/cpb/2014/001_en.pdf, last access: 31.12.2017.
[551] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.693.
[552] European Commission, Issues Paper, Revision of the State aid rules for SME access to risk finance, 22.11.2012, http://ec.europa.eu/competition/state_aid/modernisation/risk_capital_issues_paper_en.pdf, last access: 02.10.2020, p.2.
[553] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.693.
[554] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.694.
[555] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.694.
[556] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.694.

market failure: Thus, lower levels of private participation are possible in sectors where private investors are particularly reluctant to invest due to a proven market failure.[557]

In comparison with the 2006 Guidelines, instead of providing for a prescriptive list of measures that must be notified, the new 2014 Guidelines encompass a white list of measures that are expected to be most commonly notified, which fall in the three broad categories described above.[558]

What is more, in the wake of the State Aid Modernisation programme, **the concept of evaluation plans to be conducted in cases of larger aid schemes** that are likely to have the most significant impact on the internal market **was introduced**. Evaluation plans are intended to deliver feedback on whether the positive effects of state aid outweigh the potential negative effects on competition and trade and that undue distortion of the market is prevented.[559] In particular, the objective of the evaluation obligation is to allow the assessment of the direct incentive effect of the aid and the attainment of the desired policy objective as well as the examination of the proportionality and the appropriateness of the aid instrument.[560]

Hence, the ex-ante assessment and the evaluation plans of the 2014 Guidelines may be considered two sides of the same coin: the latter may confirm whether the assumptions of the former are still valid and thereby improve the design of future aid schemes and rules on state aid. Thus, while the ex-ante assessment may be seen as an application of the proportionality principle prior to the implementation of the relevant financial instrument, evaluation plans may be considered an application of it *a posteriori*, as both are concerned with the appropriateness and effectiveness of the financial instrument in relation to its objective and impact on the market.

Besides rendering the criteria more detailed and varied in the 2014 Guidelines, the Commission shifted the focus of its refined economic approach even more on the demonstration of a specific market failure through the **requirement of an ex-ante assessment**. Now, as it was envisaged in

[557] The European Commission, A new rule book for Risk Finance State aid, Competition Policy Brief, 2014, http://ec.europa.eu/competition/publications/cpb/2014/001_en.pdf, last access: 31.12.2017.
[558] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.695.
[559] European Commission, Staff Working Document, Common methodology for State aid evaluation, 28.05.2014, SWD (2014), p.4.
[560] European Commission, Staff Working Document, Common methodology for State aid evaluation, SWD(2014), p.4.

the Commission's Issue Paper in 2012, Member States are required to evidence a market failure via the ex-ante assessment for every aid measure. This is in contrast to the 2006 Guidelines, where such evidence was required only when a detailed assessment applied.[561] Stated positively, Member States must deliver both qualitative and quantitative evidence on the contribution to a common objective via the ex-ante assessment.[562]

At the same time, Member States must include in the ex-ante assessment, negatively stated, evidence on the need for state intervention due to both structural and cyclical problems leading to suboptimal levels of private funding, for which a comprehensive analysis of the sources of financing and a due diligence process on a commercially sound investment strategy are required.[563] The requirement of the ex-ante assessment is in line with other access to finance EU policies for SMEs, notably the centrally managed EU financial instruments, such as COSME and Horizon 2020.[564] Therefore, the evidence of a market failure in the form of funding gaps is central to the 2014 Guidelines.

The new economic approach may certainly be welcomed as it directly captures preconditions of effective financial instruments: A thorough ex ante assessment enables Managing Authorities and financial intermediaries to tailor financial instruments to specific regional or national circumstances, to base them on an accurate assessment of the market situation, to consider flexibility and the ability to respond to socio-economic changes, to maintain the alignment of policy objectives and outcome through monitoring and evaluation and install safeguards against an 'objective drift', to design them in a well-focused manner related to the programme strategy, as well as to incorporate previous experiences and build the basis for lessons learnt.[565] Thus, the new economic approach may strengthen the application of the proportionality principle with regard to financial instruments through the ex-ante assessment (and the evaluation plans).

[561] The European Commission, Community Guidelines on State aid to promote Risk Capital Investments in small and medium-sized Enterprises, C 194/2, section 5.2.1.
[562] European Commission, Staff Working Document, Impact Assessment accompanying Guidelines on State aid to promote risk finance investment, https://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2014/swd_2014_0006_en.pdf, last access: 02.11.2020, section 5.3.2.
[563] European Commission, Staff Working Document, Impact Assessment accompanying Guidelines on State aid to promote risk finance investment, https://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2014/swd_2014_0006_en.pdf, last access: 02.11.2020, section 5.3.2.
[564] Barbara Cattrysse, The Newly Adopted Risk Finance State Aid Rules, European State Aid Law Quarterly, vol. 4, 2014, p.696.
[565] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, pp.38, 39.

From a practical point of view, interviews with Managing Authorities showed the important role of ex ante assessments: their outcome was the paramount factor for the choice of a financial product and its introduction, as an 'obligatory element to underpin the use of financial instruments was generally viewed very positively'.[566] However, Managing Authorities expressed the view that the Commission should provide feedback on ex ante assessments, reinforcing the demand for more specific guidance from the Commission's side in general.[567]

Scholars maintain that the Commission's approach shifted from 'balancing' towards 'filtering' in the wake of the 2014-2020 framework: Under the 2006 Guidelines 'the detailed assessment of risk capital aid were based on a number positive and negative elements'; no single element was determinant nor any set of elements sufficient on its own.[568] They maintain that under the 2014 Guidelines, in contrast, a measure would only be considered compatible with the Treaty, if it satisfied all of the assessment criteria.[569] However, the analysis of two Commission decisions of the 2014-2020 period in comparison with one of the 2006-2013 period in chapter VI will show that the Commission conducted a proper balancing exercise in accordance with the EU Courts' requirements on proportionality neither under the former nor under the current framework. It still holds true that the Commission rendered the balancing more transparent, yet more formal and complex as it uses the so-called positive effects, market mechanisms and screening methods, as well as negative effects as a checklist.[570] This is in line with the rather mixed view of Managing Authorities, which regard the legislative framework as 'too detailed and especially not always clear interpretation' and 'extraordinarily complex'.[571]

Hence, for the post-2020 period, the formalistic approach should be abandoned in favour of substantive changes to rules that facilitate the effectiveness of financial instruments, while safeguarding the functioning of the internal market at the same time, i.e. away from a formalistic to a yet more effects-based approach.[572] As will be further discussed in chapter VI, the Commission does not follow the EU Courts' requirements of the proportionality principle under

[566] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, pp.90, 107.
[567] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.107.
[568] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 743.
[569] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 743.
[570] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 743.
[571] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, pp.105, 106, 113.
[572] Miek van der Wee, State Aid and Distortion of Competition, European Commission representative, speech held on 2 December 2011, http://ec.europa.eu/competition/speeches/text/sp2011_17_en.pdf, last access: 12.01.2019.

state aid law regarding financial instruments, since it does not possess any tools to conduct this very effects-based balancing exercise. Thus, the concept of 'manifest negative effects' will be explored, which may be introduced to the area of financial instruments and the Commission's compatibility assessment on proportionality in order to render them consistent with the EU Courts' requirements on the proportionality principle.

Table 1: Comparison of rules between the 2007-2013 and the 2014-2020 Programme Period

	2007-2013 Programme Period	**2014-2020 Programme Period**
Maximum thresholds	4.3.1 RCG: tranches of finance not exceeding EUR 1.5 million per target SME over each period of 12 months	Article 4 (g) GBER and Article 21 (9) GBER: notification threshold for risk finance aid EUR 15 million per eligible undertaking – otherwise notification and RFG application
Restriction of scope	4.3.2 RCG: Up to the expansion stage for small enterprises, or for medium-sized enterprises in assisted areas; up to start-up stage for medium-sized enterprises in non-assisted areas	Article 21 (5) GBER: unlisted SMEs fulfilling at least one of the conditions: have not been operating in any market, have been operating in any market for less than 7 years after their first commercial sale, or require initial risk finance investment that based on a business plan for entering new product or geographical market is higher than 50 % of average annual turnover in preceding 5 years Article 21 (6) GBER: follow-on investments - otherwise notification and RFG application
Prevalence of equity and quasi-equity investment instruments	4.3.3 RCG: risk capital measure must provide at least 70 % of its total budget in form of equity and quasi-equity instruments into target SMEs	No prevalence Article 21 GBER: Different forms of financial instruments at the levels of financial intermediaries, private investors, and eligible undertakings
Private investor participation	4.3.4 RCG: at least 50 % of funding of the investments under risk capital measures (or at least 30 % in the case of SMEs in assisted areas)	Article 21 (10) (a) – (c) GBER: for equity, quasi-equity and loan investments 10 %, 40 %, or 60 % depending on the stage of the eligible undertaking Article 21 (11) GBER: where risk finance measure is targeting undertakings at different development stages and does not provide for private capital participation rate, weighted average based on the volume of individual investments and resulting from minimum participation rates of paragraph 10 - otherwise notification and RFG application
Profit-driven character of investment decisions	4.3.5 RCG: significant involvement, business plan, and clear and realistic exit strategy	Article 21 (14) GBER: financial intermediaries to be established according to applicable laws, due diligence process to ensure commercially sound investment strategy, viable business plan, and clear and realistic exit strategy - otherwise notification and RFG application
Commercial management	4.3.6 RCG: agreement between fund manager and participants in the fund providing performance remuneration, private investors represented in decision-making, and best practices and regulatory supervision apply	Article 21 (15) GBER: financial intermediary and fund manager must be obliged by law or contract to act with diligence of a professional manager in good faith and avoiding conflicts of interest, remuneration shall conform to market practices via open, transparent, and non-discriminatory call, performance based remuneration, investment strategy, and all investors to be represented in governance bodies of investment fund - otherwise notification and RFG application
Sectoral focus:	4.3.7 RCG: sectoral focus may be accepted by Commission	No provision
Compatibility criteria: positive elements		
Common objective	No provision	3.2. RFG: contribution to a common objective
Need for state intervention	5.2.1 RCG: Existence and evidence of market failure	3.3 RFG: Need for state intervention – ex ante assessment
Appropriateness	5.2.2 RCG: Appropriateness of the instrument	3.4 RFG: Appropriateness of the aid measure
Incentive effect and necessity	5.2.3 RCG 5.2.3.1 Commercial management	3.5 RFG: Incentive effect of the aid

	5.2.3.2 presence of investment committee 5.2.3.3 size of measure/fund 5.2.3.4 presence of business angels	
Proportionality	5.2.4 RCG a) open tender for managers b) call for tender or public invitation to investors	3.6 RFG: conditions for financial instruments, fiscal instruments, and alternative trading platforms
Compatibility criteria: negative elements		
Crowding out	5.3.1 RCG	3.7 RFG: avoidance of undue negative effects on competition and trade
Other distortions of competition	5.3.2 RCG	3.7 RFG: avoidance of undue negative effects on competition and trade

Source: Author

6. The General Block Exemption Regulation and Risk Finance Aid

6.1. The methodology: When do the GBER and the Risk Finance Guidelines apply?

The following methodology will explain at which step the GBER and the Risk Finance Guidelines apply, respectively. Thereafter, the rules on risk finance aid of the GBER will be elaborated.

For the assessment of financial instruments and their compliance with State aid law at the level of the investor, the intermediary, its fund manager, and the final recipients, the following steps must be taken into account:[573]

i) Does the financial instrument in question constitute **state aid** at all? Firstly, it may be questionable whether state resources are involved, since the financial instrument in question may be derived from EU resources alone. Secondly, there may be no trade effect, as the financial instrument in question may fall under *de minimis* aid. Thirdly, there may be no advantage, since the conditions of the financial instrument are in line with the market economy investor principle.[574]

ii) Where there is state aid, the financial instrument may be implemented without prior notification and approval by the Commission, if it complies with the substantive and procedural requirements of the **GBER** specific to risk finance.

iii) If the financial instrument in question does not comply with the GBER and is hence not exempted, it must be notified to the Commission and approved under the conditions of the **Risk Finance Guidelines**.

iv) If the financial instrument in question falls outside the scope of both the GBER and the Risk Finance Guidelines, its compatibility with **Article 107 (2) and (3) TFEU** must be assessed.

[573] Steps by Kelyn Bacon, European Union Law of State Aid, Oxford University Press, 2017, p.183.
[574] Of course, beneficiaries may also not qualify as undertakings or effects on trade and competition may be absent. However, this is hardly the case for financial instruments.

6.2. Introduction to the General Block Exemption Regulation

Based on the enabling power of *Council Regulation (EC) No 994/98*, the Commission adopted *Commission Regulation (EU) No 651/2014* on the general block exemption covering several different categories of state aid: regional aid, aid to SMEs in the form of investment aid, operating aid and SMEs' access to finance, aid for environmental protection, aid for research and development and innovation, training aid, recruitment and employment aid for disadvantaged workers and workers with disabilities, aid to make good the damage caused by certain natural disasters, social aid for transport of residents of remote regions, aid for broadband infrastructures, aid for culture and heritage conservation, aid for sport and multifunctional recreational infrastructures, and aid for local infrastructures.[575]

This General Block Exemption Regulation (GBER) is divided into **four chapters**. Chapter I contains the common provisions. Article 3 GBER in Chapter I explains meaning of the GBER: aid schemes, individual aid granted under aid schemes, and ad hoc aid are compatible with the internal market according to Art. 107 (2) and (3) TFEU and exempted from the notification requirement of Article 108 (3) TFEU, if they fulfil the common provisions of Chapter I as well as the specific conditions of Chapter III. Chapter II stipulates the provisions on monitoring and reporting of the Member States vis-à-vis the Commission. Chapter III is divided into 13 sections, each stipulating specific provisions on the different categories of aid listed above, which apply together with the general provisions of Chapter I. Finally, Chapter IV covers the final provisions. With regard to this study's concern, the relevant provisions on risk finance aid are Articles 21, 22, and 23 GBER under section 3 of Chapter III on the aid for access to finance for SMEs.

Regarding the **common provisions in Chapter I**, Article 4 GBER stipulates notification thresholds, which, when exceeded, render the GBER non-applicable. In particular, the notification threshold for risk finance aid for SMEs is EUR 15 million per eligible undertaking. Article 5 GBER lays down the conditions of transparency of aid, i.e. aid may be considered 'transparent aid' and is hence compliant with the GBER, if the gross grant equivalent of the aid may be precisely calculated ex ante without any need to undertake a risk assessment. Moreover, it lists several categories of

[575] Article 1 (1) of Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty, OJ L 187 26.6.2014, p. 1.

transparent aid. Article 6 GBER requires aid to have an incentive effect in order to fall under the GBER:

Therefore, the beneficiary has to submit a written application for the aid to the Member State concerned before work on the project or activity starts, which must contain at least the following information: the undertaking's name and size, the description of the project including its start and end dates, the location of the project, a list of project costs, as well as the type of the aid and the amount of public funding needed for the project. Article 7 GBER covers the way aid intensity and eligible costs are to be calculated. Article 8 lays down provisions on the cumulation of aid in order to determine whether the notification thresholds in Article 4 GBER and the specific maximum aid intensities in Chapter III are respected. Finally, Article 9 GBER covers the publication and information requirements, which the Member State concerned has to ensure.

6.3. The substantive and procedural requirements of the GBER on risk finance aid

Article 21 of Regulation (EU) No 651/2014 (GBER) provides a **block exemption for risk finance aid schemes**, thus excluding ad-hoc measures. It exempts risk finance aid of up to EUR 15 million in the form of equity, quasi-equity, loans, or guarantees, as well as tax incentives for private investors, who are natural persons.[576] According to Article 21 (2) GBER, at the level of financial intermediaries, risk finance aid to private investors may take the form of equity or quasi-equity, loans, and guarantees. Pursuant to Article 21 (8) GBER, for aid in the form of equity or quasi-equity at the level of financial intermediaries, no more than 30 per cent of the financial intermediary's aggregate capital contribution may be used for liquidity management purposes.

At the level of the independent private investors, according to Article 21 (3) GBER, the same forms of financial instruments apply as well as tax incentives to private investors, who are natural persons providing risk finance to eligible undertakings. At the level of the eligible undertakings, risk finance aid may take the form of equity, quasi-equity, loans, guarantees, or a mix thereof, pursuant to Article 21 (4) GBER. Crucially, the total amount may not exceed EUR 15 million per eligible undertaking under any risk finance measure pursuant to Article 21 (9) GBER, or else the

[576] Article 21 (2)-(4) and (9), Commission Regulation (EU) No 651/2014.

aid must be notified. Member States are allowed to assign the implementation of a risk finance measure to an entrusted entity according to Article 21 (17) GBER.

With regard to its **scope**, eligible undertakings are unlisted SMEs as defined in Commission Recommendation 2003/361/EC at the time of the initial risk finance investment, which fulfil at least one of the following conditions pursuant to Article 21 (5) GBER: they (a) either have not been operating in any market, or (b) have been operating in any market for less than 7 years following their first commercial sale, or (c) require an initial risk finance investment, which, based on a business plan prepared in view of entering a new product or geographical market, is higher than 50 per cent of their average annual turnover in the preceding 5 years. The Commission does not consider a general market failure to be present for large undertakings.[577] Similarly, risk finance aid may not be provided to companies on the official list of a stock exchange or a regulated market, since this very fact demonstrates their ability to access private financing.[578]

In its fitness check report on state aid rules, the Commission found that 'it is sometimes difficult to identify with sufficient precision the date of the "first commercial sale", which is the baseline for the age requirement under Article 21 (5) (a) GBER, allowing aided risk finance investments only up to 7 years after that date'.[579] Neither is this definition of age in line with Article 22 (2) GBER (aid for startups), 'which defines age related eligibility based on the "registration of the company"'.[580] Thus, an alignment of these age definitions should be conducted in order to simplify the application of these rules and enhance legal certainty.

Moreover, according to the fitness check report, stakeholders face the problem of defining 'product or geographic market' of Article 21 (5) (b) GBER with sufficient certainty in practice, so that a market definition may not be upheld in court, rendering aid illegal.[581]

[577] European Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), henceforth: 'Risk Finance Guidelines', para. 21.
[578] Risk Finance Guidelines, para. 22.
[579] European Commission, Staff Working Document, Fitness Check of the 2012 State aid modernisation package, railways guidelines and short-term export credit insurance, 30.10.2020, SWD(2020) 257 final, p. 127.
[580] European Commission, Staff Working Document, Fitness Check of the 2012 State aid modernisation package, railways guidelines and short-term export credit insurance, 30.10.2020, SWD(2020) 257 final, p. 127.
[581] European Commission, Staff Working Document, Fitness Check of the 2012 State aid modernisation package, railways guidelines and short-term export credit insurance, 30.10.2020, SWD(2020) 257 final, p. 127.

Measures that do not fulfil the conditions of Article 21 (5) GBER may still be exempted from the notification requirement, if they fulfil the cumulative conditions of Article 21 (18) GBER instead: (a) at the level of the SMEs, the measure fulfils the conditions of the de minims Regulation (EU) No 1407/2013, and (b) fulfils the rest of the conditions laid down in Article 21, with the exception of those set out in paragraphs (5), (6), (9), (10), and (11), and (c) – if it provides equity, quasi-equity or a loan investment – the measure must leverage additional financing from independent private investors at the level of the financial intermediaries or the SMEs, so that an aggregate private participation rate of at least 60 per cent of the risk finance provided to the SMEs is reached.

Moreover, the **GBER appears to contradict the legal presumption of *de minimis* aid** that the latter does not amount to state aid. Article 21 (18) GBER lays down cumulative conditions to be met in the case a risk finance measure does not fulfil the conditions of Article 21 (5) GBER, i.e. if potential beneficiaries do not fulfil the conditions and fall outside the scope of eligible undertakings of paragraph 5, but still may be exempted from the notification requirement. Specifically, Article 21 (18) (a) GBER requires that – at the level of the SME – the aid fulfil the conditions of the *de minimis* Regulation. However, this defies the presumption that *de minimis* aid does not constitute state aid at all and hence does not need to be notified in any case.[582]

Confusingly, despite the adhering to *de minimis* requirement would mean the exclusion of state aid as such, the Commission still states that 'the risk scheme as such (including aid at the level of the financial intermediary and at the level of the SME) would still have to be designed in accordance with the GBER provisions or in accordance with the prescriptions of recital (19)' of the *de minimis* Regulation (e.g. through market conform premium, full pass-on of any advantage to final recipients, or respecting the *de minimis* ceiling) in order to be exempted from notification.[583]

As such, **Article 21 (18) (a) GBER may be regarded as inconsistent with the concept of *de minimis* aid** by stating that the *de minimis* ceiling and the GBER provisions must be adhered to at the same

[582] Article 3 (1) of the de minimis Regulation states that 'Aid measures shall be deemed not to meet all the criteria in Article 107 (1) of the Treaty, and shall therefore be exempt from the notification requirement in Article 108 (3) of the Treaty, if they fulfil the conditions laid down in this Regulation'. Moreover, recitals (1) and (3) of the de minimis Regulation presume that there is no effect on trade and competition, if aid is de minimis.

[583] The European Commission, General Block Exemption Regulation (GBER) – Frequently Asked Questions, March 2016, website of the German Ministry of the Economy, https://www.bmwi.de/Redaktion/DE/Downloads/B/beihilfenkontrollpolitik-kom-zusammenstellung-faq-agvo.pdf?__blob=publicationFile&v=5, last access: 17.07.2019, p. 33.

time. For the sake of legal certainty, the Commission should decide whether the concept of *de minimis* applies or not at all.

However, there might be an explanation as to an aid element present in Article 21 (18) GBER despite the *de minimis* rules applying at the SME level. The Commission presents an indication in its explanatory notes: According to the Commission, 'Article 21 (18) (a) GBER is meant to address situations where aid is present at several levels, not only at the level of the final beneficiary', so that at the level of the SME, 'all the conditions under the *de minimis* Regulation should be applied'.[584] This becomes clearer when compared with the provisions of the state aid free off-the-shelf instruments on financial intermediaries: the provisions, e.g. on the off-the-shelf instrument Risk Sharing loan model, stipulate that the 'financial advantage of the public contribution shall be fully passed on to the final recipients in the form of an interest rate reduction'. In contrast, Article 21 (16) (a) GBER, which is applicable for aid under Article 21 (18) GBER, stipulates that the financial intermediary demonstrate to operate a mechanism that ensures that all advantages be passed on, but only to 'the largest extent'.

Thus, the following reasoning as to the presence of aid could be made: While for off-the-shelf instruments the advantage at the level of financial intermediaries must be entirely passed on, for aid under Article 21 (18) GBER the advantage must merely be passed on 'to the largest extent', so that there may still be aid present at the level of the intermediary. This difference is hard to detect and may certainly enhance the lack of clarity. A more detailed comparison between the similar concepts of off-the-shelf instruments and aid under Article 21 (18) GBER can be found in Chapter VII.

More inconsistencies regarding Article 21 (18) GBER can be detected: Although stating in (b) that the conditions of Article 21 (9) GBER (maximum total amount of EUR 15 million) must not be met, Article 21 (18) GBER does not exempt the conditions of Article 21 (16) GBER to be met, which, in turn, refers under (c) to the condition of Article 21 (9) GBER. The circle does not close here. It remains thus unclear, whether Member States can simply ignore the condition of Article 21 (16)

[584] The European Commission, General Block Exemption Regulation (GBER) – Frequently Asked Questions, March 2016, website of the German Ministry of the Economy, https://www.bmwi.de/Redaktion/DE/Downloads/B/beihilfenkontrollpolitik-kom-zusammenstellung-faq-agvo.pdf?__blob=publicationFile&v=5, last access: 17.07.2019, p. 33.

(c) GBER, if they apply Article 21 (18) GBER, as it refers to conditions that need not be met under the latter.

Moreover, it remains unclear, why Article 21 (16) GBER stresses under its condition (a) that, in case of guarantees, loans, and quasi-equity structured as debt, financial intermediaries must undertake investments 'that would not have been carried out or would have been carried out in a restricted or different manner without the aid', if this is part of the advantage criterion under Article 107 (1) TFEU anyway. Probably it does so, since aid may be present, but compatible with the internal market, if it meets the GBER conditions. This may also relate to the second sentence of Article 21 (16) (a) GBER, namely that the financial intermediary must be able to demonstrate that it operates a mechanism, which ensures the passing-on of advantages to the largest extent in certain forms.

Risk finance aid may also cover **follow-on investments** made in eligible undertakings, including after the 7 year period mentioned above, if the following conditions of Article 21 (6) GBER are cumulatively fulfilled: (a) the total amount of risk finance does not exceed the EUR 15 million per eligible undertaking under any finance measure threshold, (b) the possibility of follow-on investments was foreseen in the original business plan, and (c) the undertaking receiving follow-on investments has not become linked with another undertaking other than the financial intermediary or the independent private investor providing risk finance under the measure, unless the new entity fulfils the conditions of the SME definition of Commission Recommendation 2003/361/EC.[585]

The provision on follow-on investments, Article 21 (6) GBER, lacks clarity. It states that risk finance aid may also cover follow-on investments made in eligible undertakings under certain conditions, but does not clearly state by whom these investments may be made. For instance, it is not clear, whether the private investor, who made the initial investment, ought to make these or whether

[585] According to Art. 3 (3) of Annex I of the GBER, linked enterprises are enterprises, which have any of the following relationships with each other: either (a) an enterprise has a majority of the shareholders' or members' voting rights in another enterprise, or (b) an enterprise has the right to appoint or remove a majority of the members of the administrative, management, or supervisory body of another enterprise, or (c) an enterprise has the right to exercise a dominant influence over another enterprise pursuant to a contract entered into with that enterprise or to a provision in its memorandum or articles of association, or (d) an enterprise, which is a shareholder in or a member of another enterprise, controls alone, pursuant to an agreement with other shareholders in or members of that enterprise, a majority of shareholders' or members' voting rights in that enterprise.

the requirement of Article 2 (72) GBER of an 'independent private investor' is applicable. Therefore, the Commission had to clarify in its publication on frequently asked questions regarding the GBER, that the private investor of the initial investment may make the follow-on investment rather than an 'independent private investor'.[586]

Article 2 (72) GBER merely refers to the time of the initial investment, not to a follow-on investment.[587] However, this is not clear from the text of the provision itself – Article 21 (6) GBER and its specific conditions should be formulated in a clear and unambiguous way instead of being dependent on explanatory remarks of the Commission: It should be clear from the text of the provision that follow-on investments should be made by the same private investor of the initial investment.

In the same vein, it is not clear from Article 21 GBER how its paragraphs 6 and 10 relate to each other, i.e. whether the minimum thresholds of aggregate private participation rates of Article 21 (10) GBER also apply to follow-on investments. The Commission had to clarify in its publication on the GBER that they indeed are applicable and that follow-on investments were 'only allowed for eligible undertakings that have received an initial risk finance investment in the period prior to their first commercial sale up to 7 years thereafter'.[588] A short additional remark in the provision on follow-on investments that the minimum thresholds also apply to them would enhance consistency and clarity.

Moreover, a financial instrument may provide support for **replacement capital** according to Article 21 (7) GBER only if the latter is combined with new capital representing at least 50 per cent of each investment round into the eligible undertaking with regard to equity and quasi-equity investments. For **liquidity management purposes**, no more than 30 per cent of the financial intermediary's aggregate capital contributions and uncalled committed capital may be used with regard to equity and quasi-equity investments according to Article 21 (8) GBER.

[586] The European Commission, General Block Exemption Regulation (GBER) – Frequently Asked Questions, March 2016, website of the German Ministry of the Economy, https://www.bmwi.de/Redaktion/DE/Downloads/B/beihilfenkontrollpolitik-kom-zusammenstellung-faq-agvo.pdf?__blob=publicationFile&v=5, last access: 16.07.2019, p. 31.
[587] The European Commission, General Block Exemption Regulation (GBER) – Frequently Asked Questions, March 2016, website of the German Ministry of the Economy, https://www.bmwi.de/Redaktion/DE/Downloads/B/beihilfenkontrollpolitik-kom-zusammenstellung-faq-agvo.pdf?__blob=publicationFile&v=5, last access: 16.07.2019, p. 31.
[588] The European Commission, General Block Exemption Regulation (GBER) – Frequently Asked Questions, March 2016, website of the German Ministry of the Economy, https://www.bmwi.de/Redaktion/DE/Downloads/B/beihilfenkontrollpolitik-kom-zusammenstellung-faq-agvo.pdf?__blob=publicationFile&v=5, last access: 17.07.2019, p. 32.

Pursuant to Article 21 (10) GBER, risk finance measures providing equity, quasi-equity, or loan investments must leverage additional finance from independent private investors at the level of the financial intermediary or the eligible undertakings, so that the aggregate **private participation rate** reaches the following **minimum thresholds** for the respective eligible undertakings: (a) for eligible undertakings prior to their first commercial sale on any market, the minimum threshold is 10 per cent of the risk finance provided, (b) for unlisted undertakings operating in any market for less than 7 years following their first commercial sale, the minimum threshold is 40 per cent of the risk finance provided, and (c) for unlisted undertakings requiring an initial risk finance investment, which is higher than 50 per cent of their average annual turnover in the preceding 5 years and which is based on a business plan, as well as for follow-on investments after the 7 year period, the minimum threshold is 60 per cent of the risk finance provided.

Further, 'if a risk finance measure is implemented through a financial intermediary targeting eligible undertakings at different development stages and the measure does not provide for private capital participation at the level of the eligible undertakings, the financial intermediary must achieve a private participation rate that represents at least the weighted average based on the volume of the individual investments in the underlying portfolio', resulting from the application of the minimum participation rates outlined above.[589]

In its fitness check report based on a stakeholder consultation, the Commission found that 'the requirement of private co-investments pursuant to Article 21 (10) GBER is difficult to achieve in certain Member States that suffer particularly from weak private investment markets'.[590] Since it found that this requirement is still important to ensure crowding-in of private investment and 'an adequate due diligence for investment decisions', it considers 'to adjust the level of private participation for those areas where financial markets are particularly underdeveloped, without changing the principle of private participation requirements as such'. [591] This is certainly recommendable, as it would adjust to market needs and secure private investment along state resources.

[589] Article 21 (11), Commission Regulation (EU) No 651/2014.
[590] European Commission, Staff Working Document, Fitness Check of the 2012 State aid modernisation package, railways guidelines and short-term export credit insurance, 30.10.2020, SWD(2020) 257 final, p. 127.
[591] European Commission, Staff Working Document, Fitness Check of the 2012 State aid modernisation package, railways guidelines and short-term export credit insurance, 30.10.2020, SWD(2020) 257 final, p. 127.

Moreover, risk finance measures may **not discriminate** between financial intermediaries on the basis of their place of establishment or incorporation in any Member State in accordance with Article 21 (12) GBER. Moreover, risk finance measures must fulfil the following conditions pursuant to Article 21 (13) GBER:

(a) Other than for tax incentives for private investors, the measure must be implemented via **one or more financial intermediaries**,
(b) financial intermediaries must be **selected through an open, transparent, and non-discriminatory procedure** aimed at establishing appropriate risk-reward sharing arrangements, whereby asymmetric profit sharing is given preference over downside protection (except for investments in the form of guarantees),
(c) in the case of **asymmetric loss-sharing** between public and private investors, the first loss assumed by the public investor must be capped at 25 per cent of the total investment,[592]
(d) in the case of **guarantees at the level of the financial intermediary**, the guarantee must be limited to 80 per cent and total losses assumed by the Member State must be capped at a maximum of 25 per cent of the underlying guaranteed portfolio. Thereby, only guarantees covering expected losses of the underlying guaranteed portfolio may be provided for free. If unexpected losses are to be covered, the intermediary must pay for that part a market-conform guarantee premium.

With regard to the **selection procedure of financial intermediaries**, the legal texts are consistent: Article 21 (13) (b) GBER requires that financial intermediaries be selected on the basis of an open, transparent, and non-discriminatory call, thus rendering a competitive procedure not obligatory. Similarly, the Financial Regulation stipulates in its Article 216 (3) that the selection of financial intermediaries for EU financial instruments be transparent, justified on objective grounds, and not give rise to a conflict of interests. For ESI funds, Article 38 (5) CPR, like the GBER, requires that financial intermediaries be selected on the basis of open, transparent, proportionate, and non-discriminatory procedures. However, the requirement of being proportionate under the CPR is not mentioned under the GBER. Moreover, Article 7 CDR specifies minimum requirements and

[592] This means that, if the private and the public partners each invested 50 per cent of the total investment, then a loss of 25 per of the total investment translates into a loss of 50 per cent of the investment the public partner made in total.

selection criteria for Article 38 (4) CPR (implementation of ESI financial instruments set up and managed at the Member State level), but does not refer to the GBER. Thus, it is unclear whether these requirements and criteria also apply to financial instruments, for which the CPR is not applicable, but for which the GBER indeed is.

What is more in the GBER, pursuant to Article 21 (14) GBER, risk finance measures must ensure **profit-driven decisions**: Profit-driven decisions are considered to be present if the following conditions are met:

(a) financial intermediaries must be established according to the applicable laws,
(b) the Member State or the entity entrusted with the implementation of the measure, must provide a due diligence process in order to safeguard a commercially sound investment strategy, which includes an appropriate risk diversification policy aimed at achieving economic viability and an efficient scale in terms of size and territorial scope,
(c) the risk finance must be based on a viable business plan, which contains the details of the product, sales and profitability development and which establishes the ex-ante financial viability,
(d) for each equity and quasi-equity investment, a clear and realistic exit strategy must be established so that venture capital or private equity funds may achieve maximum return.[593]

Furthermore, pursuant to Article 21 (15) GBER, financial intermediaries must be managed on a commercial basis: A commercial basis is assumed to be present if the following conditions regarding the financial intermediary and, depending on the type of the risk finance measure, the fund manager are met:

(a) they must be obliged by law or contract to act with the diligence of a professional manager in good faith and avoiding conflicts of interest, whereby best practices and regulatory supervision must apply,
(b) their remuneration must conform to market prices, i.e. this condition is met where the manager or the financial intermediary is selected through an open, transparent, and non-

[593] Rona Michie and Fiona Wishlade, Between Scylla and Charybdis: Navigating Financial Engineering Instruments through Structural Funds and State Aid Requirements, IQ-Net Thematic Paper No. 29(2), 2011, p.xi.

discriminatory selection procedure, based on objective criteria linked to experience, expertise, and operational and financial capacity,
(c) they must receive a remuneration linked to performance or must share part of the investment risks by co-investing own resources in order to ensure that their interests are permanently aligned with the interests of the public investor,
(d) they must set out an investment strategy, criteria and the proposed timing of investments,
(e) investors must be allowed to be represented in the governance bodies of the investment fund, e.g. in the supervisory board or the advisory committee.

According to Article 21 (16) GBER, a risk measure providing guarantees or loans, must fulfil the following conditions:

(a) the financial intermediary must undertake investments that would not have been carried out or would have been carried out in a restricted or different manner without the aid and it must be able demonstrate that it operates a mechanism to safeguard that all the advantages are passed on to the largest extent to the final recipients in the forms of e.g. higher volumes of financing, riskier portfolios, lower collateral requirements, lower guarantee premiums, or lower interest rates,
(b) in the case of loans, the nominal amount of the loan is taken into account in calculating the maximum investment amount of EUR 15 million,
(c) in the case of guarantees, the nominal amount of the underlying loan must be taken into account in calculating the maximum investment amount of EUR 15 million, whereby the guarantee may not exceed 80 per cent of the underlying loan.

Article 21 GBER is found under its section 3 'aid for access to finance for SMEs'. According to Articles 22, 23, and 24 GBER under the same section, aid for access to finance may also be designed for start-ups companies, alternative trading platforms specialised in SMEs, and scouting costs.

Member States are obliged to notify risk finance measures, which constitute state aid within the meaning of Article 107 (1) TFEU to the Commission pursuant to Art. 108 (3) TFEU, in particular if they do not comply with the market economy operator test, fall outside the scope of the *de*

minimis Regulation, and do not satisfy all the conditions of the GBER. From there, the Commission will assess the compatibility of those measures with the internal market under Article 107 (3) (c) TFEU. The Risk Finance Guidelines thereby focus on those risk finance measures and their conditions and features, which are most likely to be found compatible with Article 107 (3) (c) TFEU, subject to a number of conditions explained in detail in the Guidelines.[594] Thus, the Guidelines serve as an orientation for Member States to design their measures in such a way, as to render them compatible with Article 107 (3) (c) TFEU to the largest degree.

7. The Risk Finance Guidelines

Risk finance measures that do not satisfy all the conditions of the GBER will be assessed on their compatibility with the internal market based on the assessment principles of the Risk Finance Guidelines. Hence, the Guidelines are strictly complementary to the rules of the GBER. The Guidelines provide for two distinct sets of assessment principles. The first set relates to principles for the assessment of the existence of state aid, which represent an interpretation of the market economy operator test. The second set relates to principles for the assessment of the compatibility of state aid.[595]

7.1. The Application of the Market Economy Investor Principle under the Guidelines

The Guidelines' **first set of assessment principles** provide for an interpretation of the notion of state aid in the context of risk finance measures. The corresponding explanatory statements are an **application of the market economy investor principle**.[596] This test is based on the presumption that 'economic transactions carried out by a public body or a public undertaking do not confer an advantage on its counterpart, and therefore do not constitute state aid, if they are carried out in line with normal market conditions'.[597]

[594] Risk Finance Guidelines, para. 46.
[595] Risk Finance Guidelines, Section 2.1 and Chapter 3.
[596] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 732.
[597] See e.g. case-39/94 SFEI [1996] ECR-3547, paras. 60-61.

As explained above, for a measure to constitute state aid pursuant to Article 107 (1) TFEU, it must fulfil five cumulative criteria: (i) the measure forms an intervention by the state through state resources, which grants (ii) undertakings as recipients (iii) an advantage, (iv) on a selective basis, (v) whereby competition has been or may be distorted and the intervention is likely to affect trade between Member States. Thereby, 'the involvement of state resources is usually self-evident in the case of direct financial participation of public authorities in risk finance measures or tax incentives for investors'.[598] So are the distortion of competition and the effect on trade between Member States, since 'the investment of capital is an activity subject to intensive trade between Member States'.[599]

However, 'risk finance measures may be complex and thus contain advantages through State aid' at the level of both the target enterprises and other economic operators involved.[600] Therefore, the market economy operator test must be conducted at the respective level of the investors, of the financial intermediaries and/or their managers, and of the target enterprises. The test applies to all entities involved in the measure, since the design of the measure may confer an advantage regardless of any intention of the granting authority to provide aid only to eligible undertakings.[601]

At the level of **investors**, the Commission will consider an investment to be in line with the test, if it is effected **pari passu** between the public and private investors, i.e. 'when it is made under the same terms and conditions by public and private investors, where both categories of operators intervene simultaneously and where the intervention of the private investor is of real economic significance'.[602]

Firstly, a transaction is regarded as made under the same terms and conditions if the public and private investors share the same risks and rewards and hold the same level of subordination in relation to the same risk class.[603] Secondly, a transaction is considered to be made simultaneously, if the private and public investors co-invest into the final beneficiaries via the same investment transaction (in the case of investments through public-private financial

[598] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 732.
[599] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 733.
[600] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 733.
[601] Risk Finance Guidelines, para. 29.
[602] Risk Finance Guidelines, para. 31.
[603] Risk Finance Guidelines, para. 32.

intermediaries, this condition of simultaneity will be automatically presumed to be met).[604] Thirdly, the investment provided by private investors that are independent from the companies they invest in will be considered to be economically significant, if it constitutes 30 per cent in the case of risk finance measures.[605] The non pari passu nature of investments may be due to upside-incentives (e.g. preferential returns) or downside protection (e.g. reduced exposure to losses).[606] Finally, they are in a comparable situation (e.g. first time investors in a firm and not already owners) and have no outside relationship (outside the investment).[607]

The 'Guidelines apply a strict private investor concept', but do not, as the preceding 2006 Guidelines, 'provide for a definition of the term "private investor" in the context of the market economy operator test'.[608] However, the wording of the Guidelines in this context suggests 'a strict interpretation': private investors are investors, who do not use state resources.[609] This means, firstly, that the Guidelines make no reference to the term 'independent private investor', 'which is defined both in the GBER and the Guidelines' (and which implies a wider interpretation).[610] Secondly, that the Guidelines refer in the pari passu context to 'only two organisations that use public resources and that can be considered as [sic] private investors, namely the European Investment Fund and the European Investment Bank, both of which are not subject to Member State control':[611]

'Private investors will typically include the EIF and the EIB investing at own risk and from own resources, banks investing at own risk and from own resources, private endowments and foundations, family offices and business angels, corporate investors, insurance companies, pension funds, private individuals, and academic institutions'.[612] Thus, the wording of this explanation implies that investors must be entities that do not use state resources.[613] The last point of strict interpretation is due to the fact that in the *pari passu* context the addition

[604] Risk Finance Guidelines, para. 33.
[605] Risk Finance Guidelines, para. 34.
[606] Risk Finance Guidelines, para. 36.
[607] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 735.
[608] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 735.
[609] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 735.
[610] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 735.
[611] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 735.
[612] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 735, and Risk Finance Guidelines, para. 31 with footnote 35.
[613] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 735.

'regardless of ownership', 'which opens to public bodies the participation in risk finance schemes as "independent private investors" is not used'.[614]

With regard to aid to a **financial intermediary and/or its manager**, according to the Commission in paragraph 37 of the Guidelines, it considers a financial intermediary in general to be a vehicle for the transfer of aid to investors and/or enterprises in which the investment is made, rather than a beneficiary of aid in its own right. This is irrespective of whether the financial intermediary has legal personality or is merely a bundle of assets managed by an independent management company.[615] However, measures involving direct transfers to, or co-investment by, a financial intermediary may constitute aid, unless such transfers or co-investments are made on terms acceptable to a normal economic operator.[616]

If the measure is **managed by an entrusted entity**, without that entity co-investing with the Member State, the Commission will regard this entrusted entity as a vehicle to channel the financing and not a beneficiary of aid, as long as it is not overcompensated.[617] In case the entrusted entity provides funding or co-invests in a manner similar to financial intermediaries, however, the Commission will assess whether it receives State aid.[618] The manager of the financial intermediary will be presumed to receive no state aid, if it is selected through an open, transparent, non-discriminatory, and objective procedure or if the manager's remuneration fully reflects the current market levels in comparable situations.[619]

Where the financial intermediary and its manager are public entities and were not selected through such a procedure, the Member State has to ensure that their management fee is capped, that their overall remuneration reflects normal market conditions, and that it is linked to performance in order not to be considered recipients of aid according to paragraph 41 of the Guidelines. In addition, the public financial intermediaries must be managed commercially and their managers must take investment decisions in a profit-oriented manner at arm's-length from the State.[620] Moreover, the private investors have to be chosen through an open, transparent,

[614] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 735.
[615] Risk Finance Guidelines, para. 37.
[616] Risk Finance Guidelines, para. 37.
[617] Risk Finance Guidelines, para. 39.
[618] Risk Finance Guidelines, para. 39.
[619] Risk Finance Guidelines, para. 40.
[620] Risk Finance Guidelines, para. 41.

non-discriminatory, and objective selection procedure on a deal-by-deal basis. Lastly, appropriate mechanisms must be in place in order to exclude any possible interference by the State in the day-to-day management of the public fund.[621]

If investments through the financial intermediary are in the form of loans or guarantees, it suffices for the exclusion of state aid that the conditions set out in the Communication on the reference rate or the Notice on guarantees are adhered to. If the financial intermediaries increase their assets and their managers achieve a larger turnover through their commissions, these are considered to constitute only a secondary effect of the aid manager and not aid.[622]

However, this assessment by the Commission is not consistent with its provision of Article 21 (16) GBER and adds to legal uncertainty. The latter stipulates under condition (a) that the financial intermediary must operate a mechanism that ensures the passing on of all advantages to final recipients to the largest extent. Of course, the phrasing of 'the largest extent' leaves a certain leeway of interpretation, if the above-mentioned advantages may be excluded from the passing on requirement. At any rate, the Commission does not provide consistent stipulations and enhances legal uncertainty for Member States and legal practitioners.

The Commission considers it a mere 'secondary economic effect' of the aid measure and not aid to financial intermediaries and/or managers, where financial intermediaries may increase their assets and their managers may achieve a larger turnover due to their commissions.[623] However, if the risk finance measure is designed in such a way as to transfer secondary effects towards specific financial intermediaries identified in advance, those intermediaries will be presumed to receive direct aid at any rate, according to the Commission.[624]

With regard to aid to **undertakings in which the investment is made**, the Commission states the following in paragraph 44 of the Guidelines: if aid is present at the level of the investors, the financial intermediary, or its managers, it will generally consider that the aid is at least partly passed on to the target undertakings.[625] This applies even if the intermediary's manager takes

[621] Risk Finance Guidelines, para. 41.
[622] Risk Finance Guidelines, para. 43.
[623] Risk Finance Guidelines, para. 43.
[624] Risk Finance Guidelines, para. 43.
[625] Risk Finance Guidelines, para. 44.

investment decision based on a purely commercial logic. In case loan or guarantee investments fulfil the conditions set out in the Communication on the reference rate or the Notice on guarantees, undertakings will not be considered to be recipients of State aid.[626]

Chapter V will elaborate further on the MEIP and provide an analysis of its application by the Commission in relation to financial instruments and risk finance measures.

7.2. The compatibility assessment principles of the Guidelines

This sub-section will elaborate on the Risk Finance Guidelines' compatibility assessment principles outlined by the Commission therein. It will critically comment on them. Chapter VI will provide a deeper analysis of the Commission's compatibility assessment in its decisional practice by comparing it with the benchmark of the EU Court's principle of proportionality, including necessity and balancing of positive and negative effects on competition and the internal market.

With regard to the Guidelines' **second set of assessment principles on the compatibility of state aid**, the Commission identifies three different categories of measures, which must be notified to the Commission and may be found compatible with Article 107 (3) (c) TFEU. The **first category covers risk finance measures which target undertakings that do not fulfil all the eligibility requirements** provided for risk finance aid under the GBER: Member State have to conduct an in-depth ex ante assessment for these measures, since the market failure affecting the eligible undertakings covered by the GBER can no longer be presumed.[627] In particular, this category comprises the measures targeting the following undertakings: (a) small midcaps that exceed the thresholds set out in the definition of SME in the GBER, (b) innovative mid-caps carrying out R&D and innovation activities, (c) undertakings receiving the initial risk finance investment more than seven-years after their first commercial sale, (d) undertakings requiring an overall risk finance investment amount exceeding the cap fixed in the GBER, and (e) alternative trading platforms not fulfilling the conditions of the GBER.[628]

[626] Risk Finance Guidelines, para. 44.
[627] Risk Finance Guidelines, para. 47.
[628] Risk Finance Guidelines, para. 47.

The **second category covers risk finance measures, which possess design parameters differing from those set out in the GBER, while targeting the same eligible undertakings** as defined therein: for those measures, the existence of a market failure needs to be proven only to the extent necessary to justify the use of parameters going beyond the limits set out in the GBER: In particular, this category comprises the following cases: (a) financial instruments with private investor participation below the ratios provided for in the GBER, (b) financial instruments with design parameters above the ceilings provided for in the GBER, (c) financial instruments other than guarantees where financial intermediaries, investors, or fund managers are selected by giving preference to protection against potential losses (downside protection) over prioritised returns from profits (upside incentives), and (d) fiscal incentives to corporate investors, including financial intermediaries or their managers acting as co-investors.[629]

The **third category covers large schemes, which fall outside the GBER by virtue of their large budget** as defined therein: the Commission will in its assessment verify whether the risk finance conditions of the GBER are satisfied and, should this be the case, will evaluate whether the design of the measure is appropriate in the light of the ex-ante assessment underpinning the notification: If a large scheme does not fulfil all the eligibility and compatibility conditions of those provisions, the Commission will assess the evidence provided in the context of the ex-ante assessment with regard to both the existence of a market failure and the appropriateness of the measure's design, as it sets out in the Guidelines.[630] In addition, the Commission will conduct an in-depth assessment of the potential negative effects on the affected markets.[631]

The different features described for each of the categories above may be combined within one risk finance measure subject to appropriate justifications based on a full market failure analysis.[632] Except for derogations expressly stated under the Guidelines, all other compatibility conditions provided for risk finance measures under the GBER are to be regarded as guidance in the assessment of the above-mentioned categories of notifiable measures.[633]

[629] Risk Finance Guidelines, para. 48.
[630] Risk Finance Guidelines, para. 49.
[631] Risk Finance Guidelines, para. 49.
[632] Risk Finance Guidelines, para. 50.
[633] Risk Finance Guidelines, para. 51.

The Guidelines stipulate **seven common assessment principles** in order to assess whether the design of the notified aid measure ensures that the positive impact of the aid towards an objective of common interest exceeds its potential negative effects on trade and competition, and thus, whether the aid measure may be considered compatible with the internal market:[634]

i) the **contribution to a well-defined objective of common interest**,
ii) the **need for state intervention**: an aid measure must be targeted towards situations where aid can bring about a material improvement that the market cannot deliver itself by remedying a market failure,
iii) **appropriateness** of the aid measure,
iv) **incentive effect**: the aid measure must change the behaviour of undertaking(s) concerned in such a way that it engages in additional activity which it would not carry out without the aid or would carry out in a restricted or different manner,
v) **proportionality** of the aid: the aid measure must be limited to the minimum needed to induce the additional investment or activity by the undertaking(s),
vi) **avoidance of undue negative effects** on competition and trade between Member States: the negative effects must be sufficiently limited so that the overall balance is positive,
vii) **transparency** of the aid: easy access to all relevant acts and to pertinent information about the aid awarded for Member States, the Commission, economic operators, and the public must be ensured.

These common assessment principles will be explained in the following in more detail. Thereby, reference will be made to the interpretation and requirements of the EU Courts on the important principle of proportionality in state aid law and its relevance for the compatibility assessment of the Commission. The EU Courts' proportionality requirements and the Commission's decisional practice will be further discussed in chapter VI.

<u>i) Contribution to a well-defined objective of common interest</u>

The Courts clarified that the concept of the 'common interest' implies that the interest has to be a public interest and not merely a private interest of the beneficiary of the aid measure, rather

[634] Risk Finance Guidelines, paras. 53-54.

than limiting 'the objectives capable of being pursued by Member States to those that are in the interest of all or the majority of Member States'.[635] However, the Courts highlighted the importance of the connection between the concept of the common interest and the balance to be struck between the advantages and disadvantages of an aid measure, precluding measures that are liable to adversely affect trade and distort the market.[636] Thus, the interests of other Member States are safeguarded by the requirement that trade and the internal market are not excessively distorted rather than by 'coinciding policy preferences'.[637]

As an objective of common interest within the meaning of Art. 107 (3) TFEU, the general policy objective of risk finance aid is to 'improve the provision of finance to viable SMEs from their early-development up to their growth stages and to small midcaps and innovative midcaps in order to develop a competitive business finance market in the long run, which contributes to overall economic growth'.[638]

Therefore, the Member State must conduct 'an **ex-ante assessment** in order to identify the policy targets and define the performance indicators relevant for the purpose of evaluating the effectiveness of the measure and for assessing the validity of the investment strategies of the financial intermediary in the context of the selection process'.[639] 'The performance indicators may include: (a) the required or envisaged private sector investment, (b) the expected number of final beneficiaries invested in, including the number of start-up SMEs, (c) the estimated number of new undertakings created during the implementation of the measure and as a result of the risk finance investments, (d) the number of jobs created in the final beneficiary undertakings between the date of the first risk finance investment under the risk finance measure and the exit, (e) where appropriate, the proportion of investments made in conformity with the market economy operator test, (f) milestones and deadlines within which certain predefined amounts or percentage of the budget are to be invested, (g) returns/yields expected to be generated from the investments, (h) where appropriate, patent applications made by the final beneficiaries during the implementation of the measure.'[640]

[635] Case T-356/15 Austria v European Commission [2018] EU:T:2018:439, paras. 84, 85.
[636] Case T-356/15 Austria v European Commission, para. 87.
[637] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9307, last access: 20.02.2019.
[638] Risk Finance Guidelines, para. 57.
[639] Risk Finance Guidelines, paras 58-59.
[640] Risk Finance Guidelines, paras 58-59.

Member States must ensure that the **intermediary's investment strategy remains aligned with the policy targets** of the measure through '**monitoring and reporting mechanisms** and the **participation of representatives of the public investors** in the representation bodies of the financial intermediary' (e.g. the supervisory board or the advisory board), whereby the latter must demonstrate how their proposed investment strategy may contribute to the achievement of the common objective as part of their selection process.[641] The financial intermediary must possess an appropriate governance structure, which ensures that material changes to the investment strategy require the prior consent of the Member State.[642]

ii) The need for state intervention

Member States must show that the 'measure is targeted at specific market failures affecting the delivery of the common objective': While the Commission considers that there is no general market failure regarding the access to finance for SMEs as such, there may be a failure related to certain groups of SMEs depending on the specific context of the Member State concerned.[643] This applies particularly but not exclusively to 'SMEs in their early stages', since 'they are often unable to demonstrate their creditworthiness or the soundness of their business plans to investors' despite their growth prospects (due to information asymmetries and higher transaction and agency costs exacerbating investor risk-aversion).[644] Moreover, 'the scope of such market failure, both in terms of the affected companies and their capital requirement, may vary depending on the sector' concerned.[645] The Commission considers that 'small midcaps and innovative midcaps may face similar difficulties and therefore be affected by the same market failure'.[646]

Through its assumption in the Guidelines that there is no 'general market failure' affecting access to finance', the Commission heavily rests its concept of 'market failures' on asymmetric information as a justification for intervention.[647] Asymmetric information, however, 'is a problem in basically all external funding relationships, whether debt or equity', so that 'to a certain

[641] Connor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.334; and Risk Finance Guidelines, para. 62.
[642] Risk Finance Guidelines, para. 62.
[643] Risk Finance Guidelines, para. 63.
[644] Risk Finance Guidelines, para. 63.
[645] Risk Finance Guidelines, para. 63.
[646] Risk Finance Guidelines, para. 63.
[647] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 393.

extent… a market failure exists for all firms that need access to finance, whether large or small'.[648] This may be considered a logic omission, as the Commission adopts 'the approach of denying the existence of any market failure for certain types of SME rather than making the case that some types of market failure do not necessarily justify government intervention'.[649]

Accordingly relying on its rather narrow concept of market failures due to asymmetric information, the Commission requires that an **ex-ante assessment** must form the basis of the risk finance measure in order to **demonstrate 'the existence of a funding gap** affecting the eligible undertakings in the targeted development stage, geographic area, and, if applicable, economic sector'.[650] The assessment 'should preferably be conducted by an independent entity based on objective and up-to-date evidence'.[651] The measure 'must be designed in such a way as address the market failures proven in the ex-ante assessment'.[652] The analysis must contain 'both the structural and cyclical problems leading to sub-optimal levels of private funding' as well as 'a comprehensive analysis of the sources of financing available to the eligible undertakings'.[653] For the latter, aspects to be taken into account are 'the number of existing financial intermediaries in the target geographic area, their public and private nature, the investment volumes targeted to the relevant market segment, the number of potentially eligible undertakings and average values of individual transactions'.[654]

The analysis has to be 'based on data covering the five years preceding the notification of the measure and the nature and size of the funding gap', i.e. the level of unsatisfied demand for finance form eligible undertakings.[655] Existing assessments may be submitted by the Member State, if they date from less than three years preceding the notification.[656] In case the measure is co-financed by ESIFs, the Commission will accept the ex-ante assessment conducted for the purpose of ESIFs pursuant to Art. 37 (2) CPR and consider that it meet the requirements set by the Guidelines.

[648] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 394.
[649] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 394.
[650] Risk Finance Guidelines, para. 64.
[651] Risk Finance Guidelines, para. 66.
[652] Risk Finance Guidelines, para. 64.
[653] Risk Finance Guidelines, para. 65.
[654] Risk Finance Guidelines, para. 65.
[655] Risk Finance Guidelines, para. 65.
[656] Risk Finance Guidelines, para. 66.

Importantly, and in line with the findings of the analysis in chapter VI, namely that the Commission in its decisional practice does not meet the proportionality requirements of the EU Courts, the ex-ante assessment as required by the Commission's Guidelines puts 'most (or all) of the effort in collating significant amounts of data to come up with an estimate of the funding gap'.[657] In order to meet the Courts' requirements of truly conducting a balancing of positive and negative effects, the Commission would rather have to re-focus the approach of the ex-ante assessment to ensure 'that the rationale is theoretically sound, making a detailed case that the benefits of reducing existing market failures outweigh the costs of intervention and linking it in detail to the different design features of the intervention' in question.[658]

What is more, under the ESI funds rules, i.e. Article 37 (2) CPR, any public intervention requires to be justified by a specific market failure, independent of its form (be it by grants or by financial instruments). The Commission therefore provides Guidance for Member States on Article 37 (2) CPR for the compilation of ex ante assessments, which may be conducted by a managing authority or an external provider.[659] Interestingly, contributions to financial instruments designed and managed at the EU level, which do not fall under the scope of Article 107 (1) TFEU, are not exempted from the requirements of Article 37 (2) CPR (with the exception of the SME Initiative under Article 39), since the ex-ante evaluation to be conducted by the Commission for financial instruments at the EU level do 'not provide the same level of detail that is expected from ex ante assessment' under the CPR.[660]

In general, the ex-ante assessment may not be confused with the ex-ante evaluation pursuant to Article 55 (3) (h) CPR, which is to be conducted in parallel with the preparation of ESI funds programmes at the beginning of the period (in contrast, the ex-ante assessment may be conducted during the period, as long as it is completed prior to the decision of the Managing Authority to make a contribution) and which has to consider the form of interventions used at the programme level.[661]

[657] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, pp. 412, 413.
[658] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, pp. 412, 413.
[659] European Commission, Guidance for Member States on Article 37 (2) CPR – Ex-ante Assessment, 27.03.2015.
[660] European Commission, Guidance for Member States on Article 37 (2) CPR – Ex-ante Assessment, 27.03.2015, p. 3.
[661] European Commission, Guidance for Member States on Article 37 (2) CPR – Ex-ante Assessment, 27.03.2015, p. 7.

Article 37 (2) CPR foresees seven key group of elements of the ex-ante assessment: (a) analysis of market failures, suboptimal investment situations, and investment needs, (b) value added of the financial instrument, (c) additional public and private resources, (d) lessons learnt, (e) investment strategy, (f) expected results, and (g) provisions allowing the ex-ante assessment to be reviewed.[662]

Moreover, in order to target the identified market failures, Member States are required to conduct a **due diligence process** to ensure a commercially sound investment strategy, which focuses on the identified policy objective and respects the defined eligibility requirements and funding restrictions.[663] Therefore, the selected financial intermediaries must demonstrate a commercially sound investment strategy including an appropriate risk diversification policy.[664] The latter, in turn, must be 'aimed at achieving economic viability and efficient scale in terms of size and territorial scope of the investments'.[665]

In paragraphs 69 to 79, the Guidelines lay down how measures targeted at categories of undertakings outside the scope of the GBER may be considered compatible with the internal market nonetheless. These provisions are relevant for (a) small midcaps, (b) innovative midcaps, (c) undertakings receiving the initial risk finance investment more than seven years after their first commercial sale, (d) undertakings requiring a risk finance investment of an amount exceeding the cap fixed in the GBER, and (e) alternative trading platforms not fulfilling the conditions of the GBER.

In paragraphs 80 to 88, the Guidelines elaborate on how measures with design parameters not complying with the GBER may still be considered compatible with the internal market. These provisions are relevant for '(a) financial instruments with private investors' participation below the ratios provided for in the GBER, (b) financial instruments with design parameters above the ceilings provided for in the GBER, (c) financial instruments other than guarantees where investors, financial intermediaries, and their managers are selected by giving preference to downside

[662] European Commission, FI-Compass, Ex-ante Methodology for Financial Instruments in the 2014-2020 Programming Period: General Methodology, 13.05.2014, https://ec.europa.eu/regional_policy/en/information/publications/guides/2014/ex-ante-assessment-methodology-for-financial-instruments-in-the-2014-2020-programming-period-general-methodology-covering-all-thematic-objectives-volume-i, last access: 03.03.2019, pp. 27-28.
[663] Risk Finance Guidelines, para. 67.
[664] Risk Finance Guidelines, para. 67.
[665] Risk Finance Guidelines, para. 67.

protection over asymmetric profit-sharing, and (d) fiscal incentives to corporate investors including financial intermediaries or their managers acting as co-investors'.

The EU Courts clarified that 'Article 107 (3) (c) TFEU does not expressly include a condition relating to the existence of a market failure', but that 'the provision merely requires that the **aid must relate to a public interest objective**, and that it be appropriate, necessary, and not disproportionate', so that the relevant question is 'whether the public interest objective pursued by the Member State would be attained without that Member State's intervention'.[666] Thus, 'while the existence of a market failure may be a relevant factor for declaring state aid compatible with the internal market, the absence of market failure does not necessarily mean that the conditions laid down in Article 107 (3) (c) TFEU are not satisfied'.[667]

Importantly, the General Court gave the example of showing the necessity of a state intervention 'where market forces are not capable by themselves of ensuring that the public interest objective of the Member State is achieved in sufficient time, even if, as such, that market cannot be considered to be failing', i.e. the Courts stress that Member States may justify aid merely on the grounds 'that it achieves outcomes not possible or likely under the autonomous decisions of market operators' (i.e. when the market operator principle fails).[668]

What appears to be actually required by the EU Courts is thus the **proof of a divergence of desirable and actual market outcomes**: In order to bring the common assessment principles of the Commission in line with the Courts' interpretation of the proportionality principle (which will be elaborated on in chapter VI), the Commission should clarify that Member States must show how the aid measure affects market conditions in balancing the positive and the negative effects of the aid measure, rather than stressing the existence of a market failure, which is merely one way of proving the necessity of the aid, i.e. 'in essence, Member States must show a divergence

[666] Case T-356/15 Austria v European Commission, para. 150.
[667] Case T-356/15 Austria v European Commission, para. 151.
[668] Cases T-356/15 Austria v European Commission, para. 151, T-162/13 Magic Mountain Kletterhallen v European Commission, para. 77, T-92/11 RENV, Andersen v European Commission, para. 69;
and Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.

between desirable market outcomes and actual market outcomes', which would complement the reasoning for the requirement of a common interest objective.[669]

'Desirable market outcomes' may thus be understood as a broader concept than the purely economic one of market failures, forming part of a 'missiondriven [sic] policy'.[670] Its motivation is 'to address a social challenge or develop a new industry' instead of 'fixing a market or system failure', i.e. 'governments identify a goal considered to be socially desirable (for example, reducing climate change) and design a set of instruments to increase access to finance for innovations aimed at tackling it (for example, clean energy technology)'.[671]

In contrast, the more classical justifications for government intervention relate to 'behavioural biases and information gaps', where 'market failures emerge when rational behaviour by market actors leads to a suboptimal market outcome', or 'inefficiencies in the functioning of financial markets'.[672] [673] By relying heavily on information asymmetries in its rather narrow concept of market failure, as explained in more detail above, the Commission omits relevant alternative justifications for market interventions, such as externalities and their main sources, 'knowledge spillovers [sic] relating to innovation and entrepreneurship'.[674] Importantly, and in line with the broader concept of 'desirable market outcomes' in the context of risk financing innovative firms, 'externalities could be a justification for government intervention even if no equity gap existed and innovative firms were not financially constrained'.[675] [676] Moreover, the Guidelines fall short of mentioning other justifications, such as coordination failures or government-supported experimentation.[677]

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[669] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[670] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.
[671] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.
[672] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.
[673] Of course, state interventions as such remain highly debated in economic and political theory. Discussing the arguments against state interventions would go beyond the scope of this thesis. Thus, it shall suffice to refer to the list of Verouden et al.: potential disadvantage of governments to fix failures, issues associated with asymmetric information and misalignment of incentives, characterization of schemes by limited additionality and crowing-out, rent-seeking and capture leading to inefficiencies, political factors (e.g. election cycles), bad policy design leading to ineffectiveness, and implementation failures. - Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 390.
[674] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 392.
[675] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 392.
[676] However, this wide justification may be limited through the criterion of the incentive effect, which puts the focus of measures under the Guidelines on financially constrained firms, since 'one euro of public funding given to a financially constrained firm is likely to increase the innovation investment by more than would the same euro given to an unconstrained firm'. - Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 392.
[677] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 393.

It may be mentioned that and as will be discussed in chapter VI in more detail, the Commission does not follow the EU Courts' interpretation of proportionality, which would require that it assess the actual correspondence between the extent of the market failure/the gap of the desirable and actual market outcomes and the amount of the aid as well as between the amount of the aid and the distortion of competition through the aid, and importantly, the balancing of positive and negative effects of the aid measure. Rather, it applies a formalistic list for checking ceilings, caps, market mechanisms, and screening methods.

iii) Appropriateness of the aid measure

Member States must ensure that the risk finance measure be an appropriate instrument for addressing the market failures and for contributing to the achievement of the policy objectives as well as that it is the least distortive instrument to competition at the same time. Therefore, 'the choice of the specific form of the measure must be duly justified in the ex-ante assessment'.[678] This is in line with the proportionality principle elaborated by the EU Courts (see chapter VI).

In the first step, the Commission will compare the measure to other policy instruments aimed at encouraging risk finance investments into the eligible undertakings, since 'Member States have other complimentary policy tools both on the supply and demand side at their disposal, such as regulatory measures to facilitate the functioning of financial markets, measures to improve the business environment, advisory services or public investments in line with the market economy operator test'.[679] While taking into account the effectiveness and efficiency of these other policy tools not entailing state aid, the 'ex-ante assessment must also analyse the existing and envisaged national and EU policy actions that target the same identified market failures' and 'its findings must demonstrate that those cannot adequately address the identified market failures'.[680] The assessment may entail a quantitative and a qualitative dimension.[681] Moreover, the Member

[678] Risk Finance Guidelines, para. 89.
[679] Risk Finance Guidelines, para. 90.
[680] Risk Finance Guidelines, para. 91.
[681] The quantitative dimensions are e.g. the leverage of the EU (i.e. ESIF) contribution, the intensity of subsidy of the financial instrument, the revolving effect allowing the recycling of funds, and additional contributions coming from the final recipients. Examples of the qualitative dimension are the provision of a financial product that exactly matches the market gap without distorting competition, the development of new financial product types, the support of the capacity of a sector, or the

State must ensure that the risk finance measure is consistent with its overall policy 'regarding SME access to finance and complementary to other policy instruments addressing the same market needs'.[682]

In the second step, the Commission will compare the measure to alternative state aid instruments addressing the same market failures. Interestingly, the Commission states that there was the 'general presumption' that financial instruments were less distortive than direct grants and therefore constituted a more appropriate instrument.[683] However, it does not provide an explanation as to where this presumption emanates and is founded upon. One explanation may rest on their design, according to the European Parliament: For instance, financial instruments are 'accompanied by procedures to ensure that those instruments are not crowding out private finance, but rather are complementing it'.[684] However, there appear to be no empirical studies or evaluations backing this presumption.

Moreover, since Member States have different risk finance instruments at their disposal, they must ensure that the design of the measure provides for an efficient funding structure based on the fund's investment strategy and thus ensures sustainable operations.[685] Thereby, the Commission considers positively 'measures involving sufficiently large funds in terms of portfolio size, geographic coverage', and diversification of the portfolio, as such funds are considered more efficient and thus more attractive for private investors.[686]

Furthermore, **the Guidelines stipulate the conditions for financial instruments, which fall outside the scope of the GBER**. Firstly, the measure must mobilise additional funding from market participants, i.e. the Member State must demonstrate 'that the measure leverages additional private funding that would not have been provided or would have been provided in different forms or amounts or on different terms' if the measure was absent.[687] Secondly, the balance of

preference of a revolving long-term support scheme. - Ex-ante assessment methodology for financial instruments in the 2014-2020 programming period, General Methodology covering all thematic objectives, Volume I, pp. 57-64.

[682] Risk Finance Guidelines, para. 91.

[683] Risk Finance Guidelines, para. 92.

[684] The European Parliament, Financial Instruments: defining the rationale for triggering their use, October 2017, https://www.ceps.eu/system/files/IPOL_STU%282017%29603787_EN.pdf, p. 9, last access: 12.01.2019.

[685] Risk Finance Guidelines, para. 92.

[686] Risk Finance Guidelines, para. 93.

[687] Risk Finance Guidelines, para. 95.

risks and rewards between the public and private investors must be elaborated on.[688] The Commission will consider positively measures with pari passu terms for investors, i.e. whereby 'the losses are shared equally between investors and private investors only receive upside incentives'.[689]

Thirdly, the Commission will analyse the level of the funding structure at which the measure aims to leverage private investment.[690] For example, a different risk and reward profile could be accepted, if it maximises the amount of private investment and does not undermine the profit-driven character of investment decisions.[691] Fourthly, based on an open and non-discriminatory process of the selection of the financial intermediaries, the nature of incentives must be determined.[692]

Fifthly, as long as any potential conflict of interest is avoided, the financial intermediary or the fund manager may co-invest alongside the Member State, whereby the financial intermediary must take at least 10 per cent of the first loss piece and the ability of the manager to provide investment from its own resources may be one of the selection criteria.[693]

Finally, there must be a pass-on mechanism of the advantage (for instance in the form of lower interest rates, reduced collateral requirements, a combination of the two) to the final beneficiary in the case of risk finance measures making use of debt instruments including adequate monitoring arrangements and a claw-back mechanism.[694] Alternatively, the advantage may be passed on by investing in undertakings in a risk class where the intermediary would not invest in the absence of the risk finance measure.[695] Moreover, Member States may deploy a range of financial instruments as part of the risk finance measure, such as equity investments, funded debt instruments in the form of loans, or unfunded debt instruments in the form of guarantees in accordance with the conditions of paragraphs 106 to 119 of the Guidelines.

[688] Risk Finance Guidelines, para. 95.
[689] Risk Finance Guidelines, para. 95.
[690] Risk Finance Guidelines, para. 99.
[691] Risk Finance Guidelines, para. 100.
[692] Risk Finance Guidelines, para. 101.
[693] Risk Finance Guidelines, para. 103.
[694] Risk Finance Guidelines, para. 104.
[695] Risk Finance Guidelines, para. 104.

The Guidelines stipulate conditions for fiscal instruments, i.e. aid measures granted via the tax system (whereby revenue is foregone, e.g. 'in the form of income tax reliefs and/or tax reliefs on capital gains and dividends, including tax credits and deferrals'), **which fall outside the scope of the GBER** for not targeting investors who are natural persons but corporate investors.[696] In general, Member States thereby 'have to base their fiscal measures on findings of a market failure in the ex-ante assessment and thus target their instrument towards a well-defined category of eligible undertakings'.[697] If the Member State can demonstrate that 'the selection of the eligible undertakings is based on a well-structured set of investment requirements, made public through publicity' and laying down 'the characteristics of the eligible undertakings subject to a market failure', the Commission considers such fiscal measures appropriate and thus having an incentive effect.[698] The fiscal schemes may have a maximum duration of 10 years and may be prolonged only based on a new ex ante assessment and an evaluation of the effectiveness of the scheme during its implementation period.[699] The fiscal advantage must be available to all investors fulfilling the required criteria regardless of 'their place of establishment and provided that the Member State complies with the minimum standards on good governance to be ensured by an adequate publicity'.[700]

The Guidelines also cover conditions for measures supporting alternative trading platforms beyond the limits of the GBER: the operator must provide a business plan demonstrating that the aided platform can become self-sustainable in less than 10 years as well as a study on plausible counterfactual scenarios.[701]

The Courts stressed the relation of the principle of appropriateness to the first criterion of the common interest objective: it clarified that appropriateness is to be determined in relation to the 'objective pursued', which is 'decided upon by the Member State that grants the aid', and that the appropriateness, together with the necessity of the measure must be assessed in the light of

[696] The Commission Working Paper on State Aid and Tax Rulings provides the following definition: 'A measure by which the public authorities grant certain undertaking a favourable tax treatment which places them in a more favourable financial position than other taxpayers amounts to state aid within the meaning of Article 107 (1) TFEU' citing the case law of the EU Courts
- European Commission, DG Competition Working Paper on State Aid and Tax Rulings, 2016, https://ec.europa.eu/competition/state_aid/legislation/working_paper_tax_rulings.pdf, last access: 03.11.2020.
[697] Risk Finance Guidelines, para. 122.
[698] Risk Finance Guidelines, para. 123.
[699] Risk Finance Guidelines, para. 124.
[700] Risk Finance Guidelines, para. 125.
[701] Risk Finance Guidelines, para. 126.

the common interest objective in question.[702] Thereby, it is not clear from case law or Commission decisions at which stage trade-offs between conflicting common interest objectives are considered.[703] It is clear, however, that principle of appropriateness examines which aid measure is most suitable to achieve the common interest objective in question rather than whether 'the pursuit of one objective may impede the pursuit of another'.[704] Logically, it is fair to assume that policy trade-offs, which may cause market distortions, should be considered under the sixth criterion of avoiding undue negative effects on competition and trade, when balancing the positive and negative effects of the aid measure.[705]

iv) Incentive effect of the aid

Member States have to demonstrate that the financial risk measures entails 'an **incentive effect that induces the aid beneficiary to alter its behaviour by undertaking activities it would not carry out** or would carry out in a more restrictive manner in the absence of the aid measure', e.g. that the measure incentivises 'market investors to provide funding to potentially viable undertakings above the current levels and/or to assume extra risk'.[706] An incentive effect is present at the level of the eligible undertakings, if 'the final beneficiary can raise finance that would not be available otherwise in terms of form, amount, or timing'.[707] A measure 'is considered to have an incentive effect if it mobilises investments from market investors so that the total financing for eligible undertakings exceeds the measure's budget'.[708] Therefore, the Commission recommends as a key criterion for 'selecting the financial intermediaries and the fund managers their ability to mobilise additional private investment'.[709]

The ex-ante assessment must include 'an estimate of additional public and private resources potentially raised' at the different levels, 'an assessment of the need for, and level of, preferential

[702] Cases T-356/15 Austria v European Commission, paras. 370, 381, and 406,
and Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C – Part II, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[703] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C – Part II, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[704] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C – Part II, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[705] This is in line with the reasoning of Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C – Part II, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[706] Risk Finance Guidelines, para. 130.
[707] Risk Finance Guidelines, para. 130.
[708] Risk Finance Guidelines, para. 131.
[709] Risk Finance Guidelines, para. 131.

remuneration to attract private investors, and a description of the mechanisms to establish the need for, and the extent of, preferential remuneration'.[710] According to the Commission, 'the assessment of the incentive effect is closely linked to both the assessment of the market failure and the appropriateness assessment', since 'the measure's suitability to achieve a leverage effect' is dependent on 'its design on the balance of risks and rewards between public and private investors'.[711] Hence, once the market failure has been identified and the measure is considered to have an appropriate design, it may be assumed to entail an incentive effect.[712]

v) Proportionality of the aid

State aid has to be proportionate in relation to the market failure being addressed vis-à-vis the relevant policy objectives to be achieved. Thus, the measure 'must be limited to the strict minimum necessary to attract funding from the market' in order to close the funding gap while avoiding undue advantages.[713] The Commission states that it must therefore be designed in a cost-efficient manner and be in line with the principles of sound financial management. At the level of the final beneficiaries, if the total amount of funding (private and public) provided under the measures is limited to the size of the funding gap identified in the ex-ante assessment, the risk finance aid in general is considered proportionate.[714] At the level of the investors, if the aid is limited to the minimum necessary to attract private investment in order to achieve the minimum leverage effect and close the funding gap, the aid in general is considered to be proportionate.[715]

As will be elaborated in chapter VI in detail, the Commission does in fact not assess the correspondence between the extent of the market failure and the amount of the aid in its decisional practice in accordance with the principles of the EU Courts. Rather, it strives to check whether the amount of the aid is limited and in line with the ceilings and caps provided in the GBER and its Guidelines as well as whether market mechanisms listed in the GBER and Guidelines are applied that ensure the design of financial instruments that are necessary and proportional.

[710] European Commission, Ex-ante assessment methodology for financial instruments in the 2014-2020 programming period, General Methodology covering all thematic objectives, Volume I, p. 78.
[711] Risk Finance Guidelines, para. 132.
[712] Risk Finance Guidelines, para. 132.
[713] Risk Finance Guidelines, para. 133.
[714] Risk Finance Guidelines, para. 134.
[715] Risk Finance Guidelines, para. 134.

Such mechanisms, for instance, are the following. With regard to the 'conditions for financial instruments, the measure must ensure a balance between the preferential conditions offered by a financial instrument to maximise the leverage effect in addressing the market failure and the need for the instrument to generate sufficient financial returns on a viable operational basis'.[716] In the context of the open and non-discriminatory selection process of the financial intermediaries and fund managers or investors, the nature and value of the preferential conditions must be determined through their competing bids, according to the Guidelines.[717] If asymmetric risk-adjusted returns or loss sharing is established through such a process, the Commission will consider the instrument to be proportionate and reflect a fair rate of return (FRR).[718] The Commission will regard the private investors as duly selected, if the fund managers are selected through an open, transparent, and non-discriminatory call and are required to present their investor base.[719]

If private investors participate on a deal-by-deal basis within a co-investment by a public fund, they must be selected through a separate competitive process with regard to each transaction as the preferred way of establishing the FRR.[720] If this process is not followed (due to being ineffective or inconclusive), an independent expert must establish the FRR on the basis of a benchmark analysis of the market and its risks.[721] The expert must use the so-called discounted cash flow valuation method in order to avoid over-compensation of the investors and must calculate the minimum level of the FRR with an added appropriate risk margin.[722] The expert, in turn, must be appointed based on appropriate rules. 'As long as the expected risk-adjusted returns for the private investors are limited to the FRR', the measure's design 'may contain asymmetric profit sharing or asymmetrically timed public and private investments'.[723]

As a general principle, Member States may minimise the aid by aligning their economic interests with those of the financial intermediaries or their managers with regard to both the 'achievement of the policy targets and the financial performance of the public investment into the

[716] Risk Finance Guidelines, para. 135.
[717] Risk Finance Guidelines, para. 135.
[718] Risk Finance Guidelines, para. 136.
[719] Risk Finance Guidelines, para. 136.
[720] Risk Finance Guidelines, para. 137.
[721] Risk Finance Guidelines, para. 137.
[722] Risk Finance Guidelines, para. 138.
[723] Risk Finance Guidelines, para. 140.

instrument'.[724] The financial intermediary or the fund manager may co-invest alongside the Member State, as long as the terms and conditions of such a co-investment exclude any possible conflict of interests.[725]

With regard to the remuneration of the financial intermediaries or the fund managers, it must include an annual management fee as well as performance-based incentives, which must be based on the relevant market practice, be significant, and designed to reward the financial performance and the attainment of the policy targets set in advance.[726] Thereby, the total management fees may not exceed the operational and management costs for the execution of the financial instrument.[727] The fee may include a reasonable profit in line with market practice, but no investment costs.[728] Chapter VIII will discuss the selection and remuneration of financial intermediaries and their managers as a screening method of the accountability principle in more detail.

With regard to the conditions for fiscal instruments, the total investment for each beneficiary may not exceed the maximum amount stipulated by the risk finance provisions of the GBER.[729] Irrespective of the type of tax relief, the Commission states in paragraph 150 of the Guidelines, that eligible shares must be full-risk, ordinary shares, newly-issued by an eligible undertaking as defined in the ex-ante assessment. Furthermore, they must be held for at least three years and that the tax relief may not be available to investors, who are not independent from the company invested in.[730] In the case of an income tax relief, the Commission necessitates investors providing finance to eligible undertakings to receive a relief only up to a reasonable percentage of the amount invested and indicates that, according to its experience, a tax relief capped at 30 per cent may be considered reasonable.[731] In the case of a tax relief on dividends and of a capital gain tax relief, any dividend/profit received may be fully exempt from income tax/capital gain tax.[732]

[724] Risk Finance Guidelines, para. 141.
[725] Risk Finance Guidelines, para. 142.
[726] Risk Finance Guidelines, paras. 143, 144, and 145.
[727] Risk Finance Guidelines, paras. 143, 144, and 145.
[728] Risk Finance Guidelines, paras. 143, 144, and 145.
[729] Risk Finance Guidelines, para. 149.
[730] Risk Finance Guidelines, para. 150.
[731] Risk Finance Guidelines, para. 151.
[732] Risk Finance Guidelines, para. 152.

With regard to the conditions for alternative trading platforms, State aid may be granted to cover up to 50 per cent of the investment costs incurred for the establishment of such a platform according to the Commission in paragraph 153 of the Guidelines. Moreover, in the case of fiscal incentives to corporate investors, the Commission refers to the Guidelines' conditions on fiscal instruments for its assessment of the measure.[733]

The Courts clarified that it is not always necessary to establish ex ante the gross grant equivalent (GGE) of the aid measure in the wake of ensuring proportionality, albeit provisions of state aid regulations, guidelines, and good practice may require so, 'as long as there is a mechanism in place that can prevent the granting of unnecessary amounts of aid' (e.g. this is 'typically the case where aid is calculated on the on the basis of a "funding gap" methodology… or the amount [of the] aid is determined on the basis of a competitive procedure').[734] With regard to the funding gap methodology of financial instruments, this may apply to transactions based on a tender procedure, on a benchmarking method, or on other assessment methods.[735] Since financial instruments lack identifiable underlying costs, it is thus crucial that the amount of aid is kept at a minimum and is proportionate to the extent of the market failure.[736]

An interesting question is how the Commission and EU institutions ensure that the risk inherent to financial instruments stemming from the EU budget and managed at EU level is proportional to the design of the instrument and to its (expected) returns in order to cover the debt in practice: This is also in their self-serving interest, since, for instance, 'if the operations of the EIB become excessively risky in proportion to its capital base and guarantees, the financial markets will not offer the EIB the same low rates [stemming from the considerable backing by Member States and the guarantees by the EU budget], defeating the purpose of the EIB as an investment bank'.[737] As will be discussed in section 2 of chapter VI, the Commission ensures via its Delegation Agreements concluded with the EIB/EIF on financial instruments set up and managed at the EU level that

[733] Risk Finance Guidelines, para. 154.
[734] Case T-356/15 Austria v European Commission, and
Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[735] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[736] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[737] European Parliament, Financial Instruments: defining the rationale for triggering their use, October 2017, https://www.ceps.eu/system/files/IPOL_STU%282017%29603787_EN.pdf, p.8., last access: 12.01.2019.

financial intermediaries are selected, which are economically apt to assess and prove the amount of resources needed, i.e. through the prescribed eligibility and selection criteria of financial intermediaries, the necessity and proportionality of the measures are safeguarded.

vi) Avoidance of undue negative effects on competition and trade

The Commission states that 'the state aid measure must be designed in such a way that it limits distortions of competition within the internal market': Thus, at each level where aid may be present, the potential negative effects of the risk finance measure must be assessed: the investors, the financial intermediaries and their managers, and the final beneficiaries.[738] These 'negative effects have to be balanced against the overall positive effect of the measure': The Commission therefore asks the Member States to submit as part of the ex-ante assessment any study at their disposal as well as ex-post evaluations conducted for similar schemes with regard to eligible undertakings, funding structures, design parameters, and geographic area.[739]

Firstly, at the level of the **risk finance market**, state aid may lead to crowding out private investment, since it might reduce the incentives for private investors to provide funding and encourage eligible undertakings to wait for the State's providing aid for such investment.[740] The Commission indicates in paragraph 157 that 'this risk becomes more relevant the higher the amount of the total financing' into the eligible undertakings, 'the larger the size of those undertakings, and the more advanced their development stage', since private financing becomes progressively more attractive and thus available in those circumstances. What is more, the Commission warns that 'state aid should not replace the normal business risk of investments that investors would have undertaken even if the state aid' were absent, but also states that this risk may be less likely the more properly defined the extent of the market failure has been.[741]

Secondly, at the level of the **financial intermediaries**, aid may increase or maintain an intermediary's market power and thus result in distortive effects. This may occur directly, by strengthening the financial intermediary's market power, or indirectly, by 'discouraging the

[738] Risk Finance Guidelines, para. 155.
[739] Risk Finance Guidelines, paras. 155, 156.
[740] Risk Finance Guidelines, para. 157.
[741] Risk Finance Guidelines, para. 157.

expansion of existing competitors, inducing their exit, or discouraging the entry of new competitors'.[742] The measure must be directed towards growth-oriented undertakings rendering them able to attract an adequate level of financing from private resources.[743] Thereby, the investment strategy must demonstrate their potential viability, so that the measure meets the balancing test and avoids to be considered a grant. The commercial management and the profit-oriented decision-making are essential conditions set out by the GBER to ensure that the selection of the final beneficiary undertakings is based on a commercial logic.[744] Hence, these conditions may not be derogated from under the Guidelines, either. Positive factors are therefore, according to the Commission, a considerable size, scope, and regional focus of the measure, together with adequate governance arrangements.[745] These factors increase the likelihood of a more diversified and risk-spreading setting of the fund and render it more attractive to private investors.[746]

Thirdly, the Commission will assess at the level of the **final beneficiaries** whether the measure exerts distortive effects on the product markets where those beneficiaries compete.[747] Therefore, the Member State must indicate whether the measure is aimed to be sector specific or gives preference to certain sectors over others.[748] Thus, the Commission will analyse the potential demand and the level of production capacities in the indicated sector.[749] For instance, in underperforming sectors, the measure may lead to the creation or maintenance of an overproduction decreasing profit margins and the consumer surplus, in turn.[750] In its analysis, the Commission will also consider any potential negative delocalisation effects, i.e. whether the regional funds are prone to incentivise delocalisation within the internal market, comparing bordering (non-assisted and assisted) regions.[751] A regional risk finance measure that is sector specific may also lead to negative delocalisation effects.[752]

In balancing positive and negative effects, the Commission states it would take into account the magnitude of such effects, e.g. the size of the investment amount, the type and number of

[742] Risk Finance Guidelines, para. 158.
[743] Risk Finance Guidelines, para. 159.
[744] Risk Finance Guidelines, para. 160.
[745] Risk Finance Guidelines, para. 161.
[746] Risk Finance Guidelines, para. 161.
[747] Risk Finance Guidelines, para. 162.
[748] Risk Finance Guidelines, para. 162.
[749] Risk Finance Guidelines, para. 162.
[750] Risk Finance Guidelines, para. 162.
[751] Risk Finance Guidelines, para. 163.
[752] Risk Finance Guidelines, para. 164.

beneficiaries, and the characteristics of the targeted sectors.[753] In case the measure entails negative effects, the Member State must identify the means to minimise such distortions, according to the Commission.[754]

Interestingly, the Court in the case *Austria v Commission* did not appear to require the Commission to necessarily conduct a concrete quantification or weighing of the effects under the compatibility assessment; it appears to suffice that the Commission establishes that the likely negative effects remain small.[755] This may be seen critical, especially since this approach does not address the issue of how to assess cases where 'the negative effects are large', but 'represent the minimum necessary'.[756]

As will be discussed in chapter VI, the EU Courts require the assessment of the correspondence between the amount of the aid and market distortions, and, correspondingly, the balancing of positive and negative effects of the aid. However, it will also be shown that the Commission does not follow the EU Courts' requirements, but applies a rather formalistic approach of check listing whether financial instruments are designed in accordance with the conditions put down in the GBER and Guidelines, which were explained in the foregoing.

vii) Transparency

In order to enhance transparency, Member States are obliged to publish the following information on a comprehensive State aid website, at national or regional level, in accordance with paragraph 166:

i. the text of the aid scheme and its implementing provisions;
ii. the identity of the granting authority;
iii. the total amount of the Member State's participation in the measure;

[753] Risk Finance Guidelines, para. 165.
[754] Risk Finance Guidelines, para. 165.
[755] T-356/15, Austria v European Commission [2018], EU:T:2018:439, paras. 247-256, 272,
and Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C – Part II, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.
[756] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C – Part II, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.

iv. the identity of the entrusted entity, if applicable, and the names of the selected financial intermediaries;

v. the identity of the undertaking supported under the measure, including information about the type of the undertaking (SME, small mid-cap, innovative mid-cap), the region in which it is located, the principle economic sector the undertaking has its activities in (NACE group level), the form and amount of the investment;

vi. in the case of fiscal risk finance aid schemes, the identity of the beneficiary corporate investors and the amount of the fiscal advantage received, where the latter exceeds EUR 200.000, whereby the amount may be provided in tranches of EUR 2 million.

This 'information must be published after the decision to grant the aid has been taken, must be kept for at least 10 years, and must be available for the general public without restrictions'.[757]

In the following two sub-sections, the concepts of cumulation of aid and ex post evaluation in the context of financial instruments and risk finance aid will be explained.

7.3. Cumulation of aid

Neither the GBER nor the Guidelines provide a definition of the term 'cumulation', while the only legal text that defines this term stems from 1985 and relates to investment aid schemes: 'cumulation of aid is defined as the application of more than one aid scheme to a given investment project'.[758]

Risk finance aid without identifiable costs exempted under Article 21 GBER may be cumulated with any other State aid measure with **identifiable eligible costs** pursuant to Article 8 (4) GBER. Under the same Article, 'aid without identifiable eligible costs may be cumulated with any other state aid without identifiable eligible costs up to' the maximum financing thresholds under the GBER. Also according to Article 8 (3) GBER, aid exempted under the GBER may be cumulated with

[757] Risk Finance Guidelines, para. 166.

[758] Von Wendland in: Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 751, and Point I.2 of the Commission communication on the cumulation of aids for different purposes, OJ 1985 C 3/2. According to von Wendland, "that Communication was the result of an examination of the cumulation of regional aid with other aid and its effect on competition and trade between Member States".

other aid exempted under the GBER, if both aid measures in question possess different identifiable costs (e.g. cumulating training aid with regional investment aid), and is deemed legal without reservations.[759] Article 8 (3) (b) GBER stipulates that aid exempted under the GBER may be cumulated with other aid exempted under the GBER in relation to the same eligible costs that partly or fully overlap, as long as such cumulation does not result in exceeding the highest aid intensity or aid amount applicable under the GBER. State aid exempted under the GBER may not be cumulated with *de minimis* aid in relation to the same eligible costs, however, if such cumulation would result in an aid intensity exceeding those laid down in Chapter III of the GBER in accordance with Article 8 (3) GBER. Regarding aid exempted under the GBER to be cumulated with *de minimis* aid, only the maximum intensity of the GBER is relevant.

In contrast, where the other State aid measure has **no identifiable eligible costs** or is classified as ***de minimis* aid**, the cumulation may only reach the highest relevant total financing ceiling set out in the specific circumstances of each case by a block exemption regulation (see Article 8 (4) GBER) or a decision adopted by the Commission.

EU funding, which is centrally managed by EU institutions, agencies, joint undertakings, or other EU bodies, and which is not directly or indirectly under the control of the Member State, does not constitute State aid (see section 2.1.1. of this chapter). If such EU 'funding is combined with State aid, only the latter will be' assessed as to whether it complies with 'notification thresholds and maximum aid amounts, provided that the total amount of public funding granted in relation to the same eligible costs does not exceed the most favourable funding rate laid down in the applicable rules of Union law'.[760]

For instance, in the case of a Dutch 'Jessica' (Joint European Support for Sustainable Investment in City Areas) aid measure, the cities of The Hague and Rotterdam established several funds to provide revolving finance in the form of loans, equity, and guarantees to urban development projects (see section 3.3 of chapter VI).[761] The notified aid measure was equipped with rules

[759] See also Jestaedt in: Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 435, and
Kristyna Deiberova and Harold Nyssens, The new General Block Exemption Regulation (GBER): What changed?, European State Aid Law Quarterly, 2009, Vol. 8, pp. 27 and 33.
[760] Risk Finance Guidelines, para. 169.
[761] Aid No. SA.34660 (2012/N), Commission decision, 18.09.2013; the city of The Hague set up one holding fund and two urban developing funds, while the city of Rotterdam set up one urban developing fund.

preventing cumulation with other state aid measures that would result in granting to each beneficiary urban development project state aid exceeding 100 per cent of the actual project's viability gap, i.e. the available cumulated funding was limited to the amount necessary to render the projects viable.[762]

Accordingly, projects could also receive aid in the form of grants from the EU Structural Funds or other sources, but only if the maximum aid intensity were never to exceed the 100 per cent of the actual project viability gap. Therefore, fund managers must ensure that the cumulation restrictions of EU state aid legislation would be properly applied.[763] Once the investment conditions, including the relevant fair rate of return (FRR) were fixed, no additional state aid could be granted. Interestingly, in case of investments aimed at repairing environmental damage (e.g. land decontamination), the 'polluter pays' principle was applied: no aid could be provided, if there was 'a private entity responsible for the pollution of a contaminated brownfield or greenfield' and if it was 'legally possible for that entity to repair and compensate the consequences'.[764]

Similarly, under a UK 'Jessica' aid measure, the combination with grant funding from other resources could be permissible in limited cases, but only as a last resort when the repayable investments of the very aid measure had been applied and had proven insufficient to enable the project to succeed: The measure's independent expert had to review the justification for grant funding and to ensure that it was used in limited cases and as a last resort.[765] The Commission thereby noted that grant funding would be awarded under the same conditions applicable under the aid measure and would not result in higher than the established FRR levels for private investors. The Commission considered the grant funding mechanism proposed by the UK to ensure efficiency, integration, and transparency.[766] Moreover, the receipt of aid under the measure and in some cases grant funding precluded the cumulation with aid received from other local, regional, national, or EU sources to cover the same eligible costs.[767]

[762] Points 2.8 and 4.5 of Aid No. SA.34660 (2012/N), Commission decision, 18.09.2013.
[763] Points 2.8 and 4.5 of Aid No. SA.34660 (2012/N), Commission decision, 18.09.2013.
[764] Points 2.8 and 4.5 of Aid No. SA.34660 (2012/N), Commission decision, 18.09.2013.
[765] Point 4.6.5 of Aid No. SA 32835 (2011/N), Commission decision, 13.07.2011.
[766] Point 4.6.5 of Aid No. SA 32835 (2011/N), Commission decision, 13.07.2011.
[767] Point 4.6.5 of Aid No. SA 32835 (2011/N), Commission decision, 13.07.2011.

Another example of how cumulation rules are respected is the UK risk finance measure 'NISPO' granting equity investments to early stage technology SMEs in Northern Ireland and the UK.[768] Investments provided under these funds could 'be cumulated with aided investments from other funds, such as the [UK] Crescent Capital II, subject to' the maximum aid ceiling (then: 'EUR 1.5 million investments in one enterprise in a 12 months period').[769] The UK authorities were required to ensure that the minimum 30 per cent participation would be maintained. Moreover, 'if the capital provided to a target enterprise under the scheme' was used to finance initial' investments 'or other costs eligible for aid under other state aid rules, the relevant aid ceilings' would 'be reduced by 20 per cent during the first three years of the first risk finance investment and up to the total amount received'.[770]

Interestingly, while it found a German equity and quasi-equity measure and its cumulation rules compatible with the internal market, due to the significant number of risk finance schemes in place in Germany at the time of the decision, the Commission held it necessary to underline in its decision that a cumulation of compatible aid granted to the same recipient cannot lead to more favourable conditions than under the application of one risk finance scheme alone.[771]

7.4. Ex post Evaluation

The Commission may require that certain schemes be subject to a limited duration as well as to an evaluation: This evaluation obligation concerns both schemes exempted under the GBER and schemes assessed under the Guidelines. Such schemes may be large schemes, schemes with a regional focus, schemes with a narrow sectoral focus, schemes that are modified (as regard eligibility criteria, the amount of the investment, or the financial design parameters), schemes containing novel characteristics, and schemes where the Commission so requests in the decision approving the measure in the light of its potential negative effects.[772]

[768] Aid No. N 652/2007, Commission decision, 06.08.2008.
[769] Points 2.9 and 4.2 of Aid No. N 652/2007, Commission decision, 06.08.2008.
[770] Points 2.9 and 4.2 of Aid No. N 652/2007, Commission decision, 06.08.2008.
[771] Point 3.3.9 of Aid No. N 401/2009, Commission decision, 19.03.2010.
[772] Risk Finance Guidelines, paras. 170 and 171.

Importantly, in terms of proportionality and the topic of this thesis, ex post evaluations have the aim to 'assess relative positive and negative effects of a scheme i.e. the public objective of the aid relative to its impact on competition and trade between Member States'.[773] Thus, they must address the issues of the effectiveness of aid measures in the light of their predefined general and specific objectives and indicators as well as the impact of the risk finance measure on markets and competition.[774]

The systematic evaluation of aid schemes with a high distortive potential has the aim to enable the Member States and the Commission 'to verify (i) whether the assumptions and conditions, which led to the compatibility decision, have been realised, (ii) the effectiveness of the aid measure in light of its predefined objectives, and (iii) the aid measure's impact on the internal market and competition and that no undue distortive effects arise under the duration of the aid scheme that is contrary to the interests of the Union'.[775] With regard to the last aspect, an evaluation plan has, in particular, the objective to allow the assessment of the direct incentive effect of the aid, i.e. whether the aid has caused the beneficiary to take a different course of action and how significant the impact of the aid has been, and the attainment of the desired policy objective as well as the examination of the proportionality and appropriateness of the aid instrument.[776]

The Commission lays down in its Commission Staff Working Document on the common methodology for state aid evaluation the minimum elements an evaluation plan has to comprise: objectives of the aid scheme to be evaluated, evaluation questions, result indicators, methods for finding an appropriate basis for comparison, data collection and using the best possible sources, a timeline of the evaluation, the body conducting the evaluation, and the way the evaluation plan is to be made public.[777]

[773] European Commission, Staff Working Document, Common methodology for State aid evaluation, SWD(2014), p. 4.
[774] Risk Finance Guidelines, paras. 170 and 171.
[775] Point (53) of the Guidelines for the application of state aid rules in relation to the rapid deployment of broadband networks, OJ 2013 C25/1, where the Commission had introduced this principle in 2013 and provides for a more detailed explanation than in the Risk Finance Guidelines, and
Von Wendland in: Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 752.
[776] Commission Staff Working Document, Common methodology for State aid evaluation, SWD(2014), p. 4.
[777] Commission Staff Working Document, Common methodology for State aid evaluation, SWD(2014), table of contents.

Further research should analyse and compare ex post evaluations and derive valuable lessons learnt and more legal and economic guidance for future financial instruments from this analysis. Evaluations provide a valuable opportunity to assess the effectiveness and efficiency of financial instrument schemes and to hold their stakeholders accountable a posteriori, with particular regard to the question of proportionality and the effects of aid.

V. Addressing the Aid Element of Advantage in Financial Instruments: The Market Economy Investor Principle

As the name indicates, risk finance aid inherently entails risk. This represents another feature of financial instruments in the form of risk finance measures: Risk finance aid is aimed at undertakings that are new on the market, at least young, innovative, and require risk finance investment in view of a new product or geographical market, as Article 21 (5) GBER implies. As such, investment in such undertakings entails inherent risks due to information asymmetries between investor and investee with regard to the lack of credit history and the uncertainty around the soundness of business plans, for instance.[778] Under such circumstances, screening costs for private investors may even be too high relative to the investment value.[779]

Member States may thus facilitate the access to finance through financial instruments. This is the very reason for the market failure and why Member States intervene: to correct informational failures. However, they are, of course, as the element of an advantage may be given, thereby required to notify any aid measures under state aid law. This is the case, unless they consider that such an intervention is in line with the market economy investor principle (MEIP).

If the conditions of the MEIP test are met, the Member State and its public authorities had acted as a private investor under normal market conditions, so that no advantage is present and thus no state aid. Hence, if the Member State derives the conclusion that the MEIP conditions are fulfilled, no notification of the measure to the Commission is required. However, this means that the legal risk remains with the Member State and that the Commission could find at a later stage that the MEIP was in fact not satisfied, implying the recovery of the illegal aid.[780] In its assessment, the MEIP is one of the factors the Commission must take into account in establishing whether state aid is present or not.[781] Where it appears that the MEIP might be applicable, the Commission

[778] Communication from the Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), introduction, recital 3.
[779] Communication from the Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), introduction, recital 3.
[780] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), 2016, p. 182.
[781] Case C-300/16 P European Commission v Frucona Kosice [2017] EU:C:2017:706, para. 23.

is required to assess whether its criteria are met, regardless of whether the Member State concerned requests so or not.[782]

This chapter on the MEIP is concerned with the existence of state aid in financial instruments, its measurement, and its potential removal through the application of the MEIP in a possibly consistent way. The relevant sub-question is thus:

- How may an advantage through financial instruments arise and may the aid element be consistently measured and removed through the application of the MEIP?

In the following, the MEIP and its conditions will be explained in general: It may be met, if the terms of the public investor are pari passu with private investors, if the transaction is carried out through a tender procedure, if the transaction is based on appropriate benchmarking, or if it based on alternative assessment methods.

In the context of financial instruments and risk finance, the benchmarking and alternative assessment methods play an important role in order to conclude whether the beneficiaries of the measure received an advantage. Normally, the average return of the sector may be compared with the expected return in order to assess whether an investment is profitable.[783] However, in an uncertain market environment, lacking comparable business models and business indicators, a reasonable private investor would not or cannot use this benchmark to assess, if to invest.[784] Thus, under difficult circumstances, the focus shifts to 'the risks associated with the specific investment', which the private investors are expected to consider only.[785]

But how can risks be assessed and priced in a market consisting of new and innovative undertakings and business models that lack comparable competitors? This chapter will investigate how the Commission and the EU Courts apply the MEIP in comparable cases of difficult

[782] Case C-300/16 P European Commission v Frucona Kosice [2017] EU:C:2017:706, paras. 25 and 26.
[783] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 208.
[784] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 208.
[785] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 208.

market circumstances and assess whether their methods also are apt for cases of risk finance measures or defy their logic of assessing risk properly.

This chapter is structured as follows: firstly, the case law of the EU Courts on the MEIP will be discussed (section 1). Secondly, the application of the MEIP by the Commission will be elaborated on, including its conditions and assessment methods (section 2), followed by an elaboration on the application of the MEIP with regard to guarantees and loans and their particular rules (section 3). Finally, the limitations of the Commission's methods will be discussed in the conclusion (section 4).

1. Introduction: The case law of the EU Courts on the MEIP

The European Court of Justice (ECJ), following the approach proposed by Advocates General Slynn and Jacobs, established the so-called market economy operator principle or, more commonly used, market economy investor principle.[786] According to that principle, where a Member State intervenes in the market, its measures constitute the grant of an economic advantage, where it does not act in the same way as a private operator under normal market conditions – or put differently, 'to determine whether a public body's investment constitutes State aid, it is necessary to assess whether, in similar circumstances, a private investor of a comparable size operating in normal conditions of a market economy could have been prompted to make the investment in question'.[787] If this test is positive, there is no advantage attributable to the intervention by the Member State assumed to be present, since the recipient could have benefitted in the same way from the mere functioning of the market.[788]

[786] Case 84/82, Germany v Commission [1984] ECR 1451, per Advocate General Slynn, at p.1501; Cases C-278/92 to C-280/92, Spain v Commission [1994] ECR I-4103, per Advocate General Jacobs, p. 4112.
[787] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 74: See, for instance, cases C-142/87, Belgium v Commission ('Tubemeuse') [1990] ECLI:EU: C:1990:125, para. 29; C-305/89, Italy v Commission ('ALFA Romeo') [1991] ECLI:EU: C:1991:142, paras. 18 and 19; T-16/96, Cityflyer Express v Commission [1998] ECLI:EU: T:1998:78, para. 51; joined cases T-129/95, T-2/96 and T-97/96, Neue Maxhütte Stahlwerke and Lech-Stahlwerke v Commission [1999] ECLI:EU:T:1999:7, para. 104.
[788] Case T-244/08, Konsum Nord ekonomisk förening v Commission [2011] ECR II-444, para. 62.

Hence, the principle may be regarded as 'a derogation that allows for escaping aid', striking a balance between Article 107 (1) TFEU and Article 345 TFEU on the principle of neutrality and equality of public and private undertakings.[789]

While the Commission possesses a rather 'broad discretion in deciding how the MEIP applies in a specific case [question of application], it is limited in deciding whether the test is applicable in a specific case or not [question of applicability]'.[790] The Court of First Instance ruled that the principle is applicable 'when the State acts as an undertaking operating as a private investor', while its applicability is excluded when 'the State acts as a public authority'.[791] In its judgment of *Hytasa*, the Court of Justice elaborated on how to distinguish between these two capacities of the state: 'a distinction must be drawn between the obligations which the State must assume as owner of the share capital of a company and its obligations as a public authority'.[792] This logic of *Hytasa* may be regarded as the core of the market economy operator principle and enables one to determine its applicability.[793] Accordingly, its applicability depends on whether the state intervention in question 'is of entrepreneurial or public policy nature' rather than on 'the source of funds that were used to finance it'.[794] Thus, the Court summarised that 'the applicability of the private investor test ultimately depends, therefore, on the Member State concerned having conferred, in its capacity as shareholder and not in its capacity as public authority, an economic advantage on an undertaking belonging to it'.[795]

The market economy operator principle is applied on a case-by-case basis, providing it with 'flexibility and room for entrepreneurial discretion'.[796] It applies to all forms of market conditions including investments, debt collection, the acquisition or provision of goods and services, and the issue of loans or guarantees, and hence, financial instruments.[797] Thus, one may so far distinguish

[789] Malgorzata Agnieszka Cyndecka, The Applicability and Application of the Market Economy Investor Principle, European State Aid Law Quarterly, vol. 3, 2016, p. 382.
[790] Antigoni Lykotrafiti, The intersection between the market economy investor principle and the one time-last time principle in the context of airline restructuring operations, in: Erika Szyszczak (ed), Research Handbook on European State Aid Law, 2011, pp. 105, 118.
[791] Case T-196/04 Ryanair [2008] ECLI-585, para. 85.
[792] Joined cases C-278/92 to C-280/92, Spain v Commission (Hytasa) [1994] ECLI-325, para. 22.
[793] Malgorzata Agnieszka Cyndecka, The Applicability and Application of the Market Economy Investor Principle, European State Aid Law Quarterly, vol. 3, 2016, p. 384.
[794] Malgorzata Agnieszka Cyndecka, The Applicability and Application of the Market Economy Investor Principle, European State Aid Law Quarterly, vol. 3, 2016, p. 385.
[795] Case T-747/15 EDF v European Commission [2018] para. 81.
[796] Malgorzata Agnieszka Cyndecka, The Applicability and Application of the Market Economy Investor Principle, European State Aid Law Quarterly, vol. 3, 2016, p. 382.
[797] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p. 154.

the test of the private creditor, guarantor, reinsurer, lender, borrower, vendor, purchaser, supplier, and market player (operator).[798]

In order to determine whether a State measure falls within the scope of Article 107 (1) TFEU, 'it is thus necessary to establish whether the recipient receives an economic advantage, which it would not have obtained under normal market conditions'.[799] The ECJ held in *Commission v EDF*, that in cases where all constituent elements of state aid are present, the market operator test is among the factors that the Commission is required to take into account for the purposes of establishing the existence of aid, i.e. the Commission is required to consider whether the MEIP is applicable to a particular measure, regardless of whether the Member State concerned does not ask it explicitly to do so or believes it to be irrelevant.[800]

The ECJ made clear that the applicability of the MEIP may not be excluded from the outset, merely because of links that may exist between a disputed measure and the exercise of public authority in the form of an earlier grant of state aid.[801] However, the risk to which a Member State is exposed due to an earlier grant of state aid to an undertaking may not be taken into account when the MEIP test is applied to a subsequent measure by the Member State concerned in favour of that undertaking.[802]

In order to fulfil its obligation of conducting a global assessment, the Commission is required to ask the Member State concerned for all relevant information and to take into account all relevant facts, including the nature and subject matter of the measure, its context, the objective pursued and the rules to which the measure is subject.[803] Therefore, on the one hand, the EU Courts clarified in *Frucona Kosice* that the burden of proof as to the applicability of the test lies with the Commission; and if the test is applicable, it must examine its application, i.e. whether the MEIP is

[798] Malgorzata Agnieszka Cyndecka, The Applicability and Application of the Market Economy Investor Principle, European State Aid Law Quarterly, vol. 3, 2016, p. 396.
[799] Case C-39/94, SFEI v La Poste [1996] ECR I-3547, para 60; Case C-342/96, Spain v Commission [1999] ECR I-2459, para 41; Case C-256/97, Déménagements-Manutention Transports SA [1999] ECR I-3913, para 22; Case C-280/00, Altmark Trans GmbH v Nahverkehrsgesellschaft Altmark GmbH [2003] ECR I-7747, para. 84; et al.
[800] Case C-124/10P, Commission v EDF [2012] EU:C:2012:318, para. 103, case T-747/15 EDF v European Commission [2018] EU:T:2018:6, paras. 242 and 243.
[801] Case C-579/16 P European Commission v FIH Holding A/S and FIH Erhvervsbank A/S [2018], EU:C:2018:159, para. 65.
[802] Case C-579/16 P European Commission v FIH Holding A/S and FIH Erhvervsbank A/S [2018], EU:C:2018:159, para. 73.
[803] Case C-290/07P, Commission v Scott SA [2010] ECR I-7763, para. 65; case C-124/10P, Commission v EDF EU:C:2012:318, paras. 86 and 104; cases T-228/99 and T-233/99, Westdeutsche Landesbank Girozentrale v Commission [2003] ECR II-435, para. 251; cases C-214/12P, C-215/12P and C-223/12P, Land Burgenland v Commission EU:C:2013:682, para. 60; case T-305/13, SACE BT SpA v Commission [2015] EU:T:2015:435, para. 96.

satisfied.[804] On the other hand, however, the burden of proof lies with the Member State concerned to provide all necessary evidence that shows it has acted as a private investor pursuing a long-term profitability.[805]

The Commission may only refuse to examine such evidence provided by the Member State that has been established after the adoption of the decision to make the investment, since a private investor assesses the prospective profitability of a company prior to the investment, as the EU Courts made clear in the judgment of *EDF*.[806] This means that an ex-ante assessment of profitability is indispensable and that therefore economic evaluations after the investment, retrospective assessments of the profitability of the investment, and subsequent justifications are deemed insufficient to prove that the Member State has acted as a private investor.[807] The market economy investor test is only applicable 'to benefits and obligations linked to the role of the State as an economic operator' in contrast 'to those linked to its role as a public authority' and hence should 'be applied leaving aside all considerations that exclusively relate to a Member State's role as a public authority' (e.g. social, regional, or sectoral policy considerations).[808]

In order to fulfil the test, the evidence produced by the Member State has to show not only that the investment was capable of generating some profit, but that the investment could generate 'a sufficient return that would compensate a hypothetical private investor for the risk it assumed'.[809] Showing prospective profitability means that the evidence 'must be credible and be based on an analysis by independent experts on the prospects of future profitability', i.e. 'it must go beyond a description of the current situation of the company that receives public funds'.[810] If a public authority acts in conjunction with an undertaking under its control, the Commission must 'envisage the commercial transaction as a whole in order to determine whether… they have acted as rational operators in a market economy'.[811]

[804] Case C-300/16 P European Commission v Frucona Kosice [2017] ECLI:EU:C:2017:706, paras. 67-72.
[805] Case T-93/17 Duferco v European Commission [2018] EU:T:2018:558, para. 43.
[806] Case T-747/15 EDF v European Commission [2018] EU:T:2018:6, para. 244.
[807] Case T-747/15 EDF v European Commission, para. 244.
[808] Case T-747/15 EDF v European Commission, para. 245, and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 77.
[809] Phedon Nicolaides, How a Private Investor behaves: EDF v Commission, https://www.lexxion.eu/stateaidpost/how-a-private-investor-behaves-edf-v-commission/, last access: 20.05.2021,
and case T-747/15 EDF v European Commission, para. 318.
[810] Phedon Nicolaides, Ex ante Assessment of Future Profitability is absolutely necessary, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9325, last access: 19.02.2019.
[811] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p. 155.

In sum, the 'profitability or unprofitability of the beneficiary is not in itself a decisive indicator for establishing whether or not the economic transaction is in line with market conditions'.[812] Rather, 'the decisive element is whether the public bodies acted as a market economy operator would have done in a similar situation': This is the case if the investment may generate a reasonable profit that covers both the opportunity cost of the investment and the risk it bears, which requires a thorough ex ante assessment.[813] If this is not the case, the beneficiary undertaking is considered to have received an economic advantage.

The private operator principle comprises both the private investor test and the private creditor test.[814] The difference is a temporal one: they each apply at a different point in time to the underlying investment – the investor test applies before, the creditor test after the investment.[815] For instance, where a public authority grants a loan, the private investor test is to be applied as to whether the measure promises to be profitable.[816] However, if the borrowing undertaking subsequently 'gets into financial difficulty' and the 'public authority does not demand the repayment of the loan', it will be considered to be granting new state aid to the borrowing company.[817] Moreover, 'if the value of the collateral also declines as a result of the financial difficulties' of the undertaking, the private creditor test applies: the public authority may be justified, as a private creditor, 'to write off part of the loan in order to maximise the amount it can recover'.[818]

[812] Case T-747/15 EDF v European Commission, para. 318, and
Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 76.
[813] Case T-747/15 EDF v European Commission, para. 318, and
Phedon Nicolaides, State Aid Uncovered 2016, "4.1. How to Apply the Market Economy Investor Principle and what Mistakes to Avoid: The Long-running Case of EDF, Lexxion Publisher, 2017, p. 49.
[814] Phedon Nicolaides, Private Creditor v Private Investor, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9192, last access: 19.02.2019.
[815] Phedon Nicolaides, Private Creditor v Private Investor, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9192, last access: 19.02.2019.
[816] Phedon Nicolaides, Private Creditor v Private Investor, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9192, last access: 19.02.2019.
[817] Phedon Nicolaides, Private Creditor v Private Investor, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9192, last access: 19.02.2019.
[818] Phedon Nicolaides, Private Creditor v Private Investor, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9192, last access: 19.02.2019.

Summary box of case law on the MEIP:

Hytasa (joined cases C-278/92 to C-280/92, Spain v Commission [1994]):

- The Kingdom of Spain successfully applied for the annulment of the Commission decision, which declared Spain's capital contributions to Spanish companies to constitute state aid.
- It is important to distinguish a Member State's role as shareholder of a benefitting company from its obligations as a public authority – the MEIP applies only in the former case: 'The applicability of the private investor test ultimately depends, therefore, on the Member State concerned having conferred, in its capacity as shareholder and not in its capacity as public authority, an economic advantage on an undertaking belonging to it' (see case T-747/15 EDF v European Commission [2018] para. 81).

Commission v EDF (C-124/10P, Commission v EDF [2012]) and **EDF v Commission** (T-747/15, EDF v European Commission [2018]):

- The Court dismissed the appeal by the Commission on an earlier judgment, where the electricity company EDF and France successfully applied for the annulment of the Commission decision. This decision declared France's granting of a tax exemption for a debt measure in favour of EDF to constitute state aid. Later, EDF applied for the annulment of another Commission decision, declaring an aid measure in favour of EDF to be incompatible with the internal market and ordering the recovery of that aid.
- The MEIP is not an exception applying only if a Member State so requests, but the very 'test is among the factors which the Commission is required to take into account for the purposes of establishing the existence of such aid, and hence has the duty to ask the Member State concerned to provide it will all relevant information for the decision'.
- For the Commission, it is 'not enough to rely on economic evaluations made after the advantage was conferred, on a retrospective finding that the investment made by the Member State concerned was actually profitable, or on subsequent justifications of the course of action actually chosen'.
- For the Member States, its evidence provided has to show that an investment is capable of generating sufficient return to compensate the risks incurred.

Frucona Kosice (C-300/16 P European Commission v Frucona Kosice [2017]):

- The Court dismissed the appeal of the Commission against a judgment in favour of the Slovak company Frucona Kosice benefitting from several tax deferrals.
- The burden of proof as to the applicability of the test lies with the Commission, and if the test is indeed applicable, it must examine its application, i.e. whether the MEIP is satisfied.

Compiled by the author, sources: case law cited.

2. The application of the MEIP by the Commission

2.1. Overview of MEIP conditions and assessment methods

The Commission laid down its approach as to whether a State intervention is in line with market conditions, according to which a transaction should be examined on an ex ante basis having regard to the information available at the time the intervention was decided upon, e.g. on the

basis of a business plan.[819] The compliance with market conditions may be proven through specific market data.[820] Thus, a transaction's compliance with market conditions may be directly established through transaction-specific market information:

(i) Either the transaction is carried out pari passu by public entities and private operators,

(ii) or the transaction concerns the sale and purchase of assets, goods, and services carried out through a competitive, transparent non-discriminatory, and unconditional tender procedure.[821]

Thus, transactions realised on pari passu terms or through a tender procedure imply direct and specific evidence of compliance with market conditions.[822] These are sufficient conditions to exclude the presence of state aid, but not necessary conditions: It does not automatically mean that the transaction does not comply with market conditions, if they are not fulfilled.[823] In its 2016 Notice, the Commission explains that a transaction's compliance may still be established through other criteria:

(iii) the transaction is based on an appropriate benchmark, or

(iv) the transaction is based on other assessment methods, such as the evaluation of the investment decision in terms of the internal rate of return (IRR) or the net present value (NPV).[824]

In order to consider a transaction to be **pari passu**, the following criteria should be assessed according to the Commission: (a) whether the intervention of the public bodies and private operators is decided and conducted at the same time or whether there has been a time lapse and a change of economic circumstances between those interventions; (b) whether the terms and conditions of the transaction are the same for the public bodies and all private operators involved, taking into account the possibility of increasing or decreasing the risk level over time; (c) whether the intervention of the private operators has real economic significance and is not merely

[819] Case C-124/10 P, Commission v EDF [2012] ECLI:EU:C:2012:318, paras. 83, 84, 85, 105;
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 78.
[820] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, pp. 154-155.
[821] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, pp. 154-155.
[822] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 97.
[823] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 97.
[824] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, paras. 84, 101, 102.

symbolic or marginal; and (d) whether the starting position of the public bodies and the private operators involved is comparable regarding the transaction (e.g. their prior economic exposure due to a prior investment, the potential synergies, the extent of different investors bearing similar transaction costs).[825]

The General Court summarised the requirements of pari passu conditions in the judgment of *Duferco v European Commission*, citing established case law: (i) the public and private investment must be concomitant, (ii) the private investment must be of a significant amount, and (iii) the risk and rewards of the public and private investor must be equivalent.[826] With regard to the first and temporal aspect, the General Court made clear that the concomitance of the contributions is, 'at most, an indication of the absence of aid', as the purpose of the MEIP test is the comparison of the 'behaviour of the Member State with that of a hypothetical private investor'.[827] Moreover, the temporal aspect shows that the concept of pari passu is not static, but time sensitive: When comparing the behaviour of the public and private investors, it is necessary to ensure that their situations and interest do not diverge over time (e.g. an increase of claims of some public creditors during an insolvency period negated the pari passu terms through the emergence of different situations and interests).[828]

While the willingness to invest in a significant and concomitant manner may validate such a test, 'all relevant *de facto* and *de jure* data must be taken into account in assessing the legality' of the relevant measure in accordance with state aid rules.[829] Thus, the concept of pari passu merely provides a presumption of the conformity with market conditions, since, in principle, the MEIP test requires the distinction 'between situations, in which the conformity of a measure with market conditions can be established directly, on the basis of market data specific to that transaction, and the situations, in which the conformity must be assessed via other methods, such

[825] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 87; and case T-423/14 Larko v European Commission, para. 120.
[826] Case T-93/17 Duferco v European Commission [2018], paras. 100, 101.
[827] Case T-93/17 Duferco v European Commission [2018], para. 101, and Phedon Nicolaides, Ex Ante Assessment of the Future Profitability is absolutely necessary, https://www.lexxion.eu/stateaidpost/ex-ante-assessment-of-future-profitability-is-absolutely-necessary/, last access: 20.05.2021.
[828] Phedon Nicolaides, Pari passu is not static, 2019, http://stateaidhub.eu/blogs/stateaiduncovered/post/9439, last access: 19.02.2019; and case T-284/15 AlzChem v European Commission, paras. 214, 215.
[829] Case T-93/17 Duferco v European Commission [2018], para. 101, and Phedon Nicolaides, Ex Ante Assessment of the Future Profitability is absolutely necessary, https://www.lexxion.eu/stateaidpost/ex-ante-assessment-of-future-profitability-is-absolutely-necessary/, last access: 20.05.2021.

as the pari passu conditions, 'due to the absence of such data'.[830] And even if pari passu conditions may not be established, it is still possible to assess whether the measure is in line with market conditions by using other methods, such as benchmarking or other assessment methods.[831]

In its *Altrad* decision *SA.36574*, the Commission assessed whether the public investment in casu was pari passu with other transactions carried out by three private investors.[832] The Commission found that the extent of the participation by the three private investors was significant and that the terms and conditions were the same for both the public and the private investors. However, although the Commission found that the price per share paid was exactly the same and was based on the same valuation, it concluded that the public investment could not be considered strictly pari passu due to the non-fulfilment of the other two conditions: Firstly, the public investment was decided to be carried out later than its private counterparts, and secondly, the circumstances of the three private investors were different, since they were already exposed due to earlier investments in the target enterprise.

With regard to a **tender procedure**, transactions may be presumed to be in line with market conditions, if the procedure follows the principles of the TFEU on public procurement provided that the market price can be established.[833] The market price is the highest price that a private operator under normal market competitive conditions is ready to pay for the goods, services, or assets in question.[834] This is similarly applicable to investments, where 'the market price is the highest price that a private investor acting under normal market conditions is willing to pay for a company in the situation it is in'.[835]

[830] Case T-93/17 Duferco v European Commission [2018], para. 102,
and Phedon Nicolaides, Ex Ante Assessment of the Future Profitability is absolutely necessary,
https://www.lexxion.eu/stateaidpost/ex-ante-assessment-of-future-profitability-is-absolutely-necessary/, last access: 20.05.2021.
[831] Case T-93/17 Duferco v European Commission [2018], para. 103,
and Phedon Nicolaides, Ex Ante Assessment of the Future Profitability is absolutely necessary,
https://www.lexxion.eu/stateaidpost/ex-ante-assessment-of-future-profitability-is-absolutely-necessary/, last access: 20.05.2021.
[832] Aid no. SA.36574 (2015/NN), Commission decision, 07.07.2015.
[833] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 93.
[834] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p. 157.
[835] Conor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p. 157.

The tender procedure has to be competitive in order to allow all interested and qualified bidders to participate in the process.[836] Moreover it has to be transparent in order to allow all interested tenderers to be equally and duly informed at each stage of the procedure in terms of accessibility of information, sufficient time for interested tenderers, clarity of selection and award criteria, and the degree of publicity.[837] The procedure has to be non-discriminatory, i.e. the criteria for the award of the contract should enable tenders to be compared and assessed on an objective basis.[838] Finally, the procedure has to be unconditional, i.e. a potential buyer is free to acquire the assets, goods, or services and to use them for its own purposes without any condition to assume special obligations.[839]

2.2. 'Other assessment methods' in the context of risk finance aid

However, in the context of risk finance, young, innovative target undertakings under its scope, and the probable lack of information, data, benchmarks, and counterfactual scenarios, it may be very difficult to establish the market price. The Commission provides for '**other assessment methods**', which are relevant for investments and the comparison of rates of return. Importantly, 'the expected return and the risk of an investment are the two main parameters of an investment decision taken by a market economy investor', since the latter 'will invest in a specific project only' if the project's return is higher or its risk lower than that of the next best alternative use of the invested capital'.[840]

Thus, the EU Courts assume that a private investor strives to maximise its expected risk adjusted return, and, in the case *WestLB*, pointed out that 'normally a private investor is not content merely with the fact that an investment does not cause him a loss or that it produces only limited profits', but that 'he will seek to achieve the maximum reasonable return on his investment', so that it does not suffice to establish a particular transaction to be reasonable for the state merely.[841] Therefore, two methods are available for calculating the required return: The net

[836] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 90.
[837] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 90.
[838] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 92.
[839] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 94.
[840] Wilting in: Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p. 988.
[841] Cases T-228/99 & T-233/99, Westdeutsche Landesbank Girozentrale & Land Nordrhein-Westfalen v. Commission [2003] ECR II-0435, paras. 314-15,

present value and the internal rate of return method. However, as will be explained in the following, both methods merely have limited use in the context of risk finance due to the latter's lack of information and data.

Based on basic financial theory, private investors finance projects that evidence a positive **net present value (NPV)**, which is a method to assess the profitability of an investment and encompasses three main factors: (i) the amount invested, (ii) 'forecasts of future payoffs or cash flows over a limited and reasonable horizon' (the lifespan of the project), and (iii) the discount factor.[842] Usually, a medium-term horizon of around 10 years is forecasted and a terminal value of cash flows in the horizon year added.[843] However, it is often problematic 'to translate the customary accounting data back into actual cash', so that 'in order to estimate useful forecasts of cash flows, the financial manager has to deal with raw data supplied by specialists in product design, production, marketing, and so on', which may be very complex and costly, of course.[844] Moreover, the information should also be checked as to relevance, completeness, consistency, and accuracy.[845] Hence, although NPV calculations may be rather simple, 'forecasting cash flows will never be a routine task' and 'neither will be the estimation of the discount factor'.[846] This holds particularly true in the context of risk finance aid, as it appears likely that there are no or incomplete raw data and experiences with start-up and innovative companies available.

By definition, 'the discount factor that yields an NPV equal to zero is… **the internal rate of return (IRR)** of the project, commonly used to measure the project's attractiveness'.[847] However, particularly problematic from the perspective of risk finance, as the NPV's, the precision of the IRR's measurement is dependent on 'the accuracy in the calculation of cash flows' and its

and Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 183.

[842] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 193.

[843] The terminal value is the present value at the horizon of post-horizon flows. Cash flows are the difference between cash received and cash paid out.
- Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 193.

[844] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 193.

[845] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 193.

[846] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 193.

[847] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 194.

difficulties stated above.[848] The NPV and the IRR are interrelated and may serve as the two sides of the same coin of an investment decision: A common way 'to determine the discount rates used to evaluate the NPV is to compute the opportunity cost of capital', which is 'the minimum net return that an investor would require, which can be viewed as the return that could be achieved on an investment with equivalent risk in financial markets'.[849] Hence, a positive investment decision may be taken, if (i) the NPV is positive, and/or (ii), the IRR is greater than the opportunity costs of capital.

Both decision rules are considered equivalent concepts and 'any sound business plan should ideally provide all elements needed for the computation of the NPV': As Claici et al. point out, 'if cash flows have been computed in a credible manner and hence the IRR seems accurate, then the profitability of an investment is assessed simply by comparing the IRR with the opportunity cost of capital (rate of return rule)'.[850]

Even more importantly in the context of risk finance and its probable lack of information and data, and above all, counterfactual scenarios, 'the estimation of the opportunity cost is usually one of the most technically contentious elements in establishing whether state aid is present'.[851] The estimation of opportunity costs is usually conducted by estimating the so-called **weighted average cost of capital (WACC)**, i.e. 'a weighted average between the costs of the two main sources of capital – equity and debt': WACC = K_e E/C + K_d D/C, 'where C is the total capital, E and D are the equity and debt amount of capital, and K_e and K_d are the expected (forward-looking)

[848] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 194.
[849] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 194.
[850] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 194.
[851] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 194.

costs of equity capital and debt capital, respectively, at the time of the investment that is subject of the state aid investigation, not historical costs'.[852]

Summary box of case law on the MEIP:

Duferco (case T-93/17, Duferco v European Commission [2018]):

- The steel company Duferco from Luxembourg unsuccessfully applied for the annulment of a Commission decision, which declared capital contributions by Belgium to constitute state aid.
- For an investment to be pari passu, the following requirements must be met: (i) the public and private investment must be concomitant, (ii) the private investment must be of a significant amount, and (iii) the risk and rewards of the public and private investor must be equivalent.

WestLB (joined cases T-228/99 & T-233/99, Westdeutsche Landesbank Girozentrale & Land Nordrhein-Westfalen v Commission [2003]):

- The German publicly owned bank WestLB successfully applied for the annulment of a Commission decision, which declared capital contributions by a German Bundesland to constitute state aid.
- For assessing the MEIP, '…a private investor is not content merely with the fact that an investment does not cause him a loss or that it produces only limited profits. He will seek to achieve the maximum reasonable return on his investment, according to the particular circumstances and the satisfaction of his short-, medium- and long-term interests, even where he is investing in an undertaking of which he is already a shareholder'.

Compiled by the author, sources: case law cited.

2.3. The Capital Asset Pricing Model (CAPM) and its limitations as to risk finance aid

In order to calculate an adequate minimum remuneration and the returns required by investors in different investments, the Commission applies the **capital asset pricing model (CAPM)** formula, 'which is the predominant model in financial theory' and delivers the opportunity cost of equity capital.[853] The model's logic is that, 'if investors take some risk, they expect some additional return in exchange', i.e. 'the model provides the link between the risk associated with an investment and the expected return on that investment'.[854] For equity investments, the risk entails two elements, (i) 'the idiosyncratic risk that is specific to that stock', and (ii) 'the market

[852] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 194.
[853] Wilting in: Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.988, and Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), Commission decision, 08.05.2012, para. (71).
[854] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 196.

risk that is associated with economy wide fluctuations, which is conceptually equivalent to a fully diversified portfolio'.[855]

In the context of risk finance aid, however, the formula reveals a decisive flaw: 'The cost of equity capital reflects the opportunity cost of investment for shareholders in companies or projects with the same (or similar) business and financial risk as the one under consideration'.[856] Such companies or projects with similar, let alone, same business models and risks may simply not exist with regard to innovative and young beneficiary undertakings. As will be explained, the idiosyncratic risk specific to the stock may hardly be identified and priced, if information on direct or indirect competition is lacking.

In the following, the textbook case *Ciudad de la Luz*, its use of the CAPM, and its limitations in the context of risk finance aid will be explained. How can the inherent risk be adequately measured for the application of the MEIP in risk finance measures anyhow? The following analysis will seek to investigate this question.

The extensive case *Ciudad de La Luz* may be seen as a textbook example of how the Commission measures and prices risk in difficult investments, the approach of which was endorsed by the General Court later on.[857] The case regarded a green-field investment into an infrastructure project, namely the building of a film studio in Spain, so that a 'simple standard would not suffice for an MEIP calculation, as it would disregard the significant risk involved in green-field investments of this size', which in general implies the lack of information on business parameters, such as customer base, business and contractual links, and staff.[858] In particular, the investment into film studios may be compared to risk finance investments, as 'even in the best of times and in the best places […] they can be extraordinarily expensive to build and equip, and they rely on strong and sustained connection into national and international production circuits'.[859]

[855] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 196.
[856] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 195.
[857] Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), Commission decision, 08.05.2012 and joined cases T-319/12 and T-321/12 Spain v European Commission [2014] EU:T:2014:604.
[858] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 182.
[859] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 190.

The Commission rejected the argument of Spain that a market economy investor would have invested in the project of the creation of the film studios.[860] The General Court later confirmed the Commission's methodology and use of the CAPM and mentions positively that the Commission conducted two studies to test its results.[861] Through that legal endorsement, the Commission's approach may establish a precedent for future MEIP assessments.[862] However, as it will be explained, albeit showing similar difficult circumstances, the case's approach finds its limitations, when applied to risk finance measures.

Already at the beginning of its assessment, the Commission stated that the prima facie evidence showed that a private investor would not have carried out the project in question, since the only available private investor had only committed a marginal amount and withdrew at the moment, where the bulk of the investment had to be committed, and since the situation of this private investor was very specific due to its involvement in the initiation, oversight, management, and promotion of the studios.[863] Furthermore, the Commission made clear that the mere existence of (consultancy) studies in the absence of any private shareholder is not sufficient for fulfilling the MEIP test, since a private investor would have come to its own economic judgement.[864] This is in particular the case, where these studies do not contain a comparison of the expected return with the expected return of alternative studies.

The Commission therefore conducted its own assessment of the facts, as it is required by case law.[865] Firstly, it found the **weighted average cost of capital (WACC)**, which takes into account the proportion of equity capital and of debt capital as the expected costs, to be equivalent with the cost of equity capital, since the project was exclusively financed with equity capital.[866] Thus, for investors, the expected rate of return 'represent[ed] the opportunity cost of raising equity

[860] Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), Commission decision, 08.05.2012.
[861] Joined cases T-319/12 and T-321/12 Spain v European Commission [2014] EU:T:2014:604, paras. 58-60, 95, 110, 124.
[862] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 184.
[863] Point 64 of Commission decision on Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), 08.05.2012.
[864] Point 64 of Commission decision on Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), 08.05.2012.
[865] In the case T-274-01, Valmont Nederland BV v Commission of the European Communities [2004] EU:T:2004:266, the CFI considered that the Commission should not have simply relied on the existence of an independent expert's assessment to determine whether a sale of land involved the granting of state aid, but should have verified its evidential value.
[866] Point (69) of Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), Commission decision, 08.05.2012.

capital for the investment', i.e. WACC = K_e.[867] In particular for risk finance measures, the estimation of the three parameters determining K_e is difficult, since 'a forward-looking approach is always associated with a certain level of risk and uncertainty', which may only be enhanced in an uncertain start up environment.[868]

The Commission then stated that a private investor would have been willing to invest in the project, if the expected internal rate of return (the IRR corresponds by definition to the discount rate, which makes the net present value of the investment equal to zero) was higher than or equal to the opportunity cost of equity capital, i.e. the return that he could have obtained in a similar project.[869]

Therefore, the Commission applied the CAPM, which comprises the following formula: $R^* = R_f + \beta \times (R_m - R_f)$. It estimates the rate of return required by an investor, R^*, which is given by the sum of the risk-free rate (of a safe asset, e.g. sovereign bonds), R_f, and the risk premium.[870] The latter is the difference between the market rate, R_m, and the risk-free rate, multiplied by parameter β, which varies with the level of the risk of the undertaking invested in.[871]

The so-called equity beta β is decisive, as it relates to the idiosyncratic risk that is specific to the stock in question: The weight of the idiosyncratic risk specific to the stock vis-à-vis the risk of a fully diversified portfolio is dependent on its sensitivity to market changes, which is called the equity beta β and is the 'standard risk measure of an individual, non-diversifiable security'.[872] $\beta = 1$ means that the undertaking's riskiness is equal to that of the market. If $\beta < 1$, the undertaking's riskiness is lower than that of the market. On the other hand, if $\beta > 1$, the undertaking's riskiness is higher than that of the market. If the resulting cost of capital is higher than the internal rate of return (e.g. stated in the business plan), i.e. if a negative net present value is the result, a private

[867] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 196.
[868] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 196.
[869] Point 70 of Commission decision on Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), 08.05.2012.
[870] Phedon Nicolaides, State Aid Uncovered 2016, 4.1. How to Apply the Market Economy Investor Principle and what Mistakes to Avoid: The Long-running Case of EDF, Lexxion Publisher, 2017, p. 49.
[871] Phedon Nicolaides, State Aid Uncovered 2016, 4.1. How to Apply the Market Economy Investor Principle and what Mistakes to Avoid: The Long-running Case of EDF, Lexxion Publisher, 2017, p. 49.
[872] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 196.

investor would not have invested in the project. This means that the MEIP test would not be met, so that the measure constitutes an advantage.

In *Ciudad de la Luz*, for the risk free rate, the Commission took the long-term (typically 10 years) government bond rate in the country of operation in line with market practice. For the market risk premium, the Commission took the historical market risk premium over a reasonably long time period, whereby 'it is market practice to take the difference between the historical return on a diversified equity index in the country of operations, and the risk free rate'.[873] For the estimate of β, the Commission used publicly available information pertaining to companies that have been identified as direct competitors to the film studio project.[874]

This is the model's crucial problem relating to risk finance: publicly available (historical) information on similar companies and the business environment is lacking, so that there may simply exist no betas 'for investments with similar risk profile or for companies identified as competitors' as a reasonable benchmark.[875] Betas for similar projects thus cannot be used as a proxy, as the premise of a similar environment does not exist.[876] Further, unlike in *Ciudad de la Luz*, investors cannot rely on their experience either, as it is normally expected in finding a reliable estimate for beta.[877]

In *Ciudad de la Luz*, based on the business plans of the project, the Commission's analysis resulted in a negative net present value. The Commission conducted a robustness check in order to show that its results are solid: significant changes in the parameters in calculating the cost of capital did not alter the result. Thus, the Commission found the market economy investor principle test not to be fulfilled and the whole value of the investment to constitute an economic advantage. Since the measure also fulfilled the criteria of selectivity, state resources, distortion of competition, and effect on trade, the Commission concluded that state aid was present.

[873] Point 74 of Commission decision on Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), 08.05.2012.
[874] Point 73 of Commission decision on Aid No. SA.22668 (C 8/2008 (ex NN 4/2008)), 08.05.2012.
[875] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 198.
[876] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 199.
[877] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 204.

Although the decision lends itself as a textbook case on difficult investments in general, since it depicts how the CAPM may be used in order to convincingly demonstrate whether or not a private investor would have invested, it does not with regard to risk finance measures. It leaves open the crucial question of how Member States and private investors ought to measure and price risk in equity investments given the lack of information and experience, so that the MEIP might apply: A reliable beta or proxy, let alone industry-wide betas over time, may just not be available. Moreover, supporting or verifying studies as to the correct benchmarking may be very complex and time-consuming for both Member State authorities and the Commission.[878] At least, the Commission could help develop best practice rules and provide indications on qualitative requirements for studies on the MEIP assessment of state aid in general, and for even trickier ones of financial instruments under risk finance in particular.[879]

3. The application of the MEIP on guarantees and loans

3.1. The Commission's compatibility assessment of guarantees

The Commission published the Notice on state aid in the form of guarantees to provide Member States with more detailed guidance on its interpretation of Articles 107 and 108 TFEU (then Articles 87 and 88 EC) and their application to state guarantees.[880] Firstly, it lays out how the MEIP in guarantees can be established and state aid thus excluded. Secondly, it elaborates on the compatibility of guarantees, where an aid element is present. Both parts will be critically assessed from the perspective of risk finance measures and their corresponding lack of information and reliable benchmarks.

For guarantees, the Commission observes 'a triangular situation involving a public entity as a guarantor, a borrower, and a lender', whereby 'in most cases aid' would 'be present at the level of the borrower', since 'the public guarantee may grant it an advantage through borrowing at a

[878] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 208.
[879] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 208.
[880] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008),

rate that would not have been obtainable on the market'.[881] 'Under certain specific circumstances, the granting of a public guarantee might also entail aid to the lender: Where the guarantee is given ex post on an existing obligation between lender and borrower, where the complete transfer of the advantage to the borrower is not ensured, or where a guaranteed loan is used to pay back a non-guaranteed one.'[882] Any guarantee that is granted on terms more favourable than market conditions would allow, thereby taking into account the borrower's economic situation, is thus considered to confer an advantage on the borrower. In general, unlimited guarantees are presumed not to be in line with market conditions and constitute state aid.[883]

In the Notice, the Commission identifies several forms of guarantees, 'depending on their legal basis, the type of transaction covered, their duration, etc.: general guarantees, i.e. guarantees provided on its own as opposed to guarantees linked to a specific transaction (e.g. a loan or equity investment), guarantees provided by a specific instrument as opposed to guarantees linked to the status of the undertaking itself, guarantees provided directly or counter guarantees provided to a first level guarantor, unlimited guarantees as opposed to guarantees limited in amount and/or time, guarantees clearly originating from a contractual source (e.g. formal contracts or letters of comfort) or another legal source as opposed to guarantees', which have a less obvious form (e.g. side letters or oral commitments).[884]

As it is the case for equity investments described above, for the assessment of whether a guarantee constitutes state aid, the concept of the premium is crucial.[885] The benefit of a state guarantee is found in the fact that the risk associated with the guarantee is borne by the state.[886] Therefore, the state's risk bearing ought to be remunerated by an appropriated premium, the partially or entire foregoing of which means that 'there is both a benefit for the undertaking and

[881] Case C-275/10, Residex Capital v Gemeente Rotterdam [2011], para 39; Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 109.
[882] Case C-275/10, Residex Capital v Gemeente Rotterdam [2011], para. 42;
and Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 109.
[883] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01, para. 110.
[884] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 1.2.
[885] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 2.2.
[886] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 2.1.

a drain on the resources of the state'.[887] Thus, 'whether or not a guarantee constitutes state aid, and, if so, what amount that state aid may' comprise, 'must be assessed at the moment the guarantee is given'.[888] The Commission therefore lays down conditions to be fulfilled cumulatively in order to exclude the presence of state aid.[889]

Firstly, for **individual guarantees**, (i) the borrower may not be in financial difficulty (in accordance with the Commission guidelines on state aid for rescuing and restructuring firms in difficulty); (ii) the extent of the guarantee may be properly measured when it is granted, i.e. the guarantee must be linked to a specific financial transaction, for a fixed minimum amount, and limited in time; (iii) the guarantee may not cover more than 80 per cent of the outstanding loan or other financial obligation (guarantees covering debt securities are exempted from this condition, however), as otherwise the lender would be less incentivised to properly assess, secure, and minimise the risk, in particular, the borrower's creditworthiness; and (iv) a market-oriented price must be paid for the guarantee, i.e. an appropriate premium must form the remuneration for bearing the risk.[890] Concerning condition (iii), if a Member state wishes to provide a guarantee above the 80 per cent threshold, it must substantiate the claim and notify it to the Commission.[891]

With regard to an appropriate premium on the guaranteed or counter-guaranteed amount for the exclusion of state aid, according to point 3.2. of the Notice, the price paid for the guarantee ought to be 'at least as high as the corresponding guarantee premium benchmark, which can be found on the financial markets'. However, what if such a benchmark cannot be found due to a lack of information and comparable competitors, as it was described above for recipients of risk finance? The Commission answers it the following way: If a 'corresponding guarantee premium

[887] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 2.1.
[888] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 2.1.
[889] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008).
[890] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.2.
[891] Moreover, the Commission points out that attention must be given to two aspects for ensuring that the lender bears the risk effectively. Firstly, when the size of the financial obligation decreases over time, the guaranteed amount must decrease proportionally, so that at each moment in time the guarantee does not cover more than 80 per cent of the outstanding loan. Secondly, losses must be sustained proportionally and in the same way by the lender and the guarantor. Likewise, net recoveries generated from the recuperation of the debt from the securities granted by the borrower must reduce proportionally the losses borne by the lender and the guarantor.
- Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.2.

benchmark' may not be found on the financial markets, 'the total financial cost of the guaranteed loan, including the interest rate of the loan and the guarantee premium, has to be compared to the market price of a similar non-guaranteed loan', according to the Notice.[892]

This, however, does not give any indication as to cases for which no similar non-guaranteed loan exists. In both cases, the 'characteristics of the guarantee and of the underlying loan have to be taken into consideration, i.e. the amount and duration of the transaction, the security provided for by the borrower and other experience affecting the recovery rate evaluation, the probability of default of the borrower due to its financial position, its sector of activity, and prospects, as well as other economic conditions'.[893] Due to information asymmetries, the probability of default of the borrower may be hard and possibly costly to establish. What is more, there may be no experience as to the recovery rate evaluation either.

This analysis allows the classification of the borrower via risk rating, which 'may be provided by an internationally recognised rating agency or by the internal rating used by the bank providing the underlying loan'.[894] Moreover, the Member States may compare prices paid by similarly rated undertakings on the market.[895] Thus, the Commission does not accept a guarantee premium set at a single rate, which merely is supposed to correspond to an overall industry standard.[896] However, as stated, similarly rated undertakings or business models may simply not exist for risk finance measures.

Crucially, the Notice aims to provide a solution for these cases in point 3.3.: By way of derogation from condition (iv), the Commission may apply a simpler evaluation of whether or not a loan guarantee involves aid, provided that the borrower is an SME. If all other conditions are fulfilled, a state guarantee may be regarded as not constituting aid, if a certain minimum annual premium (the so-called 'safe harbour premium') based on the rating of the borrower is charged on the

[892] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.2.
[893] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.2.
[894] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.2.
[895] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.2.
[896] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.2.

amount effectively guaranteed by the state, as it is laid down in point 3.3. of the Commission Notice. 'In the case of a single upfront guarantee premium, the loan guarantee must be at least equal to the present value of the future guarantee premiums as' they are indicated by the Commission, whereby the discount rate to be used must be the corresponding reference rate. With particular regard for risk finance measures, where SMEs cannot provide a credit history or a rating based on a balance sheet approach (e.g. start-up companies or special purpose companies), the safe-harbour premium is set at 3.8 per cent, which may never be lower than the premium of the parent company. This fixed safe-harbour premium may be a relatively simple solution. However, it merely offers a one-size-fits-all-solution, where there may be none, and does not pay regard to the differences among, e.g., start up companies with entirely different business models and growth prospects.

Secondly, for **guarantee schemes**, the Commission prescribes the following conditions to be fulfilled in order to exclude the presence of state aid: (i) the scheme is closed to borrowers in financial difficulty; (ii) guarantees must be linked to specific financial transactions, for a fixed maximum amount, and be limited in time; (iii) the guarantees may not cover more than 80 per cent of each outstanding loan or other financial obligation; (iv) the terms of the scheme must be based on a realistic assessment of the risk and ensure a self-financing nature, so that premiums charged are in line with market prices (therefore, the risk of each new guarantee must be assessed on the basis of all the relevant factors and the guarantee be classified in one of the risk classes); (v) for the evaluation of the self-financing aspect, the adequacy of the level of the premiums must be reviewed at least once a year on the basis of the effective loss rate and premiums adjusted accordingly; (vi) for being considered in line with market prices, the premiums must cover the normal risks associated with granting the guarantee, the administrative costs of the scheme, and a yearly remuneration of an adequate capital; and (vii) for the sake of transparency, the scheme must provide for the terms on which future guarantees will be granted (e.g. eligible undertakings in terms of rating, sector and size, maximum amount and duration).[897]

SMEs have two possibilities in utilising guarantee schemes: either through the use of safe-harbour premiums as defined for individual guarantees for SMEs (see above) or through the 'valuation of

[897] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.4.

guarantee schemes as such by allowing the application of a single premium and avoiding the need for individual ratings of beneficiary SMEs'.[898] For the latter, 'where a scheme only relates to guarantees for SMEs and the guaranteed amount does not exceed a threshold of EUR 2.5 million per company' in that scheme, 'the Commission may accept a single yearly guarantee premium for all borrowers'.[899] This might help avoid complex and expensive ratings, but both the use of safe harbour premiums and of a single yearly guarantee premium do not tally with the lack of information on the plethora of business models of, e.g., start up beneficiaries, and their credit history, as it is the case under risk finance measures. The Commission does not provide any other solution than the simple use of the supposed one-size-fits-all solution of the safe harbour premiums. At least, condition (v) requires a yearly review and adjustment of the adequacy of premiums on the basis of the effective loss rate.

'Where an individual guarantee or a guarantee scheme does not comply with the market economy operator principle' and a state aid element is thus found, the aid element must be quantified in order to assess 'whether the aid may be found compatible under a specific state aid exemption'.[900] Therefore, the state aid element is regarded as the difference between the appropriate market price of the individual guarantee or guarantee scheme and the actual price paid for the measure.[901] The Commission lays down specific aspects for calculating the aid element, namely whether the borrower is in financial difficulty in the case of individual guarantees, whether the extent of each guarantee may be properly measured when granted (i.e. it must be 'linked to a specific financial transaction, for a fixed maximum amount and limited in time'), whether the guarantee covers more than 80 per cent of each outstanding loan or other financial obligation, and 'whether the specific characteristics of the guarantee and loan were taken into account when determining the market premium'.[902] Thus, the Commission re-states

[898] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.5.
[899] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 3.5.
[900] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.1.
[901] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.1.
[902] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.1.

its assessment criteria it regards as conditional for the assessment of the absence of state aid, as described above.[903]

For aid elements in individual guarantees, the Commission prescribes that the cash grant equivalent of a guarantee ought to be calculated as 'the difference between the market price of the guarantee and the price actually paid'.[904] Section 3.2 will elaborate on the calculation of the aid element in more detail. The Notice takes into account cases such as those of risk finance measures, where the market does not provide guarantees for the type of transaction in question, so that no market price is available: Therefore, the aid element 'should be calculated in the same way as the grant equivalent of a soft loan', i.e. 'as the difference between the specific market interest rate this company would have borne without the guarantee and the interest rate obtained by means of the state guarantee after any premiums paid have been taken into account'.[905] If there is no market interest rate, as it often is the case for risk finance measures due to the lack of information and benchmarking, the Commission's Notice refers to proxies, which may be lent from its Communication on Reference Rates.[906] These proxies lent themselves as simplifying tools, but cannot accurately reflect the inherent risk of the specific guarantees and their beneficiaries.

In the same vein, for aid elements in individual guarantees specifically for SMEs, the simplified evaluation system with its safe harbour premiums described above may be applied.[907] For aid elements in guarantee schemes, the cash grant equivalent of each guarantee ought to be 'calculated as the difference between the premium effectively charged and the premium that should be charged in an equivalent scheme' that fulfils the conditions for the absence of state aid.[908] For aid elements in guarantee schemes specifically for SMEs, the Notice refers in point 4.5. to the safe harbour premiums outlined above and the use of single premiums including their

[903] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.1.
[904] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.2.
[905] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.2.
[906] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.2
[907] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.3.
[908] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 4.4.

thresholds of EUR 2.5 million per company, so that there is no 'need to carry out a valuation for each individual guarantee or risk class within the scheme'.

Furthermore, the Commission describes in point 5. the assessment procedure of the compatibility with the internal market. Firstly, the beneficiaries must be identified. Secondly, the Commission refers to 'frameworks and guidelines concerning horizontal, regional, and sectoral aid' containing specific criteria to be applied, e.g. the Risk Finance Guidelines. With regard to general monitoring obligations, the Commission requires reports to be presented at least at the end of the period of validity of the guarantee schemes and for the notification of an amended scheme. The reports must include at least 'the number and amount of guarantees issued, the number and amount of guarantees outstanding at the end of the period, the number and value of defaulted guarantees on a yearly basis, the yearly income (from premiums charged, recoveries, and other revenues)', the yearly costs, the yearly surplus or shortfall, and the accumulated surplus and shortfall since the beginning of the scheme.[909]

With regard to unlimited and unconditional state guarantees, the Court of Justice made clear that there is a presumption of an advantage, which the recipient of the guarantee obtains in relation to banks and financial institutions (in the form of cheaper credit).[910] Further, this presumption is rebuttable only, if it is proven that the beneficiary 'did not obtain in the past and, according to any plausibility, will not obtain in the future any real economic advantage from that guarantee'.[911] However, if the Commission strives to rely on the presumption regarding an advantage for suppliers and customers, the Commission still has to prove it through examining the economic and legal context.[912]

Therefore, the General Court clarified in *HH Ferries v Commission* that 'the Commission may declare aid compatible with Article 107 (3) TFEU, only if it can establish that the aid contributes to the attainment of one of the objectives specified, something which, under normal market conditions, a recipient undertaking would not achieve by using its own resources'.[913] According

[909] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees (OJ C 155, 20.06.2008), point 6.
[910] Case C-483/16 P, European Commission v France and IFP Énergies nouvelles (IFPEN) [2018] EU:C:2018:737, para. 111.
[911] Case C-483/16 P, European Commission v France and IFP Énergies nouvelles (IFPEN) [2018] EU:C:2018:737, para. 117.
[912] Case C-483/16 P, European Commission v France and IFP Énergies nouvelles (IFPEN) [2018] EU:C:2018:737, para. 151.
[913] Case T-68/15, HH Ferries et al v European Commission [2018] EU:T:2018:563, para. 143.

to the Court, for its compatibility assessment, the Commission is required to examine whether the aid contained therein is limited in terms of time and amount.[914] Moreover, for the assessment of proportionality and the necessity of the aid, while a final precise figure is not required, the Commission is obliged to provide a method for determining the aid element: 'the assessment of the proportionality of aid implies verification whether the aid is limited to the minimum necessary to achieve its objectives… which implies knowledge of the extent, to which the aid is necessary… and therefore knowledge of how to calculate the aid element in advance'.[915] The GBER and the *de minimis* Regulation also require that guarantees must be transparent and therefore the amount of aid be known at the moment of granting.[916] In the following section, the calculation method of the grant equivalent of guarantees will be further explained.

What is more, the Commission is required to examine the impact of the aid on competition and trade within the EU through an economic assessment, for which it enjoys a wide discretion.[917] Therefore, it is obliged to weigh the beneficial effects against the adverse effects in terms of distortion of competition and the effect on trade between Member States.[918] This weighing of effects is mandatory for all exemptions under Article 107 (3) TFEU rather than only for some of them.[919] As the analysis in chapter VI shows, however, the Commission fails to conduct the weighing exercise in its decisional practice and confines itself to assessing whether the amount of aid and the potential distortive effects are limited.

[914] Case T-68/15 HH Ferries et al v European Commission, para. 137.
[915] Case T-68/15 HH Ferries et al v European Commission, para. 150.
[916] Article 5 (2) (c) (ii) of Regulation 651/2014 and Article 4 (6) (d) of Regulation 1407/2013.
[917] Case T-68/15 HH Ferries et al v European Commission, paras. 204-206.
[918] Case T-68/15 HH Ferries et al v European Commission, paras. 210, 211.
[919] Case T-68/15 HH Ferries et al v European Commission, para. 212.

Summary box of case law on MEIP:

IFP Énergies nouvelles (C-483/16 P, European Commission v France and IFP Énergies nouvelles (IFPEN) [2018]):

- The Commission successfully appealed against the judgment of the EU Courts, which had annulled a Commission decision declaring advantages stemming from a State guarantee to constitute state aid.
- With regard to unlimited and unconditional state guarantees, the Court of Justice made clear that there is a presumption of an advantage, which the recipient of the guarantee obtains in relation to banks and financial institutions (in the form of cheaper credit). Further, this presumption is rebuttable only, if it is proven that the beneficiary did not obtain in the past and, plausibly, will not obtain in the future any real economic advantage from that guarantee. However, if the Commission strives to rely on the presumption regarding an advantage for suppliers and customers, the Commission still has to prove it through examining the economic and legal context.

HH Ferries v Commission (T-68/15 HH Ferries et al v European Commission [2018]):

- HH Ferries, a privately held Danish and Swedish joint venture, successfully applied for annulment of a Commission decision that had not raised objection to a tax aid and a state guarantee by Denmark and Sweden in favour of a road and railway link consortium.
- The Court found that the 'Commission may declare aid compatible with Article 107 (3) TFEU, only if it can establish that the aid contributes to the attainment of one of the objectives specified, something which, under normal market conditions, a recipient undertaking would not achieve by using its own resources'.
- For its compatibility assessment, the Commission is required to examine whether the aid contained therein is limited in terms of time and amount, and to provide a method for determining the aid element: 'the assessment of the proportionality of aid implies verification whether the aid is limited to the minimum necessary to achieve its objectives… which implies knowledge of the extent, to which the aid is necessary… and therefore knowledge of how to calculate the aid element in advance'.

Compiled by the author, sources: case law cited.

3.2. The calculation of the aid element in guarantees and its limitations as to risk finance measures

The following discussion of Commission decision *SA.42545* will elaborate in more detail on the calculation of the aid element in guarantees. Albeit not a risk finance measure, it may highlight the problems as to the use of guarantees as risk finance measures and their inherent information asymmetries, as it may be difficult to calculate default rates for new products or to know the profitability of new business models. Afterwards, Commission decision *SA.45125* lends itself as a textbook example of a methodology for calculating a market fee and the aid element in a state

guarantee, but also shows the limitations of establishing such methodologies in the context of risk finance aid.

Commission decision ***SA.42545*** of April 2017 concerned the renovation of a congress centre in Hamburg financed through the use of financial instruments, such as equity, loans, and a state guarantee. While the equity injection was considered to be comparable to a grant and to entail a gross grant equivalent of EUR 160 million, a market price for the guarantee could not be established, as it may be the case for risk finance measures, and thus its amount of the aid was established in a similar way as the gross grant equivalent for loans, i.e. 'the advantage in the State guarantee (respectively the market-conform guarantee premium) will then be calculated 'as the difference between the specific interest rate this company would have borne without the State guarantee (price for a non-guaranteed loan) and the interest rate obtained by means of the State guarantee after any premiums paid have been taken into account' (price for the guaranteed loan including guarantee premium paid)'.[920]

Since there is no market price available, Germany proposed the use of the reference rate as a proxy on the basis of the Reference Rate Communication, 'defined as the sum of (i) the refinancing costs of the loan and (ii) the appropriate risk margin reflecting the project risks of the company', whereby the 'risk margin depends on the rating of the company and the collaterals provided' (the higher the rating and the higher the collateralisation, the lower is the risk margin).[921] However, this may be problematic for risk finance measures: There may simply be no rating and credit history available for young and innovative start-up companies, for instance, so that no risk margin may be established.

The Commission continued to explain that the advantage stemming from the guarantee as well as the market-conform guarantee premium 'can be then calculated as the difference between the risk margin of the non-guaranteed loan and the risk margin of the guaranteed loan minus a guarantee premium paid'.[922] Thereby, the Commission adhered to the requirement of the EU Court in *HH Ferr*ies that it must provide a method apt to measure the aid element.

[920] Aid No SA.42545, Commission decision, 07.04.2017, para. 16.
[921] Aid No SA.42545, Commission decision, 07.04.2017, para. 16.
[922] Aid No SA.42545, Commission decision, 07.04.2017, para. 17.

The formula is thus the following: state aid element = (reference rate + margin without guarantee) – premium = (margin without guarantee – margin with guarantee) – premium.[923]

This value means that, if it is positive, 'i.e. the guarantee premium paid is lower than the established market-conform guarantee premium, there is an advantage in the State guarantee', where 'the gross grant equivalent of this guarantee will be the sum of the annual gross-grant equivalents paid yearly on the outstanding amount of the guaranteed loan for the time of the guarantees'.[924]

Germany then proposed that 'the risk margin of the non-guaranteed loan was established on the basis of information provided by a bank of the most cautious offer made by several banks', while the 'real risk margin of the guaranteed loans was established on the basis of the indicative bank offers with 100 per cent guarantee', so that 'the advantage in the State guarantee would amount to' the difference of these two values.[925] Although the Commission did not agree on the numbers used by Germany (in particular, it disagreed with the quality of the collateral), it did agree and confirm this methodology.[926] Albeit this method may not be entirely accurate due to the lack of information and rating of comparable undertakings and their credit history, it may be a feasible solution for arriving at a plausible risk margin and thus for calculating the aid element through using the assessment by banks. However, it still depends on the very existence of available information used by banks.

In the context of the MEIP, this decision also lends itself as a textbook example for determining whether an activity is economic or not: The activity in question is conducted for non-commercial reasons, if its price is at such a rate that it leads to a financial loss that is not compensated by any other income, revenue, or benefit from another source.[927]

Moreover, the Commission assessed whether state aid was present at the level of the operator of the congress centre referring to the relevant principles of its Notice on the Notion of State Aid,

[923] Phedon Nicolaides, Calculating the Amount of State Aid in a 100% Public Guarantee, http://stateaidhub.eu/blogs/stateaiduncovered/post/8993, last access: 10.05.2020.
[924] Aid No SA.42545, Commission decision, 07.04.2017, para. 17.
[925] Aid No SA.42545, Commission decision, 07.04.2017, para. 18.
[926] Aid No SA.42545, Commission decision, 07.04.2017, paras. 30 and 31.
[927] Phedon Nicolaides, Calculating the Amount of State Aid in a 100% Public Guarantee, http://stateaidhub.eu/blogs/stateaiduncovered/post/8993, last access: 10.05.2020.

set out in its section 7.3. on 'aid to operators'. Its paragraph 223 refers back to paragraphs 90-96, according to which the operator obtains no advantage if the following conditions are satisfied: (i) a competitive tender procedure takes place, (ii) which is transparent, so that all interested tenderers and potential bidders can duly participate, (iii) and based on the principle of non-discrimination as to the treatment and objective selection and award criteria specified in advance, (iv) as well as, in the case of the public body buying assets, the selected bid is the most economically advantageous. The Commission found that the selection procedure was in line with the principles of the Notice on the Notion of State Aid complying with Articles 29 and 56 of the Directive 2014/24/EU on public procurement.[928] Therefore, the Commission stated that there was no advantage at the level of the operator, and thus, no advantage could be passed on to the users of the congress centre, either.[929]

Finally, the Commission assessed the compatibility of the measure in accordance with its common assessment principles, and found that there was an objective of common interest (Article 107 (3) (d) TFEU), the measure was appropriate (a private investor could not be found), prove of a funding gap necessitated the state intervention, the measure was proportionate, since its amount did not even cover the maximum aid amount (or funding gap), and it avoided undue negative effects on competition and trade (inter alia, the Commission considered positively that the tender procedure would minimise distortive effects and that the aid amount was smaller than the maximum aid amount/the funding gap).[930] Thus, as discussed with reference to other Commission decisions in chapter VI, the Commission did not conduct a proper weighing exercise in this decision either, but merely showed that the negative effects were limited. The Commission confirmed the compatibility of the measure with the internal market.

This decision shows how the Commission assesses the methodology for calculating the gross grant equivalent of state guarantees in case the market price cannot be established, and that it appreciates the use of the methodology outlined in its Reference Rate Communication, even though it may disagree with the numbers used *in casu*. The decision may provide a methodology for calculating the state aid element for cases, where a certain amount of information is available on the risk margin and the collateral. Moreover, the Commission requires the use of a tender

[928] Aid No SA.42545, Commission decision, 07.04.2017, para. 44.
[929] Aid No SA.42545, Commission decision, 07.04.2017, para. 45.
[930] Aid No SA.42545, Commission decision, 07.04.2017, paras. 46-54.

procedure for the selection of operators in order to exclude the presence of state aid at the level of operators, and considers this use positively with regard to the minimisation of market distortions under the compatibility assessment, without conducting a proper weighing exercise of the positive and negative effects.

Although not being a risk finance measure either, Commission decision ***SA.45125*** lends itself as an example for the calculation of the amount of aid of state guarantees, with particular regard to undertakings (e.g., farmers, small enterprises, or projects with long recoupment periods) that do not possess assets to serve as collateral amid incomplete or asymmetric information.[931] Thus, especially regarding risk finance measures, it may be difficult to calculate default rates for new products or to ascertain the profitability of new business models.[932]

Both Article 5 (2) (c) (ii) GEBR and Article 4 (6) (d) of the *de minimis* Regulation require that aid in the form of guarantees be transparent, i.e. that the aid amount is known at the moment the guarantee is granted. Therefore, they establish criteria, e.g. that aid is considered transparent, if the GGE has been calculated on the basis of the safe-harbour premium laid down in the Commission Guarantee Notice. However, if Member States deviate from these criteria, which was the case here, they are required to notify their methodology to the Commission.

In this case, the notified methodology was defined by public officials and banking experts and designed for 'the calculation of market-conform fees for individual guarantees and guarantee schemes granted by the State to large companies and for the calculation of the aid element in guarantees with State aid'.[933] The market-conform guarantee fee depends on two factors: (i) the probability of default of the borrower and (ii) the coverage of the collateral by the borrower.[934] In this case, a credit risk rating methodology of a Greek rating agency was available for assessing the probability of default of the borrower.[935] However, as already explained, this may most likely not be available in cases of risk finance aid, where risk rating may prove hard or very costly.

[931] State Aid No. SA.45125, commission decision, 29.07.2016.
[932] This is the very reason for the market failure and why Member States intervene: to correct the informational failures.
- Phedon Nicolaides, How to Calculate a Transparent Amount of State Aid in Public Guarantees, http://stateaidhub.eu/blogs/stateaiduncovered/post/7950, last access: 10.05.2020.
[933] State Aid No. SA.45125, Commission decision, 29.07.2016, 5. Decision.
[934] State Aid No. SA.45125, Commission decision, 29.07.2016, point 7.
[935] State Aid No. SA.45125, Commission decision, 29.07.2016, point 8.

Moreover, for the assessment of the creditworthiness of the borrowers and of collaterals, a ten-level scale system and coverage ratio bands were available, respectively. These two factors may also be very hard to assess for risk finance guarantees, since there may be no credit history of the borrowers available and collaterals may be harder to assess than it was the case for liens on real estate in this decision at hand. With regard to collateral, start up companies may not possess liens, but rather use intellectual property, the (future) value of which is harder to establish than for tangible assets.[936]

The combination of the probability of each borrower's default and the value of collateral lead to the establishment of the commission fee charged by the Greek authorities, which was then expressed as the annual premium.[937] The commission fees included, for instance, basis points to cover the administrative costs (including all costs relating to control and risk management as well as the management of securities) and basis points for the yearly remuneration of the capital in line with section 3.4 of the 2008 Commission Notice on Guarantees.[938]

For guarantees with an aid element, the GGE was then calculated according to the formula GGE = D x Z x [F - G], where D is the amount of the outstanding loan covered by the guarantee, Z the percentage of the outstanding loan D covered by the guarantee, F the theoretical market premium defined according to the fee grid described above, and G the premium actually paid by the beneficiary to the Member State for admission to the guarantee scheme in percentage terms.[939]

If a guarantee exceeded 12 months, the differences between the theoretical market premium and the premium actually paid at the end of each period are discounted to their present value (net present value or NPV) of the GGE was derived by using the discount rate set by the Commission in its Reference Rate Communication: $GGE = \sum [Dt \times Z \times (Ft - Gt)/(1 + i)^t]$, where i is the discount rate, Ft the theoretical yearly market premium of the guarantee for the year t, determined according to fee calculation above, Dt the outstanding debt at year t of the

[936] Jason Frank, Intellectual Property as Collateral – Today's Valuation Realities, The Secured Lender, Nov/Dec 2009, 65, 8, p.25.
[937] State Aid No. SA.45125, Commission decision, 29.07.2016, point 19.
[938] State Aid No. SA.45125, Commission decision, 29.07.2016, point 20.
[939] State Aid No. SA.45125, Commission decision, 29.07.2016, point 27 (e).

guaranteed loan, and Gt the yearly premium actually paid by the beneficiary for admission to the guarantee scheme at year t.[940]

In the end, the Commission found that 'the general provisions of the 2008 Notice on Guarantees were adhered to and that the notified methodology was capable of determining a transparent amount of state aid involved in guarantees'. This decision lends itself as a textbook case for the establishment of an own methodology for the calculation of the aid element in guarantees. However, with regard to its underlying factors of the probability of default and the coverage of collateral, it becomes clear that such a methodology is not easy to establish with regard to risk finance guarantees, where crucial information may be absent or difficult or expensive to gather.

3.3. The Commission's Reference Rate Communication and the establishment of the aid element in loans

As it is the case for guarantees, where specific market information on a debt transaction is absent, 'compliance may be established on the basis of a comparison with comparable market transactions', i.e. benchmarking.[941] Therefore, 'the Commission has developed proxies in order to determine the aid character of loans': The methodology for calculating a reference rate for loans is set out in the Reference Rate Communication to measure the grant equivalent of aid.[942] Moreover, the reference and discount rates therein are used to check the compliance with the *de minimis* rules and the GBER.

In the beginning, the Commission makes clear that the methodology of the Communication intends to avoid, among other difficulties, the favouring of 'large companies to the detriment of SMEs, 'for which either no rating is available, or a less advantageous one exists (in particular because of information asymmetry with respect to the lender)'. Therefore, the Commission sets out the following methodology. The 1-year IBOR forms the calculation basis, i.e. the base rate rests on the 1-year money market rates, available in almost all Member States. Where such rates are not available, the 3-month money market rate ought to be used. As described, these may not

[940] State Aid No. SA.45125, Commission decision, 29.07.2016, point 27 (f).
[941] European Commission, Notice on the notion of state aid, C/2016/2946, para. 111.
[942] Communication from the Commission on the revision of the method for setting reference and discount rates (2008/C 14/02), OJ C 14/6.

be available in the case of risk finance aid. If reliable or equivalent data is absent or if there are exceptional circumstances thus, the Commission may determine another calculation basis in close cooperation with the Member State(s) concerned.

Moreover, the Commission lays down loan margins 'to be applied in principle depending on the rating of the undertaking concerned and the collateral offered'. The rating categories reach from 'strong (AAA-A)' to 'bad/financial difficulties (CCC and below)', while the collateralisation degree reaches from 'high' to 'low'. The Commission thereby defines 'normal collateral' 'as the level of collateral normally required by financial institutions as a guarantee for their loan' and refers to the Basel II framework for measuring the 'loss given default (LGD)'.[943] To put the margins into perspective, the Commission states that 'normally, 100 basis points are added to the base rate', meaning '(i) loans to undertakings with satisfactory rating and high collateral or (ii) loans to undertakings with good rating and normal collateral'. The base rate ought to be increased by at least 400 basis points and the margin may never be lower than the one that would be applicable to the parent company 'for borrowers that do not have a credit history or a rating based on a balance sheet approach' (e.g. special purpose companies or start-up companies).

The Communication stipulates that the reference rate be updated every year, so that the base rate 'will thus be calculated on the basis of the 1-year IBOR recorded in September, October, and November of the previous year'. For significant and sudden variations, an update has to be made whenever 'the average rate, calculated over the previous three months, deviates by more than 15 per cent from the rate in force'.

Commission decision ***SA.38674*** lends itself as an example for how the Commission applies the Communication to loans in general, although it was not a risk finance measure.[944] Instead, it regarded subordinated loans to promote regional development. Importantly, the Commission stated in the beginning that subordinated loans were not covered by the Communication and hence 'cannot be considered to constitute transparent forms of aid' in the meaning of Article 5 (1) GBER, without explaining why this is the case, but referring to its previous decision *SA.31690*,

[943] The loss given default is explained as "the expected loss in percentage of the debtor's exposure taking into account recoverable amounts from collateral and the bankruptcy assets". – Footnote 2 of Communication from the Commission on the revision of the method for setting reference and discount rates (2008/C 14/02), OJ C 14/6.
[944] State Aid No. 38674, Commission decision, 25.11.2014.

where it found the loans *in casu* to fall under *de minimis* aid.[945] Indeed, the Communication does not mention subordinated loans and a possible explanation may be that 'the whole of a non-collateralised and subordinated loan is at risk and always ranks last on the list of creditors'.[946]

Even more puzzling, the Commission nonetheless applied the Communication to the subordinated loans in question in order to calculate the GGE. Firstly, the rating of the beneficiary is based on the information of its main bank, applying standard rating categories used by international rating agencies via the one-year probability of default.[947] As explained above, such information may not be available in the context of risk finance aid, however, as the probability of default may be difficult to forecast, for instance.[948] Secondly, in order to adapt the higher risk of subordination to regular senior debt, the rating is downgraded by one notch, and thirdly, by referring to the column 'low collateralisation' and the row 'weak rating' of the Commission's Communication for the risk margin, a proxy for the market interest rate is derived.[949] This may make sense in terms of setting the risk margin for cases of risk finance aid, as both factors, low collateralisation and weak rating may likely apply, too.

Fourthly, the resulting risk margin is combined with the base rate defined by the Commission at the time of granting the loan, and fifthly, the annual aid element results from 'the difference between the derived proxy rate and the interest rate actually payable under the loan scheme, multiplied by the outstanding amount of the loan at the start of the year'.[950] Finally, 'the overall amount of the aid is the sum of the discounted annual aid elements', where 'the rate of discount, as stipulated by the 2008 Communication, is equal to the base rate applicable at the time of granting the loan, plus 100 basis points'.[951]

In sum, as this decision shows, the application of the Reference Rate Communication appears to be sensible for risk finance measures, too, as it provides proxies for the very circumstances of risk finance aid, e.g. for SMEs, for which either no rating is available, or a less advantageous one exists, in particular because of information asymmetries. Moreover, the proxies are adjusted and

[945] State Aid No. 38674, Commission decision, 25.11.2014, point 6.
[946] Phedon Nicolaides, State Aid Uncovered 2015, 8.1. Public Loans, Lexxion Publisher, 2016, p.222.
[947] Phedon Nicolaides, State Aid Uncovered 2015, 8.1. Public Loans, Lexxion Publisher, 2016, p.223.
[948] Kay Giesecke et al., Forecasting Default in the Face of Uncertainty, Journal of Derivatives, Fall 2004, p.11.
[949] Phedon Nicolaides, State Aid Uncovered 2015, 8.1. Public Loans, Lexxion Publisher, 2016, p.223.
[950] Phedon Nicolaides, State Aid Uncovered 2015, 8.1. Public Loans, Lexxion Publisher, 2016, p.224.
[951] Phedon Nicolaides, State Aid Uncovered 2015, 8.1. Public Loans, Lexxion Publisher, 2016, p.224.

updated every year, accounting for market variations. In the case of uncertain market conditions and the lack of available benchmarks, this Communication provides a methodology Member States may use in order to establish the aid element also under difficult circumstances.

4. Conclusion

This analysis showed that there are **several conditions and assessment methods** provided by the Commission in order **to find, measure, and possibly remove the presence of an advantage in financial instruments as well as their consistent use** in accordance with the requirements of the EU Courts. In particular, as the discussion of the Commission's legal texts and decisional practice showed, in its approach towards the application of the MEIP and the measurement of the aid element, it strives to provide consistent methods and tools that are apt to measure and price the risk in financial instruments.

However, **in the context of risk finance measures**, this becomes particularly challenging due to the **inherent lack of information** and the apparent presence of **information asymmetries**. Regarding equity instruments, the Commission applies various methods, such as the WACC and the CAPM, which may be practical tools even in difficult aid scenarios as that in the decision of *Ciudad de la Luz*, but which also face limitations as to risk finance and its environment of young SMEs: A reliable beta or proxy, let alone industry-wide betas over time, may just not be available, nor may verifying studies as to the correct benchmarking.[952]

Regarding **guarantees**, the Commission provides **methods for measuring the aid element**, as required in the case *HH Ferries* by the EU Courts. In particular, its Notice on guarantees elaborates on the use of **safe-harbour premia**, which are a relatively practical solution, yet offer merely a one-size-fits-all-solution, where there may be none, and do not pay regard to the differences among, e.g., start-up companies with entirely different business models and growth prospects. As the analysis of the Commission's decision on assessment methods showed, in practice it may be very difficult to measure the aid element in guarantees as risk finance measures. Regarding loans, the Commission provides with its Reference Rate Communication a methodology Member

[952] Adina Claici et. al., The Market Economy Investor Principle: Lessons Learned from the Ciudad de la Luz Case, Journal of Competition Law & Economics, vol. 12 (1), p. 208.

States may use in order to establish the aid element also under difficult circumstances. However, of course, these merely remain proxies.

In conclusion, the analysis revealed that the EU Court's requirements and the approach by the Commission towards the application of the MEIP are consistent. However, if pari passu terms are not given, the assessment methods to find and possibly remove the advantage in financial instruments face limitations due to the very nature of financial instruments and the *per se* risky environment of young, innovative SMEs. It may hence be difficult for find a consistent way of applying these methods in practice. The difficulty of measuring the aid element in such an environment was additionally confirmed by experts interviewed (see Appendices).

VI. The Compatibility Assessment of the Commission – Consistent with the Requirements of the Courts?

Contrary to state aid in the form of grants, financial instruments have no underlying identifiable costs and therefore cannot be 'subject to a maximum intensity rate being measured as a percentage of the aid amount relative to the eligible costs' in terms of proportionality.[953] It is thus problematic to assess how financial instruments and their size relate to their relevant objective/market failure and how they affect markets and competition (i.e. what their potential of market distortion is) in the light of the proportionality principle. Hence, financial instruments are subject to absolute maximum amounts instead.

The EU Courts elaborated on the principle of proportionality, including necessity and the balancing of positive and negative effects, in order to assess the relationship between their positive effects and the potential of market distortions in particular, as well as the compatibility of state aid in general. Given the problem to assess the potential of market distortions by financial instruments due to their lack of identifiable costs, these principles become even more relevant. Hence, this chapter is concerned with the following question:

- Is the Commission's decisional practice on financial instruments consistent with the requirements of the EU Courts on proportionality under state aid law, including necessity and the balancing of positive and negative effects?

Thus, the principle of proportionality, including necessity and the balancing of positive and negative effects, of the EU Courts will be used as a benchmark for analysing whether the Commission adheres to or deviates from this principle in its decisions and whether a consistent logic along the lines of the Courts' requirements is discernible. This is relevant since the Commission enshrined this principle in the 'common assessment principles' of its Risk Finance Guidelines. This is also relevant given that it is 'the sole authority competent to assess the

[953] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.

compatibility of state aid with the internal market and therefore cannot control itself', but is subject to the EU Courts' conditions under the proportionality principle.[954]

Firstly, this chapter will cover the EU Courts' elaboration of the principle of proportionality in relation to state aid law and its specific requirements (section 1). Secondly, this is followed by a discussion of the decisional practice of the Commission with regard to the application of the proportionality principle on financial instruments through the analysis of selected decisions (section 2). Thirdly, the outcome of the analysis will be compared with legal texts comparable to the Risk Finance Guidelines and their respective assessment criteria, namely the Guidelines on regional aid and the Framework on R&D&I aid (section 3). Thereafter, the chapter will provide with an answer to the question posed above in its conclusion (section 4). Finally, the chapter will conclude with an elaboration of the evaluation mechanism introduced under the current GBER as an application of the proportionality test *a posteriori* (section 5).

1. The EU Courts and the Principle of Proportionality in State Aid Law

Under state aid law, the EU Courts have established the principle of proportionality, including necessity and the balancing of positive and negative effects of the aid, in order to assess the correspondence between the extent of the market failure and the amount of aid, as well as its impact, in order to prevent, or at least, minimise market distortions. Since one of the particular features of financial instruments is their lack of identifiable underlying costs, the amount of aid of financial instruments, which is deemed necessary and proportionate, is hard to quantify and assess.

Thus, it may remain unclear how the Commission applies these principles, established and applied by the Courts with regard to forms of aid with identifiable costs, in its compatibility assessment of financial instruments, which have found their way into the Risk Finance Guidelines of the Commission and their 'common assessment principles' (see chapter IV). This chapter and its analysis of Commission decisions will show that the Commission does not, in fact, assess or quantify the amount of the aid, but rather controls whether the prescribed caps and ceilings are

[954] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.13.

adhered to, and checks whether market mechanisms and screening methods are applied in and to the design of the relevant financial instrument in order to minimise potential distortions.[955] These screening methods are thus intended to fulfil the role of a proportionality test.

The EU Courts outlined in *Fedesa* the four elements of proportionality in its broad sense, under which the first three steps form the necessity test and the fourth step forms the balancing test under proportionality in the strict sense: under the proportionality principle, there must be

(i) an appropriate (or suitable) measure (the so-called suitability or appropriateness test, which refers to the relationship between the means and the end),
(ii) in pursuit of a legitimate objective (the test of legality is sometimes not counted as a separate step),
(iii) that is the least restrictive measure among the appropriate measures (the so-called necessity test or least restrictive means test),
(iv) and that is not manifestly disproportionate in terms of a costs versus benefits balance (the so-called proportionality test *stricto sensu* or manifestly disproportionate test).[956] [957]

As elaborated on in chapter II, not all steps are applied in practice: the 'least restrictive means' and the 'manifestly disproportionate test' are often applied alternatively rather than complimentarily, and even if proportionality in the strict sense is applied, 'an explicit balancing of costs versus benefits is rare'.[958] The 'manifestly disproportionate test', on the other hand, represents a broader and less strict test, leaving 'a relatively wide margin of discretion to the

[955] See Aid No. SA.46308, Commission decision, 25.08.2016; Aid No. SA.48840, Commission decision, 01.08.2017; Aid No. 34660, Commission decision, 16.04.2012.
[956] The Court held in Fedesa: 'The Court has consistently held that the principle of proportionality is one of the general principles of Community law. By virtue of that principle, the lawfulness of the prohibition of an economic activity is subject to the condition that the prohibitory measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question; when there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued.'
- Case C-331/88 The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health ex parte Fedesa et al [1990] ECR I-4023, para. 13.
[957] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 448, and Tor-Inge Harbo, The Function of the Proportionality Principle in EU Law, European Law Journal, vol. 16 no. 2, 2010, p. 165.
[958] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 448.

authorities', the measures of which are under review.[959] Scholars argue that EU institutions are usually subject to the so-called 'manifestly disproportionate test' as opposed to Member States, which are subject to the so-called 'least restrictive means test'.[960] This is in line with the constitutional reasoning: As it was elaborated on in chapter II, where the Commission as the primary decision-maker enjoys a wide discretion, the EU Courts are inclined to 'apply the [proportionality] concept less intensively' and 'will only overturn the policy choice if it is clearly or manifestly disproportionate', and importantly, 'this is more especially so where the policy choice required the weighing of complex variables', as it is the case in the area of state aid law and financial instruments.[961]

In the following, the case law of the EU Courts elaborating on the proportionality principle and its requirements with regard to state aid will be explained. The relevant cases and their requirements vis-à-vis the Commission lend themselves as a benchmark in assessing whether the latter deviates from them in its actual decisions, i.e. whether the Commission's decisions are consistent with the principles. Even though the Courts' cases discussed do not concern risk finance measures, they are universally applicable to state aid measures, including financial instruments and risk finance aid, and thus lend themselves for elaborating on the proportionality principle of state aid law in general.

In its judgment ***Smurfit Kappa*** of 10 July 2012, the General Court decided on Commission decision C(2008) 1107, where the Commission found inter alia that the aid in question did not exceed the thresholds of paragraph 68 of the Guidelines on national regional aid for 2007-2013.[962] The Commission rejected the arguments in the complaints stating that it was bound by the Guidelines, which, in its view, precluded it from initiating the formal investigation procedure in case the thresholds of the Guidelines were not exceeded.[963] The Commission argued that the compliance with these thresholds ensured that, firstly, the potential distortion of competition does not

[959] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 448.
[960] Wolf Sauter, Proportionality in EU law: A Balancing Act?, Cambridge Yearbook of European Legal Studies, 15, 2012-2013, p. 445.
[961] Paul Craig, EU Administrative Law, Oxford Scholarship, 2018, p. 644.
[962] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012] EU:T:2015:707.
[963] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 14.

exceed the expected benefits, and secondly, that there is a sufficient contribution to the objective of regional development.[964]

However, the Court found that 'the Commission is required to initiate the formal investigation procedure in particular, where, in the light of the information obtained during the preliminary examination procedure, it still faces serious difficulties in assessing the measure under consideration'.[965] That obligation would follow directly from Article 88 (3) EC (now Article 108 (3) TFEU), as interpreted by case law, and from Article 4 (4) of Regulation No 659/1999 (now Article 4 (4) of Regulation No 2015/1589), when the Commission finds, after a preliminary examination, that the unlawful measure raises doubts as to its compatibility with the common market.[966]

The applicant of the case claimed that it was not evident that the measure at issue was compatible with the common market and that certain difficulties of assessment ought to have led the Commission to initiate the formal investigation procedure, since it followed from Article 88 (3) EC and Article 4 (4) of Regulation No 659/1999 that the Commission was required to open that procedure when it does not succeed in eliminating all doubts about the compatibility.[967] Thus, the fact that the thresholds had not been exceeded did not preclude the Commission from an in-depth investigation.[968]

The Court held that the Commission carries out an examination of proposed state aid under Article 88 (3) EC (now under 108 (3) TFEU), which is intended to enable it to form a *prima facie* opinion on the (partial) compatibility with the common market. Thereby, the Commission 'enjoys a certain margin of discretion in identifying and evaluating the circumstances of the case in order to determine whether they present serious difficulties'.[969] However, where it encounters serious difficulties, the Commission must initiate the formal procedure having no discretion in this regard.[970] Thereby, the notion of serious difficulties is an objective one: 'whether or not such

[964] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 14.
[965] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 62.
[966] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 62.
Article 4 (4) of Regulation No 659/1999 reads as 'Where the Commission, after a preliminary examination, finds that doubts are raised as to the compatibility with the common market of a notified measure, it shall decide to initiate proceedings pursuant to Article 93 (2) of the Treaty'.
[967] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 73.
[968] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 74.
[969] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 75.
[970] Case T-388/03, Deutsche Post and DHL International v Commission [2010] ECR II-199, para. 91.

difficulties exist requires investigation of both the circumstances under which the contested measure was adopted and its content' and 'that investigation must be conducted objectively, comparing the grounds of the decision with the information available to the Commission when it took a decision on the compatibility of the disputed aid'.[971]

The Court held that although paragraph 68 of the Guidelines on national regional aid for 2007-2013 established a procedural obligation without exception for the Commission to initiate the formal procedure where the thresholds have been exceeded, this did not preclude the initiation of the formal procedure where those thresholds have not been exceeded, since that provision 'certainly does not have the effect of preventing it from doing so in cases in which the thresholds… have not been reached'.[972] In such cases, the Commission did have the power of not initiating the formal procedure, but it might not justify that decision by claiming that it is required by paragraph 68 not to initiate the procedure according to the Court. Therefore, the Commission misconstrued the scope of the Guidelines: The Court stated that, although the Commission imposes a limit on the exercise of its discretion by adopting rules of conduct, such as the Guidelines in general and the aforementioned thresholds in particular, these may not preclude it from exercising its discretion on whether the aid in question is compatible with the internal market to the full.[973]

Therefore, the Commission is required to conduct an in-depth assessment in all those cases, where the positive effects of an aid measure clearly do not outweigh the potential negative effects, even though thresholds laid down in Guidelines are not exceeded.[974]

Crucially, the Court made clear that where the Commission assesses the compatibility of state aid with the internal market in the light of the derogation provided for in Article 107 (3) TFEU (then Article 87 (3) EC), the latter must take into account the Union interest and 'may not refrain from assessing the impact of those measures on the relevant market or markets in the EEA as a whole'.[975] Thereby, 'the Commission is bound not only to verify that the measures are such as to contribute effectively to the economic development of the regions concerned, but also to

[971] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 80.
[972] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 88.
[973] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], paras. 88 and 90.
See also Case T-357/02, RENV Freistaat Sachsen v Commission [2011] ECR II-5415, para. 45.
[974] Case T-671/14, Bayerische Motoren Werke AG v European Commission [2017] EU:T:2017:599, para. 9.
[975] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 82.

evaluate the impact on the trade between Member States and, in particular, to assess the sectorial repercussions they may have' at Union level.[976] The exercise of the Commission's wide discretion involves complex economic and social assessments, which must be made in a Union context.[977] Therefore, the Commission is required to exercise its wide discretion under Article 107 (3) TFEU (then Article 87 (3) EC) in order to ascertain **whether the expected benefits outweigh distortions of competition and the impact of the measure on trade** between Member States for the assessment of the measure's compatibility with the internal market.[978] In the wording of the Court:

'[…] The Commission is required to exercise its wide discretion under Article 87 (3) EC as to whether State aid granted in a region of difficulty is compatible in order to ascertain whether the expected benefits in terms of regional development outweigh distortions of competition and the impact of the subsidised project on trade between Member States'.[979]

The Court thus stresses the importance of the weighing of positive and negative effects for assessing the compatibility of aid thus, which relates to the proportionality test *stricto sensu*. Therefore, it criticised the practice of the Commission laid down in the Guidelines on regional aid, namely that the conditions for compliance of the latter were confined to negative criteria in terms of distortions of competition to be kept at a limited level:[980]

'[92]… the Commission stated that it was not required to undertake a detailed verification as to whether the benefits of an aid measure outweigh the distortions of competition that it may bring about where the thresholds laid down in paragraph 68 of the Guidelines were not reached. Moreover, … the Commission took the view that compliance with the Guidelines was sufficient on its own to guarantee the contribution of an aid measure to regional development.[981]

'[93] In that regard, when the Guidelines are applied, the conditions verified… are limited to the following: first, that the region where the subsidised project is located is eligible for the grant of

[976] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 82.
[977] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 83.
[978] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], paras. 90 and 91.
See also Case T-357/02, RENV Freistaat Sachsen v Commission [2011] ECR II-5415, para. 45.
[979] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 91.
[980] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 94.
[981] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 92.

State aid…; second, that the maximum allowable aid intensity has been complied with… third and lastly, that a number of conduct-related requirements have been complied with, such as the submission by the recipient of an application for a subsidy before the work begins and a commitment by the recipient to use the subsidised plant for a period of at least five years. However, it must be stated that the fact that a measure complies with such conditions is not sufficient to demonstrate that it will have a positive effect on regional development…[982]

'[94] It is true that the Commission enjoys wide discretion in identifying and evaluating the circumstances of the case in order to determine whether State aid can be declared compatible with the common market… However, in the present case, the Commission confined itself to verifying that the disadvantages caused by the subsidised project in terms of distortions to competition would be kept at a limited level, but not that the advantages in terms of regional development would outweigh the disadvantages, however minimal the latter might be.'[983]

Therefore, the Court stated that a measure's compliance with the conditions of the Guidelines is not sufficient to demonstrate that it will have a positive effect in the light of the relevant objective of the aid measure. Hence, the Court emphasised the importance of the balancing requirement under state aid law.

The Court therefore pointed out that the Commission intended to adopt before January 2007 further guidance to supplement the Guidelines, in which it would take into account positive criteria, i.e. whether the aid was necessary to provide an incentive effect and whether the benefits of the aid measure outweighed the resulting distortion of competition.[984] Thus, the Court made clear the importance of the assessment and weighing of positive criteria against negative criteria, as they would find entry into the 2006 Guidelines on risk finance.

Without the weighing of the advantages against the disadvantages, the assessments made in the decision 'could not alone enable the Commission to eliminate all doubts as to the compatibility' under the derogation of Article 87 (3) EC, that presupposes that the benefits outweigh the

[982] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 93.
[983] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 94.
[984] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 95.

disadvantages.[985] Therefore, the Court held that the Commission did not only misconstrue the scope of the Guidelines, but also failed to exercise its discretion required under Article 107 (3) TFEU [then Article 87 (3) EC], so that by failing to take into account the criteria required for its assessment, 'the Commission did not put itself in a position to overcome all doubts as to the compatibility of the aid'.[986] Accordingly, the Court annulled the Commission decision.

Thus, the Court held that whenever the Commission assesses the compatibility of state aid with the internal market in the light of the derogation provided for in Article 107 (3) TFEU, it must take into account the Union interest and may not refrain from assessing the impact of those measures on the relevant market or markets in the EEA as a whole through the weighing of positive and negative effects of the aid. However, it remains doubtful whether the Commission does indeed weigh the positive against the negative effects or rather still confines itself to stating that the negative effects would be kept at a minimal level in its decisions. As will be seen in the following section, the Commission rather checks a list of whether certain market mechanisms and screening methods are applied to the financial instrument in question instead of balancing positive and negative effects of the measure.

[985] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 96.
[986] Case T-304/08, Smurfit Kappa Group plc v European Commission [2012], para. 97.

Summary box of case law on proportionality:

Fedesa (case C-331/88, The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health ex parte Fedesa et al [1990]):

- The UK High Court of Justice, Queen' s Bench Division, referred to the EU Courts for a preliminary ruling certain questions relating to the validity of a Council Directive prohibiting the use in livestock farming of certain substances having a hormonal action. Those questions arose in proceedings brought by Fedesa and others against the Minister for Agriculture, Fisheries and Food and the Secretary of State for Health. In the national court the applicants in the main proceedings challenged the validity of the national regulations which partly implement the directive at issue, on the ground that the directive is invalid. The reply given to the national court was that the examination of the questions raised had disclosed no factor of such a nature as to affect the validity of the Council Directive.
- The Court summarised former case law stating that 'the Court has consistently held that the principle of proportionality is one of the general principles of Community law. By virtue of that principle, the lawfulness of the prohibition of an economic activity is subject to the condition that the prohibitory measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question; when there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued.'

Smurfit Kappa (case T-304/08, Smurfit Kappa Group plc v European Commission [2012]):

- The General Court decided on a Commission decision, where the Commission found i.a. that the aid in question did not exceed the thresholds of the Guidelines on national regional aid for 2007-2013.
- The Commission rejected the complaints stating that it was bound by the Guidelines, which, in its view, precluded it from initiating the formal investigation procedure in case the thresholds of the Guidelines were not exceeded. The Commission argued that the compliance with these thresholds ensured that, firstly, the potential distortion of competition does not exceed the expected benefits, and secondly, that there is a sufficient contribution to the objective of regional development.
- The Court rejected the Commission's argument: The fact that the thresholds had not been exceeded did not preclude the Commission from an in-depth investigation. Where it encounters serious difficulties, the Commission must initiate the formal procedure for an in-depth investigation having no discretion. Thereby, the notion of serious difficulties is an objective one having regard to the respective circumstances and content of the measure. Although the Commission imposes a limit on the exercise of its discretion by adopting rules of conduct (e.g. the Guidelines and their thresholds) these may not preclude it from exercising its discretion on whether the aid in question is compatible with the internal market to the full.
- Moreover, the Commission is required to exercise its wide discretion under Article 107 (3) TFEU as to whether State aid granted is compatible in order to ascertain whether the expected benefits in terms of regional development outweigh distortions of competition and the impact of the subsidised project on trade between Member States. The Court criticised the Commission for having confined itself to verifying that the disadvantages caused by the subsidised project in terms of distortions to competition would be kept at a limited level, but not that the advantages in terms of regional development would outweigh the disadvantages.
- Without the weighing of the advantages against the disadvantages, the assessments made in the decision 'could not alone enable the Commission to eliminate all doubts as to the compatibility'. Therefore, the Court held that the Commission did not only misconstrue the scope of the Guidelines, but also failed to exercise its discretion required under Article 107 (3) TFEU, so that by failing to take into account the criteria required for its assessment, 'the Commission did not put itself in a position to overcome all doubts as to the compatibility of the aid'. Accordingly, the Court annulled the Commission decision.

Compiled by the author, sources: cases cited.

What is more, in its judgment T-356/15 of July 2018 concerning the nuclear power plant '***Hinkley Point C***', which was upheld by the Court of Justice in its judgment C-594/18 P in 2020, the General Court ruled on the compatibility of several state aid measures and further elaborated on the

relevance of the principle of proportionality, including necessity and the weighing of positive and negative effects in the compatibility assessment.[987]

With regard to the achievement of a public interest objective, firstly, the Court clarified that the notion of 'common interest' does not refer to the interests of all or the majority of the Member States, but that a public interest rather than a private interest of the beneficiary of the aid is meant.[988] Instead, it made clear that the concept of common interest of Article 107 (3) (c) TFEU 'relates to the **balance to be struck between the advantages and disadvantages arising from an aid measure**, and precludes measures which adversely affect trading conditions to an extent contrary to the common interest from being authorised'.[989] The Court of Justice endorsed this interpretation of the General Court, meaning that this 'entails weighing up the positive effects of the planned aid for the development of activities that that aid is intended to support and the negative effects that that aid may have on the internal market'.[990]

Thus, the Commission is not required to examine whether all Member States share an interest in the public policy objective in question, since their interests are safeguarded by the requirement of non-distortion of trade rather than the coincidence of policy preferences.[991] Again, the Court emphasises the importance of proportionality, which must be assessed by the Commission through the balancing of positive and negative effects, i.e. market and trade distortions.

Secondly, the Court clarified that Article 107 (3) (c) TFEU requires the attainment of a public interest objective, which is appropriate, necessary, and proportionate, i.e. which would not have been attained without the aid, rather than explicitly requiring the existence of a market failure.[992] It elaborated that 'while the existence of a market failure may be a relevant factor for declaring State aid compatible with the internal market, the absence of market failure does not necessarily

[987] Case T-356/15 Austria v European Commission [2018] EU:T:2018:439,
and Case C-594/18 P Austria v European Commission [2020] EU:C:2020:742.
[988] Case T-356/15 Austria v European Commission [2018], para. 84.
[989] Case T-356/15 Austria v European Commission [2018], para. 87.
[990] Case C-594/18 P Austria v European Commission [2020] EU:C:2020:742, para. 101.
[991] Case T-356/15 Austria v European Commission [2018], para. 88, and
Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9307, last access: 28.04.2019.
[992] Case T-356/15 Austria v European Commission [2018], para. 150.

mean that the conditions laid down in Article 107(3)(c) TFEU are not satisfied'.[993] This was upheld by the Court of Justice.[994]

Summary box of case law on proportionality:

Hinkley Point C (case T-356/15 Austria v European Commission [2018]):

- Austria unsuccessfully applied for the annulment of a Commission decision declaring UK aid for support to the UK Hinkley Point C nuclear power station compatible with the internal market. This ruling was later upheld by the CJEU.
- The General Court made clear that the concept of common interest of Article 107 (3) (c) TFEU 'relates to the balance to be struck between the advantages and disadvantages arising from an aid measure, and precludes measures which adversely affect trading conditions to an extent contrary to the common interest from being authorised'. The Court of Justice later endorsed this interpretation of the General Court, meaning that this 'entails weighing up the positive effects of the planned aid for the development of activities that that aid is intended to support and the negative effects that that aid may have on the internal market'.
- The General Court clarified that Article 107 (3) (c) TFEU requires the attainment of a public interest objective, which is appropriate, necessary, and proportionate, i.e. which would not have been attained without the aid, rather than explicitly requiring the existence of a market failure. It elaborated that 'while the existence of a market failure may be a relevant factor for declaring State aid compatible with the internal market, the absence of market failure does not necessarily mean that the conditions laid down in Article 107(3)(c) TFEU are not satisfied'. This was upheld by the Court of Justice. The EU Courts clarified that the decisive point is not the existence of a specific market failure, but the way the aid measure affects market conditions, so that 'Member States must show a divergence between desirable market outcomes and actual market outcomes', evidencing the existence of a market failure is only one way to prove the necessity of the aid.

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Hence, with its judgment in *Hinkley Point C*, the General Court made correctly clear that Member States might justify the compatibility of aid measures 'merely on the grounds that it achieves outcomes not possible or likely under the autonomous decisions of market operators'.[995] Thus, the EU Courts clarified that the decisive point is not the existence of a specific market failure, but the way the aid measure affects market conditions, so that 'Member States must show a divergence between desirable market outcomes and actual market outcomes', evidencing the existence of a market failure is only one way to prove the necessity of the aid. [996] As elaborated

[993] Case T-356/15 Austria v European Commission [2018], para. 151, as well as cases T-162/13 Magic Mountain Kletterhallen v European Commission [2016] EU:T:2016:341, para. 78, 79, and T-92/11 RENV, Andersen v European Commission, para. 69.
[994] Case C-594/18 P Austria v European Commission [2020] EU:C:2020:742, paras. 66, 67.
[995] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 28.04.2019.
[996] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 28.04.2019.

on in section 7.2. of chapter IV, 'desirable market outcomes' may be understood as a broader concept than the purely economic one of market failures, forming part of a 'missiondriven [sic] policy'.[997] Its motivation is 'to address a social challenge or develop a new industry' instead of 'fixing a market or system failure', i.e. 'governments identify a goal considered to be socially desirable (for example, reducing climate change) and design a set of instruments to increase access to finance for innovations aimed at tackling it (for example, clean energy technology)'.[998] In contrast, the more classical justifications for government intervention relate to 'behavioural biases and information gaps', where 'market failures emerge when rational behaviour by market actors leads to a suboptimal market outcome', or 'inefficiencies in the functioning of financial markets'.[999]

Legislation and Commission practice should accordingly rely on the broader concept of the discrepancy between desirable and actual market outcomes rather than on the narrow concept of market failure solely. In this regard, the proportionality principle is central in determining whether an aid measure is compatible or not.

Interestingly, the second principle of the common assessment principles of the Risk Finance Guidelines highlights the existence of a funding gap/market failure to be established on the basis of the ex-ante assessment. In order to render the common assessment principles consistent with the principles of the Courts, risk finance rules may be revised so that Member States must rather demonstrate 'how the aid affects market conditions and that market failure is one way of proving that the aid is needed', i.e. that there is 'a divergence between desirable market outcomes and actual market outcomes', in essence.[1000]

In fact, the argument in favour of the divergence of desirable and actual market outcomes as the relevant reason for intervention appears to be supported in cases relating to Services of General Economic Interest (SGEI) and their Public Service Obligations (PSO). SGEI are meant to provide for 'minimum requirements for a humane existence of its citizens' the market is not able or not willing to provide, as costs are higher than profits, for instance, so that a Member State may

[997] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.
[998] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.
[999] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.
[1000] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 28.04.2019.

impose a PSO on companies alongside financial compensation in order 'to ensure that a previously defined demand will be met'.[1001] However, of course, any support by a Member State 'needs to comply with the prohibition of State aid under Article 107 TFEU', while Article 106 (2) TFEU serves as a basis for reconciliation.[1002] For Article 107 TFEU to be violated, there needs to be an undertaking in accordance with the definition under state aid law, market distortions, and importantly, an advantage under the four criteria of the ***Altmark* case**.[1003]

These criteria lay down under which conditions compensation does not amount to state aid, i.e. if one of the criteria is not met, the compensation will be considered state aid.[1004] Importantly, the first *Altmark* criterion requires inter alia that the SGEI must be clearly defined, i.e. whether the compensated service is of general economic interest.[1005] Hence, the relevance of SGEI for this thesis is: The first *Altmark* criterion may be compared with the second criterion under the compatibility assessment of the Risk Finance Guidelines on the requirement to establish the need for state intervention, i.e. the necessity principle. Thus, by analogy, it is of importance how the EU Courts argue in cases on the first *Altmark* criterion: In defining the SGEI, Member States enjoy a broad scope of discretion.[1006] As it will be elaborated on in the following case reviews, this is in contrast to cases of state aid, where the discrepancy between desirable and actual market outcomes must be assessed, while in the case of SGEI, Member States may decide what services should be provided to citizens – also when the market functions perfectly.

With regard to SGEI, in the case ***RENV, Jorgen Andersen v European Commission*** the General Court first made clear that 'while evidence of market failure may be a relevant factor for declaring state aid compatible with the internal market, such evidence is not an essential condition, for, in any case, a State may justify aid by the pursuit of a legitimate objective in the public interest'.[1007] Therefore, the Court states that Member States possess a wide discretion and may base their

[1001] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.298.
[1002] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.298.
[1003] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, pp.302-323, and Case C-280/00 Altmark Trans GmbH und Regierungspräsidium Magdeburg gegen Nahverkehrsgesellschaft Altmark GmbH [2003] ECR I-7747.
[1004] Phedon Nicolaides, The Scope of Public Service Obligations, http://stateaidhub.eu/blogs/stateaiduncovered/post/7909, last access: 15.12.2019.
[1005] The second Altmark criterion on the parameters on which the compensation is calculated must be read in conjunction with the third and fourth Altmark criteria on necessity (avoidance of overcompensation) and efficiency, respectively, as they must find reflection in the parameters established under the second criterion.
- Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.312.
[1006] Franz Jürgen Säcker and Frank Montag, European State Aid Law – A Commentary, C.H. Beck, 2016, p.312.
[1007] Case T-92/11 RENV, Jorgen Andersen v European Commission [2017] EU:T:2017:14, para. 69.

decision on various reasons to justify the entrustment of undertakings for the performance of public service obligations.[1008] Hence, while the justification to impose PSO is not solely dependent on finding a market failure, the Court does not clarify what these 'various reasons' are.[1009] Instead, the Court *in casu* merely cites 'a desire' of the Member State to improve transport services as a vague and general policy objective.[1010] However, interestingly, the Court does not demand a clarification of the definition of this service, how it may be improved, how an improvement may be measured or defined, nor what the difference is from the services provided by the market.[1011] Thus, it remains 'unclear what kind of justification and what evidence Member States may safely rely on when they impose a PSO…'.[1012]

However, in the case ***SNCM v European Commission***, the General Court made clear that Member States may not rely on the mere existence of a 'general interest' in the broadest sense for justifying a PSO, but must provide evidence of a certain market shortage, if secondary legislation, *in casu* a regulation, is applicable that requires it.[1013] Importantly, however, the Court did not follow the Commission's line of argumentation that the existence of a market failure 'showing a genuine need for public service must be established in every case and every sector in order to satisfy the first *Altmark* criterion'.[1014] Instead, the Court stated that only the Commission is required to accept that the first *Altmark* criterion is met through the establishment of a market failure, if it has bound itself through soft law – Member States are not, but may oppose it to the Commission, while the Commission may not oppose otherwise to the Member State.[1015]

Thus, contrary to the Commission's interpretation of the case *Colt Telecommunications France v Commission*, the first *Altmark* criterion does not contain a market failure requirement in any case,

[1008] Case T-92/11 RENV, Jorgen Andersen v European Commission [2017] EU:T:2017:14, para. 70.
[1009] Phedon Nicolaides, The Scope of Public Service Obligations, http://stateaidhub.eu/blogs/stateaiduncovered/post/7909, last access: 15.12.2019.
[1010] Phedon Nicolaides, The Scope of Public Service Obligations, http://stateaidhub.eu/blogs/stateaiduncovered/post/7909, last access: 15.12.2019.
[1011] Phedon Nicolaides, The Scope of Public Service Obligations, http://stateaidhub.eu/blogs/stateaiduncovered/post/7909, last access: 15.12.2019.
[1012] This is especially the case if the PSO, as it was the case in *RENV, Jorgen Andersen v European Commission*, spans both profitable and unprofitable commercial services or market segments.
- Phedon Nicolaides, The Scope of Public Service Obligations, http://stateaidhub.eu/blogs/stateaiduncovered/post/7909, last access: 15.12.2019.
[1013] Case T-454/13 SNCM v European Commission [2017] ECLI-134, paras. 125 and 133.
[1014] Adrien Giraud, SNCM v Commission: A Largely Pyrrhic Victory for the Commission, European State Aid Law Quarterly, vol. 3, 2017, p.484.
[1015] Adrien Giraud, SNCM v Commission: A Largely Pyrrhic Victory for the Commission, European State Aid Law Quarterly, vol. 3, 2017, p.486.

but only does so for the Commission, if it has bound itself through its soft law, while third parties are not bound and may oppose this to the Commission.[1016] In essence, the Court 'recalled that, by and large and apart from exceptional cases, Member States enjoy a great deal of freedom in the definition of SGEIs and that the Commission can in principle only intervene in the event of a manifest error' and 'confined the market failure test to sectors where pre-existing EU legislation already curb Member States' freedom to define what should constitute a SGEI', refusing to 'allow the Commission to apply this stringent test across the board to every SGEI case'.[1017]

Thus, also in the context of SGEI, the Court emphasises that the decisive point of necessity is the assessment of how the aid measure affects market conditions under the proportionality principle rather than stressing the existence of a market failure in any case, i.e. which impact the measure has on the market in the sense of the divergence between desirable market outcomes and actual market outcomes.

As elaborated on in section 7.2. of chapter IV, 'desirable market outcomes' may be understood as a broader concept than the purely economic one of market failures, forming part of a 'missiondriven [sic] policy'.[1018] Its motivation is 'to address a social challenge or develop a new industry' instead of 'fixing a market or system failure', i.e. 'governments identify a goal considered to be socially desirable (for example, reducing climate change) and design a set of instruments to increase access to finance for innovations aimed at tackling it (for example, clean energy technology)'.[1019]

Hence, this concept is in line with the requirements of the EU Courts: In its judgment '***Hinkley Point C***', the Court stated that 'the appropriateness and necessity of the measures at issue must be assessed in the light of the public interest objective' in question.[1020] Importantly, the Court stated: 'While the existence of a market failure may be a relevant factor for declaring state aid compatible with the internal market, the absence of market failure does not necessarily mean

[1016] Adrien Giraud, SNCM v Commission: A Largely Pyrrhic Victory for the Commission, European State Aid Law Quarterly, vol. 3, 2017, p.486, and
Case T-79/10 Colt Telecommunications France v Commission [2016] ECLI-463, para. 154.
[1017] Adrien Giraud, SNCM v Commission: A Largely Pyrrhic Victory for the Commission, European State Aid Law Quarterly, vol. 3, 2017, p.486.
[1018] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.
[1019] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.
[1020] Case T-356/15 Austria v European Commission [2018], para. 406.

that the conditions laid down in Article 107 (3) (c) TFEU are not satisfied […] For example, state intervention may be considered to be necessary for the purposes of that provision where market forces are not capable by themselves of ensuring that the public interest objective of the Member State is achieved in sufficient time, even if, as such, that market cannot be considered to be failing.'[1021]

By citing inter alia the case law of *RENV, Andersen v Commission* (see above), the Court highlights that 'a Member State can justify its aid merely on the grounds that it achieves outcomes not possible or likely under the autonomous decisions of market operators'. [1022] In the context of financial instruments, for instance, this may relate to the leverage effect of private investment. Therefore, the second principle of the Commission's common assessment principle under the Risk Finance Guidelines may be adjusted in the forthcoming revision of the state aid rules so that Member States must show a 'policy mission driven' divergence between desirable market outcomes and actual market outcomes instead of stressing the purely economic concept of the existence of a market failure.[1023]

With the necessity of the aid established, the Court considered the balancing of the positive and the negative effects of the aid and found that the aid measure had only limited effects on market and trade and rejected the complainants' argument that the Commission failed to take account of the negative effects.[1024] Importantly, the Court agrees with the Commission's approach of merely establishing that the potential negative effects are small or limited vis-à-vis the relevant positive effects rather than requiring it to quantify or weigh any of the effects for the assessment of compatibility.[1025] Hence, in the light of the proportionality principle, this means that the EU Courts require the proportionality test *stricto sensu* for state aid measures. However, despite their wording, the **EU Courts do not require any quantification or actual weighing of potential**

[1021] Case T-356/15 Austria v European Commission [2018], para. 151.
[1022] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, https://www.lexxion.eu/stateaidpost/the-compatibility-of-state-aid-with-the-internal-market-lessons-from-hinkley-point-c-part-ii, last access: 10.10.2020.
[1023] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, https://www.lexxion.eu/stateaidpost/the-compatibility-of-state-aid-with-the-internal-market-lessons-from-hinkley-point-c-part-ii, last access: 10.10.2020.
[1024] Case T-356/15 Austria v European Commission [2018], paras. 467-471.
[1025] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 01.05.2019.

effects – instead, a mere **balancing or juxtaposition of potential positive and negative effects suffices**.

In its judgment ***BMW AG v European Commission***, the General Court reaffirmed the judgment of *Smurfit Kappa* and the importance of the weighing of positive and negative effects on market and competition.[1026] Moreover, it elaborated on the principles of necessity and proportionality: The Court made clear that the two principles are interrelated: '… the reference to the question whether the aid is necessary… refers back to the analysis of the proportionality of the aid', since '… it is impossible to separate those criteria and assess one a priori and the other a posteriori'.[1027] Thus, it is crucial to assess whether there is a correspondence between the extent of the market failure and the amount of aid: '…the principle of proportionality implies that aid in excess of the minimum necessary… must be considered superfluous, because it constituted an unconditional financial subsidy to the aid recipient and served no purpose that would be compatible with the State aid rules'.[1028]

Therefore, the Court refers to the aid intensity – which can, however, not be established in the case of financial instruments lacking identifiable costs: 'In any event, the aid intensity must not go beyond the actual funding gap of the investment project'.[1029] The Court then explains the consequence of the violation of the proportionality principle: '…since the "proportionality" criterion had not been shown as being met… the Commission did not err in law or make a manifest error in finding that this additional aid amount… would have negative, i.e. highly distortive effects on competition, as it might, in particular, discourage competitors to invest in similar product, thus contributing to the crowding out of private investment in the relevant market'.[1030]

Thus, the Court highlights the **interrelation of the principles**, i.e. of **the correspondence between the extent of the market failure and the amount of aid** (principle of necessity) as well as of **the correspondence between the amount of aid and its impact on the market** (balancing of positive and negative effects).

[1026] Case T-671/14, Bayerische Motoren Werke AG v European Commission [2017], paras. 36-41.
[1027] Case T-671/14, Bayerische Motoren Werke AG v European Commission [2017], para. 128.
[1028] Case T-671/14, Bayerische Motoren Werke AG v European Commission [2017], para. 120.
[1029] Case T-671/14, Bayerische Motoren Werke AG v European Commission [2017], para. 125.
[1030] Case T-671/14, Bayerische Motoren Werke AG v European Commission [2017], para. 146.

Interestingly, the Court stated that the Commission was not obliged to analyse any potential additional positive effects, once it found that the proportionality principle was not met: 'In those circumstances, the Commission could assume that there would be a negative effect consisting in a possible distortion of competition and a dissuasive effect for competing private investments, since the aid provides an undue reinforcement of the undertaking's position on the market by allowing it to finance its needs above what is necessary to pursue the stated purposes being to provide an incentive for investment in the assisted region. Therefore, the Commission could rightly find that the aid was incompatible with the single market without analysing potential additional positive effects'.[1031]

However, as it was elaborated with regard to the case *Hinkley Point C* above, for instance, if the aid amount is found to be proportionate, this does not automatically mean that positive effects outweigh negative effects, as the Commission is still required to conduct the balancing exercise in this case.

What is more, if the underlying costs and the aid intensity are not identifiable for applying the proportionality principle, the focus of the assessment may shift to the correspondence between the (maximum) amount of aid and its impact on the market and the balancing of the positive and negative effects. With regard to the analysis of the Commission decisions, the question thus may be posed whether there is a credible correspondence between the extent of the relevant market failure and the amount of aid, i.e. whether the aid is proportionate in accordance with the standards and conditions of the EU Courts, and whether and how, without the quantification of the aid intensity, it may be determined that the positive effects exceed the negative effects.

Moreover, in its judgment '***Hinkley Point C***' cited above, the Court made clear that the Commission is not necessarily required to quantify the precise amount of the gross grant equivalent (GGE) arising from an aid measure, as long as it 'is in a position to conclude that an aid measure is appropriate, necessary, and not disproportionate'.[1032] Thus, the proportionality principle is central in the compatibility assessment of aid measures. Interesting is, however, that 'although numerous provisions of state aid regulations and guidelines and good practice require

[1031] Case T-671/14, Bayerische Motoren Werke AG v European Commission [2017], para. 146.
[1032] Case T-356/15 Austria v European Commission [2018], para. 249.

that the GGE of aid be calculated before it is granted' in order to ensure proportionality, 'it is not always necessary to establish ex ante the GGE as long as there is in place a mechanism that can prevent the granting of unnecessary amounts of aid', which may be the case where the aid is calculated on the basis of a 'funding gap' methodology or on a competitive procedure, for instance.[1033] This makes particular sense in the context of financial instruments, which lack identifiable underlying costs in order to render the necessary and proportionate amount of aid quantifiable.

Summary box of case law on proportionality:

BMW (Case T-671/14, Bayerische Motoren Werke AG v European Commission [2017]):

- The German car manufacturer unsuccessfully applied for the annulment of a Commission decision, which declared the aid amount exceeding EUR 17 million for a production site in Germany to be incompatible with the internal market.
- The General Court reaffirmed the judgment of *Smurfit Kappa* and the importance of the weighing of positive and negative effects on market and competition. The Court also elaborated on the relationship between the proportionality and the necessity principles, which are not separable. Thus, it is crucial to assess if there is a correspondence between the extent of the market failure and the amount of aid.
- The Court elaborated on the consequence of the violation of the proportionality principle: '…since the "proportionality" criterion had not been shown as being met… the Commission did not err in law or make a manifest error in finding that this additional aid amount… would have negative, i.e. highly distortive effects on competition, as it might, in particular, discourage competitors to invest in similar product, thus contributing to the crowding out of private investment in the relevant market'.

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This does not hold true with regard to guarantees, however. In its judgment ***HH Ferries et al v Commission***, the General Court annulled a Commission decision concerning the aid measures *SA.36558*, *SA.38371*, and *SA.36662* and made clear that 'state aid embedded in guarantees must be quantifiable so that its necessity and proportionality can be assessed'.[1034]

Firstly, the Court observed that 'the grant of a guarantee on terms which are not equivalent to market terms, such as an unlimited guarantee granted without consideration, is, as a rule, liable

[1033] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 28.04.2019.
[1034] Case T-68/15 HH Ferries et al v European Commission [2018],
and Phedon Nicolaides, Unconditional and Unlimited Guarantees and their (In)Compatibility with the Internal Market, http://stateaidhub.eu/blogs/stateaiduncovered/post/9349, last access: 01.05.2019.

to confer an advantage on the beneficiary, in that that party thereby enjoys an improvement in its financial position through a reduction in charges which would normally burden its budget' and that 'an unlimited State guarantee enables its beneficiary, inter alia, to obtain more favourable credit terms than it would have obtained solely on its own merits and, therefore, eases the pressure on its budget'.[1035]

In casu, the Court found that 'the contested decision has no details as to any limit on the total amount of borrowing that can theoretically be covered by the State guarantees' and that 'it was not known exactly when that debt would be repaid', so that it was not sufficiently clear from the contested decision that the […] debt is limited in time and in amount'.[1036] Therefore, the Court found that the examination by the Commission was insufficient and incomplete and should have considered whether the aid contained in the guarantees was limited in time and in amount.[1037]

Thus, the Court made clear that the aid element of guarantees must be limited in time and in amount in order to be considered proportionate. As it is analysed in detail in chapter V on the application of the market economy investor principle to guarantees, the Commission decisions are in line with that requirement, as the Commission puts the focus on this very limiting of the aid element.

Furthermore, the Court observed that the aid must contribute to the attainment of one of the objectives specified in Article 107 (3) TFEU and that the knowledge of how to determine the aid element is a prerequisite for assessing whether the aid is necessary and proportionate.[1038] Thereby, the assessment of proportionality 'implies verification whether that aid is limited to the minimum necessary to achieve the objectives' and therefore 'implies knowledge of how to calculate the aid element in advance'.[1039] Hence, the Commission is required to specify the method of calculation it applies in its assessment of the compatibility of the aid.[1040] For cases where the quantification of the aid element is difficult or presumably impossible, the Court referred to point 4.4 of the 2008 Notice on Guarantees and stated 'that there are methods for

[1035] Case T-68/15 HH Ferries et al v European Commission [2018], para. 120.
[1036] Case T-68/15 HH Ferries et al v European Commission [2018], paras. 127-129.
[1037] Case T-68/15 HH Ferries et al v European Commission [2018], para. 137.
[1038] Case T-68/15 HH Ferries et al v European Commission [2018], paras. 143, 149.
[1039] Case T-68/15 HH Ferries et al v European Commission [2018], para. 150.
[1040] Case T-68/15 HH Ferries et al v European Commission [2018], para. 158.

calculating an aid element in the context of guarantee schemes, where the characteristics of each guaranteed loan are not known in advance' (see also chapter V).[1041]

Moreover, the Court found that the Commission's assessment of the necessity of the aid was insufficient and incomplete due to 'the lack of any quantification of the aid linked to the State guarantees', 'the lack of any sufficiently precise limitation on the aid linked to the State guarantees in terms of its amount and in terms of time', and the lack of examination 'whether the same result could have been achieved by requiring less aid, for example, by introducing a form of limited guarantee premium, by limiting the guarantees to cover less than 100% of the amount of each loan covered, by limiting the duration of the State guarantees, or by verifying whether the extent of the aid was limited to the minimum necessary'.[1042]

Summary box of case law on proportionality:

HH Ferries v Commission (T-68/15 HH Ferries et al v European Commission [2018]):

- HH Ferries, a privately held Danish and Swedish joint venture, successfully applied for annulment of a Commission decision that had not raised objection to a tax aid and a state guarantee by Denmark and Sweden in favour of a road and railway link consortium.
- The Court held that state aid embedded in guarantees must be quantifiable so that its necessity and proportionality can be assessed. Thus, for its compatibility assessment, the Commission is required to examine whether the aid contained therein is limited in terms of time and amount, and to provide a method for determining the aid element: 'the assessment of the proportionality of aid implies verification whether the aid is limited to the minimum necessary to achieve its objectives… which implies knowledge of the extent, to which the aid is necessary… and therefore knowledge of how to calculate the aid element in advance'.
- The Court found that 'the contested decision has no details as to any limit on the total amount of borrowing that can theoretically be covered by the State guarantees' and that 'it was not known exactly when that debt would be repaid', so that it was not sufficiently clear from the contested decision that the […] debt is limited in time and in amount'. Therefore, the Court found that the examination by the Commission was insufficient and incomplete.

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In sum, the following **important conclusions on the three different and interrelated principles** may be drawn from the cases of the EU Courts discussed. Firstly, the Commission is **required to balance the positive against the negative effects of aid measures** in order to assess whether market distortions remain minimised in the light of the relevant objective. This means that the EU Courts require the proportionality test *stricto sensu* for state aid measures, but understand it

[1041] Case T-68/15 HH Ferries et al v European Commission [2018], para. 163.
[1042] Case T-68/15 HH Ferries et al v European Commission [2018], para. 188.

as a balancing or juxtaposition of positive and negative effects rather than their actual weighing or quantification. The Commission must assess whether there is a **credible correspondence between the amount of aid and the impact on the market** rather than merely stating that the negative effects remain limited.

However, no further assessment of positive effects is required, if the aid amount is already found not to be proportionate, so that the negative effects will outweigh any positive effects. The assessment of this correspondence may be of particular importance for financial instruments, as they lack identifiable costs and calculable aid intensities for their proportionality assessment.

Secondly, instead of the presence of a particular market failure, **the divergence between desirable market outcomes and actual market outcomes** must be proven in order to show **that the aid measure is necessary**.

Thirdly, the aid must not necessarily be quantified, as long as it is considered appropriate, necessary, and not disproportionate. Therefore, it must be assessed whether there is a **credible correspondence between the extent of the market failure/the gap of the actual and the desirable market outcome and the amount of aid**.

In the case of guarantees, next to the credible correspondence between the market imperfection and the amount of aid as well as between the amount of aid and its impact on the market, the Commission must assess **whether the guarantee is limited in time and in amount as well as the calculation method of the aid element** (see also chapter V for further discussion).

In the following, these interpretations of the principles by the EU Courts will serve as a benchmark as to whether the Commission's compatibility assessment in its decisions deviates from them.

Table 2: Overview of the statements and requirements of the EU Courts on proportionality

Case	Principle and Relevance
Smurfit Kappa	The Commission is required to conduct an in-depth assessment in all those cases, where the positive effects of an aid measure clearly do not outweigh the potential negative effects, even though thresholds laid down in Guidelines are not exceeded. The Commission is required to exercise its wide discretion under Article 107 (3) TFEU (then Article 87 (3) EC) in order to ascertain whether the expected benefits outweigh distortions of competition and the impact of the measure on trade between Member States for the assessment of the measure's compatibility with the internal market (**Weighing of positive and negative effects**)
Hinkley Point C	The Court clarifies that the decisive point is not the existence of a specific market failure, but the way the aid measure affects market conditions, so that 'Member States must show a divergence between desirable market outcomes and actual market outcomes'. (**Principle of necessity)** 'The appropriateness and necessity of the measures at issue must be assessed in the light of the public interest objective'. The Court made clear that the Commission is not necessarily required to quantify the precise amount of the gross grant equivalent (GGE) arising from an aid measure, as long as it 'is in a position to conclude that an aid measure is appropriate, necessary, and not disproportionate'. (**Principles of necessity and proportionality**)
Altmark	The first Altmark criterion requires inter alia that the SGEI must be clearly defined, i.e. whether the compensated service is of general economic interest. (**Principle of necessity**)
RENV, Jorgen Andersen v European Commission	'While evidence of market failure may be a relevant factor for declaring state aid compatible with the internal market, such evidence is not an essential condition, for, in any case, a State may justify aid by the pursuit of a legitimate objective in the public interest.' (**Principle of necessity**)
SNCM v European Commission	The first Altmark criterion does not contain a market failure requirement in any case, but only does so for the Commission if it has bound itself through its soft law, while third parties are not bound and may oppose this to the Commission. (**Principle of necessity**)

BMW AG v European Commission	The Court highlights the relation of the principles, i.e. of the correspondence between the extent of the market failure and the amount of aid (**principles of necessity**) as well as of the correspondence between the amount of aid and its impact on the market. (**Principle of weighing positive and negative effects**) The Court stated that the Commission was not obliged to analyse any potential additional positive effects, once it found that the proportionality principle was not met. However, if the underlying costs and the aid intensity are not identifiable for assessing the proportionality principle, the focus of the assessment may shift to the correspondence between the (maximum) amount of aid and its impact on the market and the weighing of the positive and negative effects. (**Principles of necessity and of weighing positive and negative effects**).
HH Ferries et al v Commission	For guarantees, the assessment of proportionality 'implies verification whether that aid is limited to the minimum necessary to achieve the objectives' and therefore 'implies knowledge of how to calculate the aid element in advance'. Hence, the Commission is required to specify the method of calculation it applies in its assessment of the compatibility of the aid. For cases where the quantification of the aid element is difficult or presumably impossible, the Court referred to the Notice on Guarantees and its methods for calculating an aid element in guarantee schemes. (**Principle of necessity**) The Court found that the Commission's assessment of the necessity of the aid was insufficient and incomplete due to 'the lack of any quantification of the aid linked to the State guarantees', 'the lack of any sufficiently precise limitation on the aid linked to the State guarantees in terms of its amount and in terms of time', and the lack of examination 'whether the same result could have been achieved by requiring less aid, for example, by introducing a form of limited guarantee premium, by limiting the guarantees to cover less than 100% of the amount of each loan covered, by limiting the duration of the State guarantees, or by verifying whether the extent of the aid was limited to the minimum necessary'. (**Principle of necessity**)

Source: author

2. The compatibility assessment of the Commission in its decisions on Financial Instruments

In the following, Commission decisions will be summarised and compared with the interpretation of the principles by the EU Courts. The decisions analysed were selected from a plethora of decisions on financial instruments based on their extensive compatibility assessment. Moreover, they were selected based on their recent publication, so that the current Risk Finance Guidelines and their compatibility assessment applied, except for Commission decision SA.34660. The latter was selected as it lends itself as a textbook example for the Commission's approach to guarantees in specific as well as to the compatibility assessment during the 2007-2013 programme period in general.

Thus, these decisions will be analysed as to whether the Commission's approach to the compatibility assessment of risk finance aid is consistent with or deviates from the EU Courts' requirements of the proportionality principle for state aid law.

2.1. Commission decision SA.46308 (2016/N) – Germany: INVEST – Direct grants for risk capital investments

Commission decision *SA.46308* regarded a German aid scheme in the form of acquisition and exit grants, i.e. direct grants 'provided to natural persons who acquire in their own name, on their own behalf and at their own expense, ordinary, fully risk-bearing equity shares, newly issued by investee companies through capital increase'.[1043] Grants amount to '20 per cent of the acquisition costs (issue price, including any premiums paid)' and are 'reimbursable if the shares are not held for a minimum period of three years'. Under certain conditions, 'the shares may also be acquired through the conversion of convertible loans'. Eligible investors under the scheme are 'exclusively natural persons… who do not already hold, either directly or indirectly, shares in the company, who are not related to the investee company… and did not conclude any forward agreements, which would oblige a third party to re-purchase the investors' equity shares at a later stage.

[1043] Aid No. SA.46308, Commission decision, 25.08.2016.

In its assessment as to the existence of state aid to investors, the Commission quickly came to the conclusion that the acquisition and exit grants are financed from state resources and imputable to the state as well as that private investors obtain an advantage in the form of a reduction of costs for the undertaken investment through the aid. Moreover, since direct grants are only provided to certain private investors investing into specified target undertakings, the measure at the level of investors is selective. Since benefitting investors compete with other investors on the market for company shares and since the market is open to trade between Member States, the aid may distort or threaten to distort competition and trade. Thus, the Commission found that the measure would qualify as state aid to the investors, if the recipients of the aid qualified as undertakings.

Importantly, the German authorities regarded natural persons as not pursuing an economic activity and thus not as undertakings. Therefore, the German authorities referred to recital 16 of the Commission Notice on the Notion of State Aid insofar as the mere shareholding by an entity, even majority shareholding, in an undertaking did not mean that that entity should automatically be considered an undertaking in the sense of Article 107 (1) TFEU.[1044] Since this shareholding gave rise to exercise rights and the receipt of dividends as the status of a shareholder and the fruits of ownership of an asset, the entity would not be considered an undertaking, if it did not provide goods or services on a market, according to the Notice.

However, interestingly, the Commission did not follow this interpretation of its own Notice and found an exception for natural persons in their capacity as **business angels**: As the risk of failure of business angel investments is high, they imply a substantive due diligence and appropriate portfolio risk management strategies, and as 'business angels normally take an active role in supporting the investee company', 'the Commission… considers that it cannot exclude that the activities of some of the business angels benefitting from the scheme, even if they are not registered as business angel undertakings with a sole shareholder, have a professional quality, and go beyond the normal activity of a normal shareholder'. Thus, it found that 'it cannot exclude that some of the natural persons pursuing business angel activities would qualify as undertakings'. This means that natural persons in the capacity of business angels may be considered undertakings by the Commission, if they have a professional quality, i.e. by applying an active

[1044] Commission Notice on the notion of State aid as referred to in Article 107 (1) TFEU, 2016/C, 262/01.

role, due diligence, and risk management strategies, going beyond the activities of normal shareholders.[1045] For the compatibility assessment under the Risk Finance Guidelines in these cases, the Commission will regard such natural persons pursuing economic activities qualifying to be undertakings as 'corporate investors' under the Risk Finance Guidelines.[1046]

With regard to state aid to the target undertakings, the Commission quickly found that all the criteria of Article 107 (1) TFEU were fulfilled so that state aid is involved. The Commission held that the measure constituted a risk finance measure and had to be assessed on the basis of the Risk Finance Guidelines, as it provides incentives to private investors 'for leveraging more private capital onto the risk capital market'. Thus, it found that the requirements of section 2 of the Risk Finance Guidelines are met, since risk finance to companies listed on the official list of a stock exchange or a regulated market is excluded under the scheme, and since the requirements of the minimum involvement of private investors, the exclusion of buy-outs, and the exclusion of companies in difficulty and of those having received illegal unrecovered state aid are met.

Then the Commission carried out the **compatibility assessment**, starting with the assessment of the **contribution to a common objective** under point 3.5.1. As the EU Courts made clear, not the existence of a specific market failure is decisive, but the way the aid measure affects market conditions, so that 'Member States must show a divergence between desirable market outcomes and actual market outcomes'.[1047] However, this is not what the Commission does, but it bases its reasoning merely on the presence of a market failure (see point 3.5.2 and below), although stating under point 3.5.1 objectives of desirable market outcomes: These are, to improve the access for young, innovative companies to risk capital, to attract more people with a business mind-set for risky investments in young undertakings, and to motivate business angels who have invested before to invest more often and more risk capital in young, innovative undertakings. Importantly, although being related to a presumed market failure, these objectives do go beyond it in the sense of the 'policy driven' concept of desirable market outcomes (see above). This is the case since the objectives in question may be fostered also on a perfectly functioning market and rather strive to address the divergence of the actual and the desirable market outcome, e.g. due to the

[1045] Aid No. SA.46308, Commission decision, 25.08.2016, para. 24.
[1046] Aid No. SA.46308, Commission decision, 25.08.2016, para. 55, footnote 21.
[1047] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 20.02.2019.

lack of innovative start-ups, through fostering the conditions for a growing internal equity market.[1048]

The Commission, however, justifies the need for state intervention solely on a market failure under point 3.5.2, recital (51) to the exclusion of any other justification: It recognises that there is a funding gap larger than GBP 10-15 million per year gap and, on the basis of an evaluation, a specific market failure in the area of the provision of risk capital by business angels in Germany. Contrary to what the EU Courts demand, the Commission does not undertake an assessment on the correspondence between the extent of the market failure (let alone in quantitative terms) and the (maximum) amount of the aid. There is no discussion on the extent of the funding gap. The question remains whether the Commission would find risk finance up to EUR 15 million, as the Risk Finance Guidelines allow, justifiable if the funding gap were merely EUR 1.5 million.

This holds also true with regard to the assessment of the **incentive effect of the aid** under point 3.5.4, which refers to recitals 131 and 132 of the Risk Finance Guidelines. These recitals concern the incentive or leverage effect on private investors in order to address the market failure. Interestingly, according to recital 132 of the Guidelines, the Commission appears to be automatically content that the incentive effect is present, if the market failure has been identified and the measure's appropriateness demonstrated. In other words, the Commission's compatibility assessment rests strongly on the demonstration of a market failure, out of which the following assessment criteria follow quasi automatically. With regard to the demands of the EU Courts under the proportionality principle, the evidence of a market failure may suffice for establishing necessity, but it does not suffice for establishing complete proportionality of the measure. There would have to be a discussion of the amount of the aid and its relation to both the need of final recipients and the impact on the market in terms of the proportionality test *stricto sensu*.

This is also demonstrated by the Commission's approach to the assessment of the appropriateness of the aid measure under point 3.5.3, which also implies **questions related to the correspondence between the extent of the market failure and the amount of aid**, on the one hand, **and between the amount of aid and the impact on the market**, on the other, i.e.

[1048] Vincent Verouden et al., EU State Aid Control: Law and Economics, Kluwer Law International, 2017, p. 389.

whether the selected measure is considered appropriate in relation to them. The Commission merely finds that the measures chosen, i.e. fiscal incentives targeted at investors who are natural person and acquisition and exit grants, are appropriate by referring to recitals 120, 122-124, and 126 of the Risk Finance Guidelines (recitals 52-58). Instead of a specific or detailed assessment of the amount of aid and its correspondence with the parameters of market failure and market impact, however, for the Commission it suffices that specific amount/percentage limits (recital 57) as well as screening methods, such as the selection and eligibility of undertakings (recital 59) and the non-discrimination of investors, were adhered to by Member State authorities.

Thus, regarding the impact on the market, the Commission acknowledges the German authorities' elaboration on the advantages of grants over tax measures in terms of being more targeted and less intrusive under the recitals (54) and (55). Interestingly, however, it acknowledges this elaboration, although the latter concerns mainly the impact on administration and the tax system rather than the very impact on the market and the economy and states that the economic effect of both grants and tax relief was 'quasi identical'.

With regard to the amount of the aid, the Commission appears to be content with acknowledging in recital (59) that the publicity requirements on 'ceilings and caps defining the maximum advantage that each individual investor may draw from the measure, as well as the maximum investment amount which can be made in individual eligible undertakings' is adhered to. However, it does neither analyse the overall amount of the aid nor the specific caps or ceilings per final recipient and their correspondence with the impact on the market. Finally, the Commission appears to be content with the elaborations on the incentive effect 'to stimulate access to finance' of the instrument and on the instrument's 'being least distortive for competition' under recital (63). This is a strong indication that the Commission does not follow the demands under the EU Courts' principles, but rests its assessment on the mere risk finance measure's adherence to the maximum caps and ceilings and screening methods (e.g. the selection of eligible undertakings), implying that this would automatically lead to the addressing of the market failure and the preventing of market distortions.

The Commission's assessment of **proportionality** of the aid under point 3.5.5 also concerns the correspondence between the market failure and the amount of aid, on the one hand, and

between the amount of aid and the impact on the market on the other. This is made clear under recital 133 of the Risk Finance Guidelines: 'state aid must be proportionate in relation to the market failure being addressed in order to achieve the relevant policy objectives' (as stated, relevant policy objectives in *casu* concern first and foremost the addressing of the market failure) and 'aid must be limited to the strict minimum necessary to attract funding from the market to close the identified gap, without generating undue advantages'. With regard to the amount of aid, the Commission again acknowledges the limits on the incentives to private investors in form of caps under recital (69) and the limit on the maximum amount of the total investment under recitals (71) and (72). However, again, it does not follow the EU Courts' requirements and omits elaborating on the relation of these limits to the impact on the market.

The balancing test is supposed to be found in the assessment of the **avoidance of undue negative effects** on competition and trade under point 3.5.6. However, rather than balancing positive and negative effects in substance, as the EU Courts require, the Commission appears to use a mere checklist of whether potential negative effects were considered and may be avoided, i.e. as it does with regard to the correspondence between the market failure, the amount of aid, and the impact on the market, it pursues a formalistic rather than a true effects-based approach.

For instance, the Commission merely acknowledges that 'there is no risk of crowding out private investment', that German authorities 'are not involved in the investment decisions of the private investors and have placed no limits as to the place of establishment of the targeted investee companies', and that 'the investment decisions are entirely left to the market and the selection of investments is based on commercial logic' under recital 79. In its 'checklist', it also acknowledges that aid to investee companies 'is unlikely to contribute to the creation or maintenance of dominant market positions' or inefficient market structures and sums up that 'in view of the size… and of the limited advantage resulting from the scheme for individual investee companies, the measure is unlikely to have a significantly distorting effect on competition' as well as on trade.

This is a grave omission, since the EU Courts do require a balancing exercise of the positive and negative effects on the market for assessing whether market distortions are minimised, which

may be done through a juxtaposition of positive and negative effects rather than an actual quantification or weighing of the effects (see the case *Hinkley Point C* discussed above).

Although not having matched the positive effects with the negative effects and not having truly balanced them against each other, let alone analysed any unnecessary economic effects, the Commission appears to be content with the fulfilment of its 'checklist' and hence finds that the measure 'is designed in a way to limit the distortion of competition and minimise undue advantages, and that its positive effects outweigh any potential negative effects on competition' (recital 81). Thus, rather than analysing the favourable and the less favourable effects on the market and their balance, the Commission provides a list of how the negative effects would be minimised through the features of the scheme. This is not what the EU Courts require: Instead of the mere checking of a list of means apt to minimise market distortions, the EU Courts require the Commission to conduct a balancing of positive and negative effects, 'taking into account the magnitude of such effects', as the Commission's own Risk Finance Guidelines stipulate in recital (65).

In sum, apart from being relevant for the assessment of natural private investors as 'undertakings' in the form of business angels under certain conditions demonstrating a 'professional quality', this Commission decision proves strong omissions and does not follow the requirements of the EU Courts under the proportionality principle, including necessity and the balancing of positive and negative effects. Importantly, rather than being an effects-based analysis, the Commission's compatibility assessment is centred on the concept of market failure rather taking into account market imperfections. It appears to use a formalistic 'checklist' rather than assessing a credible correspondence between the market failure, the amount of aid, and the impact on the market as well as the potential negative effects. Instead of discussing and balancing the positive and negative effects, as the EU Courts do require, the Commission appears to centre its compatibility assessment on the question of whether the maximum ceilings of aid are adhered to, i.e. so that negative potential effects would be minimised through the minimisation of the amount of aid, and on a 'checklist' of screening methods and market mechanisms apt to minimise distortive effects.

2.2. Commission decision SA.48840 (2018/N) – Austria Risk Capital Premium Scheme

Decision *SA.48840* concerned an Austrian risk capital scheme, which was modelled on the German INVEST programme of decision *SA.46308* mentioned above due to the similar 'business angel situations' in Germany and Austria.[1049] Thus, it also covered direct grants in the form of acquisition grants amounting to 20 per cent of acquisition costs and private persons and legal persons as eligible investors. With regard to state aid to investors, the Commission followed its reasoning of decision SA.46308 that 'natural persons pursuing **business angel activities would qualify as undertakings**' receiving state aid. This held also true for target undertakings, according to the Commission, so that it found that all criteria of Article 107 (1) TFEU were fulfilled.

After it had found that the requirements of Section 2 of the Risk Finance Guidelines (i.e. exclusion of risk finance to companies listed on the official list of a stock exchange or regulated market, minimum involvement of private investors, exclusion of buy-outs, and exclusion of companies in difficulties and that have received unrecovered illegal state aid) were met, the Commission conducted the **compatibility assessment**. With regard to the measure's **contribution to a common objective**, the Commission repeats and approves of the very same objectives, which are based on the existence of a market failure, as it did in its decision on the German business angels scheme (see recitals 41-43).

This is also the case for the assessment of the **need for state intervention**, where the Commission acknowledges and relies on the ex-ante assessment demonstrating the existence of a market failure under recital 45 and the Austrian authorities' reliance on the features of the German business angels scheme. It does not discuss any objectives other than those based on the market failure. Contrary to what the EU Courts demand, the Commission omits any discussion on actual market outcomes and desirable market outcomes and rests the assessment on the common objective, necessity, and the appropriateness of the measure again with regard the existence of a market failure only.

Regarding the **appropriateness** of the measure, as it did in its German decision elaborated above and referring to the relevant recitals of the Risk Finance Guidelines, the Commission does not

[1049] Aid No. SA.48840, Commission decision, 01.08.2017.

discuss the details of the amount of the aid and its correspondence with the extent of the market failure or the impact on the market, but rather mentions formalistically that grants were less intrusive and more targeted, as well as the specific limits, the maximum percentage of the invested amount that an investor may claim, the maximum amount an investor may receive per year, and the non-active role of the Member State in the selection of eligible target undertakings (recitals 52-54). Again, the Commission rests its compatibility assessment on the adherence of the ceiling rules and the logic that if the amount of aid is minimised, then distortive effects must be minimised automatically, too. Interestingly, the Commission assesses this compatibility criterion even less detailed and more formalistic than in its decision on the German business angel scheme, concluding 'that the acquisition grant complies with the conditions of Section 3.4 of the Risk Finance Guidelines and, therefore, is considered appropriate to stimulate access to finance for the target investments' (recital 55).

Moreover, the Commission conducts the assessment of the **incentive effect** criterion as formalistic as in its decision on the German business scheme: based on the presumed existence of a market failure, the Commission merely refers to the ex-ante evaluation showing that private investments would not, or to a lesser extent, take place, as well as to 'similar studies for the German early stage equity market' under recital 57. However, it does neither elaborate on nor discuss either of these documents.

With regard to the **proportionality** criterion, there would have to be a discussion of the amount of the aid and its relation to both the market failure/the need of final recipients and the impact on the market. However, again, the Commission does not elaborate on the amount of the aid and its correspondence with the market failure, the need of final recipients, and the impact on the market in terms of concrete effects, but rather refers in a formalistic way to the limits of the aid amount and the caps and overall ceiling, which are deemed to be in accordance with the requirements of the Risk Finance Guidelines: The Commission merely states in recital (67) that 'at the level of the target undertakings, the overall ceiling on the total amount of risk finance investment into the eligible undertakings is below the funding gap identified by the Austrian authorities', and in recital (65), that at the level of investors, 'as submitted in the notification, total investment for each beneficiary undertaking may not exceed the maximum amount of EUR 15 million'.

At this point, however, the discussion on the maximum amount of the aid and its correspondence with both the need of final recipients and the extent of the market failure should have been conducted, as the EU Courts require it: Rather than formalistically checking whether ceilings are adhered to, the Commission should elaborate on the amount of the aid in question, as it does make a difference regarding its impact on the market whether EUR 1.5 million or EUR 15 million are granted per undertaking. However, the Commission appears to rely on the logic that the minimisation of the aid amount leads to the minimisation of distortive effects.

Neither does it conduct a balancing exercise of the advantages and disadvantages of the aid in its assessment of the criterion on the avoidance of undue negative effects on competition and trade in the sense of the proportionality test *stricto sensu*. Rather, in a formalistic and even less detailed way than in its decision on the German business angel scheme, the Commission merely appears to list how potential negative effects on the markets are minimised through screening methods (e.g. limiting the aid amount through ceilings or non-involvement of the Austrian authorities in investment decisions).

In sum, the approach of the Commission in this decision thus follows its approach in its previous decision *SA.46308* on the German business angel scheme with regard to both the definition of business angels as undertakings as well as the formalistic rather than effects-based compatibility assessment and its reliance on ceilings, implying that the minimisation of the amount of aid minimises distortive effects. Thus, it fails to conduct the compatibility assessment in accordance with the requirements of the EU Courts' interpretation of the proportionality principle, including necessity and balancing of positive and negative effects of the state aid measure. Moreover, it relies on the evidence of a market failure instead of discussing any divergence between desirable and actual market outcomes, as the EU Courts require.

2.3. Commission decision SA.34660 (2012/N) – The Netherlands. JESSICA Urban-development Funds The Hague and Rotterdam

It is worth analysing the Commission decision *SA.34660* on the Dutch JESSICA urban development funds, as it lends itself as a textbook example for the Commission's approach to guarantees in

specific as well as to the compatibility assessment during the 2007-2013 programme period in general.[1050] This decision concerned several Dutch urban development aid funds under the JESSICA initiative of the Commission in the form of loans, equity, and guarantees.

The Commission established that all conditions of Article 107 (1) TFEU were met and state aid present. It found that no advantage was present at the levels of the state bodies and the management authorities, as it acknowledged that they were selected through an open tender procedure. However, the Commission held that private investors at the level of both the urban development funds and the urban development projects received advantages.

With regard to private investors at the level of urban development funds, although the Commission found positively that they would be invited by a transparent public procedure and that public and private investments would be made at the same conditions, it also noted in recital 208 that the Dutch authorities could 'neither guarantee that at least 50 per cent of the funding' of the schemes would 'be provided by private investors at the same conditions as the public investors do', nor that all these private investors would 'be independent from the companies in which they invest'. Thus, it concluded that not all conditions of the market economy investor principle were satisfied.

With regard to private investors at the level of urban development projects, the Commission highlighted the possibilities that, next to potential provision of preferential sub-commercial loans and guarantees, private investors may benefit from higher profit options by urban development funds and that the latter may accept higher risks of losses in favour of private investors. Thus, the Commission stresses the elements of the market economy investor principle and states examples of how these may be violated. Hence, it found in recital 210 that 'private investors will be in a position that is economically advantageous compared with normal market conditions in the absence of state intervention, where co-investment would normally be carried out at identical, pari passu conditions for all investors and where… preferential equity instruments, sub-commercial loans and guarantees would not be available'.

[1050] Aid No. SA.34660, Commission decision, 16.04.2012.

Interestingly, the Commission states that it had assessed whether the establishment of the fair rate of return (FRR), which 'reflects the required return that a project promoter and/or any other investor require while also reflecting the level of risk proposed by the project and the level of capital they plan to invest' (see recital 75), by a competitive process or by using an independent expert would exclude the existence of a selective advantage. However, since there were numerous eligibility criteria other than the FRR and since the managers of the urban development funds had discretion in the selection and structuring of the urban development projects, the Commission nonetheless found preferential investment conditions and thus the conferring of a selective advantage. However, the Commission cited the FRR as an important element to limit the distortive effects on the market in its following assessment, which is in line with the EU Courts' requirements of stating a method of quantification under the principles of necessity and proportionality in the case *HH Ferries*. With regard to the urban development projects, the Commission found that they might be recipients of state aid as legal entities of their own.

The Commission states that 'no existing secondary state aid legislation would provide urban development funds with a uniform set of compatibility conditions for state aid compliance' and at the same time that 'no existing EU legislation prevents the notified measure from being assessed directly under Article 107 (3) (c) TFEU' in recitals 225 and 226. Thus, it conducts the compatibility assessment pursuant to Article 107 (3) (c) TFEU (to facilitate the development of certain economic activities or of certain economic areas) and analogous to the then applicable Risk Capital Guidelines, evaluating and balancing the positive and negative aspects of the aid. However, as will be explained in the following, the Commission lists rather than evaluates, let alone weighs or balances, means to limit market distortions and potential negative effects of the aid in its assessment.

Firstly, and importantly, in this case the **objective of common interest** is not a market failure as such, but the 'physical, economic and social regeneration of urban areas', which is, however, connected 'sub-commercial conditions to private investors with a view to achieving market-efficiency and equity objectives' (recitals 230 and 232). Thus, the reason for intervention appears to be that a certain level of urban development ought to be achieved, which the market itself cannot deliver. This is a good example of the difference between a market outcome that is desirable and actual market outcomes.

Secondly, with regard to the **appropriateness** criterion, the Commission assessed other policy options that might have been less distortive to competition. Thereby, it found in recital 238 that 'public funds can act as a catalyst to leverage additional funding to finance urban development investments' and emphasised in recital 241 that 'the notified measure includes numerous components aimed at maximising the participation of private investment and professional expertise, while at the same time limiting state aid to a minimum by the FRR criterion in combination with the commercial management of the urban development funds'.

Importantly, the Commission mainly refers to elements of the market economy investor principle in the form of the FRR and the commercial management of the funds in finding that the measure is apt to achieve the common interest goal and to minimise distortive effects. The Commission thus rather briefly alludes to the trade-off between maximising (social) returns and minimising distortions. However, at this point, it does neither refer to any quantitative criteria nor weigh the positive against the negative effects of the aid measure. Therefore, the Commission appears to take into account the quantification of the aid amount through the FRR, which the principles of proportionality and necessity require as stated in the case of *HH Ferries*. However, it appears to omit the requirement of balancing the positive and negative effects and instead uses a checklist of indicators hinting at commercial management.

The Commission then rather extensively assesses the measures' suitability to address efficiency objectives under the aspect of market failures due to externalities, information asymmetries and risk aversion, as well as transaction and agency costs. Thus, it emphasises the meaning of market failures in its assessment under the appropriateness criterion. With regard to externalities as a cause of market failures, the Commission states exclusively positive effects in relation to both positive (e.g. revitalisation of public spaces) and negative (e.g. pollution) externalities, in particular citing the facilitation of favourable investment conditions to attract more private investment in favour of more energy efficiency and reduced pollution. However, it does not discuss any negative effects with regard to the aid measure's objectives.

With regard to information asymmetries and risk aversion as well as transaction and agency costs, the Commission again exclusively finds positive effects (e.g. create long term value and help

address investors' negative perception of regeneration areas, provide feasibility from an economic, social, and technical point due to professional project appraisal, greater long term investment opportunities and risk diversification due to the specific portfolio approach, as well as economies of scale).

At this point, no potential negative effects, such as partial crowding out private investment or gentrification with social drawbacks, for instance, are mentioned, let alone discussed. This may be due to the Commission's previous assessment that elements of the market economy investor principle are included in the aid measure, and its assumption that 'numerous components' aim at maximising private participation and expertise, while 'limiting state aid to a minimum'. The Commission continues to refer to these elements limiting distortive effects in its following assessment. In line with the decisions analysed above, this mere referencing is evidence that the Commission does not have any tools at its disposal to assess potential negative effects, such as the loss of market share by competitors, and therefore rests its assessment on the minimisation of the aid amount as well as on checking a list of screening methods (such as ceilings and selection mechanism) and of positive elements.

Thereafter, the Commission discusses the **suitability** of the measure to address equity objectives referring to the Community Strategic Guidelines on Cohesion 2007-2013 and evaluation studies for The Hague and Rotterdam. Based thereupon and on the Operational Programme 2007-2013, to which the Dutch authorities refer and which covers socio-economic problems in deprived urban areas, the Commission finds that the measure is suitable to address the equity objectives.

With regard to the **incentive effect**, the Commission finds, firstly, that the beneficiary was required under the measure's conditions to submit an application for the aid prior to the start of the project. Secondly and importantly, with regard to the necessity test, the Commission quickly states in recitals 256 and 257 that 'the investment would not have been implemented by the market on its own because of the fairly low expected financial return and the relatively high risk of investing in such areas', while the 'necessity test applied under the measure is designed to show that the urban development projects with an IRR [the internal rate of return, i.e. the commercial potential and earning capacity] below the FRR would not be carried out by the market

(counter-factual scenario) or, at least, the investments would not take place to the same extent and in the same timeframe'.

Thus, at least in quantitative terms, the Commission bases the necessity of the aid on the FRR, as required for guarantees by the EU Courts (see also chapter V on the MEIP), and does not merely argue formalistically. However, strikingly, as in its decisions of the 2014-2020 programme period discussed above, the Commission does not assess the total amount of the aid and its correspondence with the extent of the market failure or the impact on the market. Nor does it refer to any objectives based on the divergence between desirable and actual market outcomes, but to the existence of a market failure in the context of necessity. Moreover, the Commission considers it positively that fund managers 'will carry out a professional investment appraisal for each project and will examine technical quality and economic and financial viability' in recital 257.

Thirdly, the Commission stresses that the measure foresees a minimum private participation rate that 'limits the use of public resources and… ensures the benefit of market experience and professionalism' in recital 259. Thus, it merely refers to a checklist of elements of to the market economy investor principle that are apt to minimise market distortions.

With regard to the **proportionality** criterion, the Commission puts the focus of its assessment on the commercial management of the aid rather than the amount of the aid and its impact on the market and their correspondence with each other. It states that 'the Commission has paid particular attention to those parts of the measure that enhance decision-making in line with commercial logic' in recital 261: Thus, the Commission again argues with elements of the market economy investor principle in a rather theoretical and formalistic way in order to ascertain whether the 'same result could not be reached with less aid and less distortion'.

Accordingly, it finds positively that 'investments… are selected and structured by professional and independent fund managers that have been chosen in a transparent and competitive process', which 'adds to the likelihood of economically sound investment decisions with limited deviations from market rules' in recital 262. In recitals 263 and 264, it finds positively that there is a variable remuneration part subject to overall fund performance and a business plan including an exit strategy and governance structures. By merely showing how the distortive effects of the aid may

be minimised rather than also examining negative effects, the Commission fails to conduct the balancing exercise required by the Courts in *Smurfit Kappa* and *BMW*.

Further checking its list of elements of the market economy investor principle that ought to minimise market distortions, the Commission considers the so-called 'zero floor repayment requirement', i.e. the business plan foreseeing the full repayment of urban development fund investment plus inflation rate, 'a suitable tool to ensure a minimum economic viability… and… a transparent means to exclude excessive deviation from market conditions' in recital 265. Moreover, the Commission regards 'the application of the FRR criterion as a suitable method to avoid any over-compensation of private investors' in recital 267 and notes positively that 'both private investors and the urban development funds will benefit from unforeseen project over-performance in proportion to their investment'. Although there are no pari passu terms, the Commission regards the FRR and the sharing of profits beyond the FRR as proportionate means to limit preferential investment conditions and thus market distortions.

Finally, the Commission appears to engage in assessing potential negative effects on competition and trade, identifying the market for financial investments, for investment intermediation, and the market for property and infrastructure as the relevant markets. However, the Commission merely mentions potential negative effects, such as long-term dynamic effects and crowding out, but does not undertake any weighing or quantification of the amount of aid and its impact on the market. Rather, as under its necessity assessment, it states in recital 277 that 'while the absolute amount in any given urban development project is not calculated, the amount of aid is in all cases limited to what is strictly necessary in order to cover a viability gap'. Thus, it checks the adherence of the amount ceilings on its 'minimisation list' of market distortions.

In sum, the Commission assesses the effects on the market merely in qualitative terms in a formalistic way rather than assessing the correspondence of the amount of aid and its market impact. It fails to assess negative effects and thus to fulfil the balancing exercise required by the EU Courts. For instance, it assumes in recital 279 that aid 'will be exclusively provided to unlock those urban development projects where the market would not undertake the activities on its own' as well as 'an overall increase in the level of investment activity due to the minimum private participation requirement', so that crowding-out effects would remain limited. However, it does

not substantiate this assumption with any further (quantitative) assessment, let alone through balancing any effects. It continues in its assessment of the effect on input markets and location in the same vein, stating that the measure has predominantly local and purely indirect effects on trade and that 'the distortion of competition and trade is most likely to be limited' in recital 281. Therefore, the Commission concludes in recital 282 that 'the aid does not distort the proper functioning of the internal market to any significant extent and does not produce significant disparities between undertakings established in different Member States…'.

In the end, the Commission appears to conduct the balancing test in recitals 288 to 291. However, even at this point, no actual balancing of the positive and negative effects of the aid follows, but a mere listing of the measure's objectives to be achieved and its characteristics that supposedly limit the state intervention and potential distortions. For instance, by reference to market failures and socio-economic problems, it states in recital 289 rather apodictically that 'the scheme strives to reach a European objective of great importance', while this would be achieved 'by public intervention that is limited to the minimum'. Then the Commission merely lists the means in recital 290, which it mentions in its assessment and through which the measure ought to limit the public intervention, i.e. 'by means of professionally managed financial engineered instruments, providing sub-commercial investment conditions resulting from either a competitive selection process or impartially established industry benchmarks to private investors who will in exchange leverage public investment'. Moreover, it lists that 'compared to grant funding, the aid will be particularly low' and that 'the requirement of in-depth knowledge of local specificities will limit distortive effects' in recital 290. However, again, the Commission merely provides a list of means limiting potential negative effects, but no balancing of such negative effects against positive ones.

In conclusion, the Commission focuses on market failures in its assessment of the common objectives to be achieved and of the reasons for state intervention. However, in assessing the necessity and the supposedly limiting means to the state intervention, the Commission does not refer to the (total) amount of the aid and its correspondence with the extent of the market failure or the impact of the aid. Rather, it focuses and lists formalistically elements of the market economy investor principle, in particular the FRR and the commercial management of the funds that ought to minimise market distortions. The Commission fails to examine, let alone balance, negative effects of the aid, and rather assesses the distortive effects in a formalistic and

qualitative way on its 'minimisation checklist', and thus fails to adhere to the Courts' requirements.

3. Comparison with the assessment of undue negative effects under the Guidelines on regional aid, on environmental protection and energy aid, and with the Framework on R&D&I aid

In comparison, the Commission identifies in its **Guidelines on regional aid** certain situations, 'where the negative effects of the aid manifestly outweigh any positive effects', so that the aid cannot be considered compatible with the internal market, calling them 'manifest negative effects'.[1051] These are scenarios, either where 'the creation of a capacity by the project takes place in a market which is structurally in absolute decline' (versus a growing market or a market in relative decline) or where 'without the aid the investment would have been located in a region with a regional aid intensity which is higher or the same as the target region'. [1052] If the Commission concludes in its compatibility assessment that one of these scenarios is given, it considers that there are negative effects, which are 'unlikely to be compensated by any positive effect'.

What is more, also in its **Guidelines on environmental protection and energy aid**, the Commission identifies manifest negative effects: 'In principle, an aid measure and the context in which it is applied need to be analysed to identify the extent to which it can be deemed distortive', but 'there are situations where the negative effects manifestly outweigh any positive effects, meaning that the aid cannot be found compatible with the internal market'.[1053] Therefore, the Commission lists two manifest negative effects. Firstly, it states that 'maximum aid intensities constitute a basic requirement for compatibility, and which have the aim of preventing the use of State aid for projects where the ratio between aid amount and eligible costs is deemed very high and particularly likely to be distortive'.[1054] Secondly, 'likewise, aid for environmental and energy objectives that merely leads to a change in location of the economic activity without improving

[1051] European Commission, Guidelines on regional State aid for 2014-2020 (2013/C 209/01), point 120.
[1052] European Commission, Guidelines on regional State aid for 2014-2020 (2013/C 209/01), points 128-139.
[1053] European Commission, Guidelines on State aid for environmental protection and energy 2014-2020 (2014/C 200/01), point 94.
[1054] European Commission, Guidelines on State aid for environmental protection and energy 2014-2020 (2014/C 200/01), point 95.

the existing level of environmental protection in the Member State will not be considered compatible with the internal market'.[1055]

In its **Framework on R&D&I aid**, the Commission elaborates that for the compatibility assessment of undue negative effects, it will examine effects on product markets (distortions of the competitive entry and exit process, of dynamic incentives, and the creation or maintenance of market power) as well as effects on trade and location choice.[1056] Therefore, it provides concrete elements it will consider for the assessment, such as the aid amount, closeness of the market/category of the aid, selection processes, market power of aid beneficiaries, level of entry and exit barriers, buyer power, and incentives to compete for a future market.[1057]

When comparing the elaborations on the avoidance of undue negative effects of the Guidelines on regional aid and of the Framework on R&D&I aid with those of the Risk Finance Guidelines, it becomes apparent that the latter lack concrete assessment scenarios, which may serve as benchmark cases that positive effects are unlikely to outweigh their negative effects, on the one hand, as well as concrete assessment elements, which serve as tools to assess the negative effects in order to weigh them against the aid's positive ones, on the other. Rather, the Risk Finance Guidelines mention negative effects that may emanate at the different levels:

Firstly, at the level of the market for the provision of risk finance, the Commission holds that 'State aid may result in crowding out private investors', whereby 'this risk becomes more relevant, the higher the amount of the total financing into the final beneficiaries, the larger the size of those beneficiary undertakings and the more advanced their development stage, as private financing becomes progressively available in those circumstances', and that 'to the extent the market failure has been properly identified, it is less likely that the risk finance measure will result in such crowding out'.[1058]

[1055] European Commission, Guidelines on State aid for environmental protection and energy 2014-2020 (2014/C 200/01), point 96.
[1056] European Commission, Framework for State aid for research and development and innovation (2014/C 198/01), points 97-105.
[1057] European Commission, Framework for State aid for research and development and innovation (2014/C 198/01), points 97-105.
[1058] European Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), point 157.

Thus, the Commission states indicators, which it will pay attention to in its assessment rather than 'manifest negative effects': first and foremost, it will regard 'the amount of total financing', i.e. caps and ceilings of the aid amount, and the identification of the market failure. However, apart from that, as it was analysed above, the Commission does not concern itself with any quantification or correspondence between the extent of the market failure and the aid amount, as a balancing exercise would require. In line with the Guidelines on regional aid as well as on environmental protection and energy aid, the Commission could rather define instances of where the relevant investment aid causes crowding out as a 'manifest negative effect'. This could be done along the line of the assessment of desirable and actual market outcomes, whereby the given 'desirable market outcome' is not different from the given actual market outcome, e.g. where final beneficiaries are not in need of (public) investment aid.

Secondly, at the level of financial intermediaries, the Commission emphasises that 'aid may have distortive effects in terms of increasing or maintaining an intermediary's market power' and discourage the extension or inducing the exit of competitors.[1059] Therefore, 'risk finance measures must be targeted at growth-oriented undertakings which are unable to attract an adequate level of financing from private resources', whereby the investment strategy of a public fund must 'demonstrate sufficiently the potential viability of the eligible undertaking' in order to pass the balancing test.[1060] The Commission therefore refers to the conditions of commercial management and profit oriented decision-making of Article 21 GBER to ensure that 'the selection of the final beneficiary… is based on commercial logic'.[1061] While mentioning the balancing exercise, the Commission contradicts its very meaning by directly referring to whether the conditions of commercial management and decision-making are adhered to in its 'check list assessment' discussed above.

Moreover, the Commission highlights that 'regional risk finance schemes may not have sufficient scale and scope due to a lack of diversification linked to the absence of a sufficient number of eligible undertakings as investment targets', since such funds could be less efficient, provide aid to less viable companies, and be less attractive to private investors for not being considered a

[1059] European Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), point 158.
[1060] European Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), point 159.
[1061] European Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), point 160.

viable business opportunity.[1062] Thus, instead of merely 'checklisting' the commercial management and decision making, the Commission could define manifest negative effects along the lines of the Guidelines on different aid described above: for instance, it could define the absence of a sufficient diversification and number of eligible and undertakings as a form of a manifest negative effect.

Thirdly and finally, at the level of final beneficiaries, the Commission emphasises that aid to target companies in underperforming sectors could lead to the maintenance of overcapacities and create inefficient market structures, so that it would 'analyse the level of production capacities in the given sector, in the light of the potential demand' and 'assess any potential negative delocalisation effects'.[1063] Thus, instead of focusing on the Member States' minimisation or limiting efforts towards negative effects on its assessment checklist, the Commission could define underperforming sectors and insufficient production capacities as well as delocalisation effects as manifest negative effects in line with the Guidelines on other aid described above.

4. Conclusion

The EU Courts require in their case law a balancing exercise to be conducted as to whether the positive effects of the relevant aid measure outweigh its negative effects in the sense of the proportionality test *stricto sensu*. This means that, although there is not necessarily a quantification of the aid amount and the effects required, the Commission must 'juxtapose' the positive and the negative effects, and assess whether there is a credible correspondence between the aid amount and the extent of the market failure, or rather of the divergence of desirable and actual market outcomes *in casu*, on the one hand, and the impact on the market, on the other. This is what the EU Courts require under state aid law as to the compatibility assessment under the principle of proportionality, including necessity and the balancing exercise.

[1062] European Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), point 161.
[1063] European Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04), points 162, 163.

4.1. The Commission's inconsistent proportionality assessment

However, although the Commission refers to this balancing exercise required by the Courts in its Risk Finance Guidelines ('the negative effects have to be balanced against the overall positive effect of the measure`), it does not conduct such a balancing in its decisional practice. Nor does it assess whether there is a divergence between desirable and actual market outcomes, but merely refers to a given market failure. Instead of an actual effects-based assessment of the correspondence between the aid amount and the extent of the market failure or the impact on the market and competition, the Commission uses a formalistic checklist as to whether screening methods, caps and ceiling, and market methods are adhered to in the design and implementation of financial instruments so that market distortions be minimised.

Thus, the research question of this chapter of whether the decisional practice of the Commission in its application of the proportionality principle, including necessity and the balancing of positive and negative effects, is consistent with the requirements of the EU Courts under state aid law must be answered in the negative: it is not consistent.

This stands in contrast to the EU Courts' requirements in *Smurfit Kappa* and *BMW*, according to which the Commission is required to conduct an in-depth assessment, where the positive effects of an aid measure clearly do not outweigh the potential negative effects, and to exercise its wide discretion in order to ascertain whether the expected benefits outweigh distortions of competition and the impact of the measure on trade.

In contrast to the case law of *Smurfit Kappa* and *BMW*, the General Court did not require the balancing exercise, let alone a proper weighing test, from the Commission in the case *Magic Mountain Kletterhallen*.[1064] Instead, it confined itself to stating that the Commission established implicitly that the positive effects outweigh the negative effects of the measure in question through simply showing that the effects on competition and trade were limited.[1065] This reasoning and the Commission's decisional practice defy the logic and meaning of 'balancing', as they consider only one side of the scales and blindly assume that the other side must be in balance

[1064] Case T-162/13 Magic Mountain Kletterhallen and others v Commission [2016] EU:T:2016:341, para. 110.
[1065] Case T-162/13 Magic Mountain Kletterhallen and others v Commission [2016] EU:T:2016:341, para. 110.

hence. Moreover, the crucial question remains how the EU Courts and Commission will proceed, if they find that the negative effects are large, but constitute the minimum necessary.[1066]

4.2. Introducing 'manifest negative effects' for a consistent proportionality assessment

The Commission's inconsistent compatibility assessment in the context of the proportionality principle may stem from the fact that the Commission simply does not have any tools at its disposal to assess potential negative effects. As long as the EU Courts would not disagree, the Commission could alter its approach under the compatibility of risk finance measures and align it with that of its Guidelines on environmental protection and energy aid and on regional aid, introducing manifest negative effects, which would automatically render the relevant measure disproportionate and thus incompatible.

This approach would be in line with the practice in other areas of state aid as well as with the 'manifestly disproportionate test' of the proportionality test *stricto sensu*. What is more, also the constitutional reasoning supports this approach: in policy areas where the Commission enjoys a wide discretion as the primary decision-maker, the EU Courts 'will only overturn the policy choice if it is clearly or manifestly disproportionate', and importantly, 'this is more especially so where the policy choice required the weighing of complex variables'.[1067]

Potential manifest negative effects could be, for example, certain instances of crowding out, the absence of a sufficient diversification and number of eligible and undertakings, underperforming sectors and insufficient production capacities, as well as delocalisation effects. Moreover, an excessive increase of public funds could be a manifest negative effect, as this could 'lead to a risk of non-absorption, if there is a lack of (i) venture capital funds to invest in, (ii) interested private investors, (iii) SMEs with growth potential to invest in'.[1068] Although the Commission would still have to assess positive and negative effects of the aid in its assessment, the identification of such manifest negative effects could enhance legal certainty as to which financial instruments may prove evidently incompatible.

[1066] Phedon Nicolaides, The Compatibility of State Aid with the Internal Market: Lessons from Hinkley Point C, 2018, http://stateaidhub.eu/blogs/stateaiduncovered/post/9314, last access: 01.05.2019.
[1067] Paul Craig, EU Administrative Law, Oxford Scholarship, 2018, p. 644.
[1068] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 20.

VII. Financial Instruments designed by the Commission at EU and Member State Level – Proportionate and non-distortive?

1. Introduction to financial instruments set up and managed at the EU level

This chapter covers financial instruments that are set up and managed at the EU level, for which state aid rules do not apply and which are designed by the Commission so as to ensure that they adhere to the 'consistency with state aid rules' and do not distort competition. Therefore, their provisions will be explained, compared with state aid rules, and discussed in the light of the EU Courts' requirements on proportionality in this chapter.

Funding from the EU budget managed at the EU level does not fall under Article 107 (1) TFEU, since it is neither granted by a Member State nor through State resources, as the EU budget is based on 'own resources' and decided upon by the European Parliament and the Council, the two arms of the budgetary authority, not being under the control of the Member States.[1069]

In nuce, if EU resources are 'transferred through a channel, fund, or body, over which the State can exercise control', they are regarded as state resources – in contrast, if EU resources are awarded directly to undertakings without being transferred through a state-controlled channel, fund, or body, they do not fall under the scope of Article 107 (1) TFEU.[1070]

Accordingly, the so-called General Block Exemption Regulation (GBER), exempting certain categories of aid from being incompatible with the internal market, stipulates under Article 8 (2) on the cumulation of aid that Union funding centrally managed by EU institutions, agencies, joint undertakings, or bodies that are not directly or indirectly under the control of Member States will not be considered for the determination of the notification thresholds. Moreover, under its recital 26, the GBER states that Union funding managed by EU bodies does not constitute state aid.

[1069] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.11.
[1070] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.11.

The Commission Guidelines on Risk Finance reiterate the exemption of Union resources under paragraph 169 of point 3.9. on cumulation. Moreover, paragraph 60 of the Notice on the Notion of State Aid states that Union funding managed at the EU level does not constitute state aid, and recital 13 of the *de minimis* Regulation states that it does not constitute state resources, respectively. The Introduction to Analytical Grids on State Aid to Infrastructure of the Commission also states in paragraph 6 that recourses 'awarded directly by the Union, the EIB or by the EIF, with no discretion on the part of the national authorities… do not constitute state resources'.

With regard to the case of **EU funds and Member State funds combined at the EU level**, only the latter fall under the scope of Article 107 (1) TFEU, as it is the case for co-financing of projects of the **European Fund for Strategic Investments (EFSI)**, the EU resources of which are intended to leverage private sector involvement.[1071] Paragraph 8 of the Introduction to the Analytical Grids clarifies that while financing by the EFSI does not constitute state aid, co-financing by Member States does constitute a transfer of state resources and may amount to state aid. Notification of the latter to the Commission may thus be necessary.[1072]

In contrast, the case of **EU funding allocated to Member States and then returned to the EU level** poses the question of 'whether Member States may be held responsible under state aid rules for the contributions they make to financial instruments at EU level'.[1073] Paragraph 7 of the Introduction to the Analytical Grids clarifies that such contributions from Member States 'would not be imputable to the state and, therefore, would not constitute state aid in the meaning of Article 107 (1) TFEU, provided the contributing Member State does not attach any conditions as to the use of these contributions'. According to the same paragraph, the condition that the contributions to the ESI funds are invested in the territory of the contributing Member State specified in the Operational Programme in line with the CPR does not render the resources imputable to the state, 'since the ESI funds are allocated to Member States in accordance with Union rules that have already determined in which Member State's territory those funds should be invested'. Thus, if a Member State returns EU funding to an EU institution to manage it at the

[1071] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.15.
[1072] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.15.
[1073] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.14.

EU level without the Member State's discretion as to how the funding is invested in its territory, no state resources are involved.[1074]

As the Commission and the EIB in a joint statement made clear, where the EIB group acts under a mandate from the Commission and manages EU funds, the EU financing does not fall under state aid rules, 'when it consists only of Union resources without involvement of any resources from or under the control of Member States'.[1075] However, as stated above, the financial regulation requires the consistency of EU financial instruments with state aid rules in order to avoid undue distortion of competition. The rationale of this statement is that the consistency with state aid rules required by the financial regulation is safeguarded by the Commission, the EIB, and any other EU institution 'through the pursuit of policies that avoid distortions of competition', since the EIB and the EU institutions 'commit themselves to implement programmes that do not distort competition, rather than formally notify state aid measures to the Commission or apply block exemption regulations such as the GBER' and since 'there is no procedure for state aid notification by EU institutions to the Commission'.[1076]

But how does one know whether EU resources managed at the EU level do not distort competition or the internal market? With regard to financial instruments, the financial regulation on the financial rules applicable to the general EU budget states under Article 209 (2) (c) that financial instruments may 'not distort competition in the internal market and be consistent with state aid rules'.

Moreover, the regulations on the programmes of COSME and Horizon 2020, respectively, require that financial instruments shall be implemented in compliance with state aid rules and ensure the

[1074] 'National funds do not constitute state aid if the European Structural and Investment Funds are contributed to the InvestEU budgetary guarantee compartment without any discretion of Member States and without further conditions other than the geographic allocation inherent to the European Structural and Investment Funds.'
- The European Commission, Explanatory Note accompanying the proposal for the targeted GBER revision, footnote 2, http://ec.europa.eu/competition/consultations/2019_gber/note_en.pdf, last access: 09.07.2019.

[1075] The Commission and the European Investment Bank group (EIB group) issued a joint statement on 'state aid matters in relation to the activities of the EIB group' in 2014, in which they identified three different situations.[1075] Firstly, own resources of the EIB fall outside the scope of state aid rules. However, 'wherever guarantees from Member States are granted for EIB group financing or in case of co-financing or any other state support, the Member State(s) concerned remain responsible for notifying any state aid'. Secondly, where the EIB group implements and manages the programmes funded by resources from national budgets or by resources from the EU budget that flow through national budgets (i.e. ESI funds), or by combination of those resources, state aid rules apply.
- The Joint Statement can be accessed via http://ec.europa.eu/competition/state_aid/modernisation/joint_statement_en.pdf, last access: 29.12.2018.

[1076] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.14.

prevention of market distortions.[1077] The rationale of these requirements is to oblige the Commission to safeguard the integrity of the internal market, since 'as the sole authority competent to assess the compatibility of state aid with the internal market it cannot control itself'.[1078] However, the Commission can be held accountable for complying with these regulations and state aid rules, so that the question arises how it may prove its very compliance.

Hence, although **EU funds managed at the EU level** do not fall under Article 107 (1) TFEU, they still have to be **consistent with state aid rules in order to prevent or minimise distortion of competition**. Thereby, Nicolaides detects a flaw of legal clarity because of a 'confusion concerning the relation of EU funding with state aid', and advocates a teleological solution: it were sufficient for EU regulations (e.g. COSME and Horizon 2020 – see above) to refer to the ultimate objective of preventing distortions of competition rather than mentioning the obligation of consistency and compliance with state aid rules.[1079]

In citing recital 26 of the 2014 GBER and recital 13 of the 2013 *de minimis* Regulation, Nicolaides proposes an even 'bolder revision… stipulating that EU funds managed at EU level do not fall within the scope of state aid rules', while they still 'need to be implemented in a manner that is consistent with the avoidance of distortions to competition'.[1080] Again, the rationale is that the Commission, the EIB/EIF, or other EU bodies that manage funds at EU level may 'always act in a manner that avoids distortion of competition in the internal market'.[1081] However, as Nicolaides correctly states, there appears to be no empirical study that 'has attempted to assess the actual effect of EU managed funds on competition and whether indeed they avoid distortions in the internal market and the European economy at large'.[1082]

The document 'Tool No 10' of the Commission agenda for 'Better Regulation', which has the aim 'to design and evaluate EU policies and laws based on evidence, in a transparent and open manner, and in conjunction with citizens and stakeholders thereby keeping regulatory burdens to a minimum', elaborates on the links between the requirements of the Financial Regulation and

[1077] Article 17 (10) of Regulation 1287/2013 and recital 42 of Regulation 1291/2013.
[1078] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.13.
[1079] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.16.
[1080] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.17.
[1081] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.17.
[1082] Phedon Nicolaides, State Aid and EU Funding: Are they compatible?, European Parliament, April 2018, p.16.

those of the agenda with regard to the design of financial instruments.[1083] In particular, it explains to EU staff 'when an ex ante evaluation should be performed and when the ex ante evaluation should take the form of an impact assessment'.[1084]

Thus, it elaborates on how to evaluate the need for state intervention, the appropriateness and proportionality of the measure, but also the effects and impact on markets and competition: one is required to 'assess the likelihood and possible costs of market distortions and crowding-out of private funding through financial instruments and [to] identify means to minimise negative effects of such distortions'.[1085] However, unfortunately, it does not provide any details on this requirement, which could provide further instructions as to how EU bodies are expected to prevent financial instruments from causing market distortions.

Therefore, with regard to financial instruments funded and managed at the EU level, an important question remains. Given that there is no involvement or discretion at the level of Member States in this case, they do not fall under the scope of state aid law. Yet, as market interventions, EU financial instruments are liable to distort the internal market in general. Thus, this chapter concerns the following question:

- How do the Commission and the EIB/EIF prevent or minimise market distortions by financial instruments at the EU level and are these rules consistent with state aid rules applicable to financial instruments implemented and managed at the Member State level as well as with the EU Courts' requirements on proportionality?

There appears to be no study on how EU institutions, such as the Commission and the EIB, ensure that financial instruments implemented and managed at the EU level prevent the distortion of competition, given that they do not fall under the scope of state aid rules. Hence, this chapter will analyse which rules, standards, or policies the Commission and other EU institutions apply so that

[1083] European Commission, Better Regulation: Why and How, https://ec.europa.eu/info/law/law-making-process/planning-and-proposing-law/better-regulation-why-and-how_en, last access: 03.03.2019,
and European Commission, Tool #10. Financial Programmes and Instruments,
https://ec.europa.eu/info/sites/info/files/file_import/better-regulation-toolbox-10_en_0.pdf, last access: 03.03.2019.
[1084] European Commission, Tool #10. Financial Programmes and Instruments,
https://ec.europa.eu/info/sites/info/files/file_import/better-regulation-toolbox-10_en_0.pdf, last access: 03.03.2019.
[1085] European Commission, Tool #10. Financial Programmes and Instruments,
https://ec.europa.eu/info/sites/info/files/file_import/better-regulation-toolbox-10_en_0.pdf, last access: 03.03.2019, point 6.2.

financial instruments implemented and managed at EU level be 'consistent with state aid rules', as required by law, and prevent the distortion of competition in the light of the proportionality principle and its interpretation by the EU Courts (see chapter VI). These rules will be compared to state aid rules, in particular to those of the GBER and the common assessment principles applied by the Commission in its Risk Finance Guidelines.

The Commission provides the following answer: In order to ensure that EU financial instruments are consistent with state aid rules, the Commission, as the responsible authority for state aid compliance, provides for specific terms and conditions in its Delegation Agreements.[1086] The Commission concludes these with its respective party counterparts regarding the implementation of financial instruments under EU funding programmes, such as COSME, Horizon 2020, or the Programme for Employment and Social Innovation.[1087] Moreover, the Commission and the EIF signed the Financial and Administrative Framework Agreement (FAFA) 'setting out the main principles, standard terms, conditions and procedures under which the Parties [i.e. the Commission and the EIF] shall cooperate in the preparation, set-up, implementation and management of Financial Instruments administered by the EIF, to which the Union makes a financial contribution from the Union budget'.[1088] Thus, the FAFA is no Delegation Agreement itself, but rather a frame of general provisions vis-à-vis the more specific provisions of Delegation Agreements applicable to individual financial instruments.

In the following, the Commission's 'answer' to the requirement of state aid consistency will be assessed. Through the analysis of the terms and conditions of the FAFA as well as the Delegation Agreements on the financial instruments of COSME and Horizon 2020, the thesis will analyse how the Commission ensures that financial instruments at the EU level are consistent with state aid

[1086] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.2.
[1087] Commission Staff Working Document, Guidance on State Aid in European Structural and Investment (ESI) Funds – Financial Instruments in the 2014-2020 programming period, point 3.1.2.
[1088] Delegation Agreement between the European Union and the European Investment Fund in respect of the Financial Instruments of the Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014-2020), comprising the Loan Guarantee Facility (LGF) and the Equity Facility for Growth (EFG), Schedule, Amendment and Restatement Agreement, as Amended by C(2019)16/1 Commission Decision approving Amendment No 6, pp. 7, 8, and Financial and Administrative Framework Agreement between the European Union and the European Investment Fund – both available by request from the Commission Document Register.
[1088] Delegation Agreement between the European Union and the European Investment Fund in respect of the Financial Instruments of the Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014-2020), comprising the Loan Guarantee Facility (LGF) and the Equity Facility for Growth (EFG), Schedule, Amendment and Restatement Agreement, as Amended by C(2019)16/1 Commission Decision approving Amendment No 6, Introductory Remarks (30), p. 12.

rules in order to minimise distortive effects of the instruments, and whether they are consistent with the standards and requirements of state aid rules applicable to financial instruments that contain state resources and fall under the scope of Article 107 (1) TFEU, such as those of GBER or the Risk Finance Guidelines.

The relevance of this analysis also stems from the fact that, at the writing of this thesis, there is no study on the provisions and criteria regarding 'state aid consistency' of EU financial instruments, whether they are similar to or different from the provisions of state aid law for financial instruments under Article 107 (1) TFEU, and whether they meet the requirements for the compatibility assessment pursuant to the principles of the EU Courts discussed above.

2. The Management of EU Financial Instruments and the minimisation of market distortions

This section will first elaborate on the Financial and Administrative Framework Agreement (FAFA) on Financial Instruments between the Commission and the EIF and subsequently on the provisions of the relevant Delegation Agreements on COSME and Horizon 2020 and its Annexes. It will also compare the provisions of the Delegation Agreements with one another as well as with the corresponding provisions on financial instruments that fall under state aid rules under Article 107 (1) TFEU. The conclusion will provide a summary of the comparison and its implications.

2.1. The Financial and Administrative Framework Agreement (FAFA) on Financial Instruments between the Commission and the EIF

This section will analyse the FAFA and its provisions in comparison with the legal texts of state aid rules and whether the former are consistent with the latter. The FAFA provides the common provisions vis-à-vis those special provisions of the Delegation Agreements that are specific to the respective EU financial instruments.[1089] The FAFA defines under Article 1 financial instruments as

[1089] It states that 'as a general rule, wherever the Union makes a financial contribution to a financial instrument or additional tasks administered or implemented by the EIF, the principles, standard terms, conditions and procedures contained in this Agreement shall apply as common provisions in the Delegation Agreement' - Financial and Administrative Framework Agreement between the European Union and the European Investment Fund, point 16.

'a Union measure of financial support provided on a complementary basis from the budget of the Union and/or from the EDF, managed under direct or indirect management by the Commission, in order to address one or more specific policy objectives of the Union', which 'may take the form of equity or quasi-equity investments, loans or guarantees or other risk-sharing instruments and may, where appropriate, be combined with grants'. This definition is, in essence, the equivalent of the definition under Article 2 (29) of the Financial Regulation.

Article 4 of the FAFA covers provisions on **financial intermediaries**: 'The EIF may select one or more financial intermediary/ies to implement… part of a financial instrument', which must be selected by the EIF 'in accordance with the provisions of the [respective] Delegation Agreement and the EIF's rules, policies and procedures'. Similar to Article 21 (13) (b) GBER, Article 4.2 FAFA requires that financial intermediaries be selected on the basis of open, transparent, proportionate, and non-discriminatory procedures. This is also what the RFG require in paragraph 40: If the manager of the financial intermediary is chosen through such a selection procedure, 'it will be presumed that the manager does not receive state aid' (instead of requiring a 'proportionate' one, the RFG require an 'objective' one). Importantly, however, the FAFA merely refers to the internal 'provisions of the Delegation Agreements and rules of the EIF', so that – in contrast to state aid rules – neither a public procurement procedure nor compliance with Article 7 CDR (criteria for the selection of implementing bodies) is required.[1090]

Thus, although the criteria differ somewhat, both set of rules aim at the prevention of excessive market distortions through market mechanisms in line with the market economy investor principle and screening methods of selecting viable financial intermediaries. The FAFA provisions are less demanding by only referring to internal provisions and rules for the selection of financial intermediaries, however.

Furthermore, and in line with that, the FAFA requires that due account be given to the nature of the financial instrument and the experience and financial capacity of the financial intermediary. With regard to screening methods and accountability, agreements between the EIF and the financial intermediaries must contain certain obligations, e.g. documentation and audit

[1090] European Parliament, Research for REGI Committee – Financial Instruments in the 2014-2020 Programme Period: First Experiences of Member States, 2016, p. 46.

obligations, pursuant to Article 4.3 FAFA. Article 4.4 FAFA sets out the exclusion criteria for financial intermediaries, e.g. if they are in financial difficulties, representative or decision-making persons are involved in crimes or misrepresentation, or are listed in a central exclusion data base. At this point, FAFA's rules are stricter than those of the RFG, as the latter do not stipulate such exclusion criteria at all. Rather, the RFG require in paragraph 159 that 'risk finance measures must be targeted at growth-oriented undertakings', including financial intermediaries, so that these must comply with the risk finance provisions of the GBER on commercial management and profit-oriented decision-making pursuant to paragraph 160. The FAFA rules are concerned thus with the exclusion of both non-viable and non-legal financial intermediaries, while the RFG rules focus on the prevention of undue advantages for financial intermediaries through state aid only. However, paragraph 26 RFG stipulates that risk finance aid will be considered incompatible with the internal market, if awarded to undertakings in difficulty or to undertakings that have received illegal state aid, which has not been fully recovered.

Article 5 FAFA provides **general conditions for financial instruments**: They must be used in accordance with the principles of sound financial management, transparency, proportionality, non-discrimination, equal treatment, and subsidiarity, as well as in accordance with their objectives, whereby the duration may 'not be aimed at replacing those of a Member State, private funding or another Union financial intervention' (Article 5.1 FAFA). This Article 5.1 FAFA reflects the very same principles of Article 209 (1) of the Financial Regulation. The RFG also require in paragraph 133 that state aid be 'designed… in line with the principles of sound financial management', and, of course, in accordance with the principles of necessity, proportionality, and transparency. They do not mention the principles of equal treatment and subsidiarity, however.

Pursuant to Article 5.2 FAFA, financial instruments may only support **final recipients** that are considered 'potentially economically viable' in accordance with the objectives of the relevant Delegation Agreement. Similarly, the RFG require that state aid be provided to viable recipients in its paragraphs 57 and 104. There may not be any undue advantages (e.g. undue dividends or profits to third parties) generated through EU contributions, in accordance with Article 5.3 FAFA. This Article in particular states that 'preferential treatment of investors providing co-investment or risk-sharing shall be justified, proportionate to the risks taken by the investors in the financial instrument and limited to the minimum necessary to ensure their investment or risk-sharing'.

Although expressed differently, the RFG require the same conditions for co-investors based on the requirements of the market economy investor principle under paragraph 38 and stipulates under paragraph 85 that 'any preferential treatment granted to private investors or lenders has to be weighed against the public interest, which consists in ensuring the revolving nature of the public capital committed and the long-term financial sustainability of the measure' and, regarding proportionality, under paragraph 135 that 'the measure must ensure a balance between the preferential conditions offered by a financial instrument in order to maximise the leverage effect, while addressing the identified market failure and the need for the instrument to generate sufficient financial returns'.

Importantly, however, a remark must be made at this point regarding the different **interpretations of the proportionality principle** here: According to the EU Courts, the proportionality principle under the state aid rules requires a critical correspondence between the amount of the aid (to be kept at the minimum necessary) and the closing of the divergence of the desirable and the actual market outcome, or in practice, the market failure, through incentivising beneficiaries, as well as the balancing of the positive and the negative effects of the aid, as a market intervention that generates benefits exceeding costs (see chapter VI). The interpretation of Article 5.3 FAFA is in line with this interpretation. However, the RFG's interpretation deviates: it aims at addressing the market failure, on the one hand, and the generating of sufficient profit of the financial instrument, on the other. Neither the EU Courts nor the Commission in its decisional practice take this into account, however (see chapter VI on proportionality and the compatibility assessment).

Referring to Article 4.4 FAFA, Article 5.4 FAFA stipulates that final recipients must be excluded based on the same grounds. Again, there are no similar exclusion criteria for final recipients under the GBER or under the RFG, but only eligibility criteria. However, paragraph 26 RFG stipulates that risk finance aid will be considered incompatible with the internal market, if awarded to undertakings in difficulty or to undertakings that have received illegal state aid, which has not been fully recovered.

Importantly, Article 5.5 FAFA lays down that the relevant Delegation Agreement must define the specific conditions relating to state aid consistency. Thus, the Delegation Agreements will primarily contain the rules that are supposed to ensure that the EU financial instruments in question be consistent with state aid rules.

In sum, the conditions on financial instruments of Article 5 FAFA are far less specific and fairly less strict than state aid rules and those of Article 209 of the Financial Regulation.[1091] In comparison with the Commission criteria under the Risk Finance Guidelines, the FAFA requirements are phrased differently, but the aim of the rules is similar. They both require that (managers of the) financial intermediaries be chosen through an open, proportionate, and non-discriminatory selection procedure with the aim to retain market distortions minimal. The same holds true with regard to the economic viability of aid recipients, the requirements for co-investors, and the conditions for the aid measures in accordance with the principles of sound financial management, proportionality, and transparency with the same aim to minimise market distortions. Thus, both the RFG and the FAFA apply screening methods and market tools in order to minimise market distortions.

However, in contrast to state aid rules, the FAFA does not require compliance with the provisions of public procurement and Article 7 CDR (criteria for the selection of implementing bodies) by referring to internal provisions and the EIF's rules and policies only. Yet, the FAFA is stricter than the RFG with regard to its exclusion criteria for financial intermediaries and final recipients, as the GBER and the RFG merely provide eligibility criteria rather than exclusion criteria.

[1091] According to Article 209 (2) FR, financial instruments must fulfil the following conditions: (a) address market failures or sub-optimal investment situations and provide support in a proportional manner to final recipients that are deemed economically viable, (b) achieve additionality by preventing the replacement of potential support and investment from other public and private sources (crowding-out), (c) not distort competition in the internal market and be consistent with State aid rules, (d) achieve a leverage and multiplier effect, with target range of values based on an ex ante evaluation, by mobilising a global investment exceeding the size of the Union contribution, including, where appropriate, the maximisation of private investment, (e) be implemented in a way to ensure that there is a common interest of the implementing entities or counterparts involved in the implementation in achieving the policy objectives through, e.g. co-investment, risk sharing requirements, or financial incentives, while preventing a conflict of interests with other activities of the entities or counterparts, (f) provide for remuneration of the Union that is consistent with the sharing of risk among financial participants and the policy objectives of the financial instrument, (g) where remuneration of the implementing entities or the counterparts involved in the implementation is due, provide that such remuneration is performance-based and comprises administrative fees, and where appropriate, policy related incentives, and finally (h) be based on ex ante evaluations.

Moreover, and importantly, the FAFA does not prescribe any balancing exercise for EU financial instruments, as it is required by the EU Courts with regard to the principle of proportionality of state aid rules for Member States' financial instruments.

Table 3: Comparison of the provisions of the Financial and Administrative Framework Agreement (FAFA) and state aid rules

Topic	FAFA	State aid rules
Selection of financial intermediaries	Article 4.2: To be selected by the EIF in accordance with the provisions of the respective Delegation Agreement and the EIF's rules, policies, and procedures as well as on the basis of open, transparent, proportionate, and non-discriminatory procedures	Article 21 (13) (b) GBER: To be selected through an open, transparent, and non-discriminatory call. Para. 40 RFG: Manager to be selected through an open, transparent, non-discriminatory, and objective procedure.
Exclusion criteria for financial intermediaries	Article 4.4: They may not be in financial difficulties or listed in a central exclusion data base; representative and decision-making persons may not be involved in crimes or misrepresentation.	Paras. 159 and 160 RFG: No exclusion criteria, but financial intermediaries must comply with GBER rules on commercial management and profit-oriented decision-making. Para. 26 RFG: risk finance aid not compatible if awarded to undertakings in difficulty or undertakings that have received illegal state aid, which has not been fully recovered.
General conditions for financial instruments	Article 5: Financial instruments must be used in accordance with the principles of sound financial management, transparency, proportionality, non-discrimination, equal treatment, and subsidiarity, as well as with their objectives.	Para. 133 RFG and compatibility principles: State aid to be designed in line with the principles of sound financial management as well as with the principles of necessity, proportionality and transparency.
Final recipients	Article 5.2: Final recipients must be potentially economically viable in accordance with the objectives of the relevant Delegation Agreement.	Paras. 57 and 104 RFG: Final recipients must be viable.
Preferential treatment of co-investors	Article 5.3: There may be no undue advantages generated through EU contributions. Preferential treatment of investors providing co-investment or risk sharing must be justified, proportionate, and limited to the minimum necessary.	Paras. 38, 85, and 135: Conditions for co-investors must be based on MEIP; any preferential treatment granted to private investors has to be weighed against the public interest, and the principles of proportionality and necessity with regard to the identified market failure and the need for the instrument to generate sufficient financial returns.
Exclusion criteria for final recipients	Article 5.4: see Article 4, they may not be in financial difficulties or listed in a central exclusion data base; representative and decision-making	No exclusion criteria for final recipients under the GBER and RFG, but only eligibility criteria, but:

	persons may not be involved in crimes or misrepresentation.	Para. 26 RFG: risk finance aid not compatible if awarded to undertakings in difficulty or undertakings that have received illegal state aid, which has not been fully recovered.

Source: author

In the following, the Delegation Agreement on the COSME programme and its relevant Annexes will be explained and their provisions compared to the corresponding provisions of state aid law.

2.2. The Delegation Agreement between the European Union and the European Investment Fund on Financial Instruments of the COSME Programme

As stipulated in Article 5.5 FAFA, Delegation Agreements must define the specific conditions relating to state aid consistency. In the following, these conditions will be elaborated by reference to the COSME Delegation Agreement in this section and the Horizon2020 Delegation Agreement in section 2.3.

The Delegation Agreement on financial instruments of the COSME programme comprises the Equity Facility for Growth (EFG) and the Loan Guarantee Facility (LGF), which 'aim to improve access to finance for SMEs in the form of debt and equity respectively'.[1092] On the one hand, the **EFG** is dedicated to investments in risk finance funds that provide venture capital and mezzanine finance to expansion and growth stage SMEs, in particular to those operating across borders. On the other hand, the **LGF** funds guarantees and counter-guarantees for financial intermediaries (e.g. guarantee organisations, banks, leasing companies) to support them in providing loan and lease finance to SMEs.[1093] It also includes the securitisation of SME debt-finance portfolios.

In 2019, the European Court of Auditors published a special report on centrally managed EU interventions for capital, including the EFG and LGF.[1094] It found that 'the Commission increased

[1092] Delegation Agreement between the European Union and the European Investment Fund in respect of the Financial Instruments of the Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014-2020), comprising the Loan Guarantee Facility (LGF) and the Equity Facility for Growth (EFG), Schedule, Amendment and Restatement Agreement, as Amended by C(2019)16/1 Commission Decision approving Amendment No 6, pp. 7, 8.
[1093] The European Commission, COSME Financial Instruments, https://ec.europa.eu/growth/access-to-finance/cosme-financial-instruments_en, last access: 10.09.2017.
[1094] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019.

its support to the venture capital market without fully assessing market needs covering all instruments and absorption capacity' and also 'limited evidence of the impact of its support'.[1095] It recommends that the Commission 'perform necessary analyses to improve the evaluation of the EU interventions'. Moreover, its recommendations are to 'develop a comprehensive investment strategy' and to 'engage with the EIF to streamline its management of EU interventions'.[1096] Accordingly, EU interventions are not sufficiently effective in their current form.

With regard to the COSME Delegation Agreement, it clarifies In point (33) of its introductory remarks that Union funding centrally managed and not directly or indirectly under the control of a Member State, 'such as the EU Contribution for COSME Financial Instruments', does not constitute state aid, but 'shall be consistent with state aid law' in accordance with Article 140 (2) (c) Financial Regulation (Article 209 (2) (c) of Financial Regulation 2018).[1097] Therefore, it states that 'the financial instruments covered by this Delegation Agreement are considered to be consistent with state aid rules'.[1098] However, where COSME financial instruments 'are funded with contributions qualifying as state resources… such instruments shall be designed as to comply with state aid rules'.[1099]

Article 24 of the Delegation Agreement stipulates that its annexes 'form an integral part' of itself: Annexes 1a and 1b lay down the policy and operational guidelines for the EFG and the LGF, respectively. Their final sections, section 8 and section 10, respectively, stipulate that a financial instrument, which complies with the conditions set out in the respective Annex, 'shall be

[1095] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 4.
[1096] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 5.
[1097] Delegation Agreement between the European Union and the European Investment Fund in respect of the Financial Instruments of the Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014-2020), comprising the Loan Guarantee Facility (LGF) and the Equity Facility for Growth (EFG), Schedule, Amendment and Restatement Agreement, as Amended by C(2019)16/1 Commission Decision approving Amendment No 6, point (33), p.11.
[1098] Delegation Agreement between the European Union and the European Investment Fund in respect of the Financial Instruments of the Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014-2020), comprising the Loan Guarantee Facility (LGF) and the Equity Facility for Growth (EFG), Schedule, Amendment and Restatement Agreement, as Amended by C(2019)16/1 Commission Decision approving Amendment No 6, point (33), p.11.
[1099] Delegation Agreement between the European Union and the European Investment Fund in respect of the Financial Instruments of the Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014-2020), comprising the Loan Guarantee Facility (LGF) and the Equity Facility for Growth (EFG), Schedule, Amendment and Restatement Agreement, as Amended by C(2019)16/1 Commission Decision approving Amendment No 6, point (33), p.12.

considered as consistent with state aid rules'.[1100] In the following, these terms and conditions on the management of the financial instruments of Annex 1a regarding the EFG and of Annex 1b regarding the LGF will be described and discussed. Moreover, the terms will be compared with the state aid rules applicable to financial instruments set up and managed at the Member State level, and with the compatibility principles thereunder in particular, in order to analyse whether they are consistent with the latter or deviate in any way.

2.2.1. The Policy and Operational Guidelines for the EFG (Annex 1a)

Firstly, with regard to the **maximum size of investments** by the EIF, Section 3 c) limits the maximum size of EU investments by the EIF under the EFG in an EFG financial intermediary to EUR 30 million, while each EU investment 'shall represent at least 7.5 per cent of total commitments to the EFG financial intermediary at the closing at which the EU investment is made', and up to 25 per cent of the total commitments at any closing. Moreover, when investing into a 'Pan-European Venture Capital (VC) Fund-of-Funds', the 'aggregate amount committed by EIF… shall not exceed 25 per cent of the total commitments' of the fund-of-funds, and the 'maximum amount of an EU investment into any Pan-European VC Fund-of-Funds shall not exceed EUR 100 million'.

The maximum investment amounts may be considered rather limited when compared with the notification thresholds of Article 4 GBER that apply per undertaking, for instance, as they are EUR 7,5 million for investment aid to SMEs and EUR 15 million for risk finance aid. The EIF contribution is also limited at 25 per cent of the total commitments, so that private funding must be accounted for. Thus, the Annex applies strict maximum amounts of aid, retaining the amount of aid at a minimum necessary in order to minimise the potential of any excessive aid and negative effects on market and competition.

[1100] Delegation Agreement between the European Union and the European Investment Fund in respect of the Financial Instruments of the Programme for the Competitiveness of Enterprises and small and medium-sized enterprises (COSME) (2014-2020), comprising the Loan Guarantee Facility (LGF) and the Equity Facility for Growth (EFG), Schedule, Amendment and Restatement Agreement, as Amended by C(2019)16/1 Commission Decision approving Amendment No 6, point 8 of Annex 1a and point 10 of Annex 1b, pp. 79, 104.

Section 3 e) sets the **duration** of the EU Investments in EFG financial intermediaries as 5 to 15 years, not exceeding 20 years from the time of signature of the Delegation Agreement. Thus, the EIF commitment is limited and may not be prolonged indefinitely.

Importantly, regarding the **investor base**, section 3 f) stipulates that 'the majority of the capital committed to any EFG financial intermediary or a Pan-European VC Fund-of-Funds shall be provided by investors that pass the market economy operator test' in order to leverage private sector investment. Moreover, each EFG financial intermediary and Pan-European VC Fund-of-Funds must have at least 30 per cent and 50 per cent, respectively, of its total commitments coming from independent private investors at the time of EIF's closing. These requirements highlight the importance of the objective of (EU) financial instruments to leverage private funding. In comparison, the GBER requires comparable minimum participation thresholds from private funding, which are low (10 per cent) for eligible undertakings prior to their first commercial sale, but rather high (60 per cent) for more mature eligible undertakings pursuant to Article 21 (10) GBER.

Being important for state aid consistency, in accordance with section 3 g), EU investments must 'rank **pari passu** with investors investing in the same risk class', i.e. under equivalent economic terms and conditions and the same level of subordination, while the EIF is free to accept more favourable terms applicable for other investors. The pari passu requirement is part of the market economy investor principle and presupposes that (i) the public and private investment must be concomitant, (ii) the private investment must be of a significant amount, (iii) the risk and rewards of the public and private investor must be equivalent, and (iv) private investors are independent from undertakings they invest in.[1101] With these requirements met, the investment is considered to comply with market conditions. However, the provision of the Annex to the Delegation Agreement appears to refer merely to (iii) rather than to all of the elements of the pari passu requirement.

This is interesting, since the case law clearly lays down that all four elements must be met for a transaction to be considered pari passu.[1102] Since an advantage may still be present in EU financial

[1101] Case T-93/17 Duferco v European Commission, para. 100.
[1102] Case T-93/17 Duferco v European Commission, para. 100.

instruments, the logic of the Annex's provision is to minimise the aid element to the largest extent possible by requiring that at least the risk-class is pari passu between public and private investors.

Importantly, the European Court of Auditors' special report of 2019 criticised the pari passu conditions based on the Commission's own reports and evaluations: 'Some of the Commission's final and interim evaluations of centrally managed programmes declared the pari passu principle a failure or a barrier to stimulating private investment'.[1103] The ECA held that 'the low rate of return on their investment is one of the reasons for private investors' low level of interest in EU venture capital'.[1104] The Commission's argument against deviating from the pari passu principle is that investments could then be considered state aid.[1105] However, the Risk Finance Guidelines and the GEBR do stipulate circumstances, under which asymmetric profit-sharing does not violate state aid rules.[1106] Thus, the Commission could adjust the EFG's terms accordingly.

With regard to the representation of EU investments, section 3 h) stipulates that the **EIF** ought to be '**represented in advisory boards or similar investor representation bodies**', but not 'on governing bodies of EFG Financial Intermediaries or Pan-European VC Fund-of-Funds entrusted with individual investment or divestment decisions (save in the capacity as observer)'. The comparable provision may be Article 21 (15) (e) GBER with regard to financial intermediaries, which allows investors 'to be represented in the governance bodies of the investment fund, such as the supervisory board or the advisory committee'. However, it merely refers to investors. The Risk Finance Guidelines stipulate under paragraph 62 (contribution of a common objective) that a 'Member State may not participate directly in individual investment and divestment decisions', but that 'an appropriate governance structure must ensure that material changes to the investment strategy require the prior consent of the Member State'. Thus, both the EIF and Member States may not be involved in direct, individual investment and divestment decisions, but may only supervise the overall strategy, e.g. via a seat in the supervisory or advisory body.

[1103] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 30.
[1104] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 4.
[1105] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 30.
[1106] European Commission, Commission Guidelines on state aid to promote risk finance investment (2014/C 19/04), paras. 108, 109, and Article 21 (13) of Commission Regulation (EU) No 651/2014,
and European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 30.

Regarding both the EFG and the GBER/RFG rules, their similar mechanisms ought to ensure that market methods apply and the distortive effects of the aid hence be minimised, as it was already discussed in chapter VI.

Section3 i) covers the **governance of the EFG financial intermediary and the Pan-European VC Fund-of-Funds**, which must have a 'governance structure that allows for decisions concerning investments, divestments, and risk diversification to be made in accordance with the applicable legal documentation and in line with relevant market practice'. The comparable Article 21 (15) GBER stipulates that financial intermediaries must be managed on a commercial basis. Similarly, paragraph 62 of the Risk Finance Guidelines requires 'an appropriate governance structure' with regard to the investment strategy. Again, these are market methods to ensure that any distortive effects be minimised.

Section 3 l) states that the **EIF** must 'seek to **negotiate appropriate measures** to be put in place by the EFG Financial Intermediary for **avoiding conflicts of interest and for aligning the interests** of the EFG Financial Intermediary, its manager and its investors, such measures to be in line with market practice'. Moreover, this section stipulates the direct or indirect investment of a significant amount by the Financial Intermediary's management team in the EFG Financial Intermediary. The same requirements apply for investments in Pan-European VC Fund-of-Funds.

In comparison, Article 21 (15) (a) GBER require that financial intermediaries and fund managers 'act with the diligence of a professional manager in good faith and avoiding conflicts of interest'. As the requirement of the FAFA on performance based remuneration, Article 21 (15) (c) GBER also requires that they receive a remuneration linked to performance or, and this is comparable to the requirement of the Delegation Agreement, that they co-invest own resources, 'so as to ensure that their interests are permanently aligned with the interests of the public investor'.

This is in line with the Risk Finance Guidelines, which state under paragraph 141 of the proportionality criterion that 'the Commission considers that economic alignment of interests between the Member State and the financial intermediaries or their managers… can minimise aid' and under paragraph 103 of the appropriateness criterion that 'such co-investment could contribute to ensure that investment decisions are aligned with the relevant policy targets'.

With regard to the **remuneration** of the EFG Financial Intermediary's and the Pan-European VC Fund-of-Funds manager, section 3 m) requires that it be transparent to the investors and that the fees be 'negotiated at a level that covers operational and management costs in a sustainable way without distorting the alignment of interest aimed for'. Unlike Article 21 (15) (c) GBER and paragraph 143 of the Risk Finance Guidelines (proportionality principle), the terms and conditions of the Delegation Agreement do not stipulate a performance-based component of the remuneration. However, it is the FAFA, which exclusively stipulates fees linked to performance. Article 13 (1) FAFA states that 'the Commission shall remunerate the EIF for the set-up, implementation and management of a financial instrument through performance based fees, comprising administrative fees and additional policy-related incentives', which may be foreseen in the relevant Delegation Agreement. These very similar market methods and screening methods regarding alignment of interests and remuneration under the EFG and the GBER/RFG are deemed to ensure that distortive effects may be minimised.

In accordance with section 3 o), the EFG Financial Intermediary and the Pan-European VC Fund-of-Funds are **monitored and audited by the Commission, the EIF, and the European Court of Auditors**. Accordingly, under Article 12 GBER, the Commission monitors financial instruments, while the relevant Member State must report and maintain detailed records regarding aid measures in accordance with section 5.4 of the Risk Finance Guidelines. These are screening methods in order to held the relevant agents accountable vis-à-vis the relevant principals (see chapter VIII).

Section 4. of Annex 1a lays down **criteria for the selection of EFG Financial Intermediaries and Pan-European VC Fund-of-Funds**. Section 4.1 stipulates that applicants must comply with one or more of the requirements set out. Section 4.2 lays down the general requirements for the selection of the Financial Intermediary and the Fund-of-Funds: They must a. comply with the requirements of Articles 4.3 and 4.4 of the FAFA, b. agree to publicise the support of the EU under the EFG, c. transpose these requirements into their agreements with final recipients and agree not to select excluded final recipients or agree to request their investee funds not to select excluded final recipients, respectively.

Moreover, section 4.3 lays down the **instrument-specific requirements**: Firstly, Financial Intermediaries must provide long-term equity and/or quasi-equity involving up to 15 years positions. Secondly, they may not include in their business activity certain activities.[1107] Thirdly, they must target in their investment strategy and commit in writing to invest more than 50 per cent of their invested amounts in eligible final recipients. The GBER does not state such a condition, but requires 'a commercially sound investment strategy for the purpose of implementing risk finance measures' under Article 21 (14) (b) GBER. Fourthly, they must be established in a participating country (further specified in the Delegation Agreement).

Fifthly, they must be commercially-oriented managed by independent management teams (i.e. teams operating within a corporate or university structure provided that the operation of the fund management implies a high degree of independence from the parent company/organisation), 'combining the appropriate mix of skills and experience to demonstrate the necessary capability and credibility to manage a risk capital fund' ('individual members are not required to have prior direct experience of fund management, provided that they can otherwise demonstrate appropriate capabilities within the team to manage the EFG Financial Intermediary, whereby the management team as a whole will be evaluated…') and able 'to demonstrate a clear strategy to make sufficient number of investments' into eligible final recipients/into EU target investees, 'create adequate deal flow, and establish appropriate exit strategies', as well as applying 'good market practice in areas such as legal structure, investment principles, reporting, and evaluation'. Finally, they must be willing to comply with certain requirements regarding reporting, visibility, evaluations and surveys, excluded investments, and transparency.

The requirements for financial intermediaries of the GBER and the Commission Delegated Regulation (EU) No 1303/2013 (CDR) are comparable to the terms and conditions of the Delegation Agreement. Both sets of requirements stipulate market mechanisms that strive to minimise potential distortive effects on the market. Article 21 (14) (a) and (d) GBER require that financial intermediaries be established according to applicable laws and have 'a clear and realistic exit strategy… for each equity and quasi-equity investment'. Article 21 (14) (b) GBER requires that

[1107] These are: i. illegal activities, ii. activities excluded under Article 19 of Regulation (EU) No 1291/213 (establishing Horizon 2020), and iii. any activity that would render an EU investment not compatible with the Guidelines on the EIF Restricted Sectors (i.e. economic sectors, in which the EIF is restricted to operate).

the Member State or the entity entrusted with the implementation conduct a due diligence process 'in order to ensure a commercially sound investment strategy'.

Also the RFG stipulate in point 67 that 'to ensure that the financial intermediaries involved in the measure target the identified market failures, a due diligence process shall take place to ensure a commercially sound investment strategy focusing on the identified policy objective and respecting the defined eligibility requirements and funding restrictions', i.e. financial intermediaries must therefore 'demonstrate that their proposed investment strategy is commercially sound and includes an appropriate risk diversification policy aimed at achieving economic viability and efficient scale in terms of size and territorial scope of the investments'.

Moreover, Article 21 (15) GBER requires cumulatively that they are managed on a commercial basis through being obliged by law or contract with the diligence of a professional manager, their remuneration being conform to market practices, receiving a remuneration linked to performance or co-investing, setting out an investment strategy, and investors being represented in the governance bodies. While these requirements are comparable to those of the Delegation Agreement (as elaborated above), Article 21 (13) (b) GBER also requires that financial intermediaries be selected through an open, transparent, and non-discriminatory call. Annex 1a of the COSME Delegation Agreement itself does not state such a requirement. However, Article 4.2 of the FAFA stipulates that the financial intermediaries be selected on the basis of open, transparent, proportionate, and non-discriminatory procedures.

Moreover, Section 6 covers the **selection process for EU investments into the EFG Financial Intermediaries and the Pan-European VC Fund-of-Funds** (please note, for confidentiality reasons, parts of this section have been blackened in the version accessible to the author, so that the analysis of this part could only be conducted with regard to the readable parts) and, importantly, section 6.1 refers to the call for expression of interest containing the criteria as well as the application and selection process to be applied, which can be found online on the website of the EIF.[1108] This publication of the call for expression of interest refers to the selection of

[1108] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Equity Facility for Growth and InnovFin Equity, https://www.eif.org/what_we_do/equity/single_eu_equity_instrument/call/Joint%20InnovFin%20Equity%20and%20COSME%20EFG%20Call%20for%20Expression%20of%20Interest.pdf, last access: 13.06.2019.

applicants 'in due consideration of the general principles of transparency, equal treatment, and non-discrimination.[1109] This is in line with the procedure under Article 21 (13) (b) GBER.

After the description of the application process, the **call for interest** specifies the **selection process of the Financial Intermediary**, the **assessment criteria** of which are the following: regarding the management team, the relevant experience, the composition, track record, and balance of skills, the ability to provide relevant added value and adequate commitment for the life of the fund, as well as the screening of its members in accordance with market practice; regarding the market, the identification of the target market, the size of the market and its development potential, and the growth potential of enterprises in the target market; regarding the deal flow, track record, quality of deals, and credibility of plans to develop deal flows; regarding the investment strategy, the balance between fund size and expected deal flow and the adequacy of provision for follow investment; regarding proposed terms, their being in line with market norms with explanations for deviations, any performance related remuneration, and the legal and tax structure; regarding expected returns, evidence that the fund is to be run on a commercial basis and that it can be expected to be financially viable; regarding the investor base, the pari passu ranking of market oriented investors, evidence of support from investors, the co-investment strategy and rationale, and the screening and monitoring of co-investors.

Moreover, it clarifies the assessment criteria for the policy fit, which are the expected support to eligible final recipients in the expansion and growth phase and/or early stage phase, the additionality of the envisaged investment (i.e. leverage potential and absence of crowding-out), the contribution to the development of a structurally balanced equity funding market, the investment strategy of the applicant, and the prospect of promoting the development of the portfolio companies cross-border.

In comparison, Article 7 CDR lays down similar selection and award criteria. Its selection criteria also refer to the legal, economic and financial, as well as organisational capacity and the experience of the applicants, while its award criteria likewise refer to the investment

[1109] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Equity Facility for Growth and Innovfin Equity, https://www.eif.org/what_we_do/equity/single_eu_equity_instrument/call/Joint%20InnovFin%20Equity%20and%20COSME%20EFG%20Call%20for%20Expression%20of%20Interest.pdf, last access: 16.06.2019, p.4.

methodology, the ability to raise additional resources, the additionality of investment activity, and the level of management costs and fees of the applicants. Thus, the criteria for the selection of financial intermediaries of COSME financial instruments possess a similar standard as compared to the selection criteria of those falling within the scope of Article 107 (1) TFEU. Both sets of criteria contain elements of market practice and standards as well as the alignment to the policy objective of the relevant instrument. These are again intended to minimise potential and unnecessary negative effects the aid could have on the market and competition.

Section 5 of Annex 1a lays down the **requirements for final recipients**: EFG Financial Intermediaries/investee funds of a Pan-European VC Fund-of-Funds 'shall undertake to select final recipients according to their internal rules and procedures taking due account of the economic viability of projects of the final recipients'. Section 5.1 excludes final recipients, who do not comply with the requirements of Sections 4.3 and 4.4 of the FAFA, are not willing to comply with Articles 19 and 20 of the Delegation Agreement (visibility and publication requirements), or which pursue excluded business activities.

Section 5.2 stipulates the **instrument-specific requirements**. For instance, regarding the minimum allocation by Expansion and Growth Stage Financial Intermediaries, final recipients may only be eligible if they fulfil the following conditions: the final recipient is an SME immediately before or after the time of first investment, it is established and operating in a participating country at the time of first investment, it is in its expansion and growth stage at the time of first investment, and it is not an excluded final recipient.

This scope of eligible final recipients is rather broad. In contrast, the scope of eligible undertakings under Article 21 (5) GBER is more specific and hence stricter: They may only be unlisted SMEs, which either have not been operating in any market, or have been operating in any market for less than 7 years following their first commercial sale, or require an initial risk finance investment entering a new product or geographical market. Although the Risk Finance Guidelines broaden the scope of eligible undertakings under point 47, the scope remains more specific and hence limited, while an ex-ante assessment establishing a financing gap must additionally be conducted.

In sum, although the criteria of the Annex to the Delegation Agreement on the EFG differ from those of state aid rules, i.e. the GBER and the Risk Finance Guidelines, both sets of rules follow the same aim: They set specific ceilings and maximum amounts of aid in order to retain the aid at a minimum, hence minimising the aid element. Moreover, they apply principles and rules, such as the pari passu requirement and other market mechanisms, that are meant to minimise any excessive aid and its distortive effects. However, the EFG's terms do not provide under which circumstances asymmetric profit sharing could be allowed, rendering it harder for the EFG to attract private investment.[1110] Lastly, they both employ screening methods to hold the relevant agents accountable vis-à-vis the relevant principals of EU and Member States' financial instruments, respectively.

However, and in stark contrast to what the EU Courts require for financial instruments at the Member State level in their case law, it becomes apparent that the Commission did not include any rules into the FAFA or the Delegation Agreement, which would oblige either itself or the EIF to conduct the balancing of positive and negative effects of the aid or to (pre-)assess the correspondence between the market failure and the amount of the aid or between the amount of the aid and its impact on the market.

[1110] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 4.

Table 4: Comparison of the provisions of Annex 1a to the EFG COSME financial instrument and state aid rules

Topic	Annex 1a to EFG	State aid rules
Maximum size of investments	Section 3 c): EU investment in financial intermediary up to EUR 30 million, in Pan-European VC fund of funds up to EUR 100 million.	Article 4 GBER: Investment per undertaking up to EUR 15 million for risk finance aid (notification threshold).
Private sector funding	Section 3 f): majority of capital committed must be provided by investors that pass the MEIP to leverage private investment.	Article 21 (10) GBER: Minimum participation thresholds from private funding, ranging from 10 to 60 per cent, depending on the type of the eligible undertaking.
Pari passu requirement	Section 3 g): EU investments must rank pari passu with investors investing in the same risk class; the EIF is free to accept more favourable terms applicable for other investors.	Section 2.1. RFG on MEIP: (i) the public and private investment must be concomitant, (ii) the private investment must be of a significant amount, (iii) the risk and rewards of the public and private investor must be equivalent, and (iv) private investors must be independent from undertakings they invest in.
Representation of investments	Section 3 h): EIF ought to be represented in advisory boards or similar investor representation bodies, but not on governing bodies of financial intermediaries or fund-of-funds with individual investment or divestment decisions.	Article 21 (15) (e) GBER: investors to be represented in the governance bodies of the investment fund (supervisory board or advisory committee). Para. 62 RFG: Member States may not participate directly in individual investment and divestment decisions; an appropriate governance structure must ensure that material changes to the investment strategy require the prior consent of the Member State.
Governance structure	Section 3 i): financial intermediaries and fund-of-funds must have a governance structure that allows for decisions concerning investments, divestments, and risk diversification in line with legal documentation and market practice.	Article 21 (15) GBER: Financial intermediaries must be managed on a commercial basis. Para. 62 RFG: There must be an appropriate governance structure with regard to the investment strategy.
Avoidance of conflicts of interest and alignment of interests	Section 3 l): EIF must seek to negotiate appropriate measures to be put in place by the financial intermediary for avoiding conflicts of interest and aligning the interests of the financial intermediary, its manager, and its investors; financial intermediary's management team must make direct or indirect investment of a significant amount.	Article 21 (15) (a) GBER: financial intermediaries and fund managers must act with the diligence of a professional manager in good faith and avoiding conflicts of interest. Article 21 (15) (c) GBER: financial intermediaries and fund managers must receive performance-linked remuneration or co-invest in order to align interests. Para. 103 RFG: Co-investment could contribute to ensure that investment decisions are aligned with relevant policy targets.

		Para. 141 RFG: Economic alignment of interests between Member State and financial intermediaries or their managers can minimise aid.
Remuneration of financial intermediaries and fund-of-funds manager	Article 13 (1) FAFA: Commission must remunerate EIF for set-up, implementation and management of financial instruments through performance based fees. Section 3 m): remuneration of financial intermediaries and fund-of-funds manager must be transparent to investors and fees be negotiated at a level that covers operational and management costs in a sustainable way without distorting the alignment of interest.	Article 21 (15) (c) GBER: financial intermediary and fund manager must receive a performance-based remuneration (or co-invest). Para. 143 RFG: Remuneration of financial intermediary or fund managers must include an annual management fee as well as performance-based incentives.
Audit and monitoring	Section 3 o): financial intermediaries and fund-of-funds are monitored and audited by the Commission, the EIF, and the ECA.	Article 12 GBER: Commission monitors financial instruments. Section 5.4 RFG: Member States must report and maintain detailed records.
Criteria for the selection of financial intermediaries and fund-of-funds	Section 4: General requirements and instrument-specific requirements, (i.a. of Articles 4.3 and 4.4 FAFA and exclusion of certain final recipients and activities), commercial management, clear investment strategy, clear exit strategy, reporting, visibility, evaluation requirements; assessment criteria published in term sheet online. Section 4.3: financial intermediaries must provide long-term equity and/or quasi-equity up to 15 years, may not include in their business activity certain activities, must target in their investment strategy and commit in writing to invest more than 50 per cent of their invested amounts in eligible final recipients, must be established in a participating country, must be commercially-oriented managed by independent management teams, and must be willing to comply with certain requirements regarding reporting, visibility, evaluations and surveys, excluded investments and transparency.	Article 21 (14) (a) and (d) GBER: financial intermediaries must be established according to applicable laws and have a clear and realistic exit strategy for investments. Article 21 (14) (b) GBER: there must be a commercially sound investment strategy for the implementation of risk finance measures and Member States or entrusted entity must conduct a due diligence process to ensure a commercially sound investment strategy. Article 21 (15) GBER: financial intermediaries must be managed on a commercial basis, their remuneration be conform to market practices (performance based or co-investment), setting out an investment strategy, and investors be represented in governance bodies.
Final recipients	Section 5: Financial intermediaries must select them according to their internal rules and procedures and taking into account the economic viability of the projects of the final recipients. Section 5.1: Refers to exclusion criteria of sections 4.3 and 4.4. FAFA.	Article 21 (5) GBER: unlisted SMEs, which either have not been operating in any market, or have been operating in any market for less than 7 years following their first commercial sale, or require an initial risk finance investment entering a new product or geographical market.

	Section 5.2: eligible are SMEs immediately before or after the time of the first investment, established and operating in participating country, in expansion or growth stage, and not an excluded final recipient.	

Source: author

2.2.2. The Policy and Operational Guidelines for the LGF (Annex 1b)

In the following, the specific conditions on state aid consistency of Annex 1b relating to the LGF will be elaborated on. Section 3. of Annex 1b lays down the conditions of the EU Guarantees for Debt Financing under the LGF. The **characteristics and types of EU guarantees** are the following: Pursuant to section 3. a), EU guarantees under the LGF are first loss capped portfolio guarantees 'in the form of a guarantee, co-guarantee, or counter-guarantee to be provided to a LGF Financial Intermediary and covering the LGF Portfolio' (including guarantees for LGF Financial Intermediaries providing on-lending and/or risk-sharing structures covering LGF final recipients). Pursuant to section 3. b), the LGF Financial Intermediary provides enhanced access to finance by including in the portfolio only newly generated transactions belonging to one of two specified higher risk categories with several sub-categories.

In comparison, Article 21 (9) GBER limits the maximum amount of risk finance to EUR 15 million per undertaking and Article 21 (16) (c) GBER requires guarantees that the nominal amount of the underlying loan be taken into account in calculating the maximum amount, while the guarantee may not exceed 80 per cent of the underlying loan. However, unlike Annex 1b of the Delegation Agreement, the GBER also states under Article 21 (16) (a) GBER the condition that, as a result of the measure, the financial intermediary must 'undertake investments that would not have been carried out' (or in a restricted or different manner) without the aid, being 'able to demonstrate that it operates a mechanism that ensures that all advantages are passed on to the largest extent to the final beneficiaries', e.g. via higher volumes of financing, riskier portfolios, lower collateral requirements, lower guarantee premia, or lower interest rates. This is missing in the Annex's stipulations. In a more specific way, the GBER thus ensures that advantages be passed on.

Furthermore, section 3. d) sets out an **availability period for each EU guarantee**, which may 'usually cover a period of 2 to 3 years', and section 3. e) requires a maximum portfolio volume to be agreed between the EIF and the LGF Financial Intermediary taking into account the LGF Financial Intermediary's capacity to generate the LGF transactions. Section 3. f) requires a guarantee rate for the transactions, which may not exceed 50 per cent and 'will typically be set at its maximum' to ensure a risk retention of 20 per cent and which is to be determined individually for each LGF portfolio.

The same applies for the **guarantee cap rate** under section 3 g): It must be set by the EIF after having performed its due diligence process, be determined for each EU guarantee individually having regard to the expected losses, and may not exceed 20 per cent. Furthermore, the obligation of the EIF to cover losses is to be 'capped at a pre-set amount, which is, at any time the guarantee cap amount' (amounts exceeding the cap amount must be clawed back by the EIF) pursuant to section 3. h). The guarantee cap amount is 'calculated on a portfolio basis as the product of the actual portfolio volume, the guarantee rate, and the guarantee cap rate in accordance with the same section of Annex 1b.

The conditions for LGF guarantees are similar to those of guarantees falling within the scope of Article 107 (1) TFEU. For the latter, the Commission Notice states under section 3.2 the cumulative conditions that 'the extent of the guarantee can be properly measured when it is granted', i.e. that it is linked to a specific financial transaction with a fixed maximum amount and limited in time, that the guarantee does not cover more than 80 per cent of the outstanding loan or other financial obligation (comparable in terms of the minimum risk retention of 20 per cent of LGF guarantees, although the condition of the Notice does not apply to guarantees covering debt securities), and that a market-oriented price is paid for the guarantee, which, however, is not a condition for LGF guarantees to ensure state aid consistency.

This is in line with the case law of the EU Courts: According to *HH Ferries*, the Commission is required to examine whether the aid element in a guarantee is limited in terms of time and amount.[1111] Moreover, for the assessment of proportionality and the necessity of the aid, while a final precise figure is not required, the Commission is obliged to provide a method for determining the aid element: 'the assessment of the proportionality of aid implies verification whether the aid is limited to the minimum necessary to achieve its objectives… which implies knowledge of the extent, to which the aid is necessary… and therefore knowledge of how to calculate the aid element in advance'.[1112] However, as it is the case with the Annex 1a on the EFG financial instrument, there is no requirement for the EIF, for instance, to assess the correspondence of the amount of the aid with the extent of the market failure or the impact on the market.

[1111] Case T-68/15 HH Ferries et al v European Commission, para. 137.
[1112] Case T-68/15 HH Ferries et al v European Commission, para. 150.

Article 5 (2) (c) (ii) GBER also requires that guarantees be transparent and therefore the amount of aid be known at the moment of granting. Further, Article 21 (16) (c) GBER prescribes for guarantees covering losses from risk finance investments that their guarantee rate must be limited to 80 per cent (except for the exception of the Risk Finance Guidelines, which allows for a maximum guarantee rate of 90 per cent under paragraph 117), and that the total losses assumed by a Member State must be capped at a maximum of 25 per cent of the underlying guaranteed portfolio, in accordance with Article 21 (13) (d) GBER (at any rate, not exceeding 35 per cent in accordance with paragraph 118 of the Risk Finance Guidelines). However, unlike the GBER under Article 21 (9) in conjunction with (16) (c) GBER, Annex 1b of the Delegation Agreement does not provide a maximum total amount of risk finance per eligible undertaking.

The **guarantee coverage period** must cover losses 'occurred at the latest ten years after the date of signature of the relevant' Intermediary LGF transaction, while the relevant final recipient LGF transaction 'may have longer terms', according to section 3. j). Similarly, the Risk Finance Guidelines state in paragraph 119 that 'the duration of a guarantee should be limited in time, normally up to a maximum of 10 years'.

Section 3. k) provides that 'subject to the relevant guarantee rate and the guarantee cap amount, the EIF will rank **pari passu** with the LGF Financial Intermediary with regard to loss recoveries. However, as a deviation from the pari passu rule, loss recoveries may be 'deducted from the payments to be made by the EIF against guarantee calls', and 'be taken into account by an estimated loss recovery rate ex ante'. Importantly, for the consistency with state aid rules, the Commission thus requires from the EIF that it enjoy downside protection on the same terms as the Financial Intermediary, so that it may not possess a more advantageous position. However, it does not state conditions with regard to the equal sharing of rewards. Interestingly, in its Risk Finance Guidelines, the Commission lays down in paragraph 85 that 'any preferential treatment granted to private investors or lenders has to be weighed against the public interest which consists of ensuring the revolving nature of the public capital committed and the long-term sustainability of the measure' and in paragraph 135 that 'the measure must ensure a balance between the preferential conditions offered by a financial instrument in order to maximise the leverage effect while addressing the identified market failure and the need for the instrument to

generate sufficient financial returns to remain operationally viable' under the necessity and proportionality principles, respectively. Interestingly, the Commission does not require such a weighing against the public interest for the EIF, as such a mechanism would be apt to minimise distortive effects caused by preferential conditions.

Furthermore, unlike the Annex 1a, Annex 1 b does not provide requirements as to the representation of the EIF or the governance structure of the Financial Intermediary. This may have to do with the fact that the former is concerned with equity, while the latter is with guarantees.

Section 4 of Annex 1b lays down the **conditions for the EU Guarantee for Securitisation**. Pursuant to section 4. a), the EU Guarantee for Securitisation 'will be provided in respect of the mezzanine tranche of securitised portfolios consisting of at least 80 per cent of SME debt finance transactions (the remainder may include corporate loans with larger corporates) and implemented, depending on market demand, according to options specified in the Annex. In accordance with section 4 b), the EIF may issue the EU Guarantee in form of a wrap (i.e. a financial guarantee provided for the benefit of all note holders in respect of a given class of notes) or a bilateral guarantee (i.e. a bilateral agreement between the EIF and a note holder), or, alternatively, a credit default swap, depending on the nature of the transaction, the size of the tranche, and the budget available for the relevant transaction.[1113]

With regard to the **alignment of interests between originators and investors**, the Financial Intermediary must 'keep a material interest in the Portfolio by either (i) retaining a vertical tranche, which has a nominal value of no less than 5 per cent of the total nominal value of the securitised portfolio, or by (ii) retaining the first loss piece of the portfolio (at least 5 per cent of the total nominal value of the securitised portfolio)' pursuant to section 4. c). This provision is similar to its counterpart in Annex 1a on the EFG, which requires that the Financial Intermediary's management team make a direct or indirect investment of a significant amount. Interestingly, neither the GBER, nor the Risk Finance Guidelines, nor the Commission Notice on Guarantees

[1113] Moreover, in accordance with section 4. d), the Securitised Portfolio must 'contain at least 80 per cent of transactions with SMEs' and 'none of the financing transactions… shall be made with companies active in the restricted sectors', which are defined in section 7.1. of Annex 1b.

provide comparably specific conditions for the alignment of interests with regard to guarantees falling within the scope of Article 107 (1) TFEU.

Furthermore, the EU Guarantee has a **maximum term** of up to 10 years and has to be 'up to 100 per cent of the portion of the mezzanine tranche, which is subject to the EU Guarantee for Securitisation' in accordance with sections 4. e) and f). The Risk Finance Guidelines provide in paragraph 119 a similar maximum duration: 'The duration of a guarantee should be limited in time, normally up to a maximum of 10 years'. The beneficiaries may be the note holders and the originator under section 4. g).

Section 4. i) lays down that the EU Guarantee must be provided against a **guarantee fee** to be paid by the beneficiary (note holders or originator) to the EIF, which must be in line with 'prevailing market rates' or, in the absence thereof, at a level that sufficiently covers the risk and associated costs of the mezzanine tranche. For the definition of the latter, importantly, this section refers to the Guarantee Notice of the Commission. Thus, the terms and conditions of Annex 1b of the Delegation Agreement are aligned with section 3.2 (d) of the Commission Notice, requiring that 'a market-oriented price is paid for the guarantee', and section 3.4 (f) that premia be in line with market prices for guarantee schemes, so that an aid element may be minimised.

Section 4 j) provides **conditions for the coverage of the Guarantee**: The EIF must 'undertake to pay certain amounts of principal and interest in respect of the guaranteed asset backed securities, or, in the case of synthetic structures, amounts due in respect of losses allocated to the guaranteed tranche'. Moreover, this section stipulates that the allocation of losses be on a sequential basis, go inversely to tranche amortisation, and that all losses be allocated first to the first loss tranche, then to the mezzanine tranche, and finally to the senior tranche. The more general Commission Notice on Guarantees does not provide information regarding a sequential basis of loss allocation, but states in section 3.2 (c) that 'losses have to be sustained proportionally and in the same way by the lender and the guarantor'.

Section 4. k) covers the Guarantee **coverage period**, i.e. losses occurred must be covered at the latest ten years after the date of signature of the relevant EU Guarantee. Similarly, the Risk

Finance Guidelines state in paragraph 119 that 'the duration of a guarantee should be limited in time, normally up to a maximum of 10 years'.

Under the LGF, the build-up of an additional portfolio is possible: Section 4. m) stipulates that the EIF must 'contractually link the EU Guarantee for the mezzanine tranche of the securitisation transaction to the written commitment by the originator', so that the **build-up of an additional portfolio**, i.e. the portfolio of new eligible final recipient transactions under an EU Guarantee for Securitisation, of 100 per cent final recipient transactions is possible. In accordance with section 4. n), the availability period, during which the additional portfolio is built up, must be agreed between the originator and the EIF, covering 'typically up to 3 years'.

Section 4. o) requires the application of **commitment fees**, if the Financial Intermediary does not reach the target size of the Additional Portfolio volume, 'in order to encourage the build-up by the originator and to ensure that it cannot derive an undue benefit from the EU Guarantee'.[1114] Interestingly, such a commitment fee to prevent an undue benefit can neither be found in the GBER, nor in the Risk Finance Guidelines, nor in the Commission Notice on guarantees, as they do not elaborate on additional portfolios in a comparable way. Article 21 (15) (c) GBER and paragraph 143 RFG provide for performance-based remuneration only, as discussed above.

Section 5 covers **reporting, monitoring and audit, and management of reputational risk requirements** for EU Guarantees, which must be adhered to by the Financial Intermediary vis-à-vis the Commission, the EIF, and the ECA, as it is the case under Annex 1a. Similarly, section 6 of the Commission Notice on guarantees requires Member States to report on details of i.a. the guarantees issued and outstanding (numbers and amount), the yearly income, and the yearly costs to the Commission on a regular, therein specified basis.

Section 6 of Annex 1b covers the **selection of Financial Intermediaries**, namely the eligibility criteria and general requirements. Referring to Article 4 of the FAFA, the EIF must select Financial Intermediaries on the basis of open, transparent, objective, and non-discriminatory procedures, avoiding conflicts of interest and taking into account 'the nature of the financial instrument, the

[1114] The commitment fees must be calculated 'by applying 450 bps on the difference between the Actual Portfolio Volume and the target Additional Portfolio volume as per the formula further specified under section 4. o) of Annex 1b to the Delegation Agreement on COSME financial instruments.

experience and the operational and financial capacity of the entities concerned' and the guidelines elaborated on by section 6.
Thus, like Article 21 (13) (b) GBER, Annex 1b requires that financial intermediaries be selected through an open, transparent, and non-discriminatory call. Like Article 7 CDR, it refers to the required financial capacity and experience of the financial intermediary.

Section 6.1 covers the **eligibility requirements** for the LGF Financial Intermediary, the Originator, and the LGF Financial Sub-Intermediary: They must be 'a financial institution or credit institution duly authorised… to carry out lending or leasing activities or providing bank guarantees, or a guarantee scheme, guarantee institution, or other financial or credit institution duly authorised… to issue guarantees… as well as be established and operating in one or more participating countries. Like Article 7 CDR, this refers to the legal capacity of the applicant. With regard to the general requirements, section 6.2 requires that LGF Financial Intermediaries comply with the requirements of Article 4.3 and 4.4 of the FAFA and with specified requirements regarding visibility, reporting, evaluation, and activities.

Section 8 elaborates on the **selection process**, **selection criteria, and the impact assessment** regarding applicants. It prescribes a call for expression of interest to be published on the EIF website and the selection process, including the pre-selection, due diligence, and final selection.[1115] The publication of the expression of interest specifies the assessment criteria for applications regarding capped '(Counter-)Guarantee expressions of interest' as well as 'Securitisation expressions of interest', which are the capacity of the applicant to comply with all contractual obligations, the capacity to manage the risk of the operation, the experience and ability to finance (or facilitate finance) SMEs, and the quality and plausibility of the COSME LGF implementation proposal.[1116] Thereafter, the due diligence will assess general information, such as the institution's business plan, risk management, and reporting abilities, financial information,

[1115] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019.
[1116] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019, pp.6, 7.

such as funding sources and ownership structure, pricing policy, and the proposal of enhanced access to finance, i.e. showing the ability to build up the envisaged portfolio.[1117]

As stated above, in comparison, Article 7 CDR lays down similar selection and award criteria. Its selection criteria also refer to the legal, economic and financial, as well as organisational capacity and the experience of the applicants, while its award criteria likewise refer to the investment methodology, the ability to raise additional resources, the additionality of investment activity, and the level of management costs and fees of the applicants. Thus, the criteria for the selection of financial intermediaries of COSME financial instruments possess a similar standard as compared to the selection criteria of those falling within the scope of Article 107 (1) TFEU. Both sets of criteria contain elements of market practice and standards as well as the alignment to the policy objective of the relevant instrument. These tools are aimed at minimising the potential distortive effects in a comparable way, namely through a prescriptive screening and selection process of the financial intermediaries, as can be seen from the comparison of both sets of criteria.

Section 7 covers the **selection of final recipients**: Financial (Sub-)Intermediaries must select them 'according to their internal rules and procedures and taking due account of the economic viability of projects of the final recipients'. The general requirements are listed in section 7.1, according to which final recipients must comply with the requirements of Article 4.4 of the FAFA and Articles 19 and 20 of the Delegation Agreement, may not pursue illegal activities, and may not be subject to insolvency proceedings. Section 7.2 lists the instrument-specific eligibility criteria: The Final Recipient must be an SME and be established and operating in a participating country. In contrast, as stated above, the scope of eligible undertakings under Article 21 (5) GBER is more specific and hence stricter: They may only be unlisted SMEs, which either have not been operating in any market, or have been operating in any market for less than 7 years following their first commercial sale, or require an initial risk finance investment entering a new product or geographical market. Although the Risk Finance Guidelines broaden the scope of eligible undertakings under point 47,

[1117] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019, p.8.

the scope remains more specific and hence limited, while an ex-ante assessment establishing a financing gap must additionally be conducted.

Section 7.3 covers the **instrument-specific transaction criteria for EU Guarantees for Debt Financing**: They must be newly generated transactions, which fall into one of the higher risk categories laid out in section 3. b), have a minimum maturity of 12 months, be granted for investment in tangible and/or intangible assets and/or financing working capital, be financing transactions up to EUR 150,000, be transactions that comply with the thresholds laid down in Article 4 (6) (b) of the *de minimis* Regulation 1407/2013, and be a debt instrument, such as loans or leases or bank guarantees. Accordingly, state aid consistency is aimed at through the compliance with the *de minimis* requirement, thus excluding an aid element.

Section 7.4 covers the **instrument-specific transaction criteria for EU Guarantees for Securitisation**: They must be newly generated transactions, have a minimum maturity of 12 months, and be granted for investment in tangible and/or intangible assets and/or financing working capital.

In sum, as those of Annex 1a on the EFG, the provisions of Annex 1b on the LGF differ from those under state aid law, but apply the same market and screening mechanisms in order to retain the aid element at a minimum. As the EU Courts require it following the judgment of *HH Ferries*, guarantees under the LGF are limited both in the amount of aid and in time. This limitation only relates to the input, but does not indicate what the output, let alone the outcome of the use of the relevant financial instrument is, i.e. whether market distortions are caused.

Importantly, the provisions of the Annex on the LGF require neither a weighing of preferential conditions of financial instruments against the public interest and in terms of the necessity and proportionality principles in particular, nor a weighing/balancing of positive and negative effects of the aid in general in accordance with the balancing exercise of the case *Smurfit Kappa*. Thus, also with regard to the provisions on the LGF, the Commission applies rules and mechanisms that limit the amount of aid and hence minimise excessive aid elements, but does not implement tools for the assessment of the correspondence between the amount of aid and the extent of the market failure or the impact on the market.

Table 5: Comparison of the provisions of Annex 1b to the LGF COSME financial instrument and state aid rules

Topic	Annex 1b to LGF	State aid rules
Conditions for guarantees	Section 3a): EU guarantees are first loss capped portfolio guarantees in the form of a guarantee, co-guarantee, or counter-guarantee or to be provided to a LGF financial intermediary and covering the LGF portfolio. Section 3 b): LGF financial intermediary provides enhanced access to finance by including in the portfolio newly generated transactions pertaining to one of two in the Annex specified higher risk categories with several sub-categories. Section 3 d): availability period of guarantees may usually cover a period of 2 to 3 years. Section 3 e): maximum portfolio guarantee volume must be agreed between the EIF and the LGF financial intermediary. Section 3 f): guarantee rate for transactions required, which may not exceed 50 per cent and will typically be set at its maximum to ensure risk retention of 20 per cent and which must be determined individually for each LGF portfolio. Section 3 j): guarantee coverage period must cover losses occurred at the latest ten years after the date of signature of the relevant intermediary transaction. Section 4 a) (on EU guarantees for securitisation): must be provided in respect of the mezzanine tranche of securitised portfolios consisting of at least 80 per cent of SME debt finance transactions. Section 4 e) and f) (on EU guarantees for securitisation): maximum term of 10 years and must be up to 100 per cent of the portion of the mezzanine tranche. Section 4 i) (on EU guarantees for securitisation): guarantee fee paid by the beneficiaries to the EIF must be in line with prevailing market rates or at a level	Article 21 (9) GBER: maximum amount of risk finance must be EUR 15 million per undertaking. Article 21 (13) (d) GBER: total losses assumed by Member States must be capped at a maximum of 25 per cent of the underlying guaranteed portfolio. Article 21 (16) (a) GBER: financial intermediary must undertake investments that would not have been carried out or in a restricted or different manner without the aid, and that it is able to demonstrate that it operates a mechanism that ensures that all advantages are passed on to the largest extent to the final beneficiaries. Article 21 (16) (c) GBER: in calculating the maximum amount for guarantees, the nominal amount of the underlying loan must be taken into account; the guarantee may not exceed 80 per cent of the underlying loan. Para. 117 RFG: guarantee rate up to 90 per cent. Para. 118 RFG: in the case of capped guarantees, total losses assumed by Member States may not exceed 35 per cent. Para. 119 RFG: duration of the guarantee should be limited in time, normally up to a maximum of 10 years. Sections 3.2 (b) and 3.4 (b) Commission Notice on guarantees: Extent of the guarantee must be properly measured when granted, must be linked to a specific financial transaction, for a fixed maximum amount and limited in time. Section 3.2 (d) Commission Notice on guarantees: a market-oriented price must be paid for the guarantee. Section 3.4 (f) Commission Notice on guarantees: premia must be in line with market prices for guarantee schemes.

	that sufficiently covers the risk and associated costs of the mezzanine tranche. Section 4 k) (on EU guarantees for securitisation): losses occurred must be covered at the latest 10 years after the date of signature of the EU guarantee.	
Pari passu requirement	Section 3 k): subject to relevant guarantee rate and guarantee cap amount, the EIF will rank pari passu with LGF financial intermediaries regarding loss recoveries; loss recoveries may be deducted from the payments to be made by the EIF against guarantee calls. Section 4 j) (on EU guarantees for securitisation): The allocation of losses must be on a sequential basis, inversely to tranche amortisation, and all losses be allocated first to the first loss tranche, then to the mezzanine tranche, and finally to the senior tranche.	Paras. 38, 85, and 135: Conditions for co-investors must be based on MEIP; any preferential treatment granted to private investors has to be weighed against the public interest, and the principles of proportionality and necessity with regard to the identified market failure and the need for the instrument to generate sufficient financial returns. Section 3.2 (c) Commission Notice on guarantees: losses have to be sustained proportionally and in the same way by the lender and the guarantor.
Representation of investments	No provision	Article 21 (15) (e) GBER: investors to be represented in the governance bodies of the investment fund (supervisory board or advisory committee). Para. 62 RFG: Member States may not participate directly in individual investment and divestment decisions; an appropriate governance structure must ensure that material changes to the investment strategy require the prior consent of the Member State.
Governance structure	No provision	Article 21 (15) GBER: Financial intermediaries must be managed on a commercial basis. Para. 62 RFG: There must be an appropriate governance structure with regard to the investment strategy.
Avoidance of conflicts of interest and alignment of interests	Section 4 c) (on EU guarantees for securitisation): financial intermediary must keep a material interest in the portfolio by either retaining a vertical tranche, which has a nominal value of no less than 5 per cent of the total nominal value of the securitised portfolio, or by retaining the first loss piece of the portfolio.	No comparable provision specific to guarantees.
Remuneration of financial intermediaries and fund-of-funds manager	Article 13 (1) FAFA: Commission must remunerate EIF for set-up, implementation and management of financial instruments through performance-based fees.	Article 21 (15) (c) GBER: financial intermediary and fund manager must receive a performance-based remuneration (or co-invest). Para. 143 RFG: Remuneration of financial intermediary or fund managers must

	Section 4 j) (on EU guarantees for securitisation): EIF must pay certain amounts of principal and interest regarding the guaranteed asset backed securities, or in the case of synthetic structures, amounts due in respect of losses allocated to the guaranteed tranche. Section 4 o) (on EU guarantees for securitisation): application of commitment fees, if the financial intermediary does not reach the target size of an additional portfolio volume to encourage the build-up by the originator and ensure that it cannot derive undue benefit from the EU guarantee.	include an annual management fee as well as performance-based incentives.
Audit and monitoring	Section 5: reporting, monitoring and audit, and management of reputational risk requirements for EU guarantees vis-à-vis the Commission, the EIF, and the ECA.	Section 6. Commission Notice on guarantees: reports on details of the guarantees issued and outstanding (number and amount), yearly income, yearly costs, etc. must be provided to the Commission by Member States on a regular specified basis.
Criteria for the selection of financial intermediaries and fund-of-funds	Section 6: General requirements and instrument-specific requirements, (i.a. of Articles 4.3 and 4.4 FAFA and exclusion of certain final recipients and activities), commercial management, clear investment strategy, clear exit strategy, reporting, visibility, evaluation requirements; assessment criteria published in term sheet online. Section 8: elaborates on the selection process, selection criteria, and the impact assessment regarding applicants as well as on the call for expression of interest to be published on the EIF website and the selection process.	Article 21 (14) (a) and (d) GBER: financial intermediaries must be established according to applicable laws and have a clear and realistic exit strategy for investments. Article 21 (14) (b) GBER: there must be a commercially sound investment strategy for the implementation of risk finance measures and Member States or entrusted entity must conduct a due diligence process to ensure a commercially sound investment strategy. Article 21 (15) GBER: financial intermediaries must be managed on a commercial basis, their remuneration be conform to market practices (performance based or co-investment), setting out an investment strategy, and investors be represented in governance bodies. Article 7 CDR: selection criteria refer to the legal, economic and financial, as well as organisational capacity and the experience of the applicants, and its award criteria refer to the investment methodology, the ability to raise additional resources, the additionality of investment activity, and the level of management costs and fees of the applicants.

Final recipients	Section 7: Financial (Sub-)Intermediaries must select final recipients according to their internal rules and procedures and take due account of the economic viability of projects of the final recipients. Section 7.1: lists the general requirements, according to which final recipients must comply with the requirements of Article 4.4 of the FAFA and Articles 19 and 20 of the Delegation Agreement, may not pursue illegal activities, and may not be subject to insolvency proceedings. Section 7.2 lists the instrument-specific eligibility criteria: the Final Recipient must be an SME and be established and operating in a participating country. Section 7.3: covers the instrument-specific transaction criteria for EU Guarantees for Debt Financing: They must be newly generated transactions, which fall into one of the higher risk categories laid out in section 3. b), have a minimum maturity of 12 months, be granted for investment in tangible and/or intangible assets and/or financing working capital, be financing transactions up to EUR 150,000, be transactions that comply with the thresholds laid down in Article 4 (6) (b) of the *de minimis* Regulation 1407/2013, and be a debt instrument, such as loans or leases or bank guarantees. Section 7.4: covers instrument-specific transaction criteria for EU guarantees for securitisation: They must be newly generated transactions, have a minimum maturity of 12 months, and be granted for investment in tangible and/or intangible assets and/or financing working capital.	Article 21 (5) GBER: unlisted SMEs, which either have not been operating in any market, or have been operating in any market for less than 7 years following their first commercial sale, or require an initial risk finance investment entering a new product or geographical market.

Source: author

2.3. The Delegation Agreement between the European Union, the European Investment Bank and the European Investment Fund on Financial Instruments under Horizon 2020

The EU concluded a Delegation Agreement on financial instruments under the funding initiative Horizon 2020. Since this Horizon 2020 Delegation Agreement is very comprehensive, comprising several financing measures, its INNOVFIN Equity Facility for Early Stage (IFE) shall serve as an example of how the Delegation Agreement facilitates the consistency with state aid rules through the terms and conditions in its Annex C.[1118] It is selected, since it concerns the financial instrument in the form of equity and thus becomes comparable to the equity instrument EFG under the COSME Delegation Agreement, i.e. whether it stipulates similar rules regarding state aid consistency as the latter vis-à-vis state aid rules.

Under the IFE, the EIF has the task to 'implement investments and co-investments in the area of early stage venture capital, business angel, technology transfer and fund-of-funds'. Therefore, the IFE is 'financially supported by i) the EU contribution for Horizon 2020 Equity Financial Instrument provided on a first loss basis and ii) EFSI and EIF provided on a second loss basis'. As the relevant provisions of the Annexes to the COSME Delegation Agreement, Article 53 of Annex C to the Horizon 2020 Delegation Agreement lays down that IFE Operations, i.e. an investment, co-investment, or any contractual arrangement entered into between the EIF and an IFE Financial Intermediary, are considered consistent with state aid rules, if they comply with the conditions set out in the Annex.

The Annex C to the Horizon 2020 Delegation Agreement is structured in the same way as the Annexes to the COSME Delegation Agreement. It covers, firstly, definitions of the terms. Secondly, it refers to the requirements regarding private investment participation to the financial instruments and the limited scope and duration of the latter. Thirdly, and importantly, it stipulates provisions on the pari passu requirement as well as on the representation and governance of the EIB/EIF in the financial intermediaries and their alignment of interests with investors. Fourthly, it lays down the exclusion and eligibility criteria of the financial intermediaries and the final

[1118] Annex to the Commission Decision on the 7th Amendment of the Delegation Agreement concluded on 12 June 2014 between the European Union, the European Investment Bank and the European Investment Fund in respect of Financial Instruments under Horizon 2020, 09.06.2017, C(2017) 3842 final.

recipients (as well as their selection process). Finally, it covers reporting, monitoring, and visibility requirements.

The **phase of early stage** is defined by Annex C as 'the early phase of development of an enterprise and includes proof of concept stage, (pre-)seed-stage, start-up stage' as well as 'the phase of development of an enterprise that has completed the product development phase and needs further funding for commercial manufacturing and/or sales, which may or may not have occurred yet'. Compared to the relatively specific scope of eligible undertakings under Article 22 (2) GBER on aid for start-ups, i.e. unlisted small enterprises up to five years following their registration, and which have not taken over the activity of another enterprise, have not yet distributed profits, and have not been formed through a merger, the scope of Annex C is formulated rather broadly. Since the latter mentions and includes start-ups, it may refer to the criteria of the scope under Article 22 (2) GBER on start-ups.

While Article 6 of Annex C sets out **minimum contributions** by the EIF and its possibility to co-invest, Article 6bis provides a **minimum required geographical spread and the maximum commitment** under an IFE Operation to a Pan-European VC Fund-of-Funds of EUR 100 million. Article 8 states that the leverage effect for early stage investments has been set at 6, according to Horizon 2020, but may be lower, depending on the nature of the investments and adverse fundraising conditions.

The requirement of a leverage effect is consistent with Article 209 (2) (d) of the Financial Regulation applicable to all financial instruments financed by EU resources, 'which states that financial instruments must achieve a leverage and a multiplier effect, with a target range of values based on an ex ante evaluation for the corresponding financial instrument'.[1119] However, for instance, Article 37 (2) (c) CPR applicable to EFSI financial instruments does not lay down a specific maximum or minimum leverage effect, but merely refers to 'an estimate of additional public and private resources to be potentially raised by the financial instrument down to the level of the final recipient (expected leverage effect)'. Thus, the Annex is rather strict as compared to the CPR

[1119] The European Commission, Guidance for Member States on Article 46 – Reporting on Financial Instruments and on Article 37 (2) (c) – Leverage Effect, https://ec.europa.eu/regional_policy/sources/docgener/informat/2014/guidance_leverage_reporting_en.pdf, last access: 21.06.2019, p.8.

provision. The private participation requirements of Article 21 (10) GBER are yet stricter, as they range from 10 to 60 per cent, depending on the type of the eligible undertaking.

Article 9 (4) of Annex C provides the **maximum commitments** of EUR 50 million and EUR 100 million under any IFE Operation in an IFE Financial Intermediary and a fund-of-funds, respectively. The EIF 'may make co-investments alongside IFE Operations using EIF's own resources' pursuant to Article 10. Annex 1a on the EFG is stricter, however, requiring the financial intermediary's management team make 'direct or indirect investment of a significant amount', which is also in line with the stipulations of Article 21 (15) (c) GBER requiring performance-linked remuneration or co-investment from the financial intermediary and fund managers.

With regard to the **duration** of IFE Operations, Article 11 requires that they 'usually be concluded for 5 to 15 years' with 3 years extension. The maximum amounts are comparable to those stipulated in the Annexes to the COSME Delegation Agreement, both accounting for private investment with regard to the required leverage effect. Likewise, operations are limited in time.

The majority of the **investor base** must comprise investors, who pass the market economy operator test in order to 'catalyse private sector investments', in accordance with Article 12 (1). Thereby, no single investor may 'account, directly or indirectly, for more than 50 per cent of the total commitments to any IFE Financial Intermediary' (except in the case of investments in a co-investment fund or scheme), pursuant to Article 12 (3). Furthermore, an IFE Financial Intermediary is required to receive at least 30 per cent of its total commitments from independent private investors, being exhaustively listed in Article 12 (4).

As the Annexes to the COSME Delegation Agreement and in line with its requirement of the leverage effect and the maximum contribution amounts elaborated on above, Annex C requires private sector investments. Compared to the GBER provisions, the minimum participation rate is higher than the participation rate for undertakings prior to their first commercial sale (10 per cent), but lower than that for undertakings that have been operating in any market for less than 7 years following their first commercial sale (40 per cent), as stipulated in Article 21 (10) GBER. However, it is the same minimum participation rate as that for eligible undertakings of Annex 1a to the COSME Delegation Agreement (SMEs immediately before or after the time of first

investment at the expansion or growth stage). This provision strives to ensure the leverage effect and the minimisation of the aid element in IFE financial instruments.

Importantly, IFE Operations must rank **pari passu** with investors investing in the same risk class, i.e. 'investors in the same risk class make their investment under equivalent economic terms and conditions and hold the same level of subordination', pursuant to Article 13. Also corresponding to the terms and conditions of the COSME Delegation Agreement, the IFE may accept more favourable terms than applicable for other investors. This provision and the definition of the pari passu requirement, i.e. that investors in the same risk class make their investment under equivalent economic terms and conditions and hold the same level of subordination, mirror their counterpart provisions in the Annexes to the COSME Delegation Agreement. Thus, they fall short of referring to the elements of concomitance and the significance of the private investment as well as the independence between the investors and the undertakings targeted, too.

The EIF must strive 'to be **represented**… **in advisory boards** or similar investor representation bodies', but may not 'be represented on governing bodies of IFE Financial Intermediaries entrusted with individual investment or divestment decisions', save in the capacity as observer, pursuant to Article 14 of Annex C. This requirement to strive for participation in the investor representation bodies applies also to the manager and advisor of a fund-of-funds. These provisions are in line with the provisions of the Annexes to the COSME Delegation Agreement and similar to those under Article 21 (15) (e) GBER (investors must be represented in governance bodies) and paragraph 62 RFG (Member States may not participate directly in investment and divestment decisions).

Moreover, the IFE Financial Intermediary must possess 'a **governance structure** that allows for decisions concerning investments, divestments and risk diversification to be made in accordance with the applicable legal documentation and in line with relevant market practice' in accordance with Article 15 (1). 'Changes to the fundamental nature of the IFE Financial Intermediary, including material changes to the investment strategy' must require prior consent from the EIF, pursuant to Article 15 (2). This requirement is the same as the one stipulated in the Annexes to the COSME Delegation Agreement and, as such, comparable to the provisions of Article 21 (15) GBER and paragraph 62 RFG, requiring the management on a commercial basis and appropriate

governance structure, respectively. It remains doubtful, to what extent these conditions may guarantee that market distortions are indeed minimised, however.

With regard to the avoidance of **conflicts of interests and the alignment of interests** of the IFE Financial Intermediary, its managers, and its investors, the EIF is required to 'seek to negotiate appropriate measures to be put in place by the IFE Financial Intermediary', which must be in line with market practice and transparent to the investors, in accordance with Article 15 (3). This requirement is the same as the one stipulated in the Annexes to the COSME Delegation Agreement and, as such, comparable to the provision of Article 21 (15) (a) GBER (financial intermediaries and fund managers must act with the diligence of a professional manager and avoid conflicts of interest). However, in contrast to section 3 l) of Annex 1a to the COSME Delegation Agreement and the recommendations of the Risk Finance Guidelines, Annex C does not require a co-investment by the management team of the financial intermediary in order to align interests. Its Article 10 states merely that the EIF may make co-investments alongside IFE operations. As will be further discussed in chapter VIII, it remains doubtful, however, whether the alignment of interests and co-investment may help achieve the minimisation of market distortions next to the attainment of the public policy objective, as they are merely tied to the latter.

Moreover, under Article 15 (4), the **remuneration** of the IFE Financial Intermediary must be transparent to the investors and management fees must be negotiated 'at a level that covers operational and management costs in a sustainable way without disturbing the alignment of interests aimed for'. The level of management fees must 'in principle allow for the execution of the… strategy'. This provision is comparable to the one of the Annexes to the COSME Delegation Agreement. Moreover, as stated, the FAFA appears to require that this remuneration be exclusively based on performance. In contrast, Article 21 (15) (a) GBER and point 143 of the Risk Finance Guidelines merely require a performance based remuneration element next to the standard remuneration.

Article 16 of Annex C states that the **borrowing by funds should be 'limited in amount and short-term in nature'** (except for specific cases) and the lending by funds 'only be made alongside or for the preparation of equity investments… and limited to a maximum of 20 per cent of the

aggregate commitments at any point in time'. However, this is a 'should' rather than an obligatory provision. Nonetheless, it seeks to limit the amount and time of borrowing and to limit the amount and purpose of lending by funds.

Article 17 lays down **exclusion criteria** of IFE Financial Intermediaries and IFE Final Recipients, which are the performance of illegal activities, situations of Article 4.4 of the EIF FAFA, non-compliance with specific EIF FAFA provisions on Non-Cooperating Jurisdiction, and activities referred to in Article 19 of Horizon 2020. On the other hand, Article 18 lays down the eligibility criteria of IFE Financial Intermediaries and IFE Final Recipients. The former may be eligible, if it is not excluded and if its manager is established or operating in a participating country. The latter may be eligible, if it is an SME, if it is not excluded, if it is established or operating in a participating country (as specified in the Delegation Agreement), if it is at the time of first investment in the early stage, and if it meets any additional eligibility criteria that may be specified in the contractual documentation underlying an IFE Operation. Thus, the general eligibility criteria are comparable with those of the Annexes to the COSME Delegation Agreement.

With regard to the application process, as it is laid down in the Annexes of the COSME Delegation Agreement, the EIF must publish on its website an **open call for expression of interest**, highlighting **specific objectives and criteria for IFE Operations**, in accordance with Article 20. Corresponding to the selection processes of the COSME Delegation Agreement, the selection process under the Horizon Delegation Agreement must be in line with the general principles of transparency, equal treatment, and non-discrimination, the EIF's policies, rules, and procedures, as well as good market practices, pursuant to Article 21. Thus, the procedure is in line with the requirements of Article 21 (13) (b) GBER, which requires an open, transparent, and non-discriminatory call. However, it remains doubtful whether processes that select viable financial intermediaries, investors, and final recipients are necessarily apt to minimise market distortions to a large degree.

The **selection criteria** pursuant to Article 22 refer to the expected performance and the policy fit subject to Article 6bis, and an assessment of an investment proposal with regard to management team skills, stability, and motivation, as well as conflicts of interest, structuring and cost, and validation. With regard to the assessment of the policy fit, the criteria of the expected support to

eligible IFE Final Recipients, the catalytic role of IFE Operation, i.e. the mobilising of funding resources, and the contribution to the development of a structurally balanced business angels/venture capital/technology transfer market must be taken into account. The EIF is entitled to assess the impact of a specific IFE Operation on the overall risk profile of the IFE facility, pursuant to Article 22 (4).

These criteria are comparable to those under the Annexes to the COSME Delegation Agreement and thus also in line with the legal, economic and financial, as well as organisational capacity and experience criteria of Article 7 CDR. Hence, the selection and award criteria for both EU and Member State financial instruments contain elements of market practice and standards that are aimed at minimising potential distortive effects by screening and selecting viable financial intermediaries in line with the relevant public objective.

In sum, the provisions on the IFE Delegation Agreement are very similar to those of the Annexes to the COSME Delegation Agreement and thus stipulate, even though criteria may differ, similar rules as those applicable to Member State financial instruments for minimising excessive aid and its negative effects. Therefore, regarding both EU instruments and instruments under Article 107 (1) TFEU, the Commission applies rules to limit the amount of aid in terms of ceilings and market mechanisms with the aim to minimise the aid element of the financial instruments. However, these limitations only relate to the input of the use of financial instruments, but do not indicate whether the output, let alone the outcome are liable to distort the market. Importantly, also for the IFE, the Commission fails to apply the EU Court's requirements of balancing positive and negative effects of the aid and of assessing the correspondence between the amount of aid and the market failure or the impact on the market.

3. Conclusion

3.1. The common provisions of the FAFA

One of the particular features of financial instruments is the fact that they may be implemented at both the Member States level under Article 107 (1) TFEU as well as at the EU level. Financial instruments set up and managed at the EU level do not fall under the scope of state aid law, but require consistency with it. This is heavily criticised by experts concerned with financial

instruments at the Member State level for being unfair, as EU instruments may likewise distort the level playing field and thus competition.[1120]

In order to render EU financial instruments consistent with state aid law, the Commission set up the FAFA and Delegation Agreements (and its Annexes). Thereby, the FAFA provides the common provisions to the provisions of the respective Delegation Agreement, which are specific to the individual EU financial instruments, such as the provisions on financial intermediaries and the general conditions for financial instruments. The FAFA stipulates conditions on the selection of financial intermediaries, their obligations and exclusion criteria, the principles applicable to the financial instruments, the criterion of economic viability of final recipients, and the prevention of the granting of undue advantages through the EU contributions. As such, the FAFA builds the basis for state aid consistency, which is to be further specified under the Delegation Agreements, pursuant to Article 5.5 of the FAFA.

In comparison with state aid rules and those of Article 209 FR, the FAFA provisions are less prescriptive and strict. For instance, for the selection of financial intermediaries, they refer to internal provisions of the Delegation Agreements and rules and policies of the EIF rather than to the provisions on public procurement and selection criteria of Article 7 CDR under state aid rules. In general, the FAFA provisions and those under state aid law share similar content and the same aim, namely the minimisation of market distortions. Importantly, no obligation can be found in the FAFA provisions that requires a balancing exercise for EU financial instruments, as it is required by the EU Courts with regard to the principle of proportionality of state aid rules for Member States' financial instruments.

3.2. The specific conditions of the Delegation Agreements and their 'consistency with state aid law'

With regard to the specific conditions of the Delegation Agreements, it is clear from the comparison of the Annexes to the Delegation Agreements of COSME and Horizon 2020/InnovFin that their structure and content follow similar lines with minor deviations only. With regard to the structure, the Annexes begin with definitions, followed by requirements on private

[1120] This is contested by an expert working with an EU body, however, claiming that the EU and its institutions are per se impartial and only concerned with achieving the overall EU policy goals (see Appendices).

investment participation, the leverage effect, and limitations regarding amounts and duration of operations. Subsequently, provisions on the pari passu requirement of the operations and on representation within and governance of financial intermediaries / fund of funds as well as the alignment of interests of all actors follow. The Annexes then cover the exclusion and eligibility criteria of the financial intermediaries and the final recipients, as well as their selection process. Finally, they stipulate the reporting, monitoring, and visibility requirements. These rules and mechanisms (of the market economy investor principle) aim to minimise the aid element.

In addressing the research questions of how the Commission and the EIB/EIF prevent or minimise market distortions by financial instruments at the EU level and whether these rules are consistent with state aid rules applicable to financial instruments at the Member State level, the following became apparent:

The provisions of the Annexes to the Delegation Agreements with the aim to ensure consistency of EU financial instruments with state aid rules apply tools to limit the aid amount as well as market mechanisms and screening methods with the goal to minimise distortive effects. These tools and mechanisms are, in sum, comparable to the standards of state aid rules applicable to financial instruments falling under the scope of Article 107 (1) TFEU. Thus, the rules for financial instruments at the EU level mirror those for financial instruments at the Member State level under state aid law – without the compatibility assessment of proportionality, however.

Firstly, all Annexes contain limitations as to the amount, the duration, and the scope of operations under the Delegation Agreements in order to minimise the distortion of markets – comparable with the provisions contained in GBER and the Risk Finance Guidelines.

Secondly, as the GBER and the Risk Finance Guidelines prescribe, all of the Annexes contain provisions requiring certain minimum rates of private investor participation and the leverage of private capital. Therefore, the Annexes ensure that the investor base satisfies market elements derived from the market economy investor principle (MEIP).

Thirdly, and importantly, in order to ensure the absence of an advantage at the investor level, the Annexes stipulate that the investments/guarantees rank pari passu with investors investing in the

same risk class. Since not all conditions of the pari passu principle must be met (the provisions on the Delegation Agreement merely refer to equivalent terms and conditions and the same level of subordination), an advantage and hence state aid for investors are definitely present, but the aid element is minimised.

Fourthly, as it is the case for Member States under the Risk Finance Guidelines, the Annexes prevent the EIF from being represented in the governing bodies of the relevant financial intermediary and thus from participating in individual decisions regarding operations under the Delegation Agreements, e.g. investment or divestment decisions. However, prior consent of the EIF with regard to material changes to the investment strategy is required, as it is the case with financial instruments under state aid law and Member States' consent for changes of the financial intermediary's investment strategy. Fifthly, being consistent with the regulations of the GBER and the Risk Finance Guidelines, the Annexes require that the financial intermediaries / Pan-European VC Fund-of-Funds possess a governance structure that allows for decisions in line with the legal documentation and market practice as well as that they be managed on a commercial basis.

While the FAFA appears to require an exclusively performance based remuneration – contrary to the GBER and the Risk Finance Guidelines, which merely require performance based remuneration elements – the Annexes contain several elements ensuring the alignment of interests between the EIF, the financial intermediaries / Pan-European VC Fund-of-Funds, and the investors, e.g. through the co-investment by the management team of the financial intermediary and an adequate remuneration. However, that these mechanisms of alignment of interests do not necessarily attain the minimisation of market distortions but merely relate to the achievement of the public policy objective will be further discussed in chapter VII.

Finally, in line with the provisions of the GBER and the Risk Finance Guidelines, the Annexes stipulate an open, transparent, and non-discriminatory selection procedure for financial intermediaries. Moreover, they, too, lay down a comparable set of selection criteria with regard to the legal, economic, financial, and organisational capacity and experience of the applicants. However, being funds with a special purpose, their scope of eligible final recipients is more specific as compared to the rather broad scope under Articles 21 and 22 GBER, for instance.

Moreover, LGF EU guarantees for debt financing under Annex 1b to the COSME Delegation Agreement must even be compliant with the *de minimis* requirement.

3.3. Comparison with state aid rules

In comparison, the provisions of the Annexes to the Delegation Agreements on EU financial instruments appear to reach a similar standard as those applicable to financial instruments falling under the scope of Article 107 (1) TFEU. At the same time, they appear to be clearer, less dispersed, and more concise than state aid rules, which may be due to the fact that they are covered in one legal document, the relevant Annex to the Delegation Agreement. Hence, a grouping of the state aid rules in a more coherent way, possibly along the lines of the Annexes or the off-the-shelf instruments, may lead to their simplified application.

However, and importantly, the comparison of the rules applicable to EU and Member State financial instruments presents that the Commission formalistically applies tools that are merely deemed to minimise market distortions, but does not possess tools to quantify, let alone balance positive and negative effects, as the EU Courts require it in their case law. Neither the rules on EU financial instruments nor the rules on Member State financial instruments contain any provisions on an effects-based balancing exercise.

Hence, the similarity of the content of rules of the FAFA/Delegation Agreements on the one hand, and the state aid rules, on the other, shows that the Commission strives to avoid adverse effects on trade and competition not by quantifying positive and negative effects and balancing them, but by preventing unnecessary distortions through the limitation of the amount of aid and the application of market mechanisms that are deemed to minimise the aid element. t remains doubtful whether the Commission's limitations, market mechanisms, and screening methods are indeed apt to minimise distortive effects eventually.

Through the analysis of the Commission's own criteria on EU financial instruments, it becomes apparent that, as it was already shown with regard to the compatibility assessment in Commission decisions under state aid law (see chapter VI), the Commission lacks the tools to balance positive and negative effects and fails to adhere to the requirements of proportionality set up by the EU

Courts in their case law, especially in relation to the omitted assessment of the correspondence between the amount of the aid and the market failure or the impact on the market. Instead of conducting an effects-based quantification of positive and negative effects, the Commission merely strives to minimise excessive aid and its distortive effects and thus fails to adhere to the EU Courts' requirements. In line with the proportionality test *stricto sensu* applied by the EU Courts, alternative criteria, such as the definition of manifest negative effects, which indicate that the aid in question causes excessive and non-proportionate negative effects is thus incompatible, may be advocated.

What is more, in the following section, the so-called off-the-shelf instruments provided by the Commission for the easy uptake by Member States will be explained, which lend themselves for a comparison with the state aid rule of Article 21 (18) GBER, having a similar structure, as well as with the rules of the Annexes applicable to EU financial instruments discussed above. This analysis may elucidate whether these instruments are structured along similar lines of the Commission's own Annexes. How does the Commission ensure that market distortions are limited and does it so in accordance with the EU Courts' interpretation of the proportionality principle?

4. Comparison with the Commission's off-the-shelf instruments

Member States may structure financial instruments under the European Structural Investment Funds (ESIF) programme as **'off-the-shelf instruments**' on the basis of standard terms and conditions provided by the Commission in Article 38 (3) (a) CPR making them 'ready to use'. These off-the-shelf instruments allow financial instruments to be structured in such a way that their standard 'terms and conditions either do not involve State aid at all, or do not require' the use of the notification procedure under Article 108 (3) TFEU and the 'subsequent clearance from the Commission' (formulated in the Annexes of the respective Regulation).[1121] The Commission has defined three model templates in 2014 in Regulation (EU) No 964/2014 and two further model templates in 2016 in Regulation (EU) No 2016/1157 (amending the former).

[1121] Fiona Wishlade and Rona Michie, Financial Instruments in 2014-20: learning from 2007-13 and adapting to the new environment, 2014, p.19.

From a practical perspective, the uptake of off-the-shelf instruments has been rather limited for several reasons.[1122] Firstly, the main reason for their non-use was the Managing Authorities' 'preference for building on existing financial instruments', since they had 'invested a considerable amount of time' for the design and compliance of the instruments and since off-the-shelf instruments that do not contain state aid 'may be less generous' than the scope for compatible aid under the GBER.[1123] Secondly, off-the-shelf instruments were not deemed apt to meet the respective needs of the Operational Programmes of EU Cohesion Policy under the Common Provisions Regulation.[1124] Thirdly, off-the-shelf instruments were deemed to be unattractive for financial intermediaries for requiring 'too great a contribution' from them in terms of risk sharing.[1125]

Last but not least, off-the-shelf instruments are considered inflexible, as they were said 'not to offer [sufficient] scope to adjust or amend elements' in accordance with the national context.[1126] As Wishlade et al. correctly point out, the last argument presents a 'circular problem', since off-the-shelf instruments' *raison d'etre* lies in the assurance of their compliance with the relevant state aid, procurement, and selection criteria for taking them readily 'off-the-shelf'.[1127] Adjustments or amendments would run counter to this assurance of compliance.

In the following, the five different off-the-shelf instruments will be elaborated on and compared with each other as to their provisions on state aid (*de minimis* versus compliance with the GBER) with regard to proportionality and the minimisation of distortive effects. Strikingly, the off-the-shelf instruments, which are designed to be free of state aid, appear to follow the similar structure as exempted aid under Article 21 (18) GBER. Therefore, the two structures lend themselves for comparison as to the question why these off-the-shelf instruments are considered free of state aid, while measures under Article 21 (18) GBER include an aid element despite their similar legal structures. Thus, the structures of the Risk Sharing Loan and of Article 21 (18) GBER merit closer investigation and will be compared as to their (absent) aid elements.

[1122] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.100.
[1123] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.100.
[1124] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.101.
[1125] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.101.
[1126] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.101.
[1127] Fiona Wishlade et al., Improving the Take-up and Effectiveness of Financial Instruments, Final Report, May 2017, p.101.

Moreover, the provisions on the off-the-shelf instrument Capped Portfolio Guarantee (CPG) will be compared with those on the financial instrument of the Loan Guarantee Facility (LGF), which is established and managed at the EU level, i.e. a EU financial instrument. Respectively, the provisions on the off-the-shelf instrument Co-Investment Facility will be compared with those on the EU financial instrument Equity Facility for Growth (EFG). Regarding the research question of this chapter, the comparison and its analysis will reveal whether rules on proportionality and the prevention of market distortions are consistent between financial instruments both established and managed at the Member State level and those solely established at the EU level and in accordance with the requirements of the EU Courts.

Therefore, firstly, the off-the-shelf instrument of the so-called Risk Sharing Loan will be analysed and then compared to Article 21 (18) GBER. Afterwards, the off-the-shelf-instruments Capped Portfolio Guarantee, Renovation Loan, Co-Investment Facility, and Urban Development Fund will be analysed. The Capped Portfolio Guarantee will be compared with the Loan Guarantee Facility (LGF) under the Annex to the COSME Delegation Agreement. Moreover, the Co-Investment Facility will be compared with the Equity Facility for Growth (EFG) under the Annex to the COSME Delegation Agreement. Finally, the conclusion will add to the answer to the research question of this chapter, i.e. whether the rules of EU financial instruments and those on Member State financial instruments designed by the Commission are consistent with regard to proportionality and the minimisation of distortive effects in the light of the EU Courts' requirements.

4.1. The Risk Sharing Loan

Loan fund for SMEs based on a portfolio risk-sharing loan model (**Risk Sharing Loan** or RSL): The RSL takes 'the form of a loan fund set up by a financial intermediary with contribution from the ESIF programme and additional contribution of at least 25 per cent of the loan fund from the financial intermediary'.[1128] Both contributions are pro-rata, i.e. they bear the losses and benefits in proportion to their size and the RSL shall finance a portfolio of newly originated loans.[1129] Its aim 'is to combine resources from the ESI fund programme and the financial intermediaries to support financing to SMEs' and to facilitate for SMEs 'easier access to finance by providing the

[1128] Annex II to Regulation (EU) No 964/2014.
[1129] Annex II to Regulation (EU) No 964/2014.

financial intermediaries with a funding contribution and credit risk sharing', so that SMEs may 'benefit from preferential conditions in terms of interest rate reduction and collateral reduction'.[1130]

Annex II to Regulation (EU) No 964/2014 lays down the RSL's state aid implications. This off-the-shelf instrument is designed as a state aid free instrument. This implies that the remuneration for the financial intermediary is market-conform, a full pass-on by the financial intermediary to the final recipients, and that the financing provided to the final recipients be *de minimis* (in accordance with the *de minimis* Regulation).

At the **level of the financial intermediary and the fund of funds** (i.e. a fund set up with the objective of contributing support from (a) ESI fund programme(s) to several financial instruments), aid is excluded, if, firstly, the 'financial intermediary and the managing authority or fund of funds bear at any time the losses and benefits in proportion to their contributions (pro-rata)', whereby 'there is an economically significant participation of the financial intermediary'. Secondly, the remuneration, i.e. 'the management costs and/or fees, of the financial intermediary and the fund of funds has to reflect the current market remuneration in comparable situations' either through the selection in an open, transparent, non-discriminatory, and objective procedure or through the alignment of the remuneration with Articles 12 und 13 of Delegated Regulation (EU) No 480/2014 supplementing the CPR and no other advantages are granted by the state.[1131]

If the fund of funds only transfers the ESIF contribution to the financial intermediary, 'has a public interest mission, has no commercial activity when implementing the measure, and is not co-investing with its own resources', thus not being 'considered a beneficiary of aid, it suffices that the fund of funds is not overcompensated'. Thirdly, 'the financial advantage of the public contribution to the instrument must be fully passed on to the final recipients in the form of an interest rate reduction in line with Article 7 (2) of Delegated Regulation (EU) No 480/2014 (if the financial intermediary does not pass on all the financial advantage, the undisbursed public contribution must be transferred back to the managing authority)'.

[1130] Annex II to Regulation (EU) No 964/2014.
[1131] Article 12 lays down criteria for determining management costs and fees on the basis of performance, while Article 13 stipulates thresholds for management costs and fees and elaborates on the calculation methods of the base and performance-based remuneration parts.

At the **level of the final recipients**, the loan must comply with the *de minimis* rules. Therefore, the financial intermediary must calculate for each loan inserted in the portfolio the gross grant equivalent (GGE) following the prescribed methodology in order to comply with Article 4 of the *de minimis* Regulation: GGE = nominal amount of the loan (EUR) x (cost of funding (standard practice) + cost of risk (standard practice) - any fees charged by the managing authority on the programme contribution to the financial intermediary) x weighted average life of the loan (years) x risk sharing rate.

Next to the state aid requirements, Annex II to the Regulation also lays down provisions on the management of the off-the-shelf instrument.

With regard to the **lending policy**, for instance, disbursement may only be conducted in tranches and be pursuant to the ceilings of Article 41 CPR. The financial intermediary may 'originate a portfolio of new eligible loans in addition to current loan activities only within a pre-determined limited period of time'. Further, 'resources paid back to the financial instrument may either be re-used within the same financial instrument or after being paid back to the managing authority or the fund of funds may be used in accordance with Article 44 CPR'. With regard to loss recoveries, the financial intermediary must take 'recovery actions in relation to each defaulted SME loan financed by the financial instrument in accordance with its internal guidelines and procedures'.

Moreover, the financial intermediary is required to present a '**pricing policy and the methodology** to ensure the full pass on of the financial advantage of the programme public contribution to the eligible SMEs', which must include an interest rate set at market basis, an 'overall interest rate to be reduced proportionally to the allocation provided by the public contribution of the programme', the GGE calculation to be applied on each loan, and their constancy throughout the eligibility period. However, in practice, it may be very difficult to establish a pricing methodology and to calculate the GGE for risk finance under the presence of asymmetric information, as it is discussed in chapter V.

The portfolio may only include newly originated loans, the managing authority's liability must be set out, and the lending period must be set in order to ensure that the programme contribution is used for loans no later than 31 December 2023.

The **alignment of interest between the managing authority and the financial intermediary** has to be achieved through performance fees as provided in Articles 12 and 13 CRD, the contribution of the financial intermediary 'under local market conditions to the financing of at least 25 per cent of the total financing commitment', and pro rata conditions of losses and recoveries between the managing authority and the financial intermediary according to the risk sharing rate to be based on the ex-ante assessment findings. Accountability issues of financial intermediaries as agents to the principal of Member State authorities and the rules in place for financial instruments will be further discussed in chapter VIII.

Eligible financial intermediaries may be 'public and private bodies established in a Member State, which shall be legally authorised to provide loans to enterprises', such as financial institutions, microfinance institutions or any other institution authorised to provide loans.

With regard to the **eligibility of final recipients**, the following criteria must be met: Final recipients must be micro, small, and medium enterprises, not be active in the sectors mentioned in Article 1 (d) – (f) of the *de minimis* Regulation, not be part of one or more restricted sectors, not be in difficulty as defined by state aid rules, and 'not be delinquent or in default in respect of any other loan or lease either granted by the financial intermediary or by another financial institution'. Moreover, eligible undertakings must have 'a registered place of business in a Member State and the economic activity for which the loan was disbursed shall be located in the relevant Member State' at the time of the investment and during the reimbursement of the loan.

The **product for the final recipients** must possess the following **characteristics**: the loans must have the purpose to invest in tangible and intangible assets or provide working capital for development or expansion activities that are ancillary and linked to such investment activities. The loans must be newly originated and have a principal amount of up to EUR 1 000 000 based on the ex-ante assessment and 'be provided under such conditions that would not cause the GGE with respect to each final recipient to exceed EUR 200 000… over any period of three fiscal years'.

Loans must provide financing for one or more permitted purposes, must have a repayment schedule, a minimum maturity of 12 months and a maximum maturity of up to 120 months, may not be in the form of mezzanine loans, subordinated debt, quasi-equity, or in the form of revolving credit lines, as well as 'not finance pure financial activities or real estate development when undertaken as a financial investment activity and shall not finance the provision of consumer finance'.

Financial intermediaries have **reporting requirements** vis-à-vis the managing authority or fund of funds and are required to 'reduce the overall effective interest rate (and collateral policy, where appropriate) charged to the final recipients under each eligible loan… reflecting the favourable funding and risk sharing conditions' of the off-the-shelf instrument. Thus, 'the entire financial advantage of the programme public contribution to the instrument shall be transferred to the final recipients in the form of an interest rate reduction'. The exact calculation of interest rates, taking into account and calculating the risk element and collateral, may be very difficult for risk finance under asymmetric information in practice, however, as it is further discussed in chapter V.

Having outlined the structure and content of rules pertaining to the RSL off-the-shelf instrument, the next section will compare them with the structure of financial instruments under Article 21 (18) GBER.

4.2. The Risk Sharing Loan in comparison with Article 21 (18) GBER: Same structure, different aid relevance?

As stated above, the structure of off-the-shelf instruments being based on *de minimis*, such as the Risk Sharing Loan (RSL), is similar to the structure of aid under Article 21 (18) GBER, the former being free of state aid, the latter containing state aid. What is thus the difference between the two?

Risk finance aid that does not meet the conditions on eligible undertakings may still be compatible with the internal market, if it fulfils the conditions of Article 21 (18) GBER. The RSL off-the-shelf instrument, as elaborated above, complies with *de minimis* rules. The same holds true for Article 21 (18) GBER regarding its condition (a): the conditions of the *de minimis* Regulation must be met

at the SME level. Thus, aid is excluded both for the RSL and Article 21 (18) GBER at the SME level. Moreover, under its condition (b), other conditions of Article 21 GBER, except for certain conditions that are specifically exempted, must be met.

Therefore, Article 21 (14) GBER applies, stipulating conditions on profit driven financing decisions for financial intermediaries, which are similar to the conditions for RSL with regard to potential aid at the level of the financial intermediary: Both require for the financial intermediary to implement policies that include risk diversification and due diligence mechanisms. The same holds true for the conditions of Article 21 (15) GBER, which are comparable to the conditions for the RLS: Both require for financial intermediaries performance-linked remuneration and/or an economically significant participation of the financial intermediary. Further, both Article 21 (13) (b) GBER and the conditions of the RSL require that the financial intermediary be selected through an open, transparent, and non-discriminatory selection procedure.

However, a crucial difference may be detected at the level of financial intermediaries, when looked at the conditions of Article 21 (16) GBER very closely, being applicable for aid under Article 21 (18) GBER: its condition (a) requires that financial intermediaries demonstrate a mechanism that ensures that all advantages be passed on 'to the largest extent to final beneficiaries'. This limitation to a full pass on of advantages does leave room for aid at the level of financial intermediaries, as they may still profit from favourable conditions due to the aid in terms of interest rates that are not market-conform, for instance.

In contrast, an important feature of the RSL for the exclusion of aid at the level of the financial intermediary is that the financial advantage of the public contribution must be fully passed on to the final recipients in the form an interest rate reduction and that the financial intermediary must be able to present a constant pricing policy and methodology that ensures this full passing on (through setting the interest rate at market basis, the reduction of the overall interest rate in proportion to the public contribution's allocation, and the application of the GGE calculation on each loan). Thus, aid is excluded at the level of financial intermediaries through the requirement of a full and unlimited passing on of any advantages. This difference is hard to detect and may certainly be detrimental to Member States' clarity as to whether state aid is present or not.

Moreover, there may be another indication as to the presence of aid under Article 21 (18) GBER. For the RSL, the managing authority and the financial intermediary must share the risk pro-rata, i.e. both bear at any time the losses and benefits in proportion to their contributions. In contrast, Article 21 (13) (c) GBER provides the possibility of asymmetric risk sharing between the private and public investors (including co-investing financial intermediaries), thus containing a potential aid element.

In sum, although the structures of the off-the-shelf instruments that are designed to be free of state aid and compatible aid under Article 21 (18) GBER are very similar, one may detect aid elements in the latter at the level of financial intermediaries through a look at the details (e.g. in the possibility of asymmetric risk-sharing). However, this is hard to discern and adds to the overall uncertainty for Member States when implementing financial instruments. As such, the expressions of the passing on of 'all advantages' on the one hand, and 'to the largest extent' on the other under Article 21 (16) GBER strike as contradictory and appear to be inconsistent also in a semantic way. To be on the safe side, ensuring that the respective financial instrument be free of state aid, a national authority would thus have to select the off-the-shelf instrument prepared by the Commission rather than one under the GBER, so that the latter does not find it incompatible with the internal market.

Table 6: Comparison of the rules under Article 21 (18) GBER and those applicable to the off-the-shelf instrument 'Risk Sharing loan model'

Article 21 (18) GBER: risk finance aid that does not meet the conditions of Article 21 (5) GBER on eligible undertakings still compatible and exempt from notification, if the following conditions are met:	**Off-the-shelf instrument:** **Risk Sharing loan model (RS loan)**
(a) at the level of SMEs, conditions of the *de minimis* Regulation must be met (i.a. the total amount of the *de minimis* aid granted per Member State to a single undertaking may not exceed EUR 200 000 over any period of three fiscal years)	At SME level, loan must comply with *de minimis* rules. The financial intermediary must calculate the GGE for each loan inserted in the portfolio – the total amount of the GGE may not be above EUR 200 000 over a 3 years fiscal period, taking into account the cumulation rule for final recipients of the *de minimis* Regulation The entire financial advantage of the programme public contribution to the instrument must be transferred to the final recipients in the form of an interest rate reduction. The financial intermediary must monitor and report on the GGE for final recipients, which must be established in the funding agreement between the managing authority or fund of funds and the financial intermediary.
(b) all conditions of Article 21 except (5), (6), (9), (10), and (11) are met, i.e.	
Types of risk finance aid: (2) at the level of financial intermediaries: equity, quasi-equity or financial endowment, loans, guarantees (3) at the level of private investors: see (2) and tax incentives to private investors (4) at the level of eligible undertakings, equity, quasi-equity, loans, guarantees, or a mix thereof	Risk Sharing loan model (RS loan)
(7) conditions on replacement capital	
(8) conditions on use of the financial intermediary's aggregate capital contribution and uncalled committed capital	
(12) for financial intermediaries, no discrimination on the basis of their place of establishment or incorporation; financial intermediaries may be required to fulfil pre-defined criteria objectively justified regarding the nature of investments	Public and private bodies established in a Member State, legally authorised to provide loans to enterprises operating in the jurisdiction of the programme, which contributes to the financial instrument.
(13) conditions for financial risk finance measures: (a) implemented via financial intermediaries (except for tax incentives for private investors) (b) financial intermediaries, investors, and fund managers shall be selected through an open, transparent, and non-discriminatory call; preference for asymmetric profit sharing over downside protection (except for guarantees) (c) for asymmetric loss-sharing between private and public investors, first loss assumed by public investor to be capped at 25% of total investment (d) for guarantees for financial intermediaries, guarantee rate limited to 80% and total loss assumed by Member State capped at 25% of underlying guarantee portfolio	Pro-rata risk sharing between managing authority and financial intermediary
(14) profit driven financing decisions must be ensured through: (a) financial intermediaries established according to	The financial intermediary must implement a consistent lending policy, especially regarding portfolio diversification, enabling a sound credit portfolio management and risk

applicable laws (b) Member States or entrusted entity must provide due diligence process for commercially sound investment strategy, including risk diversification policy (c) business plan (d) clear and realistic exit strategy	diversification, complying with industry standards and remaining aligned with the managing authority's financial interests and policy objectives. The financial intermediary must perform the identification, selection, due diligence, documentation, and execution of the loans to final recipients.
(15) financial intermediaries must be managed on a commercial basis through: (a) required diligence of a professional manager in good faith and avoiding conflict of interests (b) remuneration must conform to market practice – this is given, if selected through open, transparent and non-discriminatory call (c) performance-linked remuneration or co-investment (d) investment strategy, criteria and proposed timing of investments (e) investors must be allowed to be represented in governance bodies of investment fund	Aid at the level of the financial intermediary and fund of funds excluded, when - financial intermediary and managing authority or fund of funds bear at any time the losses and benefits in proportion to their contributions (pro-rata) and there is an economically significant participation of the financial intermediary - remuneration (management costs and fees) of financial intermediary and fund of funds must reflect the current market remuneration, which is given if selected through an open, transparent, non-discriminatory, and objective selection procedure or if remuneration aligned with Article 12 and 13 CDR - financial advantage of public contribution fully passed on to the final recipients in the form of an interest rate reduction Alignment between managing authority and financial intermediary must be ensured through: - performance fees according to Articles 12 and 13 CDR - the financial intermediary must contribute under market conditions financing of at least 25% of the total financing commitment for lending to SMEs in addition to the programme contribution - financial intermediary and managing authority must bear losses and recoveries pro-rata according to the risk-sharing rate based on the ex-ante assessment
(16) guarantees, loans, and quasi-equity structured as debt must fulfil the following conditions: (a) financial intermediary must undertake investments that would not have been carried out or in a restricted or different manner without the aid; financial intermediary must demonstrate that it operates a mechanism that ensures that all advantages are passed on to the largest extent to final beneficiaries (b) for loans and quasi-equity as debt, nominal amount of instrument must be taken into account in calculating maximum investment amount (c) for guarantees, the nominal amount of the underlying loan must be taken into account in calculating the maximum amount of paragraph (9); the guarantee may not exceed 80% of the underlying loan.	The financial intermediary must present a pricing policy and methodology that ensures the full pass on of the financial advantage to the eligible SMEs, including the following elements: the interest rate on the financial intermediary must be set at market basis, the overall interest rate must be reduced proportionally to the allocation provided by the public contribution (taking into account the fees charged by the managing authority), GGE calculation must be applied on each loan, pricing policy and methodology must remain constant.
(17) implementation to entrusted entities.	
(c) for equity, quasi-equity or loan investments, leverage of additional private financing at the level of the financial intermediary or SMEs, so as to achieve an aggregate private participation rate of > 60% of risk finance provided to SMEs	

Source: author

4.3. The Capped Portfolio Guarantee

This template represents a guarantees fund for SMEs: the Capped Portfolio Guarantee provides credit risk coverage on a loan by loan basis up to a guarantee rate of 80 per cent for the creation of a portfolio of new loans to SMEs. It shall thus facilitate access to finance addressing concrete and well-identified market gaps and leverage EU funds for SMEs.

Annex III of Regulation (EU) No 964/2014 explains that the Capped Portfolio Guarantee is, as the RSL, designed as a state aid free instrument. Therefore, it implies market conformity 'at the level of the financial intermediary managing the guarantee fund and the financial institutions building up portfolios of new loans and aid to the final recipients under the applicable *de minimis* Regulation'.

In the following, the provisions on state aid and the management of the CPG will be elaborated on. Moreover, they will be compared with those of the RSL, which is also based on the *de minimis* Regulation. Differences will be detected and explained.

What is more, the provisions on CPG will be compared to those of the Loan Guarantee Facility (LGF) under the Annex to the COSME Delegation Agreement, which is a financial instrument designed and managed at the EU level. As such, merely state aid consistency is required rather than full compliance with state aid rules and the *de minimis* Regulation, as it applies for the CPG. Since both the CPG and the LGF are in the form of guarantees and since both are designed at the EU level by the Commission, they lent themselves for comparison with regard to the similarity and hence consistency of state aid rules of their provisions. This is particularly interesting since the former is intended for the implementation at EU level, while the latter is intended for the 'ready-to-use' implementation by Member States. Thus, the question whether they possess similar provisions on proportionality and the minimisation of market distortions merits closer investigation.

At the **level of the fund of funds**, of the financial intermediary, and of the financial institutions building up portfolios, aid is excluded through the following features. Firstly, as it is the case for the RSL, the remuneration, i.e. management costs and/or fees, of the financial intermediary and

the fund of funds has to reflect the current market remuneration in comparable situations either through an open, transparent, objective, and non-discriminatory selection procedure or through the alignment with Articles 12 and 13 of Delegated Regulation (EU) No 480/2014, as it is for the RSL, while no other advantage may be granted by the state. As for the RSL, if the fund of fund 'merely transfers' the ESI fund contribution 'to the financial intermediary, has a public interest mission, has no commercial activity when implementing the measure, and is not co-investing with its own resources', i.e. not being beneficiary of aid itself, it suffices 'that the fund of fund is not overcompensated'.

Secondly, also the financial institution must be selected through an open, transparent, non-discriminatory, and objective procedure in order 'to build up the portfolio of new loans with its own resources'. Thereby, the risk retained may in no case be less than 20 per cent of the loan amount. Thirdly, as it is the case for the RSL, the 'financial advantage of the public contribution to the instrument must be fully passed on to the final recipients in the form of an interest rate reduction' in line with Article 7 (2) CDR. If the financial advantage is not passed on in full to the final recipients, the financial intermediary has to transfer the public contribution back to the managing authority.

At the **level of the final recipients**, the guaranteed loan must 'comply with the *de minimis* rules and, for each loan inserted within the portfolio, the financial intermediary must calculate the gross grant equivalent' through the following methodology: GGE = nominal amount of the loan (EUR) x cost of risk (standard practice) x guarantee cap rate x weighted average life of the loan (years) in order to comply with Article 4 of the *de minimis* Regulation. The total amount of aid calculated with the GGE may not be above EUR 200 000 over a three years fiscal period in accordance with the *de minimis* Regulation.

In comparison, Annex to the Delegation Agreement on the LGF contains no provision on remuneration. However, with regard to the selection of financial intermediaries, section 6 refers to Article 4 FAFA and requires a selection 'on the basis of open, transparent, objective, and non-discriminatory procedures'. Unlike the Annex on the CPG, the Annex on the LGF does not require a pass on of the advantage, presumably since the LGF is not based on the *de minimis* Regulation nor designed as a state aid free instrument. Also with regard to the GGE in favour of the final

recipients, the aid of the LGF does not need to be calculated due to its not being based on the *de minimis* Regulation. Thus, there are merely certain transaction amount thresholds in terms of instrument-specific transaction criteria for the guarantees, i.e. financing to be guaranteed up to EUR 150 000, EUR 1 500 000, or EUR 750 000, depending on different criteria.

As Annex II for the Risk Sharing Loan, Annex III lays down the conditions as to the management of the Capped Portfolio Guarantee. The conditions of Annexes II, III, and IV, i.e. of all off-the-shelf instruments under Regulation No 964/2014 are very similar.

As it is the case for the RSL in Annex II, the **guarantee policy** requires that the transfers be in tranches and respect the ceilings of Article 41 CPR as well as that the build-up of the portfolios of new SME loans be within a pre-determined limited period of time. While the conditions on loss recoveries for the RSL merely refer to the internal guidelines and procedures of the financial intermediary, the CPG may only cover losses 'in respect of each defaulted eligible SME loan in accordance with the guarantee rate of a maximum percentage of 80 per cent'. Moreover, the losses covered by the CPG 'in respect of the portfolio of eligible SME loans shall in aggregate not exceed the cap amount', the latter being, as the maximum liability under the CPG instrument, the 'product of the volume of the target loan portfolio multiplied by the guarantee rate and the guarantee cap rate'.

In contrast to the Annex on the CPG, the Annex to the COSME Delegation Agreement on the LGF does not stipulate tranches or ceilings. However, it does provide tranche options for the EU Guarantee for Securitisation under its section 4. With regard to the guarantee policy and the origination of loans, as the Annex on the CPG, the Annex on the LGF stipulates criteria under its sections 3. and 4. These regard the characteristics and types of guarantees, risk categories, the availability period, the maximum portfolio volume, the guarantee rate, the guarantee cap rate, amount, and fee, as well as the coverage period, pari passu clause, and the alignment of interest. As the Annex on the CPG, the Annex on the LGF stipulates for both the LGF EU Guarantee for Debt Financing and the LGF EU Guarantee for Securitisation a maximum guarantee rate. However, it provides for a cap amount and a guarantee cap rate only for the EU Guarantee for Debt Financing. Unlike the Annex on the CPG, it does not state a guarantee payment at all. Hence, the conditions

of the off-the-shelf instrument and the EU instrument prove to be very similar as to the limitation of aid in terms of their amount and time.

Regarding the conditions on **pricing and collateral policy and their methodology**, the CPG instrument may 'cover a maximum of 80 per cent of the risk exposure of each eligible SME loan'. Furthermore, as for the state aid free RSL discussed above, there must be a pass-on of the 'entire financial advantage of the programme public contribution' via a 'reduction of the interest rate charged and/or a reduction of the collateral required by the financial institution'. The GGE calculation must be applied for each loan and the financial intermediary may charge no guarantee fees to the financial institution.

The pricing policy and its methodology must ensure the full pass on of the financial advantage via the reduction of the overall interest rate and/or of the collateral requirement. Based on the ex-ante assessment and the ex-ante risk assessment, the managing authority may decide on guarantee fees charged to the final recipients. Therefore, the GGE must be calculated as provided in the Annex or aligned with the conditions of the Guarantee Notice. As it is the case for the RSL, the pricing policy and the methodology must remain constant during the eligibility period.

In comparison, the Annex to the Delegation Agreement on the LGF barely indicates any pricing and collateral policies. As the Annex on CPG, section 3. i. merely states for the EU Guarantee for Debt Financing that it be provided free of charge, while section 4. i. states for the EU Guarantee for Securitisation that the guarantee fee charged by the EIF be in line with market rates.

The Guarantee Cap of the CPG, which may not exceed 25 per cent in any case, must be determined in accordance with Article 42 (1) (b) CPR and Article 8 CDR. The guarantee may cover expected and unexpected losses.

As the RSL, the CPG portfolio may only include newly originated loans and the financial institution must estimate *ex ante* a recovery rate for calculating the amount expected to be recovered from the defaults, 'which impacts the evaluation of the guarantee cap rate'. As it is for the RSL, the managing authority's liability must be in accordance with Article 6 CDR. Moreover, as for the RSL, the duration is set as follows: 'the guarantee period… shall be set in order to ensure that the

programme contribution… is used with guarantees of loans disbursed to final recipients no later than 31 December 2023'.

In comparison, the Annex to the Delegation Agreement on the LGF does not stipulate the managing authority's liability. However, under section 5. a., it sets out that EU Guarantees may be signed until 31 December 2022.

As is it for the RSL with regard to the **alignment of interest between the managing authority, the financial intermediary, and the financial institution**, the credit risk retained by the financial institution may not be less than 20 per cent in any case on a loan by loan basis, the financial institution must build up a portfolio of new loans with own resources, the financial advantage of the capped guarantee must be fully passed on to the final recipients, and there must be a performance fee for the financial intermediary in accordance with Articles 12 and 13 CDR.

Similarly, the Annex to the Delegation Agreement on the LGF provides for a risk retention rate of 20 per cent for the EU Guarantee for Debt Financing under section 3. f. While it does not stipulate anything on the alignment of interest under section 3. l. for the EU Guarantee for Debt Financing, it does so for the EU Guarantee for Securitisation under section 4. c.: The financial intermediary is required to maintain a 'material interest in the portfolio' by either retaining a vertical tranche of a nominal value of less than 5 per cent compared to the total nominal value of the securitised portfolio, or by 'retaining the first loss piece of the portfolio', which is also at least 5 per cent of the total nominal value of the securitised portfolio.

The **requirements for eligible financial intermediaries and financial institutions** for the CPG are analogous to those for the RSL: financial intermediaries and financial institutions must 'be public and private bodies established in a Member State, which are legally authorised to provide guarantees on loans to enterprises operating in the jurisdiction of the programme which contributes to the financial instrument'.

In comparison, the eligibility criteria for LGF financial intermediaries under the Annex to the LGF Delegation Agreement cover a similar scope under section 6.1.: It has to 'be financial institution or credit institution duly authorised… to carry out lending or leasing activities or providing bank

guarantees' or 'a guarantee scheme, guarantee institution or other financial or credit institution…' as well as 'be established and operating in one or more participating countries'. Moreover, financial intermediaries under the LGF Delegation Agreement have detailed documentation requirements under section 6.2., which refers to Articles 4.3 and 4.4 FAFA.

With regard to the **eligibility of final recipients**, the CPG shares the requirements with the RSL (being an SME, not active in sectors excluded by the *de minimis* Regulation, not active in restricted sectors, not be in difficulty, not be delinquent or in default, as well as have a registered place of business and the profiting activity be located in relevant Member State).

Similarly, the Annex to the Delegation Agreement on the LGF requires under its sections 7.1 and 7.2 that eligible final recipients be SMEs, neither be insolvent nor active in illegal activities, and be established and operating in a participating country. Moreover, they have to adhere to Articles 19 and 20 of the Delegation Agreement, i.e. meeting requirements on visibility, publication, and information.

Except for the maximum principal amount, which is EUR 1 000 000 for the RSL and EUR 1 500 000 for the CPG, respectively, the characteristics of the product for the final recipients under the CPG are the same as under the RSL. The reporting requirements under the CPG mirror those under the RSL. Moreover, as it is for the RSL, the financial advantage of the programme public contribution must be fully passed on to the final recipients through the reduction of the overall interest rate required by the financial institution and/or collateral reduction.

In comparison and in a similar way, the Annex to the LGF Delegation Agreement provides for instrument-specific transaction criteria for EU guarantees for Debt Financing and for Securitisation under its sections 7.3 and 7.4, namely that they be newly generated transactions, have a minimum maturity of 12 months, and be granted for investment in tangible and/or intangible assets and/or for financing working capital, respecting the transaction amount thresholds mentioned above. However, the Annex does not require a repayment schedule under the LGF.

Under the CPG, financial intermediaries have **reporting and target results obligations** vis-à-vis the managing authorities. Moreover, the Member States are required to fulfil their reporting obligations pursuant to the *de minimis* Regulation. Moreover, the financial intermediary is obliged to monitor and report the pass on of the financial advantage and on the GGE for final recipients.

Similarly, under the Annex to the LGF Delegation Agreement and its section 5. b) and c), there are (quarterly) reporting, monitoring, and audit requirements by the Commission, the EIF, and the ECA, as well as documentation requirements under section 6.2. However, there is no requirement on the monitoring and reporting of a pass on of the advantage nor on the GGE, since the LGF is not based on *de minimis*.

In sum, the conditions for EU financial instruments and the off-the-shelf instruments are very similar as to the limitations of the aid in terms of amount and time, the selection and eligibility of financial intermediaries and final recipients, and transaction criteria, and are structured in a similar way. However, EU financial instruments do not contain provisions on remuneration nor on pricing and collateral policies. Apart from that, the Commission employs the same rules in order to minimise distortions by limiting the amount of the aid and applying screening methods and market mechanisms, as it was analysed in chapter VI regarding the compatibility assessment. However, it becomes apparent that for both EU financial instruments and off-the-shelf instruments, the Commission does neither provide nor apply any tools that are apt to assess the correspondence between the amount of the aid and the extent of the market failure or the impact of the aid on the market and competition in terms of proportionality and its balancing exercise, as required by the EU Courts in their case law.

In the following, the structure and conditions of the Renovation Loan will be compared with those of the off-the-shelf instrument CPG and the EU financial instrument RSL.

4.4. The Renovation Loan

This template represents a loan fund for energy efficiency and renewable energy in the residential building sector: The Renovation Loan takes the 'form of a loan fund to be set up by a financial intermediary with contribution from the' ESI fund programme 'and additional contribution of at

least 15 per cent of the loan fund from the financial intermediary'.[1132] It supports renovation works, which implement energy efficiency or renewable energy measures and aims 'to offer preferential loans to natural and legal persons or independent professionals owing premises as well as administrators or other legal bodies acting on behalf and for the benefit of owners to undertake renovation works being eligible' for ESI fund support. [1133]

Annex IV of Regulation (EU) No 964/2014 lays down that the Renovation Loan, as the RSL and the CGP, be designed as a state aid free instrument. Therefore, it implies market conform remuneration for the financial intermediary, that the financial advantage of the public contribution to the instrument is fully passed on to the final recipients, and that the financing provided to the final recipients is in accordance with the *de minimis* Regulation.

At the **level of the financial intermediary** and the fund of funds, aid is excluded via the same conditions as in the RSL and the CPG: through pro-rata conditions, market remuneration, and the pass on of the financial advantage to the final recipients.

At the **level of an entity acting on behalf of the owners** (i.e. 'natural and legal persons, independent professionals owning premises, administrators, and other legal bodies') aid is excluded through the following conditions: Firstly, the entity may 'not benefit from any direct transfers of public support', and secondly, 'the entity transfers all the financial advantages of the public contribution to the final recipients'.

At the **level of the owners** described above or with an economic activity (i.e. 'legal person or independent professionals, landlords, and owners who install renewable energies, supplying part of the energy produced to the grid'), Annex IV elaborates on several points regarding the exclusion of aid. 'Owners that are natural persons and are not considered to be undertakings for not exercising an economic activity' are not regarded as beneficiaries of aid. Owners that do exercise an economic activity qualify as undertakings are subject to state aid rules and hence the aid must comply with *de minimis* rules. This is in line with the requirements of the EU Courts, as was discussed in chapter IV. For those, the financial intermediary must, for each loan inserted

[1132] Annex IV of Regulation (EU) No 964/2014.
[1133] European Commission, FI Compass, Financial Instrument Products, https://www.fi-compass.eu/sites/default/files/publications/ESIF-factsheet-FI-products.pdf , p.4, last access: 03.11.2020.

within the portfolio, calculate the gross grant equivalent according to the same methodology as it is prescribed for the RSL (see above) in order to comply with Article 4 of the *de minimis* Regulation.

Annex IV lays down the management requirements for the Renovation Loan. The **requirements of the lending policy** mirror those of the RSL and the CPG with regard to the disbursement from the managing authority or fund of funds to the financial intermediary (i.e. in tranches, respecting the ceilings of Article 41 CPR, and the maximum risk-sharing of the financial instrument towards final recipients must be 85 per cent), the origination of a portfolio of new loans (i.e. predetermined limited period of time, loans with predefined eligibility criteria to be automatically included in portfolio, and consistent lending policy), the re-use of resources paid back to the financial instrument, as well as the loss recoveries.

Moreover, also with regard to the **pricing policy**, the requirements mirror those of the RSL and the CPG (i.e. interest rate on the financial intermediary participation to be set at market basis, overall interest rate to be reduced proportionally to the allocation by the public contribution, the GGE calculation to be applied to each loan, and the pricing policy and methodology to remain constant during the eligibility period).

As it is for the **programme contribution** to the financial instrument, i.e. the amount and rate (product details) under the RSL, the minimum risk-sharing rate under the Renovation Loan must be based on the ex-ante assessment findings in accordance with Article 37 CPR.

Analogous to the requirements under the RSL and the CPG, the Renovation Loan instrument may only include 'newly originated loans to the final recipients to the exclusion of the refinancing of existing loans'. As it is under the RSL and the CPG, the managing authority's liability is set out in Article 6 CDR and the lending period to be set no later than 31 December 2023.

With regard to the **alignment of interest between the managing authority and the financial intermediary**, corresponding to the RSL and the CPG, the Renovation Loan includes performance fees pursuant to Articles 12 and 13 CDR, the pro rata impact of losses and recoveries on the financial intermediary and the managing authority, and the obligation of the financial

intermediary to 'contribute under local market conditions to the financing with at least 15 per cent of the total financing commitment to final recipients'. Analogous to the RSL and the CPG, eligible financial intermediaries under the Renovation Loan are 'public and private bodies established in a Member State, which shall be legally authorised to provide Renovation loans…'.

The Renovation Loan requires that **eligible final recipients** be 'natural or legal persons or independent professionals' with an economic activity 'as well as administrators or other legal bodies acting on behalf and for the benefit of owners, owning premises… implementing energy efficiency or renewable energies measures…'. As under the RSL and the CPG, the eligibility requirements are that the final recipient is a SME, not being active in a restricted sector or one excluded by the *de minimis* Regulation, not being in difficulty, not being delinquent or in default, and have a registered place of business in a Member State.

Analogous to the characteristics under the RSL and the CPG, the **products** under the Renovation Loan possess a maturity of up to 20 years and the maximum amount of each loan must be fixed in relation to the ex-ante assessment, which may not exceed EUR 75 000 per individual household. Moreover, the Renovation Loan must be subject to a fixed interest rate set at market basis and include regular amortisation. There may also be reduced interest rates, an interest rate subsidy, and the cover of certain technical support costs. As for the RSL and the CPG, there are reporting and evaluation requirements on targeted results.

In sum, the Commission designed the Renovation Loan along the same lines of the RSL and the CPG in terms of the limitation of the aid amount and its duration, the selection and eligibility of financial intermediaries and final recipients, as well as of reporting and evaluation requirements. In the following, the structure and conditions of the off-the-shelf instruments that are designed under GBER rules will be discussed.

4.5. The Co-Investment Facility

The Co-Investment Facility takes the form of an equity fund managed by a financial intermediary investing contributions from the ESIF programme into SMEs: It shall attract additional investments in SMEs through a partnership approach with private co-investors on a deal-by-deal

basis.[1134] Its aims are to invest in SMEs at the seed, start-up, and expansion stage or, for the realisation of new projects, the penetration of new markets or new developments by existing enterprises through co-investment agreements with co-investors on a deal by deal basis, as well as to provide more capital to increase investment volumes for SMEs.[1135]

In the following, the provisions on state aid and the management of the Co-Investment Facility will be elaborated on. Moreover, they will be compared with those of the other off-the-shelf instruments, i.e. the RSL, the CPG, and the Renovation Loan, designed as state aid free instruments. Differences will be detected and explained, with particular regard to the fact that the Co-Investment Facility adheres to the GBER provisions.

What is more, the provisions on the Co-Investment Facility will be compared to those of the Equity Facility for Growth (EFG) under the Annex to the COSME Delegation Agreement, which is a financial instrument designed and managed at the EU level. As such, merely state aid consistency is required rather than full compliance with state aid rules and the GBER, as it applies for the Co-Investment Facility. Since both the EFG and the Co-Investment Facility are in the form of equity and quasi-equity and since both are designed at the EU level by the Commission, they lent themselves for comparison with regard to the similarity and hence consistency of state aid rules of their provisions. This is particularly interesting since the former is intended for the implementation at EU level, while the latter is intended for the 'ready-to-use' implementation by Member States. Thus, the question whether they possess similar provisions regarding proportionality and the minimisation of market distortions merits closer investigation.

Annex V of Regulation (EU) No 2016/1157 amending Regulation (EU) No 964/2014 explains that the Co-Investment Facility is implemented as an instrument entailing state aid, but one that is compatible with the internal market and does not require an ad hoc notification, provided that the conditions of Article 21 GBER are satisfied. This is in contrast to the RSL, the CPG, and the Renovation Loan, all of which adhere to the *de minimis* Regulation and are hence designed as state aid free instruments.

[1134] Annex V of Regulation (EU) No 2016/1157.
[1135] Annex V of Regulation (EU) No 2016/1157.

According to Annex V, the **aggregate participation rate** at the level of the SME must reach at least the following thresholds on a deal by deal basis, which is in accordance with Article 21 (10) GBER: '(a) 10 per cent for risk finance provided to the eligible undertakings prior to their first commercial sale on any market, (b) 40 per cent for risk finance provided to eligible undertakings operating in any market for less than 7 years following their first commercial sale, and (c) 60 per cent for risk finance provided either to eligible undertakings requiring an initial risk finance investment, which, based on a business plan, is higher than 50 per cent of their average annual turnover in the preceding 5 years, or for follow-on investments in eligible undertakings after the 7-year period of the first commercial sale'.

In comparison, the Annex to the COSME Delegation Agreement on the EFG states under section 3 f) that 'the majority of the capital committed to any EFG Financial Intermediary/VC Fund-of-Funds shall be provided by investors that pass the market economy operator test' and that 'each EFG Financial Intermediary shall have at least 30% of its total commitments' (Fund-of-Funds at least 50%, respectively)… coming from independent private investors…'. Thus, there is no comparable gradation of aggregate participation rates as under the GBER for the EFG.

Aid at the **level of the final recipients**, eligible pursuant to Article 21 (5) GBER, is regarded as allowable, if (a) there is also allowable aid to private co-investors, (b) the financial intermediary is managed on a commercial basis pursuant to Article 21 (15) GBER and its financing decisions are independent and profit-driven, and (c) the ceiling provisions of private participation as set out in Article 21 (10) GBER are satisfied.

In comparison, Annex to the COSME Delegation Agreement on the EFG is not as specific in terms of Article 21 (15) GBER and the management of the financial intermediary on a commercial basis, but rather states under section 4.3 e. that the financial intermediary must 'be commercially-oriented managed by independent management teams combining the appropriate mix of skills and experience to demonstrate the necessary capability and credibility to manage a risk capital fund'.

Private participation is regarded as investments made by private bodies and 'the costs associated with the development of the investment projects, for the due diligence and for accompanying the

final recipients must be covered by the management costs and fees of the financial intermediary', according to Annex V. The total investment, i.e. one or more investment rounds including follow-on, combining public and private resources, may not exceed EUR 15 million per eligible final recipient pursuant to Article 21 (9) GBER.

As the RSL, the CPG, and the Renovation Loan, Annex V to the Co-Investment Facility lays down the **management requirements**. With regard to the conditions on investment policy and the eligibility of the financial intermediary, these requirements are more detailed and stricter than those under the RSL, the CPG, and the Renovation Loan, since, and in contrast to the them, the Co-Investment Facility is not free of state aid, but merely compatible with the internal market through meeting the requirements of Article 21 GBER.

Firstly, Annex V lays down the **conditions of the investment policy**. With regard to the disbursement from the managing authority/fund of funds to the Co-Investment Facility, the amount of the transfer must 'cover the needs in terms of investments and management costs and fees' and 'be carried out in tranches'. Moreover, the investment policy must include 'a clear exit strategy'. The disbursement from the Co-Investment Facility to the eligible SMEs must occur with the financial intermediary and other private investors in a pre-determined limited period of time. Moreover, for the purpose of the alignment of interests, the selected financial intermediary must on a deal by deal basis 'leverage additional finance from the financial intermediary or a vehicle affiliated to the financial intermediary for at least 1 per cent' as well as from private co-investors. This requirement as such cannot be found in the GBER.

However, equal to the requirements of Article 21 (14) GBER, **investment decisions** of the Co-Investment Facility must be profit-driven: The financial intermediary must be established in accordance with the applicable laws and provide for a due diligence process to ensure a commercially sound investment policy (including a risk diversification policy), the investment in eligible SMEs must be 'based on a viable business plan, containing details of product, sales and profitability development, establishing the ex-ante viability of the investment', as well as a clear and realistic exit strategy must exist for each investment.

The requirements for the EFG under the Annex to the COSME Delegation Agreement are similar: As stated, the financial intermediary must be 'commercially-oriented managed by independent management teams' and possess a certain minimum private participation rate. Moreover, section 4.3 e. requires that its management team demonstrate 'a clear strategy to make a sufficient number of investments into eligible final recipients', 'create adequate deal flow and establish appropriate exit strategies'.

Moreover, with regard to **disbursements from the co-investors to the eligible SMEs**, Annex V prescribes that the financial intermediary must 'identify, screen, and assess potential co-investments in final recipients as well as any co-investors' and 'carry out a due diligence assessment on a deal by deal basis'. The due diligence must cover 'key aspects such as the business plan, the viability of the investment, and the exit strategy'. For the private participation rates, the minimum thresholds of Article 21 GBER apply.

In contrast, the conditions under the Annex to the COSME Delegation Agreement on the EFG are less specific. Rather, financial intermediaries must merely 'undertake to select final recipients according to their internal rules and procedures taking due account of the taking into account the economic viability of the projects of the final recipients'.

The **eligible SMEs** are in line with those under Article 21 (5) GBER: SMEs, which have note been operating in any market, which have been operating in any market for less than seven years following their first commercial sale, or which require an initial risk finance investment higher than 50 per cent of their average annual turnover in the preceding five year based on a business plan. Moreover, without laying out the additional requirements of Article 21 (6) GBER, also SMEs, which require follow-on investments in eligible undertakings, even after the seven-year period of the first commercial sale, are eligible.

In comparison, the EFG under the Annex to the COSME Delegation Agreement excludes certain final recipients that do not meet the requirements of the FAFA and the Delegation Agreements itself, and includes final recipients that are 'an SME immediately before or after the time of first

investment' and are in their 'expansion and growth stage at the time of its first investment' under section 5.2.1.[1136]

For the **determination of the co-investment amount and rate per deal**, the size and focus of the Co-Investment Facility, the participation of co-investors, and the expected 'catalytic effect', i.e. the leverage effect, of the Facility respecting the ceilings of Article 21 (10) GBER, must be taken into account.

In comparison, for EFG instruments, the co-investment rate must be 30 per cent of the total commitments for financial intermediaries and 30 per cent of total commitments for fund-of-funds at the time of the closing under section 3. f of the Annex to the COSME Delegation Agreement, and, 'the majority of the capital committed… shall be provided by investors that pass the market economy operator test'.

As for the RSL, the CPG, and the Renovation Loan, for the **managing authority's liability in relation to the financial instrument**, Annex V refers to Article 6 CDR. The indicative duration of the Co-Investment Facility is ten years and may be extended with the consent of the managing authority, while the investment period of the financial instrument must be set out in order to adhere to the deadline of 31 December 2023, after which investments will be assessed for compliance with state aid rules.

In comparison, for the EFG, the Annex to the COSME Delegation Agreement states under its section 3. e) that the duration of EU investments in EFG financial intermediaries may not exceed 20 years from the time of signature of the Delegation Agreement.

With regard to the **alignment of interest between the managing authority and the financial intermediary**, Annex V stipulates requirements on the investment and risk sharing at the level of the financial intermediary, as the Annexes for the RSL, CPG, and the Renovation Loan instruments: performance fees must comply with Articles 12 and 13 CDR, the remuneration must reflect the current market remuneration, co-financing by private co-investors, again, must be in accordance

[1136] The same section requires that the final recipient is established and operating in a participating country at the time of the first investment. Moreover, there are different requirements for final recipients under a multi-stage financial intermediary under section 5.2.2.

with the minimum levels of Article 21 (10) GBER, and as stated earlier, co-financing with own resources of the financial intermediary must represent a minimum of 1 per cent on each deal under the same conditions as the Co-Investment Facility (this holds also true for private co-investors, except if the ex-ante assessment provides for asymmetric profit-sharing). Furthermore, the financial intermediary may not 'engage in investment activities under a new investment vehicle targeting the same type of final recipients until either such a time as 75 per cent of the Co-Investment Facility commitments have been invested and the remaining 25 per cent are committed to be invested, or, the end of the investment period… if earlier'.

In comparison with the Annex to the COSME Delegation Agreement, the provision on the alignment of interests between the EIF and the EFG financial intermediary is less strict under its section 3. l). This is because, next to the requirement of co-investment of a 'significant amount' by the financial intermediary's management team, it merely requires that 'the EIF, when implementing EU investments, shall seek to negotiate appropriate measures to be put in place by the EFG financial intermediary for avoiding conflicts of interest and for aligning the interests of the EFG financial intermediary, its manager and investors…'.

In contrast to those of financial intermediaries under the RSL, CPG, and Renovation Loan, the stipulations on the **eligibility requirements of financial intermediaries** under the Co-Investment Facility are more detailed and in accordance with the GBER. The selected financial intermediary must be 'a private body established at international, national or regional levels in the Member States' and 'legally authorised to provide equity to enterprises established in the Member States'. What is more, the selection of financial intermediaries must be 'open, transparent, and non-discriminatory' and establish 'appropriate risk-sharing arrangements in the case of preferential remuneration and determine possible carried interest'.

During the selection, the financial intermediary must 'specify conditions and criteria for the evaluation of co-investors' and 'demonstrate a non-discriminatory approach to find and invest with co-investors'. In accordance with Article 21 (15) GBER, the financial intermediary must be managed on a commercial basis by fulfilling its requirements (i.e. act as a professional manager, market remuneration and remuneration linked to performance or co-investment, investment strategy, and investor representation in the governance structure).

Moreover, the Co-Investment Facility must 'seek to mobilise **co-investors** implementing best practice, which must be 'long-term private investors investing own resources' and be 'operating in circumstances corresponding to the market economy investor principle in a free market economy, irrespective of their legal nature and ownership'. Interestingly, the requirement is not meant to comply with the conditions of the MEIP, but to merely find investors in corresponding circumstances. This lighter wording might have been intended to provide the financial intermediaries with more leeway in detecting eligible private co-investors. However, it is inconsistent with the requirements of state aid rules on private investors, which follow the MEIP, and thus may enhance legal uncertainty.

The requirements of the Annex to the COSME Delegation Agreement for the EFG are similar: section 4.2 refers to the requirements of an open, transparent, and non-discriminatory selection procedure under the FAFA (Articles 4.3 and 4.4 FAFA). Moreover, there are instrument-specific requirements on the eligibility of financial intermediaries under section 4.3. regarding, for instance, their business activities, targeting of private investors in their investment strategy, the commercially-oriented management, as well as reporting, visibility, and evaluation obligations.

In line with the conditions under the RSL, CPG, and Renovation Loan, Annex V lays down the following **eligibility conditions for final recipients**: As micro, small, or medium enterprises, i.e. SMEs, they may not be excluded under Article 1 (2) to (5) GBER, not be part of one or more restricted sectors, not be in difficulty, not be in default, not be listed companies, not receive investment as replacement capital, and must be established and operating in the relevant region of the ESI fund programme.

As stated and similar thereto, the Annex to the COSME Delegation Agreement excludes certain final recipients that do not meet the requirements of the FAFA and the Delegation Agreements itself and includes final recipients that are 'an SME immediately before or after the time of first investment' and are in their 'expansion and growth stage at the time of its first investment' under section 5.2.1

With regard to the **characteristics of the product for final recipients**, as for the RSL, CPG, and Renovation Loan, the amount and rates of the Co-Investment Facility must be in line with the results of the ex-ante assessment and the investment by the financial intermediary must be in the form of equity or quasi-equity 'co-financed by the programme public contribution, the financial intermediary's own contributions and the co-investors' contributions'. The total investment amount may not exceed EUR 15 million per eligible final recipient in accordance with Article 21 (9) GBER. Moreover, the financial intermediary and the Member States have requirements on reporting and targeted results vis-à-vis the managing authority.

In comparison, the product of the EFG under the COSME Delegation Agreement comes also in the form of long-term equity and/or quasi-equity. Thereunder, the maximum investment amounts are EUR 30 million for financial intermediaries and EUR 50 million for Fund-of-Funds as per section 3. c). Section 7.1 states monitoring obligations of the EIF.

In sum, compared to the off-the-shelf instruments based on *de minimis*, the Co-Investment Facility off-the-shelf instrument contains stricter, more detailed, and more specific conditions on, for instance, commercial management, investment policy, and the eligibility of financial intermediaries, as it is based on Article 21 GBER and thus not free of state aid. This holds also true for the comparison with EU financial instruments, e.g. the EFG instrument under COSME, as the Co-Investment Facility instrument's rules are more detailed and specific. However, off-the-shelf instruments and EU financial instruments contain very similar rules to minimise distortive effects, such as market mechanisms, screening methods, and ceilings, which are structured alike around private participation rates, commercial management of financial intermediaries, eligibility of final recipients, as well as co-investment and alignment of interests between managing authorities and financial intermediaries.

The reason that the rules on the Co-Investment Facility are stricter, more specific, and more detailed as compared to those of *de minimis* off-the-shelf instruments straightforward: the former instrument is based on the GBER and thus contains aid elements. However, when compared with EU financial instruments, the Commission appears to provide for itself (or the EIF) slightly more leeway than for its Member State counterpart instruments under the GBER, as it appears to trust itself and the EIF more in the design of financial instruments that are consistent

with state aid rules. However, again, rules on the assessment of the correspondence between the aid amount and the market failure or the impact of the aid are missing.

4.6. The Urban Development Fund

The Urban Development Fund takes the form of a loan fund and is set up and managed by a financial intermediary with contributions from the ESI fund programme and a mobilisation of co-financing of at least 30 per cent from the financial intermediary and co-investors: Its aim is to combine resources from the ESI fund programme, the financial intermediary, and co-investors to support the implementation of urban development projects in assisted areas, which are designed in a regional aid map.[1137]

Corresponding to the implications of the Co-Investment Facility, Annex VI of Regulation (EU) No 2016/1157 amending Regulation (EU) No 964/2014 explains that the Urban Development Fund is implemented as an instrument entailing state aid, but one that is compatible with the internal market and does not require an ad hoc notification, provided that the conditions of Article 16 GBER are satisfied, i.e. the GBER's rules on regional urban development aid.

According to Annex VI, the **financial intermediary and the fund of funds must comply with the following conditions**: '(a) the management costs and fees of the financial intermediary and the fund of funds reflects the current market remuneration in comparable situations, i.e. the latter has been selected through an open, transparent, non-discriminatory procedure or if the remuneration is aligned with Articles 12 and 13 of Delegated Regulation (EU) No 480/2014 and no other advantages are granted by the state. If the fund of fund only transfers the ESI fund contribution to the financial intermediary, has a public interest mission, has no commercial activity when implementing the measure, and is not co-investing with its own resources (thus, not being considered a beneficiary of aid), it suffices that the fund of fund is not overcompensated'. Moreover, (b) the private contribution to each urban development project must exceed 30 per cent of the total financing and be compliant with Article 16 (6) GBER, and (c)

[1137] Annex VI of Regulation (EU) No 2016/1157.

the urban development fund must be managed on a commercial basis and ensure profit-driven financing decisions.

Due diligence costs have to be covered by the management costs and fees of the financial intermediary. Asymmetric conditions are not allowed for the other co-investors at the project level, as their contributions are not invested in loans and outside the fund. Preferential remuneration and asymmetric conditions on risk-sharing arrangements for fund of funds, financial intermediary contribution, and co-investors contributions at fund and project level are only allowed, if they are in line with Article 44 (1) CPR and Article 16 (8) (b) and (c) GBER. Final recipients are only eligible pursuant to Article 16 GBER. The total investment amount of the urban development fund may not exceed EUR 20 million pursuant to Article 16 (3) GBER.

Corresponding to Annex V on the Co-Investment Facility, Annex VI stipulates the management requirements of the Urban Development Fund. Both of these off the shelf instruments are not designed as free of state aid, but as compatible with the internal market and Article 16 GBER. Since regional urban development aid is not the concern of this thesis, suffice to state that the management requirements of the Urban Development Fund are similar to those of the Co-Investment Facility as opposed to the partially less detailed requirements of the other three off-the-shelf instruments, except that it is in accordance with the rules of Article 16 GBER instead of Article 21 GBER.

4.7. Conclusion

First of all, the off-the-shelf instruments are structured in the same way with regard to the limitations of the aid in terms of amount and time, the requirements for the selection and eligibility of financial intermediaries as well as of final recipients, the commercial management of financial intermediaries, and the alignment of interests between managing authorities and financial intermediaries, for instance. However, those off-the-shelf instruments that are designed as state aid free instruments entail specific conditions as to the full pass on of the aid and its *de minimis* requirements, while those off-the-shelf instruments that do contain aid adhere to the requirements of risk finance aid under Article 21 GBER. As the latter do contain state aid and are merely compatible, their conditions on the investment policy and the eligibility of financial

intermediaries, for instance, are more detailed, more specific, and stricter, as they follow the requirements of Article 21 GBER.

When compared to the very similar structure of Article 21 (18) GBER, the main difference of the off-the-shelf instruments adhering to the *de minimis* requirements is that they do not contain any aid, as any advantage is to be passed on entirely. In contrast, any advantages under the structure of Article 21 (18) GBER in conjunction with Article 21 (16) GBER are to be passed on to 'the largest extent', leaving room for aid.

In comparison to EU financial instruments and their Annexes to the Delegation Agreements, it becomes apparent that the **Commission uses the same mechanisms and tools also for off-the-shelf instruments** in order to limit market distortions, as it was already discussed in chapter IV regarding the compatibility assessment and the Commission's 'check listing' of these mechanisms: It employs conditions limiting the aid in terms of amount and time as well market mechanisms and screening methods, such as the selection, eligibility criteria, and commercial management of financial intermediaries, for instance .

Thus, the research question of this chapter may be answered as follows: although the rules and their structure of off-the-shelf instruments and EU financial instruments are very similar and thus consistent with each other, they are not consistent with regard to the interpretation of the EU Courts on the proportionality principle and its requirements for state aid law. In fact, for both types of instruments, the provisions on proportionality and the minimisation of market distortions are weak: They do not provide tools for the balancing exercise and the assessment of the correspondence between the aid amount and the extent of the market failure or the impact on the market. Rather, they merely rely on capping the aid amount, applying market mechanisms, and screening financial intermediaries and final recipients on their viability.

The introduction of manifest negative effects for both EU financial instruments and those at Member State level, including off-the-shelf instruments, could bridge this Commission's very failure, as it would clarify which effects would be too excessive, rendering any instrument incompatible, and make the conditions for instruments consistent with the requirements of the EU Courts under the proportionality principle, including its *stricto sensu* interpretation. This would

enhance legal consistency and certainty in all financial instruments, at whichever level, and could put the pressure off from the current very detailed provisions on ceilings, market mechanisms, and screening methods. This may hold true especially for the seemingly complicated off-the-shelf instruments currently in place, which could improve their acceptance and uptake by Member States.

VIII. Accountability Mechanisms for Financial Intermediaries in the Light of Proportionality

1. Financial accountability and risk finance measures

Next to the lack of identifiable costs and different implementation levels, another particular feature of financial instruments under risk finance aid is that, in accordance with Article 21 (13) GBER and paragraph 20 of the Risk Finance Guidelines, they must be implemented through financial intermediaries, i.e. non-state actors.[1138] Thus, if funding is provided directly by a public authority to an undertaking, it is not considered to be a risk finance measure under the GBER or the Risk Finance Guidelines, so that 'a different legal basis must be found'.[1139] These financial intermediaries thus serve as non-state agents on behalf of public authorities, which may have their own agenda and different interests than their principal, i.e. this dilemma forms the so-called principal-agent problem. Within the principal-agent framework, the principal exerts formal authority over the agent, whereby 'the latter benefits from an informational advantage about the real use of its abilities and about the correctness of its behaviour that could result in so-called adverse selection and moral hazard problems', i.e. 'the agent's behaviour does not conform to the principal's expectations because agents have their own preferences and agendas'.[1140]

In the context of financial instruments, two problems may arise from this: transactions through financial instruments may cause market distortions at different levels, and in particular also at the level of financial intermediaries, since (a) they receive an advantage and thus state aid and (b) they may make the wrong choices or decisions, which are not in the interest of the managing authority and the overall public policy objective. With regard to the principle of proportionality, these market distortions may be minimised either by limiting state aid in terms of amount and time and the remuneration of financial intermediaries or by accountability mechanisms, which are intended to incentivise, check, and monitor whether the financial intermediaries' decisions

[1138] European Commission, Communication from the Commission, Guidelines on State aid to promote risk finance investments (2014/C 19/04).
[1139] Phedon Nicolaides, The Puzzle of Financial Instruments, European Structural and Investment Funds Journal, vol. 6 no. 2, 2018, p.125.
[1140] Martino Maggetti et al., The Principal-Agent Framework and Independent Regulatory Agencies, Political Studies Review, vol. 16(3), 2018, pp. 172, 173.

are in line with the public policy objective and minimise market distortions, and hence proportionate.

Accordingly, in order to safeguard that financial intermediaries act in line with the interests of public authorities and the objectives of aid measures, accountability mechanisms are built into risk finance rules, i.e. several rules aim at the accountability of intermediaries via incentives and performance measures. Thus, the following sub-question in this chapter merits closer investigation:

- Are the accountability rules for financial intermediaries at both the EU and the Member State level consistent and are they apt to achieve public policy objectives and to minimise market distortions?

Bovens defines accountability 'as a social mechanism or an institutional relation or arrangement, in which an agent can be held to account by another agent or institution' as well as 'a relationship between an actor and a forum, in which the actor has an obligation to explain and justify his or her conduct; the forum can pose questions and pass judgment, and the actor may face consequences'.[1141] Bovens states that accountability, in a broad sense, connotes legal matters such as transparency, controllability, responsiveness, responsibility, and liability.[1142] 'Legal doctrines', and it may thus be inferred, legal principles and rules, may be 'effective oversight mechanisms, which can be used effectively and systematically to alter the behaviour of principals and agents, making the outcomes of the implementation of policy processes more predictable and acceptable'.[1143]

Two mechanisms provide the basis, on which accountability is applied: information and sanctions.[1144] Thus, accountability is 'about the construction of an agreed language or currency of discourse about conduct and performance, and the criteria that should be used in assessing

[1141] Mark Bovens, Two concepts of accountability: Accountability as a virtue and as a mechanism, West European Politics 33, 2010, p.948, and
Mark Bovens, Analysing and assessing accountability: A conceptual framework. European Law Journal 13, 2007, p.450.
[1142] Mark Bovens, Analysing and assessing accountability: A conceptual framework. European Law Journal 13, 2007, p.447.
[1143] Hon S. Chan et al., Legal Control of Public Administration: A Principal-Agent Perspective, International Review of Administrative Sciences, vol. 60, 1994, p.572.
[1144] Brigid Laffan, Auditing and accountability in the European Union, Journal of European Public Policy, 2003, p.764.

them'.[1145] Forms of accountability are administrative, parliamentary, electoral, judicial accountability, and financial accountability.[1146] Financial accountability is linked to administrative and parliamentary accountability, whereby administrative budgetary processes are to 'ensure accountability that funds are actually expended for stipulated purposes, that programmes carried out as intended, and that funds, from whatever sources, are not spent on unauthorised activities' as well as to support managerial functions, 'tying financial decision making to programme performance'.[1147] It relates to 'the control and elimination of waste and corruption and involves compliance with legal procedures, as well as the use of external audit mechanisms'.[1148] In the context of financial instruments, this addresses the question of how the Commission may ensure that financial intermediaries as agents follow the rules intended to minimise market distortions.

Thereby, the performance aspect of accountability 'emphasises the improvement and learning, drawing partly on legal, regulatory, and policy frameworks, but also on instruments, such as benchmarking, monitoring, and evaluation'.[1149] The particular feature of risk finance measures embedded in Cohesion policy is that they 'involve multilevel and networked forms of governance' and that 'policy-making is based on complex formal and informal relationships between multiple levels and actors', so that core formal responsibilities are set out in the EU Treaty and are further elaborated in the Financial Regulation and Cohesion policy regulations'.[1150] While Member States bear the main responsibility in using EU funds, Cohesion policy regulations 'are highly prescriptive and allow Member States and regional authorities less scope than in the past to decide how to ensure accountability in relation to the use of EU funds'.[1151] This holds also true for the accountability rules concerning risk finance measures, as will be shown.

On the one hand, the state aid framework on financial instruments entails several rules on the accountability and performance of financial intermediaries that have the task to implement the financial instruments at the Member State level. On the other hand, for financial instruments set up and managed at the EU level, the FAFA and the Delegation Agreements cover the aspects of

[1145] Brigid Laffan, Auditing and accountability in the European Union, Journal of European Public Policy, 2003, p.763.
[1146] Brigid Laffan, Auditing and accountability in the European Union, Journal of European Public Policy, 2003, p.764.
[1147] Naomi Caiden, Budgetary processes, in M. Hawkesworth and M. Kogan (eds), Encyclopedia of Government and Politics, 1992, p.806,
and Brigid Laffan, Auditing and accountability in the European Union, Journal of European Public Policy, 2003, p.764.
[1148] Sara Davies et al., Financial Accountability and European Union Cohesion Policy, Regional Studies, 2011, p.697.
[1149] Sara Davies et al., Financial Accountability and European Union Cohesion Policy, Regional Studies, 2011, p.697.
[1150] Sara Davies et al., Financial Accountability and European Union Cohesion Policy, Regional Studies, 2011, pp.697, 698.
[1151] Sara Davies et al., Financial Accountability and European Union Cohesion Policy, Regional Studies, 2011, p.699.

accountability and performance. This section will describe the different rules for instruments both at the Member State and the EU level, and will compare them with regard to their consistency, i.e. the degree of accountability and performance of the fund managers at Member State level and of the EIB at the EU level will serve as benchmarks of consistency.

What is more, under Article 21 (15) GBER, financial intermediaries may co-invest own resources in order to align interests with the public investor. However, this co-investment might lead to the crowding out of investment by other private investors and may imply that its inherent goal of profit seeking may be detrimental to the very achievement of the public policy objective of the public authority under the risk finance measure. This chapter will thus discuss this aspect of accountability and the seemingly contrasting goals thereunder, with particular regard to the special interpretation of proportionality that concerns profitability.

2. Accountability and the selection of financial intermediaries at EU and Member State Level

Pursuant to Article 38 (4) (b) CPR, Managing Authorities may entrust the implementation of financial instruments to (i) the EIB group, (ii) an international financial institution, or (iii) a body governed by public or private law.

Under Section II of Chapter II on provisions supplementing the CPR, the CDR lays down in Article 7 the criteria for the selection of bodies implementing financial instruments. However, pertaining to secondary law, both the CPR and the CDR do not apply to the bodies of the EIB group, as primary law rules the relation between Member States and the EIB group.[1152] Thus, Article 7 CDR does not refer to the selection of the EIB group for implementing financial instruments, but only to international financial institutions and bodies governed by public or private law under Article 38 (4) (b) (ii) and (iii) CPR.

[1152] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, p.9.

Hence, in the following, the accountability criteria on the bodies other than the EIB/EIF will be elaborated, which will then serve as a benchmark for the corresponding provisions applicable to the EIB/EIF under the FAFA and the Delegation Agreements.

Article 7 (1) (a) to (f) CDR and the first paragraph of Article 7 (2) CDR lay down certain **minimum selection criteria**, which refer to the legal, financial, economic, and organisational capacity of the implementing body. Firstly, the legal capacity implies that the body 'is allowed to carry out the tasks of implementation of the financial instrument under national and EU law', so that 'the selection procedure must… check the entitlement of the body'.[1153]

In comparison, the provisions on financial instruments set up and managed at the EU level apply very similar criteria in terms of screening methods: Article 6 of the COSME Delegation Agreement stipulates that its Annexes 1a and 1b shall set out the selection criteria and process for financial intermediaries. In terms of the legal capacity, Section 6.1 of Annex 1b covers the eligibility requirements for the LGF Financial Intermediary, the Originator, and the LGF Financial Sub-Intermediary: They must be 'a financial institution or credit institution duly authorised… to carry out lending or leasing activities or providing bank guarantees, or a guarantee scheme, guarantee institution, or other financial or credit institution duly authorised… to issue guarantees… as well as be established and operating in one or more participating countries'. Like Article 7 CDR, this refers to the legal capacity of the applicant in a similar way.

Regarding the general requirements, section 6.2 requires that LGF Financial Intermediaries comply with the requirements of Article 4.3 and 4.4 of the FAFA and with specified requirements regarding visibility, reporting, evaluation, and activities. Article 4.3 FAFA requires that the EIF and the financial intermediaries include in their agreements important accountability tools in order to be able to keep the European Anti-Fraud Office (OLAF) and the ECA informed, to keep documentation, and to provide for the Commission to conduct controls and audits, including on-the-spot checks and inspections.

[1153] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.1.1., p.19.

With regard to Delegation Agreements, for instance, Annex 1b refers in its section 8 to the call for expression of interest, containing the criteria as well as the application and selection process to be applied to financial intermediaries, which can be found online on the website of the EIF.[1154] This publication of the call for expression of interest refers to the selection of applicants 'in due consideration of the general principles of transparency, equal treatment, and non-discrimination.[1155] This is in line with the procedure under Article 21 (13) (b) GBER.

With regard to financial instruments at Member State level and the second minimum selection criterion for ESI fund instruments under Article 7 (1) CDR, the economic and financial capacity refers to the body's adequate economic and financial viability, which has to be checked 'by reference to the type of tasks that will be entrusted… and their implementing modalities including their duration'.[1156] Thirdly, the organisational capacity required means an adequate 'organisational structure and governance framework providing the necessary assurance to the managing authority', which has to evaluate 'how well the system put in place in the body… is directed and controlled'.[1157] Moreover, it means 'an effective and efficient internal control system' that ensures that the body possess an 'adequate control environment and respects the procedures in place for the execution, measurement, follow up, and mitigation of risks', as well as an 'accounting system providing accurate, complete, and reliable information in a timely manner'.[1158]

Fourthly, the body to be selected must have experience in the implementation of financial instruments, not necessarily of EU funds, in general, and the team members the expertise and experience in particular.[1159] This ensures that the financial intermediary is actually able to carry

[1154] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019.
[1155] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Equity Facility for Growth and Innovfin Equity, https://www.eif.org/what_we_do/equity/single_eu_equity_instrument/call/Joint%20InnovFin%20Equity%20and%20COSME%20EFG%20Call%20for%20Expression%20of%20Interest.pdf, last access: 16.06.2019, p.4.
[1156] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.1.2., p.19.
[1157] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.1.3., p.19.
[1158] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.1.3., pp.19, 20.
[1159] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.1.4., p.20.

out the tasks in achieving the public policy objectives delegated by the Member State managing authority. However, this may not necessarily guarantee that the financial intermediary in question is indeed able to achieve the relevant objective and is experienced in minimising market distortions, for instance.

With regard to financial instruments set up and managed at the EU level, for instance, Annex 1b to the COSME Delegation Agreement refers to the economic, financial, and organisational capacity of their financial intermediaries in a similar way and elaborates in its section 8 on the selection process, selection criteria, and the impact assessment regarding applicants. It prescribes a call for expression of interest to be published on the EIF website and the selection process, including the pre-selection, due diligence, and final selection.[1160] The publication of the expression of interest specifies the assessment criteria for applications regarding capped '(Counter-)Guarantee expressions of interest' as well as 'Securitisation expressions of interest', which are the capacity of the applicant to comply with all contractual obligations, the capacity to manage the risk of the operation, the experience and ability to finance (or facilitate finance) to SMEs, and the quality and plausibility of the COSME LGF implementation proposal.[1161]

Thereafter, the due diligence will assess general information, such as the institution's business plan, risk management, and reporting abilities, financial information, such as funding sources and ownership structure, pricing policy, and the proposal of enhanced access to finance, i.e. showing the ability to build up the envisaged portfolio.[1162] This is intended to ensure that the financial intermediary be able to fulfil its tasks in achieving the public policy objective on behalf of the Commission and the EIF and to avoid causing unnecessary market distortions. Again, the due diligence does not necessarily guarantee in practice that the relevant objective be achieved and market distortions be minimised, but at best is apt to facilitate these goals.

[1160] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019.
[1161] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019, pp. 6, 7.
[1162] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019, p. 8.

For financial instruments at Member State level, Article 7 (2) (a) to (f) CDR regarding ESI fund financial instruments provides a second set of criteria, namely **minimum award criteria** linked to the subject matter of the contract on the implementation. These must be applied, since 'the use of price only or cost only (i.e. in the context of financial instruments management fees or management costs only), methodology to evaluate offers submitted by bodies… would not allow managing authorities to apply the full minimum set of evaluation criteria'.[1163] The Commission explains in its guidance that managing authorities 'must apply the most economically advantageous methodology to evaluate the offers' by using the minimum award criteria:[1164]

Firstly, the managing authority must evaluate the offers on the basis of the methodology proposed by the potential implementing bodies, i.e. the selection of financial intermediaries or final recipients, the terms and conditions applied relating to the support of final recipients, including pricing, and where the body co-invests own resources or shares the risk, the 'proposed measures to align interests and to mitigate possible conflicts of interests', including an 'appropriate profit and risk sharing structure for the resources invested'.[1165]

This means, the managing authority has to take into account 'the robustness and credibility of the methodology for identifying and appraising financial intermediaries and final recipients', whereby its credibility 'may be reinforced by the fact that it already exists and it is effectively functioning in the financial institutions participating in the tender'.[1166] These requirements are intended to ensure that the managing authority apply the right methodology for selecting viable and reliable financial intermediaries as agents for the achievement of the public policy objectives, which are not prone to cause market distortions. However, all of these requirements cannot guarantee that these two goals are attained in practice, as the financial intermediary may still have other incentives that do not align with the interests of the managing authority: for instance, the fund managers of the financial intermediary may still take higher risks than the managing

[1163] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2., p.20.
[1164] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2., p.20.
[1165] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2.1., pp.20, 21.
[1166] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2.1., p.20.

authority is prepared to, knowing that it will benefit from the aid and thus has a larger economic leeway.

For instance, the Call for Expression of Interest of the ESI fund instrument '*Junta de Andalucía*' between Spain and the EIB as manager of the fund-of-funds, states and clarifies the following assessment criteria for the eligibility of applicant financial intermediaries under that programme: quality of the investment strategy, robustness and credibility of the methodology for the identification of market opportunities and assessment of final recipients, relevant experience and track record, quality of legal ownership, reliability and credibility of governance, risk management, internal controls, management structure and organisational capacity, administrative capacity and reporting, co-financing and its level of commitment, adequacy of envisaged leverage strategy, and the level of management fees.[1167] These criteria are then weighted based on a scoring system.

With regard to the **terms and conditions relating to the support to final recipients**, the pricing should 'cover the range of prices for different types of services and additional advantages offered compared to a standard commercial transaction', and where the price is not pre-determined, the price calculation method (or at least a sufficiently detailed estimate) should be 'foreseen and communicated'.[1168] Thereby, the Commission recommends that the terms and conditions 'could take the form of a simple step-by-step guide helping the final recipients to understand how they should present their requests for investments'.[1169] Thus, the Commission prescribes in detail how managing authorities can calculate prices in a transparent way in order to prevent any information advantages its agents may have.

The second award criterion is the ability to raise additional resources in order to ensure the highest possible leverage effect, i.e. 'resources for investments in final recipients additional to programme contributions'.[1170] The Commission does not provide more detailed explanations on

[1167] European Investment Bank, Call for Expression of Interest to select Financial Intermediaries that will receive resources from a fund of funds established under cooperation of Junta de Andalucía and the European Investment Bank for the implementation of a financial instrument, 2018, https://www.eib.org/attachments/eoi/pc-1510-tor-en.pdf, last access: 08.11.2020.
[1168] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2.1., p.20.
[1169] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2.1., p.21.
[1170] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2.2., p.21.

this criterion other than that the offers must be evaluated on the basis of this capacity. This criterion aims at ensuring that the managing authority and its financial intermediary achieve the highest possible leverage effect, which is an inherent goal of financial instruments, of course. However, even if the highest possible leverage effect is achieved, market distortions may still be excessive, which is not regarded for under this criterion.

Thirdly, 'in order to ensure the value added of the intervention of ESI funds', implementing bodies to be selected must demonstrate the ability of additional investment activity, i.e. that the 'implementation of the financial instrument will not substitute the current activity of the body'.[1171] The Commission does not provide more indication on the application of this criterion. Again, this criterion is intended to ensure that managing authorities and their financial intermediaries achieve significant private sector investment with financial instruments, while avoiding unnecessary market distortions. Although additional private investment is an inherent goal of financial instruments, this may still be detrimental to the market, as it is difficult to evaluate the counterfactual situation, i.e. to assess whether there might have been private investment even without the aid.

Finally, of course, also the level of management costs and fees is an award criterion to be taken into account: they 'constitute the "price" of the services provided to the managing authority' and the calculation 'methodology proposed must be taken into consideration'. [1172] However, management costs and fees cannot guarantee the attainment of the public policy objective, and are not apt for the minimisation of market distortions except for avoiding overcompensation.

In comparison, regarding financial instruments set up and managed at the EU level, section 8.2.2 of Annex 1b to the COSME Delegation Agreement and the call for expression of interest stipulate similar assessment criteria for the applicants, for instance: These are the capacity of the applicant to comply with all contractual obligations, the capacity to manage the risk of the operation, the experience and ability to finance (or facilitate finance to) SMEs, and the quality and plausibility of

[1171] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2.3., p.21.
[1172] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.2.4., p.21.

the implementation proposal.[1173] Again, these criteria cannot guarantee that the public policy objective and the minimisation of market distortions are indeed achieved, but may merely facilitate these to some extent.

Moreover, the due diligence under the call or expression of interest is concerned with the assessment of the general information, such as the institution's business plan, risk management, and reporting abilities, financial information, such as funding sources and ownership structure, pricing policy, and the proposal of enhanced access to finance, i.e. showing the ability to build up the envisaged portfolio.[1174] These prescriptive criteria ought to ensure that the financial intermediary will only select final recipients that are considered viable and eligible under the COSME programme, thus facilitating the necessary and proportionate use of the aid, and rendering financial instruments repayable. Therefore, financial intermediaries cannot deviate from the selection and award criteria for own profit-seeking purposes through information advantages, for instance.

Importantly, however, neither the Annexes nor the calls for expression of interest under the Delegation Agreements appear to require that the price of services rendered to final recipients or the management costs and fees of the applicant financial intermediaries be taken into account as award criteria. Thus, there is no accountability mechanism for minimising potential aid in the form of (over-)compensation/remuneration.

Section 6.2. i. of Annex 1b to the COSME Delegation Agreement, for instance, merely requires that financial intermediaries 'shall undertake in the documentation… to comply with its established pricing policy as set out in its internal guidelines, in force at the time of the final recipient transaction, and not make any amendments to its pricing policy that result in a negative pricing discrimination…'. However, it does not stipulate that any specific pricing policy be an award criterion. This is in contrast to Article 7 (2) (f) CDR for financial instruments at the Member

[1173] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019, pp.6, 7.
[1174] The European Investment Fund, Open Call for Expression of Interest to select Financial Intermediaries under the COSME Single Union debt financial instrument for Union enterprises' growth and research and innovation, https://www.eif.org/what_we_do/guarantees/single_eu_debt_instrument/cosme-loan-facility-growth/call/cosme-lgf-call-for-expression-of-interest-final.pdf, last access: 14.06.2019, p.8.

State level, which requires that pricing policy be an award criterion. However, as stated, remuneration and pricing policies cannot guarantee, but merely facilitate the achievement of the public policy goal – and to an even lesser degree – of the minimisation of distortive effects of the aid. The right pricing policy may mitigate market distortions, but remuneration cannot be tied to the minimisation of them, especially since the Commission does not provide any tools to measure them (see chapter VI).

Importantly for the **information aspect of accountability**, with regard to ESI fund financial instruments, 'in order for the Commission to check that the procedures set up and implemented by the body… are in line with these conditions aiming at protecting EU Funds', the implementing body must agree to be audited by Member State audit bodies, the Commission, and the ECA, whereby the Commission recommends that this condition be indicated in the terms of reference of the call as well as in the relevant funding agreement.[1175] This accountability mechanism, however, cannot ensure that the financial intermediary and its fund managers as agents act in accordance with the public policy objective and the minimisation of market distortions at the very execution of the financial instrument, but rather a posteriori and for the future application of the financial instrument in question.

The 'reporting hierarchy' of accountability continues thus: Article 12 GBER stipulates that financial instruments are monitored by the Commission and section 5.4 RFG that Member States must report and maintain detailed records. Moreover, section 6 of the Commission Notice on guarantees stipulates strict reporting requirements: Member States are obliged to provide the Commission with reports on details of the guarantees issued and outstanding (number and amounts, respectively), yearly income, and yearly costs on a regular therein specified basis.

In a similar way, regarding rules on EU financial instruments, section 5 of the Annex 1b on the LGF of the COSME Delegation Agreement stipulates several requirements on reporting, monitoring and audit, as well as reputational risk management of financial intermediaries vis-à-vis the Commission, the EIF, and the ECA. Again, these accountability mechanisms may only ensure that

[1175] The European Commission, Guidance for Member States on the selection of bodies implementing FIs, including funds of funds, 13.10.2015, para. 3.8.3., p.22.

the agents act in accordance with the objectives and the minimisation of market distortions in the future.

In sum, state aid rules and the rules applicable to EU financial instruments apply similar accountability mechanisms. In a comparable way regarding content and prescriptiveness of the rules, they ensure that the agents, the financial intermediaries, adhere to the principals' interests, that of the Member State managing authorities, as well as to the public policy objectives to be achieved through state measures. They do this in order to prevent financial intermediaries and their fund managers from taking wrong choices and decisions, which would be detrimental to the attainment of the objectives and which could cause unnecessary market distortions.

Holding the agent accountable is achieved through prescriptive rules on the selection of financial intermediaries and final recipients, through award criteria for them, and through reporting and audit requirements to be applied by the financial intermediaries. However, there are minor differences, e.g. a pricing policy is not an award criterion for financial intermediaries of EU instruments, as the Commission appears to be less strict in formulating provisions for the latter (see also chapter VII).

However, in conclusion, it may be stated that the accountability mechanisms applied rather consistently by the Commission both at the Member State and the EU level, cannot guarantee that the financial intermediary and its fund managers as agents will indeed strive to attain the public policy objectives, let alone the minimisation of market distortions. At best, screening methods may facilitate these goals in the future. In particular, with regard to proportionality, the goal of the minimisation of market distortions may hardly be facilitated, except for the prevention of overcompensation, as the Commission itself does not provide any tools that are apt to measure distortive effects in the first place (see chapter VI).

3. Accountability through performance-based remuneration

As elaborated above, integral parts of accountability are rewarding and sanctioning agents' behaviour. As such, remuneration, especially when linked to performance, is a means of incentivising a desired behaviour by the agent. In the context of risk finance aid and financial

instruments, performance based remuneration is presumed to incentivise fund managers to actually transfer funds to the final recipients.[1176] Therefore, the ECA criticised the fact that the legal framework of the 2007-2013 programme period did not require performance based remuneration, thus being the exception rather than the rule in risk finance schemes of the past.[1177]

An ECA report on implementing the EU budget through financial instruments found that excessive endowments 'have a negative impact on management costs and fees, where these are determined on the basis of the total capital paid into the fund rather than the fund manager's performance'.[1178] Thus, for reasons of accountability and the achievement of the financial instrument's public policy goals, performance based remuneration is a crucial element to incentivise the agent's behaviour accordingly.

Hence, under the 2014-2020 programme period, for enhancing the performance of implementing bodies based on remuneration, Article 41 (1) (d), (2), (5), and (6) CPR and Article 42 (2) CPR stipulate that management costs and fees of implementing bodies falling under Article 38 (4) (b) CPR may be considered eligible expenditure at closure, if they comply with the performance-based criteria of Article 12 CDR and the thresholds of Article 13 CDR or Article 14 CDR (and, if applicable, further conditions on the eligibility of capitalised management costs and fees for equity-based instruments and micro-credits pursuant to Article 42 (2) CPR and Article 14 CDR).[1179] Thereby, management costs are understood to comprise direct and indirect costs reimbursable against expenditure evidence, while management fees are defined as an agreed price for services rendered.[1180]

[1176] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.66.

[1177] Only in 2012, the Commission recommended to managing authorities that the fund manager's remuneration be linked to the quality of investments. However, this recommendation, was not legally binding, of course.
- European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.66.

[1178] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.32.

[1179] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, para. 2.1., p. 3.

[1180] What includes eligible expenditure for management costs depends on national rules in the first instance. It may include, e.g. 'costs incurred by the body implementing the financial instrument as part of the preparation of investment decisions… and the subsequent monitoring and follow-up of investments, but should not include costs which are directly imputable to the preparation or implementation of individual projects or investment plans by final recipients…'.
- The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, para. 2.2., p.3.

In comparison, with regard to the remuneration regarding financial instruments set up and managed at the EU level, the FAFA, interestingly, refers exclusively to fees linked to performance. Article 13 (1) FAFA states that 'the Commission shall remunerate the EIF for the set-up, implementation and management of a financial instrument through performance based fees, comprising administrative fees and additional policy-related incentives', which may be foreseen in the relevant Delegation Agreement.

Regarding ESI fund financial instruments, the funding agreement between the managing authority and the body implementing the financial instruments must enclose provisions on the calculation and payment of management costs or fees, pursuant to Annex IV (1) (h) CPR. Importantly, Article 12 (1) CDR prescribes that these provisions must entail certain performance-based criteria: the 'disbursement of contributions provided by the ESI funds programme, the resources paid back from investments or from the release of resources committed for guarantee contracts, the quality of measures accompanying the investment before and after the investment decision to maximise its impact, and the contribution of the financial instrument to the objectives and outputs of the programme'.[1181]

Thereby, the managing authority has to translate these criteria 'into more concrete targets' and adjust them to the requirements of the operational programme and the local needs and conditions.[1182] Performance-based criteria are certainly apt to align the agent's interests with the achievement of the given public policy objective to a certain extent. However, they are hardly so with regard to the minimisation of market distortions, since this goal is not tied to the performance-based remuneration and since distortive effects are not measureable for the Commission. Moreover, particularly the tying of remuneration to the criterion of the resources paid back, i.e. the profitability of financial instruments, is not covered by the interpretation of the proportionality principle by the Courts in the field of state aid. Rather, the proportionality principle under the state aid rules requires a critical correspondence between the amount of the aid (to be kept at the minimum necessary) and the closing of the divergence of the desirable and

[1181] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, para. 2.2., p.4.
[1182] Performance could be linked to, e.g. the number of eligible SMEs, geographical or sectorial coverage, ability to raise additional resources, jobs created, measurable social and/or environmental impact.
- The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, para. 2.2., p.4.

the actual market outcome, or in practice, the market failure, through incentivising beneficiaries, as well as the balancing of the positive and the negative effects of the aid, as a market intervention that generates benefits exceeding costs (see chapter VI). This will be discussed in more detail in the following section.

Concerning financial instruments at the EU level, comparable to the performance-based criterion of the disbursement rate stipulated by the CDR, the FAFA states under Article 13 (1) FAFA that the administrative fees 'may, inter alia, be in the form of a percentage of the EU contribution utilised and/or a lump sum in relation to various pre-defined levels of the EU contribution utilised or in relation to set-up costs and actions'.

Importantly, 'EU contributions utilised' are defined under Article 1.1 FAFA as 'the EU contribution allocated by the EIF to operations signed or to portfolios of operations', i.e. their definition does not equate to disbursement rates, which are the ratio of contributions actually paid to final recipients through the relevant financial instrument.[1183]

Thus, the FAFA's performance indicator could be aligned in the sense that it would require actual disbursement rates as a stricter and possibly more effective criterion rather than the mere allocation of resources to operations under the Delegation Agreements. However, and importantly, actual disbursement rates only indicate that the financial instrument is effective, but they do not provide any indication as to a desired outcome, i.e. whether the relevant public policy objective is achieved. And they certainly do not indicate whether market distortions are minimised. On the contrary, they ignore whether investments are profitable and create a return, the absence of which could render market distortions in the form of, for instance, crowding-out, even more probable.

Regarding ESI fund financial instruments, the performance-based criteria of Article 12 (1) CDR apply, as do the CPR and the CDR in general, to both the funding agreement between the

[1183] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, para. 30 and table 4.

managing authority and the implementing body as well as to the funding agreement between the manager of fund of funds and the financial intermediary.[1184]

Article 13 (1), (2), and (3) CDR lays down certain thresholds for management costs and fees declared as eligible at closure, defining it as 'the sum of…', so that thresholds are to be understood 'as an aggregate value over the whole eligibility period and not on an annual basis'.[1185] This ensues a rather complicated calculation process, comprising the elements of base remuneration and performance-based remuneration.[1186]

Although the Commission recognises that this process is complicated, it merely refers to the experience and expertise of implementing bodies, which may 'in their daily business… set up information and accounting systems to make such calculations automatic' – a remark that may not turn out to be particularly helpful for representatives of managing authorities in understanding this task and its implications, especially in the light of a potential principal-agent problem.[1187] Financial intermediaries could thereby derive an information advantage and hence not align to the interests of the managing authority, lacking information through incomplete transparency. At best, such ceilings may mitigate market distortions caused by overcompensation to a certain extent.

The calculation method need not strictly follow the one stipulated under Article 13 CDR, but is to be decided between the managing authority and the relevant implementing bodies.[1188] However, it must include the performance-based criteria of Article 12 CDR in any case.[1189] Under certain conditions provided by the Commission, i.e. 'if management costs and fees conform to market terms and do not exceed those payable by private investors or if the fund manager has been selected through a public procurement procedure', these ceilings may be exceeded.[1190] Article 46

[1184] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, Annex: Q&A, p.14.
[1185] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, para. 2.4.2., p.6.
[1186] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, paras. 2.4.2. and 2.4.3., pp.6-10.
[1187] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, Annex: Q&A, pp.12, 13.
[1188] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, Annex: Q&A, p.12.
[1189] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, Annex: Q&A, p.12.
[1190] Article 13 (6) CDR (Commission Delegated Regulation (EU) No 480/2014).

(2) (e) CPR requires the managing authorities to report the management costs and fees to the Commission, so that the ECA assumes that the Commission may analyse and supervise these data much better in the future.[1191]

Article 43 CPR stipulates that the ceilings on costs and fees must relate to the capital contributed from the operational programme. This is criticised by the ECA for ceilings being 'applicable to the total contribution to the financial instrument, rather than the actual contribution used to provide financial support to final recipients'.[1192] Hence, the ECA advocates an interpretation, according to which the ceilings apply to the actual used capital endowment contributed from the operation programme to the financial instrument, thus preventing fund managers to be remunerated for not making use of the capital endowment of the instrument.[1193] This would certainly further incentivise the fund managers' effective use of capital endowments and the achievement of the principals' interest of achieving the financial instruments' goals, e.g. closing the funding gap established in the ex-ante assessment.

In comparison, regarding financial instruments set up and managed at the EU level, as it is the case under Article 13 CDR, Article 13 (1) FAFA prescribes that the fees for bodies implementing EU financial instruments must be capped. However, the FAFA appears to neither prescribe nor indicate any cap amounts or calculation methods. Its Article 13 (1) FAFA merely refers to the relevant Delegation Agreement defining the structure of the fees and the size of its components 'having regard to the characteristics of the financial instrument, in particular, its duration, scope and the possibility of achieving economies of scale, its complexity, its geographical outreach, the target market and the nature of the specific eligibility requirements'. The concrete specifications on the remuneration of the EIF and the reimbursement of management costs remain unclear, however, since Article 12 of the version of the COSME Delegation Agreement and Delegation Agreements available to the author are blackened.

[1191] Article 46 (2) (e) CPR
and European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.71.
[1192] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.65.
[1193] European Court of Auditors, Special Report on Implementing the EU Budget through Financial Instruments – Lessons to be learnt from the 2007-2013 Programme Period, 2016, p.65.

Moreover, regarding ESI fund financial instruments, the managing authority must inform the monitoring committee 'about the provisions regarding the performance-based calculation of management costs and fees of the financial instrument' and must report to the latter 'on an annual basis on the management costs and fees effectively paid in the preceding calendar year'.[1194] This specific report must comprise information on 'the management costs incurred or management fees paid, by each financial instrument and by programme and priority or measure'.[1195] This serves as an accountability mechanism for enhancing transparency and thus reducing information asymmetries between the principal and the agent.

Similarly, the FAFA requires under its Article 15 that the EIF report to the Commission on the operational and financial aspects of a financial instrument in accordance with schedules attached to the FAFA. More specifically, point 5 of Schedule IV to the FAFA requires that the EIF's annual remuneration be invoiced 'in respect of each accounting period on the basis of the audited financial statements sent to the Commission'. The financial statements are subject to 'an independent external audit, which shall be carried out in accordance with internationally accepted audit standards', pursuant to Schedule III to the FAFA.

In sum, the rules on performance-based remuneration for financial instruments at EU and Member State level to incentivise the agent's behaviour are similar as regards content and prescriptiveness. Nonetheless, there are some differences. Firstly, unlike state aid rules, the FAFA on EU financial instruments speaks exclusively of performance-based fees, comprising both administrative fees and additional policy related incentives specified in the relevant Annex to the Delegation Agreement.

Secondly, in contrast to the use of disbursement rates as a performance-based indicator under state aid rules, the FAFA provides for 'EU contributions utilised', which merely indicates EU contributions allocated. Thus, the question arises whether FAFA's performance indicator should be aligned, so as to indicate the ratio of contributions actually paid to final recipients, which is the aim of the use of financial instruments. However, the criterion of actual disbursement rates

[1194] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, para. 2.6., p.11.
[1195] The European Commission, Guidance for Member States on Article 42 (1) (d) CPR – Eligible management costs and fees, 26.11.2015, para. 2.6., p.11.

ignores (a) whether financial instruments achieve the relevant public policy objective and (b) whether they are profitable and generate sufficient returns, the absence of which could render market distortions (e.g. crowding-out) even more probable. Thus, they are not recommendable as indicators.

Finally, the Commission's interpretation of the application of ceilings on costs and fees under Article 43 CPR may be criticised. A review could alter ceilings so as to apply to the actual contribution used to support final recipients rather than to the total contribution merely. This could be apt to achieve the public policy objective and indirectly minimise market distortions, as fund managers would be prevented from being remunerated for not making use of the capital endowment.

In conclusion, performance-based criteria are certainly apt to align the agent's interests with the achievement of the given public policy objective to a certain extent. However, as stated, they are hardly so with regard to the minimisation of market distortions, since this goal is not tied to any performance-based remuneration and since the Commission does not provide tools to measure distortive effects in the first place, rendering the latter goal not adaptable to performance-based remuneration. In terms of proportionality, the Commission's performance-related accountability mechanisms for financial instruments both at the Member State and the EU level are not sufficient, as they are hardly apt to attain the goal of minimising market distortions.

4. Financial intermediaries as co-investors: profitability versus public policy objectives

Adding to the complexity of accountability aspects for financial instruments, financial intermediaries may serve as co-investors. As co-investors, they may, according to the reasoning of the Commission, align their interests and prevent conflicts of interests with managing authorities as principals as well as with the ultimate public policy objective of the financial instrument.[1196] However, as co-investors, their inherent goal is to make profit. Thus, the question remains of how the legal framework ensures that financial intermediaries as co-investors strive

[1196] Risk Finance Guidelines, para. 141.

to achieve the public policy objectives of financial instruments, which might clash with their inherent goal of profit seeking. How does the Commission address this question?

And, importantly, how is profitability related to the requirement of minimising market distortions in terms of proportionality? This question arises, since the profitability of financial instruments is not covered by the interpretation of the proportionality principle by the Courts in the field of state aid. Rather, the proportionality principle under the state aid rules requires a critical correspondence between the amount of the aid (to be kept at the minimum necessary) and the closing of the divergence of the desirable and the actual market outcome, or in practice, the market failure, through incentivising beneficiaries, as well as the balancing of the positive and the negative effects of the aid, as a market intervention that generates benefits exceeding costs (see chapter VI). In the following, answers will be sought and analysed.

Article 21 (15) (c) GBER stipulates that financial intermediaries must either receive performance-linked remuneration, as discussed above, or co-invest in order to align interests. The Commission appears to provide some answers. First of all, it elaborates in its Risk Finance Guidelines that Member States are required to ensure that the financial intermediary's investment strategy remain aligned with the public policy objectives of the measure through monitoring and reporting mechanisms and the participation of representatives of the public investors in the financial intermediary's representation bodies.[1197]

As explained above, the financial intermediary must demonstrate, as part of its selection process, how the proposed investment strategy contributes to the achievement of the relevant public policy objective.[1198] The option of co-investment may certainly support the achievement of the objective to a certain degree by financial intermediaries and pays regard to their profitability. However, it neglects the EU Courts' requirement of minimising market distortions, which is not covered by this reasoning.

Moreover, financial intermediaries are obliged to possess an 'appropriate governance structure', which ensures that 'material changes to the investment strategy' (that might otherwise solely

[1197] Connor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.334; and Risk Finance Guidelines, para. 62.
[1198] Connor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.334; and Risk Finance Guidelines, para. 62.

focus on profit-seeking and thus hamper the achievement of the public policy objectives) 'require the prior consent of the Member State'.[1199] In order to obviate any undue interventions by Member States, the Commission balances the Member States' influence with that of the financial intermediary through the provision that the former 'may not participate directly in individual investment and divestment decisions', however.[1200] The Commission appears to strike a sensible balance between the attainment of the overall public policy objectives safeguarded by the Member State's consent and monitoring on the one hand, and the financial intermediary's economic decision-making with regard to investments and divestments, on the other hand. However, in terms of proportionality, only the latter, namely the investing and divesting in accordance with market terms may minimise market distortions.

Moreover, the Guidelines explain in paragraph 141 that the 'economic alignment of interests between Member States and financial intermediaries or their managers' could minimise aid with regard to both the achievement of the policy targets and the financial performance of the public investment into the instrument, and crucially, in paragraph 103 that co-investments 'could contribute to ensure that investment decisions are aligned with relevant policy targets'. However, it does not further discuss or back up these presumptions. Rather, the Commission appears to require elements of the MEIP as safeguards: For instance, in the context of granting preferential conditions, the measure must ensure a balance between the preferential conditions offered to maximise the leverage effect in addressing the market failure and the need for the instrument to generate sufficient financial returns on a viable operational basis.[1201] As stated, profitability is not covered by the EU Courts' interpretation of proportionality in state aid law, however, its absence may certainly be detrimental to the minimisation of market distortions, as this would mean that unprofitable financial instruments could crowd-out profitable private investment.

Moreover, again, the mechanism of an open and non-discriminatory selection process of the financial intermediaries and fund managers or investors is deemed to safeguard the financial intermediary's adherence to the public policy objective: the nature and value of the preferential conditions must be determined through their competing bids, according to the Guidelines, and if asymmetric risk-adjusted returns or loss sharing is established through such a process, the

[1199] Connor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.334; and Risk Finance Guidelines, para. 62.
[1200] Connor Quigley, European State Aid Law and Policy, Hart Publishing, 2015, p.334; and Risk Finance Guidelines, para. 62.
[1201] Risk Finance Guidelines, para. 135.

Commission will consider the instrument to be proportionate and reflect a fair rate of return (FRR).[1202] The Commission will regard the private investors as duly selected, if the fund managers are selected through an open, transparent, and non-discriminatory call and are required to present their investor base.[1203]

This means that the Commission trusts the fund managers to select economically viable private investors, which may help attain the public policy objective through leveraging, if the managers have been selected through such a call themselves. However, this is a rather weak connection to the goal of attaining the public policy objective. The selection process may ensure that private investors are viable, but not necessarily that they will help attain the objective. Moreover, their viability may also only to a small degree guarantee profitability and thus minimise potential market distortions. Their viability does not indicate whether they will indeed attain investments that are (a) profitable and (b) in line with the public policy objective.

What is more regarding elements of the MEIP, if private investors participate on a deal-by-deal basis within a co-investment by a public fund, they must be selected through a separate competitive process with regard to each transaction as the preferred way of establishing the FRR.[1204] If this process is not followed (due to being ineffective or inconclusive), an independent expert must establish the FRR on the basis of a benchmark analysis of the market and its risks: The expert must use the so-called discounted cash flow valuation method in order to avoid over-compensation of the investors and must calculate the minimum level of the FRR with an added appropriate risk margin.[1205] As it was discussed in chapter V, these methods and their calculation face certain limitations in the context of risk finance aid due to information asymmetries, however.

In sum, the Commission appears to address the question of how the diverging interests of profitability and the achievement of the public policy objective of a co-investing financial intermediary are to be reconciled through market mechanisms and formalistically checking these in its compatibility assessment, as it was explained in chapter VI. In particular, it safeguards the

[1202] Risk Finance Guidelines, para. 136.
[1203] Risk Finance Guidelines, para. 136.
[1204] Risk Finance Guidelines, para. 137.
[1205] Risk Finance Guidelines, para. 138.

interests of the principal through specific selection criteria and the required governance structure preventing the agent from diverting its investment strategy from the public policy objective. As such, financial intermediaries are deemed to attain both goals of being profitable as well as achieving the public policy objective at the same time, while not interfering with each other.

However, from the perspective of proportionality, these mechanisms are weak. For instance, co-investment may indeed help align the principal's and the agent's interests in line with the financial intermediary's sought after profitability, but does certainly not ensure that market distortions are necessarily minimised, the goal of which it appears to neglect. Indeed, the profitability of financial intermediaries at least avoids creating market distortions through crowding-out, but it remains doubtful, if co-investment does secure this goal. After all, the investment may still be unprofitable despite co-investment. Moreover, also the screening methods (e.g. the selection processes) are weak tools to ensure the profitability of financial intermediaries and private investors. Their viability does not indicate whether they will actually attain investments that are both profitable and in line with the public policy objective in the end.

5. Conclusion

Financial instruments have the feature that they are implemented via financial intermediaries, which function thus as agents of the Member States' managing authorities as principals. Hence, in terms of state aid law, financial intermediaries as agents may receive aid and may make the wrong choices or decisions, resulting in market distortions. Next to the limiting of state aid in terms of amount and time and remuneration of agents, accountability mechanisms are enshrined in the rules in order to align the intermediaries' interests with the relevant public policy objective as well as to minimise market distortions caused by these transactions in accordance with the proportionality principle.

5.1. Accountability through prescriptive rules on market mechanisms and screening methods

In addressing this chapter's question, the following may be summarised: state aid rules and the rules applicable to EU financial instruments apply similar accountability mechanisms. In a comparable way regarding content and prescriptiveness of the rules, they ensure that the agents,

the financial intermediaries, adhere to the principals' interests, that of the Member State managing authorities, as well as to the public policy objectives to be achieved through aid measures. With minor differences and an overall consistency thus, they hold the agent accountable through prescriptive rules on the selection of financial intermediaries and final recipients, through award criteria for them, and through reporting and audit requirements to be applied by the financial intermediaries. However, it was shown that they cannot guarantee that the financial intermediary and its fund managers as agents will indeed strive to attain the public policy objectives, let alone the minimisation of market distortions. In particular, with regard to proportionality, the goal of the minimisation of market distortions may hardly be facilitated, except for the prevention of overcompensation, as the Commission itself does not provide any tools that are apt to measure distortive effects in the first place (see chapter VI).

This chapter's analysis of accountability for financial intermediaries was divided into the aspects of performance-based remuneration and profitability versus the goals of achieving the public policy objective and the minimisation of distortive effects under co-investing.

5.2. Differences for financial instruments at EU and Member State level

With regard to accountability in the form of performance-based remuneration, the rules for financial instruments at EU and Member State level to incentivise and align the agent's behaviour are similar as regards content and prescriptiveness. However, there are differences: Firstly, unlike state aid rules, the FAFA on EU financial instruments speaks exclusively of **performance-based fees**, comprising both administrative fees and additional policy related incentives specified in the relevant Annex to the Delegation Agreement.

Secondly, in contrast to the **use of disbursement rates** as a performance-based indicator under state aid rules, the FAFA provides for 'EU contributions utilised' as an alternative, which indicates EU contributions allocated. However, the criterion of actual disbursement rates ignores (a) whether financial instruments achieve the relevant public policy objective and (b) whether they are profitable and generate sufficient returns, the absence of which could render market distortions (e.g. crowding-out) even more probable. Thus, they are not recommendable indicators.

Thirdly, the Commission's interpretation of the application of **ceilings on costs and fees** under state aid law may be criticised. Instead, tying ceilings to the actual contribution rather than the total contribution could be apt to achieve the public policy objective and indirectly minimise market distortions, as fund managers would be prevented from being remunerated for not making use of the capital endowment.

Provisions on **performance-based remuneration** may be apt to align the agent's interests with those of the principal and the achievement of the public policy objective to a certain extent, but are very weak in terms of minimising market distortions and may hardly be tied to this goal, especially since the Commission does not provide any measurement tools.

With regard to the **diverging interests of the financial intermediary between making profit and the achievement of the public policy objective** under co-investing, the Commission appears to reconcile them, again, through market mechanisms and screening methods. In particular, it safeguards the interests of the principal through specific selection criteria and the required governance structure preventing the agent from diverting its investment strategy from the public policy objective. However, these mechanisms are weak with regard to minimising market distortions, a goal the Commission appears to neglect: the mechanism of co-investment does not necessarily guarantee that profitability and thus the prevention of crowding out are achieved. Nor do the screening methods and selection processes on the viability of financial intermediaries and private investors easily guarantee that profitability, the public policy objective, and the minimisation of distortive effects are realised.

In conclusion, although accountability rules for financial intermediaries both at the Member State level and the EU level are overly consistent, they are relatively weak in facilitating the relevant public policy objective and are in their present form hardly suitable to minimise market distortions as regards the EU Courts' requirements and their effects-based approach under the proportionality principle. If these rules are sufficient to solve present principal agent issues, is also debated among experts, as the interviews conducted for this thesis revealed (see Appendices).

Table 7: Comparison of the provisions of the Financial and Administrative Framework Agreement (FAFA), of the COSME and Horizon2020 instruments, and state aid rules

	FAFA	COSME EFG	COSME LGF	Horizon 2020	State Aid Rules
Limitations of scope	See relevant Delegation Agreement	Maximum investment amounts: EUR 30 million (financial intermediary) / EUR 100 million (Pan-European VC Fund-of-Funds)	First loss capped portfolio guarantees including only newly generated transactions belonging to one of two higher risk categories; maximum portfolio volume to be agreed and guarantee rate that may not exceed 50 % and ensures risk retention of 20 %; guarantee cap rate to be set individually	Early stage, including proof of concept stage, (pre)seed stage, start-up stage, and the phase of development of an enterprise that has completed the product development phase and needs further funding for commercial manufacturing and/or sales; maximum commitments of EUR 50 and 100 million	**GBER**: Notification thresholds EUR 7.5 million for investment aid and EUR 15 million for risk finance per undertaking; **Commission Notice on Guarantees**: extent of guarantee must be properly measureable, i.e. liked to specific financial transactions with fixed maximum amount, and may not cover more than 80 % of outstanding loan or other financial obligation; guarantee rate must be limited to 80 %, total losses assumed by Member State to be capped at maximum of 25 % of underlying portfolio.
Limitations of duration	See relevant Delegation Agreement	5 to 15 years, not exceeding 20 years	Availability period usually covering 2 to 3 years; Guarantee has a maximum term of up to 10 years	Usually concluded for 5 to 15 years with 3 years extension	**Commission Notice on Guarantees**: guarantees must be limited in time
Private participation	See relevant Delegation Agreement	Majority of capital committed to be provided by private investors	Securitised Portfolio to contain at least 80 % of transactions with SMEs.	Leverage effect for early stage investments set at 6, but may be lower depending on investments and adverse	**GBER**: 10-30-60 minimum participation thresholds

				fundraising conditions; majority of investor base must pass market economy investor test	
Pari passu	See relevant Delegation Agreement	EU investments to rank pari passu with investors investing in the same risk class	Subject to relevant guarantee rate and cap, EIF ranks pari passu with financial intermediary	IFE operations to rank pari passu with investors investing in the same risk class	
Representation	See relevant Delegation Agreement	EIF to be represented in advisory bodies, but not on governing bodies entrusted with investment and divestment decisions	No provision	EIF to be represented in advisory bodies, but not on governing bodies entrusted with investment and divestment decisions	**RFG**: Member State may not participate directly in investment and divestment decisions, but prior consent required in case of material changes to investment strategy
Governance structure	See relevant Delegation Agreement	Governance structure of financial intermediaries and fund-of-funds must allow for decisions on investments, divestments, and risk diversification in accordance with law and market practice	No provision	Governance structure of financial intermediaries must allow for decisions on investments, divestments, and risk diversification in accordance with law and market practice	**GBER**: financial intermediaries to be managed on a commercial basis **RFG**: appropriate governance structure regarding investment strategy
Avoiding conflicts of interest and aligning interests	See relevant Delegation Agreement	EIF to negotiate measures to be put in place for avoiding conflicts of interest and aligning interests management team of financial intermediary/fund-of-funds must invest significant amount in financial	Financial intermediary to keep material interest in portfolio by either retaining vertical tranche or first loss piece of the portfolio	EIF to negotiate measures to be put in place by the financial intermediary and to be in line with market practice	**GBER**: financial intermediary and fund manager to act with diligence of a professional manager in good faith and avoiding conflicts of interest; Performance linked remuneration required or co-investment of own resources

		intermediary/fund-of-funds			
Monitoring and auditing	See relevant Delegation Agreement	Financial intermediary/fund-of-funds monitored and audited by Commission, EIF, and ECA	Financial intermediary/fund-of-funds monitored and audited by Commission, EIF, and ECA	Extensive reporting, monitoring, and auditing requirements of the financial intermediary vis-à-vis the Commission and the EIF, and of the EIF to the Commission	**GBER**: Commission monitors financial instruments, Member States must report and maintain records (RFG)
Selection of financial intermediaries / fund-of-funds	Open, transparent, and non-discriminatory procedures; Due account to be given to nature of financial instrument and experience and financial capacity	General requirements and instrument-specific requirements, (i.a. of Articles 4.3 and 4.4 FAFA and exclusion of certain final recipients and activities), commercial management, clear investment strategy, clear exit strategy, reporting, visibility, evaluation requirements; assessment criteria published in term sheet online	Refers to FAFA: open, transparent, objective, and non-discriminatory procedures; taking into account the nature of the financial instrument, the experience and the operational and financial capacity; assessment criteria published in term sheet online	Refers to FAFA, stipulates exclusion and eligibility criteria; selection process must be in line with the principles of transparency, equal treatment, and non-discrimination; stipulates performance and policy fit	**GBER and CDR**: open, transparent, and non-discriminatory call; and clear and realistic exit strategy, due diligence for commercially sound investment strategy, management on a commercial basis, performance linked remuneration or co-investment CDR: selection and award criteria
Final recipients	Must be potentially economically viable in accordance with the objectives of the relevant Delegation Agreement, and specific exclusion criteria	Financial intermediaries must select them according to their internal rules and procedures and taking into account the economic viability of the projects of the final recipients; eligible are SMEs immediately before or after the time of the first investment, established and operating in	Financial intermediaries must select them according to their internal rules and procedures and taking into account the economic viability of the projects of the final recipients; final recipient must be an SME, specific eligibility criteria apply	Eligible if not excluded, established and operating in participating country, and in the early stage.	**GBER**: Unlisted SMEs, not having been operating in any market or been operating in any market for less than 7 years following first commercial sale, or requiring an initial risk finance investment entering a new product or geographical market

		participating country, in expansion or growth stage, and not an excluded final recipient			

Source: Author

IX. Conclusion

The increased uptake of financial instruments during and after the Covid-19 crisis and the urgency of the Commission's review of the state aid law framework raised the question of whether the current 2014-2020 programme period's legal framework of financial instruments proves itself as a consistent one, especially in relation to the general principle of proportionality. Crucially, this regards the central question of whether contradictions and ambiguities should be eliminated for an improved legal use of more proportionate (and thus probably more economically efficient) financial instruments in the future. Thus, the overall question posed by this thesis was:

- **Are financial instruments, in secondary legislation and Commission acts and guidelines inside and outside state aid law, compliant with the principles of proportionality and consistency?**

In the following, this question will be answered based on the findings of this thesis's analysis, which looked at the particular features of financial instruments.

1. Chapters II and III: The importance of proportionality and consistency for financial instruments

The exploration of the principles of proportionality and consistency in **chapter II** showed that they are central principles of EU law, the right application of which is crucial for the legally and economically efficient application of proportionate financial instruments that do not excessively distort markets and competition. Therefore, secondary legislation and Commission acts and guidelines are required to be consistent with the proportionality principle and its elements: According to the EU Courts, they must be appropriate and pursue a legitimate objective and either meet the least restrictive means test or the manifestly disproportionate test of the proportionality principle *stricto sensu*, including the balancing of positive and negative effects.

Chapter III elaborated on the inconsistent definition of the concept of financial instruments at the EU and Member State level and explained their different types (equity, quasi-equity, loans, and guarantees) as well as features: they are designed to address particular market imperfections,

have a revolving nature and are repayable, including profit-seeking considerations, and create a leverage effect for private investment. Importantly, in contrast to grants, they imply no identifiable underlying costs and do not possess maximum intensity rates, but are subject to maximum amounts, and are managed and implemented by financial intermediaries.

2. Chapter IV: The legal framework on financial instruments is a patchwork rather than a consistent set of rules

Chapter IV investigated the following question: Are state aid rules and the legal framework of financial instruments in the General Block Exemption Regulation (GBER), the Common Provisions Regulation (CPR), and the Financial Regulation (FR) consistent or do they reveal ambiguities and contradictions?

Although the Commission stated in its final fitness check report that state aid rules are coherent overall, this thesis's analysis found otherwise: By analysing the GBER rules, several inconsistencies and ambiguities within Article 21 GBER on risk finance aid despite the Commission's explanatory remarks became apparent. For instance, as was also found in chapter V on state aid free off-the-shelf instruments with a similar structure, the relationship of Article 21 (18) GBER towards *de minimis* aid and its question if an aid element is present remain unclear. In addition, the relevant paragraphs of Article 21 GBER as to whether the minimum thresholds also apply to follow-on-investments are not formulated in a consistent way and leave room for interpretation.

What is more, wordings and definitions in the GBER and the CPR are not consistent, for instance, with regard to the formulation of the selection procedure of financial intermediaries and its conditions. Moreover, it showed that the Commission in its legal texts mainly relies on the concept of market failure in justifying market interventions and necessity via financial instruments instead of the divergence of desirable and actual market outcomes, as the EU Courts require it – an inconsistency, which was also detected in its decisional practice in chapter VI, and which does not form part of the Commission's final fitness check report. Legislation and Commission should therefore rely on the broader concept of the discrepancy of desirable and actual market outcomes rather than on the narrow concept of market failure primarily.

In sum, the legal framework of financial instruments with its plethora of legal texts, binding and non-binding, appears to be a patchwork rather than a consistent set of rules, rendering the application of financial instruments rather complicated for national managing authorities that lack the legal capacity. This was also confirmed by experts working at the Member State level (see Appendices). The result may be potentially less efficient and/or less effective financial instruments, or the preference of less advantageous, but simpler forms of aid over financial instruments altogether. In the worst case, financial instruments that turn out to be violating state aid rules may even be declared non-compatible by the Commission, so that state aid would have to be recovered to the detriment of stakeholders involved, including opportunity costs amassed of their resources.

3. Chapter V: Economic methods are hard to apply for financial instruments and their MEIP

Chapter V investigated the particularity that financial instruments and risk finance measures often face information asymmetries: How may an advantage through financial instruments arise and may the aid element be consistently measured and removed through the application of the MEIP?

The analysis of the EU Courts' requirements under the MEIP and the Commission's decisional practice made it apparent that the application of benchmarking and calculation methods of the aid element is very difficult to follow, as cases of financial instruments and risk finance measures often suffer from inherent information asymmetries. This is confirmed in cases under complicated circumstances, as assessed by the Commission (and the EU Courts, see *Ciudad de la Luz*). Although the Commission's decisional practice appears to be consistent with the requirements of the EU Courts on MEIP benchmarking and calculation methods in general, ensuring consistency in their application regarding financial instruments and risk finance measures amid an inherently risky and uncertain environment of young and innovative SMEs may thus prove very difficult in practice. This was also confirmed in expert interviews (see Appendices).

4. Chapter VI: The Commission's inconsistency with the EU Courts' requirements on the proportionality assessment

Chapter VI looked at the particular feature of financial instruments that no underlying costs are identifiable, hence asking: Is the Commission's decisional practice on financial instruments consistent with the requirements of the EU Courts on proportionality under state aid law, including necessity and the balancing of positive and negative effects of financial instruments?

The answer is no. As was already elaborated on in chapter III on the development of the legal framework of risk finance aid, the Commission's approach in its compatibility assessment developed gradually into a rather formalistic exercise: It checks whether the aid is limited in terms of amount and time and whether certain market mechanisms formulated in its Risk Finance Guidelines are implemented in risk finance schemes. Thus, the Commission assesses whether distortive effects are limited in general through the limitation of the aid amount (caps and ceilings), market mechanisms (e.g. commercial management), and screening methods (e.g. selection processes).

However, this is far from an actual balancing exercise of positive and negative effects of the aid as required by the EU Courts in e.g. *Smurfit Kappa* in line with the proportionality test *stricto sensu*, as well as from a proper assessment of any correspondence between the amount of aid and the extent of the divergence between desirable and actual market outcomes, or that of market distortions. Nor does the Commission assess whether there is a divergence between desirable and actual market outcomes to begin with, as the EU Courts require it. Instead, it merely refers to market failures as reasons for intervention.

The Commission's inconsistent compatibility assessment may stem from the fact that the Commission simply does not have any tools at its disposal for assessing potential negative effects. In order to bridge the gap between the EU Courts' requirements and the Commission's practice, the latter could alter its formalistic approach and adjust it to that under its own Guidelines on environmental protection and energy aid and on regional aid, by introducing manifest negative effects, which would automatically render the relevant measure non-proportionate and thus incompatible. What is more, also the constitutional reasoning supports this approach: In policy areas where the Commission enjoys a wide discretion as the primary decision-maker, the EU

Courts 'will only overturn the policy choice if it is clearly or manifestly disproportionate', and importantly, 'this is more especially so where the policy choice required the weighing of complex variables', as it is the case for financial instruments.[1206]

Potential manifest negative effects in the area of financial instruments could be, for instance, certain instances of crowding out, the absence of a sufficient diversification and number of eligible and undertakings, underperforming sectors and insufficient production capacities, as well as delocalisation effects. Moreover, an excessive increase of public funds could lend itself as a manifest negative effect, as this could 'lead to a risk of non-absorption, if there is a lack of (i) venture capital funds to invest in, (ii) interested private investors, (iii) SMEs with growth potential to invest in'.[1207] This approach would be in line with the 'manifestly disproportionate test' of the proportionality test *stricto sensu* and entail the advantage of enhancing legal certainty: Although the Commission would still have to assess – next to the other aspects of proportionality – positive and negative effects of the aid in its assessment, the identification of such manifest negative effects could enhance legal certainty as to which financial instruments may prove themselves to be evidently incompatible.

5. Chapter VII: EU financial instruments minimise market distortions through aid amounts, market mechanisms, and screening methods rather than balancing of effects

Chapter VII looked at the particular feature of the different implementation levels of financial instruments, which may be implemented and managed at both the EU level and Member State level: How do the Commission and the EIB/EIF prevent or minimise market distortions by financial instruments at the EU level and are these rules consistent with state aid rules applicable to financial instruments implemented and managed at the Member State level?

In line with findings of chapter VI, the analysis revealed that the Commission follows a similar approach as in its compatibility assessment for Member State instruments. It ensures that market distortions are limited with regard to financial instruments implemented and managed at the EU level and their requirement of 'consistency with state aid law': Along the lines of the criteria of

[1206] Paul Craig, EU Administrative Law, Oxford Scholarship, 2018, p. 644.
[1207] European Court of Auditors, Centrally managed EU interventions for venture capital: in need of more direction, Special Report, no. 17, 2019, p. 20.

the GBER and the Risk Finance Guidelines, the Commission set up the Financial and Administrative Framework Agreement and concluded with the EIB/EIF specific Delegation Agreements. The latter follow a similar structure and content as that of the GBER and the Risk Finance Guidelines, such as conditions on ceiling and caps, the very detailed requirements for the eligibility and selection of financial intermediaries and final recipients, as well as governance, monitoring, and reporting mechanisms.[1208]

Hence, also for EU financial instruments, the Commission strives to minimise market distortions through the limitation of the aid amount and market mechanisms. Thus, there is no indication of an effects-based balancing exercise conducted by the Commission at all, as required by the EU Courts for the compatibility assessment. The rules for financial instruments at the EU level therefore mirror those for financial instruments at the Member State level under state aid law – apart from the compatibility assessment of proportionality, however. In comparison with the legal framework of financial instruments under state aid law, they appear to be clearer, less dispersed, and more concise than state aid rules, mainly due to the fact that they are covered in one legal document, the relevant Annex to the Delegation Agreement. Hence, a grouping of the state aid rules in a more coherent way, possibly along the lines of the Annexes or the off-the-shelf instruments, may lead to their simplified application.

Again and in line with the findings of chapter VI, the comparison of the rules applicable to EU and Member State financial instruments presented that the Commission formalistically applies tools that are merely deemed to minimise market distortions. Yet, the Commission does not possess tools to quantify, let alone balance positive and negative effects, as the EU Courts require it in their case law.

Further analysis of the so-called off-the-shelf instruments supported this finding. These instruments are financial instruments likewise designed by the Commission, but intended for the ready and compliant use by national managing authorities at the Member State level. All five of these instruments are structured in a similar and consistent way, whereby three are based on *de minimis* and thus free of state aid. The other two instruments are based on Article 21 GBER (the

[1208] However, experts working on the Member State level stated that EU financial instruments may also distort competition and thus should also fall under state aid law. This was contested by an expert concerned with financial instruments at the EU level (see Appendices).

de minimis off-the-shelf instruments possess a similar structure as financial instruments under Article 21 (18) GBER, but while the former do not contain aid, as the advantage is fully passed on, those under Article 21 (18) GBER may contain aid, since the advantage ought to be passed on 'to the largest extent' only).

Crucially, when compared with financial instruments at the EU level, which are also designed by the Commission, it becomes apparent that the Commission uses the same mechanisms and tools to limit market distortions. This was revealed in chapter VI: The Commission employs conditions limiting aid in terms of amount and time as well as market mechanisms and screening methods, but provides no tools for assessing and balancing distortive effects of the aid. Hence, although the rules and their structure of both off-the-shelf instruments and EU financial instruments are very similar and thus consistent with each other, they are not consistent with regard to the interpretation of the EU Courts on the proportionality principle and its requirements for state aid law. In line with other areas of state aid and the constitutional reasoning, the stipulation of manifest negative effects in the field of financial instruments both at Member State and EU level could support the proportionality assessment of the Commission and its design of proportionate financial instruments along these lines. This would strengthen the overall adherence to the principle of proportionality by the EU and its institutions, as it has increasingly come under scrutiny by national constitutional courts.

6. Chapter VIII: Accountability mechanisms of financial instruments cannot ensure proportionality

Moreover, **chapter VIII** looked at the particularity that financial instruments are implemented by financial intermediaries as agents of Member States being their principals. As such, financial intermediaries may cause market distortions either by receiving state aid or by taking the wrong decisions, which are not in line with the interest of the principal and the public policy objective of the financial instrument. Therefore, accountability mechanisms are enshrined in state aid rules and the Delegation Agreements at the EU level in order to align the intermediaries' interests with the relevant public policy objective as well as to minimise market distortions caused by these transactions in accordance with the proportionality principle. This raises the following question: Are these accountability rules for financial intermediaries at both the EU and the Member State

level consistent and are they apt to achieve public policy objectives and to minimise market distortions?

The analysis revealed that state aid rules and the rules applicable to EU financial instruments apply similar accountability mechanisms. In a comparable way regarding content and prescriptiveness of the rules, they ensure that financial intermediaries adhere to the interests of managing authorities, as well as to the public policy objectives to be achieved through aid measures. With minor differences and an overall consistency thus, they hold the agent accountable through prescriptive rules on the selection of financial intermediaries and final recipients, through award criteria for them, and through reporting and audit requirements applied by the financial intermediaries.

In particular, the analysis showed that the accountability mechanism of performance-based remuneration may be apt to align the agent's interests with those of the principal and the achievement of the public policy objective to a certain extent. However, it is very weak in terms of minimising market distortions and may hardly be tied to this goal, especially since the Commission does not provide any measurement tools. The incentive of co-investment for financial intermediaries to align interests proved problematic, as the goal of profit seeking may be detrimental to the attainment of the public policy objective: The Commission strives to reconcile them, again, through market mechanisms and screening methods.

Specifically, the Commission safeguards the interests of the principal through specific selection criteria and the required governance structure preventing the agent from diverting its investment strategy from the public policy objective. However, these mechanisms are weak in terms of minimising market distortions, a goal the Commission appears to neglect: The mechanism of co-investment does not necessarily guarantee profitability and thus the prevention of crowding out. Nor do the screening methods and selection processes on the viability of financial intermediaries and private investors easily guarantee that profitability, the public policy objective, and the minimisation of distortive effects are realised.

In sum, the analysis found that the rules cannot guarantee that the financial intermediary and its fund managers will indeed strive to attain the public policy objectives, let alone the minimisation

of market distortions. In particular, with regard to proportionality, the goal of the minimisation of market distortions may hardly be facilitated, as the Commission itself does not provide any tools that are apt to measure distortive effects in the first place, as it was found in chapter VI and VII. As findings of chapter V on the guarantees and loans showed, it is indeed difficult to quantify and measure the aid element of advantage in a consistent way in practice. Moreover, albeit accountability rules for financial intermediaries both at the Member State level and the EU level are consistent, they are weak in facilitating the relevant public policy objective. Crucially, in their present form, they are hardly suitable to minimise market distortions, as the EU Courts require it in their effects-based approach under the proportionality principle.

7. Outlook: The development of 'manifest negative effects' to meet the requirements of proportionality and consistency

In conclusion, the thesis and its analysis revealed that (a) the legal texts pertaining to financial instruments under state aid law are not entirely consistent. They rather consist of a complex piecemeal with parts of contradictory provisions.[1209] (b) The decisional practice of the Commission is not consistent with the case law of the EU Courts, as it fails to adhere to an effects-based approach of proportionality. This includes the balancing exercise of positive and negative effects, as required by the EU Courts. (c) For not providing tools for measuring distortive effects, the Commission designs financial instruments at the EU and Member State level with mechanisms hardly able to achieve public policy objectives, let alone to minimise market distortions. Through these inconsistencies, the level of proportionality of financial instruments at both the Member State and EU level is compromised and does not meet the requirements of the EU Courts.

As long as it does not alter its current approach, the Commission should thus no longer speak of the balancing exercise, and instead focus on the aspect of necessity. At least, this is what it assesses in practice. However, future research could focus on the review of the Commission's proportionality assessment, so as to align it with the requirements of the EU Courts and the proportionality test *stricto sensu*. As in other areas of state aid, the Commission could develop manifest negative effects it could apply in the area of financial instruments and risk finance aid.

[1209] This fragmentation and complexity were also confirmed by the experts interviewed for this thesis (see Appendices).

A coherent approach towards proportionality in general and manifest negative effects across the different areas of state aid law in particular could enhance legal certainty and guarantee a high degree of their proportionate application. This holds especially true amid a heightened uptake of state aid in times of economic crises.

Specifically, further research could investigate the development of financial instruments at least three-fold. Firstly, it could analyse the special rules of the Temporary Framework, which was heavily relied upon during the Covid-crisis, and compare its more simplified, lenient rules to the 'regular' legal framework of state aid and financial instruments. What lessons can be learned from it to render the rules of the current framework less complex, clearer, and more transparent (as experts demanded it in the interviews conducted)?

Secondly, further research could investigate how financial instruments fared in practice. This holds especially true as the economic necessities and innovations develop very quickly and the framework ought to be adjusted, yet not necessarily rendered more complex, as the expert interviews revealed. Thus, such research could deliver further guidance on how to review the legal framework and design proportionate financial instruments. With the help of ex post evaluations conducted, their analysis could address the following questions in terms of proportionality: Was the aid amount sufficiently quantified or evaluated? Was there an actual correspondence between the amount of the aid and the extent of the discrepancy between desirable and actual market outcomes? Was there an actual correspondence between the aid amount and the impact of the aid on beneficiaries and on markets and competition? Would alternative aid measures have been more efficient or effective? Were negative effects of the aid sufficiently minimised? Were accountability mechanisms for financial intermediaries vis-à-vis managing authorities effective?

Finally, future research could further analyse the concepts of grants and financial instruments. How do they compare legally in terms of consistency, complexity, and legal certainty? Is the presumption of the Commission that financial instruments are a more efficient tool, as they are repayable, correct? And, connected to the latter question, under which circumstances are financial instruments more proportionate than grants and *vice versa*?

Appendices: Interviews with Policy Makers

1. Interview Guidelines and Questions

Guidelines for Policy Maker Interviews of the Dissertation on "Financial Instruments and their Proportionality and Consistency under EU Law" at Maastricht University

1. **Vorstellung / Introduction**:
   Mein Name ist Maximilian Vollmer, ich bin derzeit Fachgebietsleiter für Europäische Finanzmarktpolitik beim Wirtschaftsrat und seit vier Jahren Doktorand an der Universität Maastricht zur Promotion über „Financial Instruments and their Proportionality and Consistency under EU Law". Die Verteidigung der Dissertation wird am 8. September 2021 um 10 Uhr stattfinden.
   My name is Maximilian Vollmer, currently working as Head of Department, European Financial Market Policy at the Economic Council and being PhD candidate at Maastricht University with the thesis on 'Financial Instruments and their Proportionality and Consistency under EU Law'. The defence will take place on 8 September 2021, 10 am CET.

2. **Dank und Einverständnis / Thank you and consent:**
   Vielen Dank, dass Sie bereit sind, mich bei meinem Projekt zu unterstützen und sich die Zeit dafür nehmen. Sofern Sie damit einverstanden sind, wird das Gespräch über Webex/Telefon aufgenommen. Ihre Daten werden selbstverständlich vertraulich behandelt.
   Darf ihr Name in der zu veröffentlichenden Dissertation gegebenenfalls erscheinen? Gibt es für Sie noch offene Fragen?
   Thank you very much for supporting my project and taking your time therefore. Given your consent, I am going to record the exchange over webex/phone. Of course, your data will be treated confidentially. May I indicate your name in the thesis to be published, if applicable? Are there any open questions?

3. **Forschungsziel / Research Goal:**
   Ziel des Interviews ist es, die Frage der Verhältnismäßigkeit und Konsistenz von Finanzinstrumenten auf europäischer Ebene und auf der Ebene der Mitgliedsstaaten aus Sicht von Policy Maker aus der Praxis zu klären. Es geht insbesondere darum, ob Finanzinstrumente umgesetzt werden können, welche Möglichkeiten und Hürden es von rechtlicher Seite gibt, ob die Kriterien der Gerichte eingehalten werden (können) und wie der rechtliche Rahmen verbessert werden kann.
   The purpose of this interview is to elucidate the questions of proportionality and consistency of financial instruments at the European and Member State level from the perspective of practicing policy makers. Specifically, the interview shall investigate the questions of if financial instruments may be implemented in practice (easily), which opportunities and hurdles from the legal perspective there are, if the EU Courts' criteria are adhered to, and how the legal framework may be improved.

4. **Fragen / Questions:**

   a. Wie unterstützt, wie verhindert der derzeitige europarechtliche Rahmen das Auf- und Umsetzen von Finanzinstrumenten?
      How does the EU legal framework support, how does it hinder the set up and management of financial instruments?

b. Gibt es im rechtlichen Rahmen von Finanzinstrumenten Inkonsistenzen, Brüche oder Doppeldeutigkeiten?
Does the legal framework of financial instruments contain inconsistencies, gaps or ambiguities?

c. Wie bewerten Sie die Geeignetheit der Methoden zur Messung/Quantifizierung des Beihilfenelements unter dem Market Economy Investor Principle (MEIP) im Kontext des unklaren und risikobehafteten Marktumfelds von Finanzinstrumenten?
How do you evaluate the applicability of the methods to measure/quantify the aid element under the MEIP in the context of the unclear and risky market environment of financial instruments?

d. Wie bewerten Sie hinsichtlich der Umsetzung von Finanzinstrumenten die Prüfkriterien der Kommission zur Verhältnismäßigkeit, die – entgegen des Kriteriums der EU-Gerichte zur Gewichtung von vor- und nachteiligen Markteffekten des Instruments – auf Höchstgrenzen und Elemente des MEIP/Marktmechanismen setzt?
With regard to the setting up of financial instruments, how do you find the assessment criteria of the Commission on proportionality, which – in contrast to the criterion of the EU Courts to balance the positive and negative effects – rely on maximum amounts and elements of the MEIP/market mechanisms?

e. Würde die Einführung von "manifest negative effects", wie in anderen Bereichen des Beihilferechts, statt der erforderten Gewichtung von vor- und nachteiligen Effekten die Rechtssicherheit und Transparenz für das Aufsetzen von Finanzinstrumenten erleichtern?
Would the introduction of 'manifest negative effects', as in other areas of state aid law, in lieu of the required balancing of positive and negative effects, enhance legal certainty and transparency in setting up financial instruments?

f. Wie bewerten Sie die Tatsache, dass Finanzinstrumente, die auf EU-Ebene umgesetzt und gemanagt werden, nicht unter EU-Beihilferecht fallen?
How do you find that financial instruments that are set up and managed at the EU level do not fall under the scope of state aid law?

g. Gibt es Ihrer Ansicht nach ein Principal-Agent-Problem bezüglich der verschiedenen Stakeholder eines Finanzinstruments, wie der Behörden der Mitgliedsstaaten, Finanzintermediäre, Fondsmanager und den Investoren? Ist es dem Erreichen der Ziele von Finanzinstrumenten abträglich?
Is there a principal agent problem present among the different stakeholders of financial instruments, such as Member State managing authorities, financial intermediaries and fund managers, and investors? Does it compromise the achievement of the goals of financial instruments?

h. Wie kann und sollte der rechtliche Rahmen von Finanzinstrumenten unter dem derzeitigen State Aid Policy Review verbessert werden?
How can and should the legal framework of financial instruments be improved under the current state aid policy review?

Herzlichen Dank / Thank you very much.

2. Expert Interviews

Interview Number 1: legal expert of a Member State implementing/consulting body | date: 15 June 2021, 12:00 – 12:45

a) How does the EU legal framework support, how does it hinder the set up and management of financial instruments?	There are multiple ways to set up financial instruments, be it state aid free or compliant with the rules. In practice, my observation is that the rules of the GBER and the Guidelines are too difficult for the different actors to comply with, so that most financial instruments are set up free of state aid. In my professional past, no financial instrument was set up based on Article 21 GBER, as it is too complicated in practice, e.g. the private participation rates are too difficult to reach [Article 21 (10) GBER]. Less complexity and rigidness are wished for by practitioners, also to enhance legal certainty. Moreover, in practice, it is very difficult to find an 'independent private investor', who has not already invested in the financial instrument at hand.
b) Does the legal framework of financial instruments contain inconsistencies, gaps or ambiguities?	There is an apparent inconsistency regarding the complexity of the rules: While the de minimis Regulation and its rules are very straightforward, Article 21 GBER is very complicated and complex and its very rigid provisions are very hard to adhere to in practice. The requirements for financial instruments should be simpler and less strict, e.g. regarding private participation rates.
c) How do you evaluate the applicability of the methods to measure/quantify the aid element under the MEIP in the context of the unclear and risky market environment of financial instruments?	Especially regarding risk financing for start-ups, the measurement is very difficult. It is very hard to even engage a rating agency for companies without any track record and financial statements. Thus, it is very difficult to measure the aid element. Therefore, simplified methods or criteria would be helpful. For example, in the wake of the Covid-19 crisis, the Temporary Framework stipulates under section 3.11. criteria for recapitalisation measures that are easier to adhere to (e.g. on remuneration). There is demand for risk financing measures and such simplified criteria should also be applied to beyond the Temporary Framework.
d) With regard to the setting up of financial instruments, how do you find the assessment criteria of the Commission on proportionality, which – in contrast to the criterion of the EU Courts to balance the positive and negative effects – rely on maximum amounts and elements of the MEIP/market mechanisms?	In practice, this is not a major issue. Mostly, this balancing exercise is relevant for ex ante assessments in order to establish market failures, but a market failure is always to be found.
e) Would the introduction of 'manifest negative effects', as in other areas of state aid law, in lieu of the required balancing of positive and negative effects, enhance legal	See d)

certainty and transparency in setting up financial instruments?	
f) How do you find that financial instruments that are set up and managed at the EU level do not fall under the scope of state aid law?	I never understood why the Commission draws this distinction and why state aid rules should not apply to EU financial instruments. It does not make any difference if companies receive funding from a Member State or EU fund. There is also confusion in practice how cumulation rules apply, in case there are EU and Member State funding at the same time.
g) Is there a principal agent problem present among the different stakeholders of financial instruments, such as Member State managing authorities, financial intermediaries and fund managers, and investors? Does it compromise the achievement of the goals of financial instruments?	There is a clash between the interest of the Member State to take influence and the requirements for financial instruments to render them free of this very influence. For example, Member States may be part of the governing bodies, but may not have a say or exert a blocking minority. This is a perceived problem for public bodies, as they have no say in investment decisions.
h) How can and should the legal framework of financial instruments be improved under the current state aid policy review?	There needs to be less complexity. For example, the provisions of Article 21 GBER, especially on significant private participation rates and maximum amounts should be more lenient. One major obstacle is also the time the notification procedures take. The criteria of off-the-shelf instruments are unfortunately also too rigid, but could in principle be a very helpful instrument and should be further adjusted to practical needs.

Interview Number 2: legal expert of an EU institution/body | date: 1 July 2021, 14:30 – 15:00, and 2 July, 16:00 – 16:15

a) How does the EU legal framework support, how does it hinder the set up and management of financial instruments?	The framework has to be reviewed in order to operationalise the policy objectives of the EU. The experience and expertise with financial instruments vis-à-vis grants gained over the years helps to use the framework for these objectives.
b) Does the legal framework of financial instruments contain inconsistencies, gaps or ambiguities?	Of course, there are gaps, but this is the nature of financial instruments. They evolve very quickly and because they correspond to market demands, the legislative framework with its cycles lags behind the market development. New and more complex types of financial instruments emerge, for example. It takes time to accommodate for the legal framework. Therefore, the framework has to be improved.
c) How do you evaluate the applicability of the methods to measure/quantify the aid element under the MEIP in the context of the unclear and risky market environment of financial instruments?	It depends. Some of the methods of the MEIP are easy to prove (e.g. Reference Rates or pari passu), others are more difficult and require a financial and economic analysis (e.g. expected returns, expected losses).
d) With regard to the setting up of financial instruments, how do you find the assessment criteria of the Commission on proportionality, which – in contrast to the criterion of the EU Courts to balance the positive and negative effects – rely on maximum amounts and elements of the MEIP/market mechanisms?	Financial instruments are rarely a form of state aid on which the Commission takes a decision. Most financial instruments are either market conform or comply with the de minimis Regulation or the GBER. The vast majority of financial instruments are compliant with these rules. Only a minority is assessed by the Commission. Proportionality is mainly ensured by the amount and the structure, e.g. through financial intermediaries as private bodies investing their own resources to align interests and ensure a better quality.
e) Would the introduction of 'manifest negative effects', as in other areas of state aid law, in lieu of the required balancing of positive and negative effects, enhance legal certainty and transparency in setting up financial instruments?	The selection of final beneficiaries is dedicated to the financial intermediary, so how would they carry out such an assessment of positive and negative effects? Also, the most important market failure of financial instruments is the access to finance. Financial instruments are often in the form of wide schemes, so that there may be multiple beneficiaries rather than individual benefitting companies and because of these scheme's wideness they are a rather egalitarian system. Therefore, the size of such schemes plays a role.
f) How do you find that financial instruments that are set up and managed at the EU level do not fall under the scope of state aid law?	They should not be treated the same. The state aid rules are there to ensure that the Member States do not pick and choose their favourite companies, in a simplified sense. EU institutions and the EU level do not have national political interests in picking individual companies over others. In contrast, at the national level, there are certain political forces that may influence decision makers and select certain specific companies.
g) Is there a principal agent problem present among the different stakeholders of financial	There is an issue of agency. But this is to be regulated in the agreement between the Managing Authority and

instruments, such as Member State managing authorities, financial intermediaries and fund managers, and investors? Does it compromise the achievement of the goals of financial instruments?	the financial intermediary, e.g. by contributing their own resources to align interests as 'skin in the game', for example. Also, they have to manage the funds as their own funds and have to apply due diligence, so that they cannot misuse the resources. The main question is how this is calibrated by the Managing Authority [in the agreement] with the flexibility given and how it is adjusted to the circumstances in different Member States, e.g. if you compare Germany to Bulgaria.
h) How can and should the legal framework of financial instruments be improved under the current state aid policy review?	I was mainly responsible in drafting the current rules on financial instruments for the Commission. With new market developments and new and more complex types of financial instruments emerging, the rules have to be accommodated.

Interview Number 3: Appointee of the German Ministry of Economics for the promotion of start-ups and Member of the German Bundestag | date: 9 July 2021, 13:15 – 13:35

a) How does the EU legal framework support, how does it hinder the set up and management of financial instruments?	In general, state aid law is necessary and important, as it guarantees a fair level playing field among Member States. It might sometimes be complicated and time-consuming in daily business, but it is essential for the functioning of the internal market. As we could see during the Covid-crisis, we were also able to quickly adjust the framework to market changes. However, from a bird's eye view and what I understand from those responsible at the operative level, e.g. those working for the [German EUR 10 billion start up fund] '*Zukunftsfonds'*, the framework is very complex and setting up instruments thus very time-consuming. For example, it is very difficult to find private investor participation from private investors that have not already invested in another tranche of the same fund already.
b) Does the legal framework of financial instruments contain inconsistencies, gaps or ambiguities?	See a)
c) How do you evaluate the applicability of the methods to measure/quantify the aid element under the MEIP in the context of the unclear and risky market environment of financial instruments?	In general, the MEIP and pari passu are very sensible tools, which avoid hurdles for investment. It is always helpful to have private sector partners on board [with regard to know how].
d) With regard to the setting up of financial instruments, how do you find the assessment criteria of the Commission on proportionality, which – in contrast to the criterion of the EU Courts to balance the positive and negative effects – rely on maximum amounts and elements of the MEIP/market mechanisms?	-
e) Would the introduction of 'manifest negative effects', as in other areas of state aid law, in lieu of the required balancing of positive and negative effects, enhance legal certainty and transparency in setting up financial instruments?	See h) [processes should become simpler and more transparent]
f) How do you find that financial instruments that are set up and managed at the EU level do not fall under the scope of state aid law?	It is interesting that the EU Commission proclaims that it per se always acts in accordance with state aid law, as it is no Member State and hence per se had no interest in market interventions. In theory, that sounds correct, but in practice, it may be different. There are EU programmes that do present market interventions. However, they do not require private investor participation in contrast to Member State instruments, but are financed by 100 per cent through EU funds. If a start-up receives 100 per cent financing and its competitor doesn't, it is questionable if that does not

	distort the market. Also, there may be a heavy regional focus instead of untargeted funding, likely distorting the market at the expense of start-ups in other European regions. Therefore, the same legal framework should apply to such EU financial instruments.
g) Is there a principal agent problem present among the different stakeholders of financial instruments, such as Member State managing authorities, financial intermediaries and fund managers, and investors? Does it compromise the achievement of the goals of financial instruments?	There is normally always a principal agent issue present. This question should ideally be forwarded to the German Finance Ministry, e.g. regarding the question of privileged conditions for private investors.
h) How can and should the legal framework of financial instruments be improved under the current state aid policy review?	The framework should provide faster, simpler, clearer, and more transparent procedures for setting up financial instruments. Of course, the innovative strength of the industry steadily requires an adjustment of the rules.

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