Compatibility rules for SMEs access to risk finance

Workshop with Member states and Stakeholders
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Revision of compatibility rules in accordance with common principles

1. **Objective of common interest & market failure**	→	Aid targeted at market failures affecting access to risk finance for high-growth SMEs
2. **Appropriateness** aid	→	Effective tool compared to other policy options or instruments
3. **Incentive effect**	→	Leveraging private capital
4. **Proportionality**	→	Incentives limited to minimum
5. **Negative effects & balancing**	→	Potential negative effects do not alter the level playing field within the internal market

1. Objective of common interest & market failure under the new GBER

- **Current approach**:
  - "Equity gap" approach (aid to high-growth SMEs through equity/quasi-equity instruments)= Narrowly defined market failure
  - €1.5 million maximum investment tranches per 12 month periods, per SME
- **Main issues**:
  - Insufficient to fill the funding gap for high-growth SMEs
  - Undesirable rigidity both for investors and final recipients
- **Possible new approach:**
  - Switch to a "funding gap" approach, catering for both equity and debt finance for initial commitments and follow-on investments
  - Replace annual investment tranches by an overall investment cap [€ 10-15 million]

1. Objective of common interest & market failure under the new Guidelines

- **Current approach :** evidence of market failure based on studies focused on certain macro-level indicators
- **Main issue:** difficult to assess the link between market failure and the specific design of the measure
- **Possible new approach:** strengthen the requirement for a proper *ex-ante* assessment
  - Clear identification of the objectives of the measure supported by evidence of sub-optimal investment situations affecting SMEs with high-growth potential
  - Evidence of constraints affecting investors resulting in insufficient fund raising by VC funds and in a material “funding gap” for the target group of SMEs
  - Justification of the financial design parameters of the measure against expected outcomes (counterfactual scenarios)

2. Appropriateness test

- **Current approach :**
  - Aided equity injections by private/public funds are presumed to be an appropriate instrument under the GBER
  - For measures falling outside the safe harbour the aid measure is compared against other policy interventions
- **Main issue:**
  - Establish the necessity of aid for different aid instruments (financial and fiscal) and funding structures (fund of funds, intermediate funds and co-investments) possibly falling within the enlarged scope of the new GBER
- **Possible new approach**:
  - Keep it simple and flexible under the new GBER: the same positive presumption could apply within a wider safe-harbour
  - Measure falling under the new Guidelines assessed against alternative policy interventions and aid instruments (e.g. equity injections v. fiscal incentives)

3. Incentive effect under the new GBER (1)

- **Current approach :** the measure must leverage capital from private investors into potentially viable firms in light of their business plans and due diligence appraisal
  - Incentive effect presumed if private-public fund achieves a flat ratio of 50% private capital (30% in assisted areas)
  - Requirements for commercial management and profit-driven character of investment decisions by fund managers
- **Main issues:**
  - No correlation between market failure, development stages of the investee and expected leverage through public investment
  - Asymmetric risk/rewards sharing: no balancing of downside protection v. upside boosters
  - Requirements for profit-oriented investments & commercial management unclear and inadequate for fiscal aid instruments

3. Incentive effect under the new GBER (2)

Possible new approach:

➢Tailored minimum private capital ratios based on the SME's development stage (uniform for assisted and non-assisted regions)

- Pre-sales stage: [20-30]%
- Within the 5-year post-first sale period : [40-50]%
- Follow-on investments beyond the 5-year post-first sale period: [60-70]%

➢Public investments in uncapped first loss position not covered by the GBER (e.g. individual assessment in case of loss coverage >20%)

➢Refined commercial management criteria for financial instruments:

- Best practices requirements for profit-driven investments into SME and funds
- Professionalism of fund managers & governance standards (including clarifications for in-house management of public funds)
- Alignment of interests (performance-based managers' fees, co-investment)

➢Publicity requirements for transparent and well-targeted investment restrictions for fiscal aid instruments

3. Incentive effect under the new Guidelines

- **Current approach :** analysis focused on
  - Effectiveness of tendering procedures for the selection of fund managers
  - Presence of an investment committee
  - Sufficient fund size
- **Main issue:** criteria insufficiently clear to filter situations where private capital would have been invested anyway
- **Possible new approach:** introduce additional/clearer criteria
  - *Ex-ante* assessment demonstrating low expected risk-adjusted rates of return for target investments based on reasonable exit strategies
  - Evidence of failed attempts to raise finance from private sources
  - Balance of downside risk protection and upside boosters depending on the funding structure of the measure (fund of fund, intermediate fund, co-investment at the SME level)
  - *Ex-post* evaluation of fund's efficiency in terms of scale and diversification of investments

4. Proportionality under the new GBER (1)

- **Current approach :** three levels of analysis
  - Aid to target SMEs: maximum annual investment tranches of €1.5 million (€2.5 million under 'standard' assessment)
  - Aid to investors: positive presumption if amounts of investments into SMEs are within maximum annual tranches
  - Aid to funds and their managers: requirements for market-conform remuneration
- **Main issues:**
  - Too strict and inflexible approach, not reflecting market practices
  - Not adequate for all types fiscal aid instruments (e.g. in case of reliefs from corporate taxes)
  - No sufficient safeguards to ensure proportionate aid to investors in view of the enlarged scope of the GBER

4. Proportionality under the new GBER (2)

- **Possible new approach:** improved compatibility conditions at the three relevant levels
  - Aid to target SMEs: introduce an overall cap of [€ 10-15 million] for equity and debt, covering both initial commitments and follow-on investments
  - Aid to funds and their managers:
    - Open and non-discriminatory competitive process for selecting funds and fund managers (current rule)
    - For debt instruments: full pass-on of aid to target SMEs
  - Aid to investors:
    - Incentives to be determined via competitive process for selecting private investors
    - Limit the scope of the GBER to fiscal incentives granted to physical persons (corporate tax breaks subject to individual assessment)
    - For debt instruments: possibly a maximum intensity threshold

4. Proportionality under the new Guidelines

- **Current approach :**
  - Overcompensation presumed if risk of losses fully borne by public sector or benefits fully reserved to private investors
  - Proportionality presumed in case of call for tender or public invitation to investors
- **Main issue:** current criteria insufficient to cater for all types of financial and fiscal aid instruments
- **Possible new approach**: introduce additional conditions
  - Positive assessment for funds with credible plans for public capital repayment/fund's self-sustainability
  - Effective mechanisms for ensuring a fair rate of return (FRR) to private investors
  - Transparency: coupled selection of investors and fund managers
  - Appropriate limits for fiscal advantages on corporate taxes

5. Negative effects & balancing

- **Current approach :**
  - certain aid measures (e.g. aid to firms in difficulty or to export-related activities) are excluded by the current GBER
  - RCG mainly focused on crowding out effects
- **Main issues:**
  - Uncertain whether the list of excluded measurers is exhaustive
  - Due to wider scope of the proposed new regime, negative effects in downstream markets may become more relevant
- **Possible new approach:**
  - Simplify the assessment under the GBER through a 'black list' approach (including e.g. LBOs, measures with no private capital participation, investments in firms and funds without viable business plans/exit strategies)
  - Better guidance for assessing crowding out effects and risks of maintenance of inefficient market structures in product markets (namely in case of aid to mid-caps)

Thank you for your attention