EGESIF_15-0030-00
07/10/2015

EUROPEAN COMMISSION

European Structural and Investment Funds

Guidance for Member States on preferential remuneration

DISCLAIMER: *This is a document prepared by the Commission services. On the basis of the applicable EU law, it provides technical guidance to colleagues and other bodies involved in the monitoring, control or implementation of the European Structural and Investment Funds (except for the European Agricultural Fund for Rural Development (EAFRD)) on how to interpret and apply the EU rules in this area. The aim of this document is to provide Commission's services explanations and interpretations of the said rules in order to facilitate the programmes' implementation and to encourage good practice(s). This guidance note is without prejudice to the interpretation of the Court of Justice and the General Court or decisions of the Commission.*

1. REGULATORY REFERENCES AND TEXT

Regulation	Articles
Regulation (EU) 966/2012 (Financial Regulation)	Article 139(5)
Regulation (EU) N° 1303/2013[1] Common Provisions Regulation *(hereafter CPR)*	Article 37(2)(c) Article 38(9) Article 44(1) Article 120(2)(a)
Regulation (EU) 1305/2013[2]	Article 81 Article 82
Regulation (EU) 1306/2013[3]	Article 36(1)
Regulation (EU) 480/2014[4] Commission Delegated Regulation *(hereafter CDR)*	Article 6(1)(d)
Commission Regulation (EU)[5]651/2014 *(hereafter GBER)*	
Guidelines on State aid to promote risk finance investments (2014/C 19/04)	

2. GUIDANCE

The purpose of this guidance note is to explain the concept of preferential remuneration and its use in the context of ESIF financial instruments. This guidance does not serve the purpose of establishing a particular need or level of preferential remuneration as this is an individual process which is part of the ex-ante assessment.

2.1. Role of private investors in the context of financial instruments in ESIF programmes

Financial instruments are one of the forms of support in ESIF programmes. The purpose of financial instruments is to **transfer ESIF programme support to the final recipients in the form of loans, guarantees or equity** in line with the programme objectives. Thus, financial instruments are vehicles for transferring programme support from a managing

[1] 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 and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006, OJ L 347, 20.12.2013, p. 320.

[2] Regulation (EU) No 1305/2013 of the European Parliament and of the Council of 17 December 2013 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD) and repealing Council Regulation (EC) No 1698/2005

[3] Regulation (EU) No 1306/2013 of the European Parliament and of the Council of 17 December 2013 on the financing, management and monitoring of the common agricultural policy and repealing Council Regulations (EEC) No 352/78, (EC) No 165/94, (EC) No 2799/98, (EC) No 814/2000, (EC) No 1290/2005 and (EC) No 485/2008

[4] 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, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund , OJ L 138, 13.5.2014, p. 5.

[5] 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 TFEU

authority to the final recipients.

The common feature of financial instruments is that they are managed by fund managers and very often, in addition to the programme contribution by a managing authority, there are also other co-investors.

The ESIF framework encourages managing authorities to attract private co-investors to ESIF financial instruments as their presence brings at least two advantages:

1. Private resources co-invested with public resources ensure market orientation of the delivery mechanism and strong commercial reasoning behind each investment decision.
2. Moreover, private resources leverage ESIF resources (in addition to any other public funds co-invested with ESIF) and thus increase the impact of ESIF programme.

In case of projects with good financial viability and moderate risk, a private investor might be willing to co-invest along ESIF programme resources without any additional incentive. The presence of public investor taking certain part of the risk may already sufficiently motivate the private investor to co-invest. In such situations private and public investors would usually invest on the same terms and conditions.

In some cases there might be, however, a need for specific incentive for a private investor (e.g. in terms of higher profit or lower risk) in order to attract private capital. This incentive constituting "preferential remuneration" is under certain conditions allowed under CPR.

Preferential remuneration of a private investor may be thus an important tool in attracting private resources which are co-invested with public funds through financial instruments in areas of high risk/low return, therefore allowing pursuing public policy objectives.

2.2. Sources of preferential remuneration

Preferential remuneration implies State resources' benefits to the private investor and therefore the scheme envisaging preferential remuneration needs to be State aid compliant.

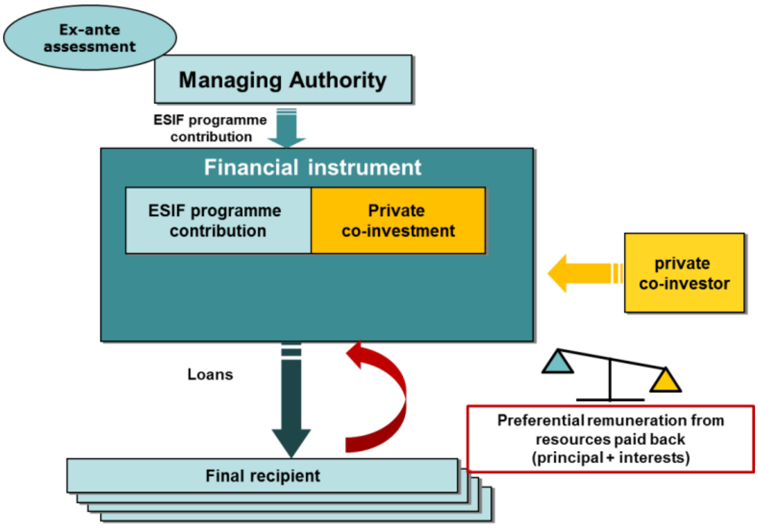
An incentive to the private investor in the form of preferential remuneration does not come from the ESIF programme contribution and consequently cannot be presented as eligible expenditure.

Managing authority may nevertheless decide to allocate for preferential remuneration part of the **resources paid back to financial instruments** from investments in final recipients. This would have a direct impact on the revolving effect of financial instruments and this is why a thorough assessment of the need for and the level of preferential remuneration is needed.

In addition, as provided for in Article 6(1)(d) of CDR' preferential remuneration of private investors or public investors operating under the market economy principle[6], as

[6] The CPR indicates that preferential remuneration can be given to a public investor operating under the market economy principle, which is a public body borrowing money on the financial market and investing it into/through a financial instrument managed according to market economy principles.

referred to in CPR Article 37(2)(c) and Article 44(1)(b) must be proportionate to the risks taken by these investors and limited to the minimum necessary to attract such investors.



2.3. How it is different from the 2007-2013 period?

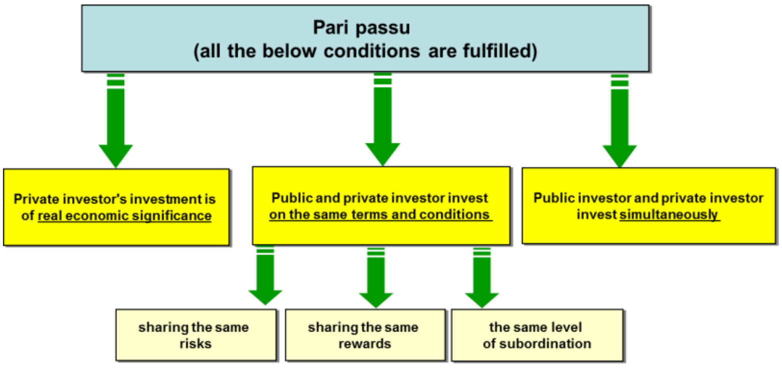
In the 2007-2013 period preferential remuneration was envisaged only in financial instruments supported with Structural Funds (ERDF, ESF). In 2014-2020 this possibility is open to all ESI Funds.

	2007-2013	**2014-2020**
Preferential remuneration	Article 43(5) of Regulation 1828/2006 allowed for preferential remuneration of investors operating under the market economy investor principle only in relation to returns.	Article 44 of CPR allows for preferential remuneration both in relation to returns (gains, other earnings or yields, such as interest, guarantee fees, dividends, capital gains or any other income generated by investments) and to capital[7]. Thus, preferential remuneration may take the form of asymmetric sharing of gains and other earnings or yields and asymmetric sharing of the risk.

2.4. Pari passu

An investment is *pari passu* when 1) it is made under the same terms and conditions by public and private investors, 2) both investors intervene simultaneously and 3) the intervention of the private investor is of real economic significance[8].
A transaction is made under the same terms and conditions if public and private investors share the same risks and rewards and hold the same level of subordination.

[7] Within the limitations presented in chapter 2.4
[8] In the State aid framework it is considered as minimum 30% investment by the independent private investor in the overall volume of investment (cf. paragraph 34 of Guidelines on State aid to promote risk finance investments; 2014/C 19/04)



2.5. Non Pari passu and preferential remuneration

Preferential remuneration of a private investor or a public investor operating under the market economy principle is a situation where the private investor and the public investor **do not share** the same risks and rewards, specifically when private investor invests on terms more favourable than the public investor[9]. It is thus a non *pari passu* situation.
It may take the form of:

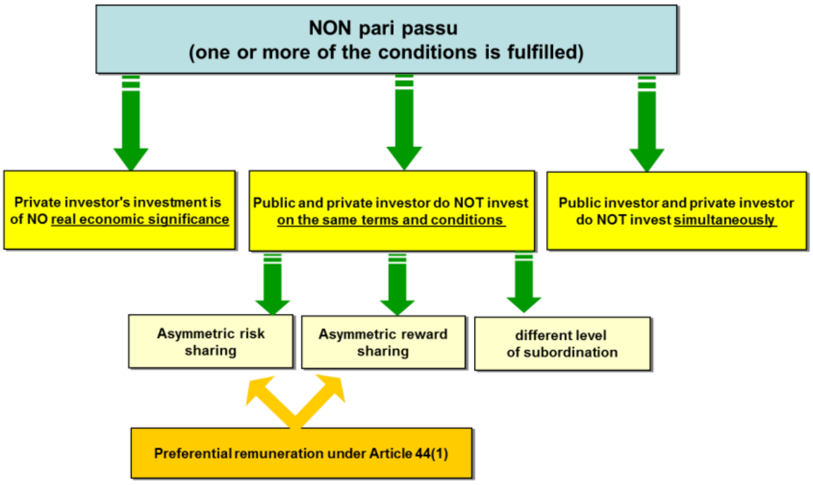
- Asymmetric reward sharing: preferential returns for private investor (upside-incentive).;
- Asymmetric risk sharing: reduced exposure to losses in the event of underperformance or non-performance of the underlying transaction compared to the public investors (downside protection).

In accordance with CPR Article 44 the notion of "resources paid back" to financial instruments from investments in final recipients covers both the **capital** repayments (nominal ESIF amount invested in final recipients) and **returns** (gains, other earnings or yields, such as interest, guarantee fees, dividends, capital gains or any other income generated by investments and attributable to ESI Funds).

The possibility of using "resources paid back" for preferential remuneration as referred to in CPR Article 44(1)(b) must be understood as covering only 1) asymmetric reward sharing and/or 2) asymmetric risk sharing.

A construction where capital repayments from an investment in final recipient are asymmetrically shared, i.e. a public investor is foregoing part of the nominal amount of its ESIF investment to the benefit of the private investor could not be found compatible under State aid rules.

[9] If the public investor is in a better position than the private investor, such construction is considered to be in line with normal market conditions.



2.6. Remuneration of an investor versus remuneration of the fund manager

Preferential remuneration of the private investor should be distinguished from the remuneration of the fund manager. The remuneration of the fund manager is the remuneration for managing the ESIF programme resources contributed to the financial instrument managed by the fund manager. The fund manager does not have to act as co-investor and does not need to co-invest its own resources (although in some specific cases this takes place, c.f. standard terms and conditions on Risk Sharing Loan). The remuneration of the fund manager takes the form of management costs and/or fees and can be financed directly from the ESIF programme contribution to the financial instrument (eligible management costs and fees)[10].

2.7. Assessment of preferential remuneration within the ex- ante assessment

As provided for in CPR Articles 37(2) and 44(1) the need for and the level of the preferential remuneration has to be assessed in **the ex- ante assessment**. Preferential remuneration reduces resources paid back because part of the capital[11] and/or gains attributable to the support from the ESI Funds, instead of being reused for further investments, is distributed to the private investor (or the public investor operating under the market economy principle).

In a global assessment this may even decrease the entire impact of financial instrument (leveraged private resources may not compensate for the lost opportunity of reinvestments). Therefore, it is crucial that the ex-ante assessment includes, as appropriate, an assessment of the need for, and level of, preferential remuneration to attract counterpart resources from private investors and/or a description of the mechanisms which will be used to establish the need for, and extent of, such preferential remuneration, such as a competitive or appropriately independent assessment process.

2.8. Preferential remuneration to the investor providing national co-financing of FI operation

In accordance with Article 38(9) CPR national public and private contributions may be provided at the level of the fund of funds, at the level of the financial instrument or at the level of final recipients in accordance with the Fund-specific rules. These national public and private contributions may constitute national co-financing and be declared as eligible expenditure.

[10] See Guidance on eligible management costs and fees

[11] Within the limitations presented in chapter 2.4, i.e. asymmetric risk sharing only

Thus, in priority axes based on total eligible expenditure in accordance with Article 120(2)(a) CPR[12], private resources co-invested by the private investor in the fund of funds, in the financial instrument or at the level of the final recipient can be considered as national co-financing and declared as eligible expenditure. (This does not apply to the EAFRD, where the expenditure which is declared and to which the co-financing rate is applied has to be public expenditure[13]).

2.9. State aid

It should be underlined that preferential remuneration of a private investor (or a public investor operating under the market economy principle) has to comply with **State aid** rules[14]. For example this may require full compliance with Article 21 of GBER (e.g. on the selection, on maximum first loss cap) or a need for a State aid notification to the European Commission. It is underlined further that for instruments other than guarantees, 'profit-sharing shall be given preference over downside protection'[15] in order to limit a bias towards excessive risk-taking by the manager selecting the undertakings in which the investment is made. In any case in the event of asymmetric risk sharing (downside protection) the first loss assumed by the public investor needs to be capped at 25% of the total investment. This is meant to ensure that, whatever the form of the financial instrument, any preferential treatment granted to private investors has to be weighed against the revolving nature of the public capital committed and the long-term financial sustainability of the intervention.

In certain cases, however, it may prove necessary to give preference to downside protection, namely when the measure targets certain sectors in which the default rate of SMEs is high. This may be the case for measures targeting SMEs before their first commercial sale or at the proof-of-concept stage, sectors faced with important technological barriers, or sectors where the companies have a high dependence on single projects requiring large upfront investment and entailing high risk-exposure, such as the cultural and creative industries.

3. REFERENCE, LINKS

Ex-ante assessment methodologies for financial instruments 2014-2020
http://ec.europa.eu/regional_policy/index.cfm/en/funding/financial-instruments/

4. QUESTIONS AND ANSWERS

To be added following discussions in EGESIF

[12] Applicable to the ERDF, the ESF and the Cohesion Fund
[13] Article 36(1) of Regulation (EU) 1306/2013
[14] In the context of the European Agriculture Fund for rural Development, Article 81(2) of Regulation (EU) 1305/2013 (according to which State aid rules do not apply to payments made by the Member States in conformity with the Regulation and within the scope of Article 42 (TFEU), may be relevant.
[15] Article 21(13)(b) GBER