EUROPEAN COMMISSION

Brussels, 20.12.2011
C(2011)9341 final

Subject: State Aid n° SA.33683 (2011/N) – United Kingdom
Big Society Capital

Sir,

The Commission wishes to inform the United Kingdom (UK) that, having examined the information notified by your authorities on the matter referred to above, it has decided not to raise objections to the above-mentioned measure for the reasons set out below.

1. PROCEDURE

(1) On 4 October 2011, the UK authorities notified to the Commission the above-mentioned measure. The UK authorities had pre-notified the measure on 25 May 2011, which was registered under case reference SA.32777 (PN/2011).

(2) Following a number of informal exchanges of information with the UK authorities, the Commission sent formal requests of information on 21 September, 27 September and 27 October 2011. The UK authorities responded to the above requests for information on 4 October and 7 and 14 November 2011, respectively.

2. DESCRIPTION OF THE MEASURE

2.1. Overview

(3) The UK authorities have set up the Big Society Capital (BSC) project with the overarching aim to help frontline social organisations increase their social impact, by improving their access to affordable finance. To achieve that aim, BSC will support the development and growth of a market for social investment products in the UK, for both social and financial

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returns. The development of such social investment products will foster the currently unattractive – and therefore undeveloped - intermediation function between investors and social undertakings. It will allow greater levels of capital to be attracted from a more diverse range of sources in order both to address social issues and to be able to allocate capital more effectively.

(4) The proposed measure will address the identified market failure (the funding gap of the social sector) by contributing through investment in Social Investment in Finance Intermediaries (SIFIs) to the development of a market infrastructure (intermediaries, dedicated funds, ad hoc investment instruments, investment and information platforms) that addresses the funding needs of social frontline social organisations. Support of SIFIs through BSC will take the form of co-investment both in SIFIs' capital and in funds marketed by SIFIs in order to leverage available private money (charities, socially conscious High Net Worth Individuals).

(5) Under the notified measure, the UK government plans to set up a social investment wholesale institution, BSC, which will invest capital into existing and new SIFIs and social investment funds to invest into frontline social organisations. BSC will provide support and help to build the infrastructure necessary to facilitate the creation of an efficient social investment finance sector.

(6) BSC will be capitalised with both public and private funds.

2.2. The social sector in the UK

Definition

(7) The social sector in the UK encompasses a wide variety of organisations operating across different markets. Social sector organisations are not defined by their legal form (social sector organisations can take widely diverse legal forms) but by their end goal, that is to deliver social (including environmental) results, as opposed to that of private sector businesses which is to generate profit for owners or shareholders. Social sector organisations can operate in a commercial way but are to be distinguished from commercial undertakings by the fact that <u>they affect corresponding surplus to their social and/or environmental objectives</u>. The ability to distribute at least some surplus is often essential in enabling social sector organisations to raise the finance that they need to grow and ultimately to increase their effectiveness. An additional distinctive element of social sector organisations is that they are independent of government.

(8) Social sector organisations range in size from informal community organisations which are generally very small with very limited, if any, income and no staff, to the 453 major charities with income above GBP 10 million and which account for 44% of all charitable income.[1]

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[1] NCVO (2010) The UK Civil Society Almanac 2010.

- *Role*

(9) According to the UK authorities, the social sector in the UK plays a key role in promoting social and environmental change. Indicatively, examples of situations where the social sector helps include: helping to design and deliver innovative and responsive public services, often reaching people and communities that the public sector struggles to reach; contributing to building new markets by pioneering the provision of new ethical and socially or environmentally responsible products and setting new standards for socially responsible business practices; and encouraging enterprise entrepreneurship, by attracting those who may not be interested in conventional business into social enterprise, including women, young people, and people from ethnic minority communities.

(10) The social sector also makes an important contribution to the economy: social enterprises employ about 800,000 people[2], while the total expenditure of charities in 2007/8 was GBP 32.8 billion[3].

2.3. Social Investment Finance Intermediaries (SIFIs)

(11) Social Investment Finance Intermediaries (SIFIs) provide a link between socially conscious investors and frontline social sector organisations. They primarily provide, facilitate or structure financial investments (not exclusively grants) to/for organisations that have a primary objective of achieving a positive social impact, and to provide business support to those organisations.

(12) As intermediaries, SIFIs are themselves mainly social sector organisations, which primarily describe themselves as non-profit. The UK SIFI market is dominated by a few large players (six organisations account for 90% of the social investments made in 2010. Social Banks account for two-thirds of the total market for social investment (~GBP 105 million).[4]

(13) Additionally, they generally provide funding on concessional terms, mostly through secured lending (69%). Rates offered may be comparable to mainstream banks but the terms, conditions and levels of risk taken are not comparable. Over 80% of the money provided for investment to funds expects a sub-commercial but still positive return, while over 60% of capital for on-lending is grant-based (primarily from government).

(14) SIFIs receive the vast majority (66%) of funds for investment from central government. Smaller proportions originate from charitable trusts and foundations (11%), individuals (8%), and banks and commercial institutions (7%). Balance sheet funding is also dominated by funds originating from central government, although social banks' deposits account for 44% of the sector's balance sheet funding.

(15) SIFIs are diverse and take a variety of legal forms ranging from trusts, to companies limited by guarantee, industrial and provident societies, companies limited by shares, community interest companies, trusts and limited liability partnerships.

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2 Department for Business Innovation and Skills (2008) Annual Small Business Survey, 2005-7 average.

3 NCVO (2010) The UK Civil Society Almanac 2010.

4 The big four social banks are: Charity Bank, Ecology Building Society, Triodos UK and Unity Trust Bank.

(16) Overall, the SIFI market in the UK is not yet mature. Consequently, the BSC project seeks to develop and foster the growth of that market with the ultimate goal to diversify the funding sources of social sector organisations towards private money.

2.4. Market Failure

(17) According to the UK authorities, there are market failures which prevent the social sector from accessing private money. Among those market failures are capital shortage and misperception of the risk/return couple.

(18) As regards capital shortage, for example nearly half of all social enterprises see access to finance as a key obstacle to their success[5] (compared to only one-third of SMEs)[6]. Although 16% of frontline social sector organisations access finance from public sources, the remaining 84% do not and thus are denied sufficient access to finance, limiting the efficiency of the frontline social market.

(19) As regard misperception of the relationship between risks and returns, there are two principal reasons for the failure of private financial markets to supply sufficient capital to the frontline social sector, positive externality and asymmetric information..

- *Positive externality*

(20) By hypothesis, commercial institutions take into account only the expected financial return offered by considered projects and do not capture positive externalities that mostly contribute to social return and increase the overall macroeconomic return. Because social sector organisations' aim is precisely to achieve a social return, commercial institutions will not award finance for the majority of their activities and thus social sector organisations will obtain a socially sub-optimal level of funding for all investment types.

- *Information asymmetries*

(21) Private retail investors lack the experience and understanding of social sector organisations; it creates investor uncertainty. The specific investment profile and needs of frontline social sector organisations, which differs from "mainstream" investments, make it harder for private retail investors to identify good and bad investment opportunities, deterring risky investments.

(22) To confirm that hypothesis the UK authorities provided an economic paper testing for difficulties encountered by frontline social sector organisations compared to their private sector equivalents. It is demonstrated that there are two distinct types of front-line social sector organisations with very different relationships with the private financial markets: social sector organisations with grants and social sector organisations without.

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5 Department for Business, Innovation and Skills (2010) Social Enterprise Barometer, February 2010.

6 SME benchmark is a conservative one as SME lending in the UK is in itself constrained- http://www.bis.gov.uk/assets/biscore/corporate/docs/f/10-1081-financing-private-sector-recovery.pdf

(23) It is suggested by evidence brought forward by the UK authorities that frontline social sector organisations with no grants (84% of social sector organisations) are receiving around GBP 0.9-1.7 billion less than they would need.[7] That annual finance 'gap' holds the frontline social sector back from operating as efficiently as non-social sector peers as they are less likely to obtain working capital to smooth business cycles or growth capital to expand. Equally, capital investment does not keep pace with the growth in turnover of the sector.[8]

(24) Frontline social sector organisations receive less investment than their peers partly because they are more likely to be rejected for certain types of private finance, particularly for risk capital and unsecured finance which are more uncertain for private investors. Social sector organisations are for example one-third more likely to be rejected for private overdraft finance where they are seemingly identical to their peers[9]. That poorer performance is likely to be because frontline social sector organisations have different cash-flow issues (the frontline funding cycle is more irregular)[10] and because it is a niche business model and banks do not fully understand the risks of investing and so reject more applications than they should.

(25) Furthermore, social sector organisations were significantly more likely to be rejected for overdraft finance, leaving social sector organisations with just over half the overdraft finance of their private sector counterparts, constricting their working capital. Overall, they are 15% less likely to receive private repayable finance than private firms and they do not cover that gap from public/social sources. That analysis indicates significant market failure.

(26) On the other hand, frontline social sector organisations with grants (16% of social sector organisations) appear to obtain the finance they need from the public and/or social sector on easier terms, indicating that grant income is probably offsetting risk or cross-subsidising loan repayments.

(27) The evidence brought forward by the UK authorities concludes that the market fails to supply frontline social sector organisations with GBP 0.9-1.7 billion *per annum*. The data indicates that that the market failure is driven by mispricing of risk as theory predicted because social sector organisations do not suffer any disadvantage in secured finance (in case of secured lending, the bank can rely on the value of the real estate taken as security and is therefore less concerned by/does not need to deeply understand the activity

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7 Based on Cabinet Office regression analysis of the Small Business Survey (2010).

8 According to NVCO (2010) The UK Civil Society Almanac 2010, the income of the sector grew at 5% *per annum* between 2003 and 2007, but its asset base did not grow to the same extent: fixed asset growth was 3% *per annum* and current asset growth -1% *per annum* over the same period. Those quantitative insights are also supported by strong anecdotal evidence that the sector is undercapitalised (Goodall E and Kingston J (2009) Access to Capital: A briefing paper. London: CAF Venturesome; Commission on Unclaimed Assets (2007) The Social Investment Bank: Its organisation and role in driving development of the third sector. London: Commission on Unclaimed Assets; NCVO Funding Commission (2010) Funding the Future: A 10-year framework for civil society. London: NCVO).

9 Based on Cabinet Office regression analysis of the Small Business Survey (2010) which found that when all relevant factors available are controlled for social frontline organisation (without grants) are more likely to be rejected.

10 Department for Business, Innovation and Skills (2010) Social Enterprise Barometer, February 2010.

undertaken by the borrower) but are only half as likely to obtain overdraft finance. There is also clear evidence that the emerging market for social finance lacks sufficient infrastructure to efficiently deliver its services as the emerging market hypothesis predicted.

- *SIFIs' level*

(28) SIFIs are currently able to only partly offset that private sector finance gap. In 2010/2011 they provided GBP 0.2 billion to the frontline social sector. The social finance intermediary market is thus still far from maturity and does not respond adequately to the financing needs of frontline organisations, in particular when they require risk and working capital.

(29) Concerning capitalisation and balance sheet growth, the total SIFI market does not have sufficient capital to fully offset the finance gap: SIFIs lack the volume of capital and the appropriate market structures to distribute capital efficiently. In total they were only able to invest GBP 0.2 billion into the frontline social sector in 2010 when the funding gap for frontline businesses was at least GBP 0.9 billion. Furthermore, SIFIs do not have sufficient scale to underwrite frontline social sector risks. As described above, frontline social sector organisations receive less investment than their peers partly because they are more likely to be rejected for certain types of private finance (supply is constrained), particularly around risk capital and unsecured finance which present difficulties in terms of analysis to private investors. In order to invest in the riskier end of the frontline social sector and offset that market failure the SIFIs themselves need to be sufficiently capitalised to allow them to underwrite risks which private retail investors are unwilling to take. The social finance sector is small and not yet mature and there are few, if any, market players of sufficient size to underwrite these risks. Moreover, SIFIs do not have sufficient capital to expand their lending: Less than 1% of SIFIs' capitalisation is equity restricting their ability to ultimately expand their lending to the frontline. That level of equity capitalisation is also greatly below the average social enterprise capitalisation average of 11%.

(30) As for risk and working capital, SIFIs operate a particularly high risk business model with longer time horizons. Higher risk results inter alia from complex structures, low security and the bespoke, lengthy and expensive transaction process necessary to adequately meet the needs of the frontline social sector. The average loan size is around GBP 340,000.

(31) Finally, concerning operating sustainability and growth, some SIFIs are not able to cover their operating costs. Most SIFIs carry an operational gap in their model where the cost of investing and supporting frontline organisations is not covered by the income earned on the investment. It is partly due to the lack of scale and the associated efficiencies as well as the length of time required for a social investment to begin delivering financially. That operating gap has been filled to date by government grants and donations. As that source of financing reduces, SIFIs will need long-term, patient finance in order to grow to the required scale necessary to offset that gap.

2.5. The UK Government response to market failures

(32) The BSC project is the UK government's response to the market failures identified above. BSC will be a wholesale investment institution. It will thus not invest directly in social

sector organisations but only through dedicated investment vehicles (in particular funds, innovative financial instruments). As a financial institution, BSC will be subject to prior FSA authorisation.[11]

(33) As an instrument to foster market infrastructures, BSC will also invest directly in intermediaries (SIFIs, SIFI-sponsored funds and capacity-building infrastructure organisations). Through investments into SIFIs in the form of debt (subordinated loans), equity or both, BSC will contribute to develop that market and accelerate its maturing. A more mature SIFI market will be able to attract more private sector funds for investment aimed at achieving social change. Eventually, BSC will act as a catalyst to develop the social investment market so that it will able to fully offset the current finance gap, allowing the frontline social sector to achieve economic efficiency.

(34) BSC will tackle the twin issues of providing sufficient capital to SIFIs to invest and increasing the efficiency of the social investment finance sector so that it is able to fully support the finance needs of the frontline social sector.

(35) The overall objectives of BSC are described as follows: BSC will enable SIFIs to become more financially robust, able to attract investment, and able to provide effective financial and business support services to frontline social sector organisations. BSC will achieve those goals through direct investment in SIFIs, co-investing in social-purpose funds, or providing SIFIs with subordinated capital. Furthermore, it is envisaged that new financial products and market infrastructure will be developed and brought to market. BSC will do this by providing appropriate support, including investment, to SIFIs that are developing viable, innovative products and mechanisms that can attract investment and meet a financing need in the social sector. Other objectives of BSC are to increase awareness of and confidence in social investing by promoting best practice and disseminating information; to improve links between SIFIs and other parts of the financial services market; and to promote best practice by integrating social impact assessment and measurement into the investment decision-making process.

(36) It is intended that BSC would act in the following ways: co-investment in SIFIs' sponsored funds, provision of subordinated capital to such funds, capitalisation of SIFIs, capacity-building investments in infrastructure organisations, investment and underwriting of innovative social investment products such as outcome financial instruments, social impact bonds, credit guarantees and first loss capital. […][*]

(37) BSC will focus, initially, on making investments and providing support to the social investment market in response to demands for capital from SIFIs, who in turn will be driven by the needs and demands of front-line social sector organisations Through its capacity to invest debt and equity and to co-invest with other investors, BSC will have the ability to accelerate the establishment of diversified social purpose funds, such as venture funds, property funds, community asset funds, microfinance funds and funds that invest in social impact bonds. Such funds will provide social and management expertise as well as

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[11] Expected to be granted by the end of January 2012.

[*] Confidential information

investment capital to social sector organisations capable of expanding to deliver significant social impact as well as a financial return.

(38) As the market develops and as BSC, through its initial investment activity and through its research, builds up a more and more detailed picture of both the social investment market and of the finance needs of the frontline social sector, BSC will take a more proactive approach to its investments, potentially identifying a need for capital or greater intermediation activity where there is neither articulated demand nor supply and facilitating flows of capital and support to those areas.

(39) BSC has developed an investment process aiming at ensuring that the correct equity valuation methodology is applied. The investment officer will examine the profile of each SIFI investment proposition to select the most appropriate valuation tool, looking at various factors. One of the valuation criteria would be whether the SIFI has a banking licence- *ceteris paribus* a banking licence will make book value a better valuation tool. Furthermore, attention will turn to whether the SIFI has a reached a "steady state" income stream which is, on average, growing at a rate comparable to GDP - *ceteris paribus* a stable income stream will make multiples of earnings a more appropriate valuation tool: it is better to base the company's worth d on its earnings rather than its assets which could undervalue the company or depreciate. Thirdly, it will be noted whether the SIFI exhibits high growth rates (or high growth potential) - *ceteris paribus* a high growth rate will mean that BSC will generally apply a higher multiple of earnings in order to value equity investments. That multiple will reflect the fact that the company's earnings are forecast to grow. Also, whether a SIFI is a start up or otherwise likely to incur initial losses and realise later returns will be an important factor - *ceteris paribus* a negative short-term income stream will make Discounted Cash Flow a better tool because it will most accurately take account of the possibility of early losses. Lastly, it will be examined whether a SIFI has assets that are depreciating- *ceteris paribus* if the SIFI has a large depreciating stock of capital then Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) will often be a more appropriate tool because it disregards asset depreciation. In most cases however, both revenue multiples and EBITDA multiples will be utilised and the most appropriate valuation tool selected.

2.6. Funding approach and architecture of BSC

(40) BSC will be capitalised progressively, up to an amount of GBP 600 million, coming both from the private banking sector and from public resources.

(41) The Big Society Capital group (BSC group) comprises a holding company called The Big Society Trust (BST), a company limited by guarantee and its wholly-owned operating subsidiary BSB42 Limited, trading as Big Society Capital (BSC), a private company limited by shares.

2.6.1. *Private Funding*

(42) HSBC Plc, Barclay's Bank Plc, The Royal Bank of Scotland Plc and Lloyd's Banking Group Plc (collectively the "Merlin Banks"[12]) will each make a capital injection of GBP 50 million into BSC.

(43) That GBP 200 million capital injection will be disbursed in tranches. The timing and the quantum of such investment will be dependent on the timing and quantum of releases of dormant accounts (see below).

(44) If BSC decides to distribute a surplus, the Merlin banks will have a right to a share proportionate to their capital contribution to BSC. The participation of the Merlin banks is capped to 40% of the capital. Their voting rights will be capped to 20% of the voting rights.

2.6.2. *Funding with public resources*

(45) The UK government has decided to capitalise BSC with dormant funds on English banking accounts. The legal framework of the Dormant Accounts Scheme is the Dormant Bank and Building Society Accounts Act 2008 ("the 2008 Dormant Accounts Act"). Its rationale is to release money from dormant accounts for the benefit of society, while protecting the rights of account holders.

(46) The allocation mechanism of dormant accounts monies to BSC involves two intermediary institutions: the Reclaim Fund and the Big Lottery Fund.

(47) Following the 2008 Dormant Accounts Act, banks and building societies can voluntarily transfer account balances that have been dormant for 15 years or more to a Reclaim Fund. The Reclaim Fund is a private body managing private funds. It has been established by Cooperative Financial Services and was authorised by the Financial Services Authority in March 2011. The Reclaim Fund has started receiving dormant account funds.

(48) The transfer to Reclaim Fund is discretionary and irrevocable. The rights of legal persons entitled to dormant funds who are subsequently identified will be preserved.

(49) As the sole institution liable for transferred funds, it is the responsibility of the Reclaim Fund to estimate the prudential level of funds necessary to meet potential claims. Accordingly, it is thus the Reclaim Fund's responsibility to determine the amount to be transferred to the Big Lottery Fund.[13] That transfer will be irrevocable. Nevertheless, the Reclaim Fund remains liable vis-à-vis the legal persons entitled to the funds transferred. As a full-fledged member of the Financial Services Compensation Scheme, the Reclaim Fund

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[12] HSBC, Barclay's, RBS and Lloyd's. Referred to as "Merlin Banks" following the agreement on the project Merlin – an agreement between the UK government and the UK's four biggest banks on lending, pay and bonuses.

[13] The Reclaim Fund Limited’s board has indicated that they will currently keep back: 20% to meet their capital requirement which will be reserved permanently by the Reclaim Fund; a 40% provision to meet claims from account holders which may reduce over time depending on the experienced rate of reclaim; and a further 20% as a contingency fund which may reduce over time depending on the experienced rate of reclaim.

will benefit from its coverage in the same way as any financial institution accepting deposits.

(50) The money transferred to the Big Lottery Fund will be apportioned between England, Scotland, Wales and Northern Ireland according to formulae agreed by Parliament. Specific government ministers in each in these countries will have the power to give the Big Lottery Fund legally binding directions as regard the affectation of transferred funds. Legally, the dormant account money can only be used for provision of youth facilities or services, to increase individuals' financial capabilities or financial inclusion or for a social investment wholesaler (namely BSC). In the case of England, the UK indicated that the full amount of English funds (83%) shall be transferred to BSC against shares via a dedicated structure, Big Society Trust.

(51) Funding for BSC will come in tranches, in the form of equity investments by Big Society Trust, funded with the English share[14] of dormant accounts and capital injections from the four largest UK retail banks.

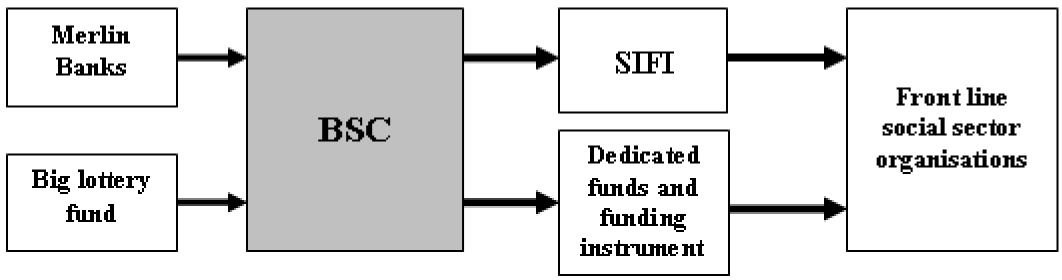
(52) Because of its capital structure and because of the contingency provisioning requirement applicable to the Reclaim Fund (see footnote 13), of the GBP 300 million currently available to the Reclaim Fund, Big Society Capital could initially receive only GBP 50 million. Over time that amount could rise to GBP 265 to 400 million as the full GBP 400 to 600 million becomes available to the Reclaim Fund and the percentages allocated to the contingency provisions are reduced. Although it is highly uncertain, current estimates indicate that the capital allocation to BSC is likely to be at the lower end of that range.

(53) So far the Reclaim Fund has authorised the release of GBP 30 million to the Big Lottery Fund. Indications are that it will release about GBP 60 million in total by summer 2012. The Board of the Reclaim Fund meets on a quarterly basis and has the power and ability to authorise quarterly releases of funds to Big Lottery Fund. However, as there is only one quarter reclaim data currently available, they are not yet able to forecast the rate of reclaim accurately and thus cannot forecast how much they will be able to release. Consequently the Reclaim Fund has a very cautious release policy and is currently expecting to release funds on an ad hoc basis only. Releases of dormant accounts are therefore likely to take place over many years.

[14] 83% of the total pool.

(54) Figure 1 below shows the funding architecture and funding flows.

Figure 1



3. POSITION OF THE MEMBER STATE

(55) The United Kingdom contends that the proposed measure is compatible under Article 107(3)(c) TFEU on the basis that it will facilitate the development of certain economic activities without adversely affecting trading conditions and competition to an extent contrary to the common interest.

(56) As a basis for its reasoning, the United Kingdom justifies the creation of Big Society Capital and its funding through public money by the fact that the funding market for social sector enterprises is affected by market failures. Those market failures lead to a funding shortage of at least GBP 0,9 to 1,7 billion per annum. The main causes of these market failures are: (1) positive externality and (2) asymmetry of information.

(57) The United Kingdom contends that the creation of BSC and its funding through dormant account money is efficient since it will close a funding gap of GBP 0,9 to 1,7 billion by injecting only GBP 0,2 to 0,4 billion of public monies into BSC.

(58) Further, the BSC is expected to improve market efficiency by: (i) improving the efficiency of the existing capital invested in the social investment market by supporting the development of more effective intermediation, including a wider range of services, currently too costly for the (small) investment market to develop easily itself. That development will increase the quantity of capital invested in the SIFIs by raising the sector's profile, demonstrating results and improving information; and (ii) addressing the externality directly by increasing the supply of capital available to the SIFIs immediately.

(59) The United Kingdom does not deny the fact that the proposed measure contains aid but contends that frontline social organisations will be the final recipients of the aid and that aid is therefore concentrated at that downstream level.

(60) The United Kingdom further contends that its intervention creates virtually no distortion to competition or trade because (1) BSC will be operating in the "missing market" for social benefit which is, by nature, not valued by or contested by the private sector, and (2) the

overall 'distortion' which the BSC creates will actually move the market to a more socially optimal level of output.

(61) As regard competition distortions at the level of BSC that might potentially affect enterprises providing financial services to SIFIs, the United Kingdom contends that there are actually no profit-maximizing wholesale competitors to the BSC. For the UK government, the wholesale market for financing SIFIs is ignored by private entities because the cost is greater than the return.

(62) As regards the risk of BSC entering into direct competition with any SIFIs or private investors operating at the retail level, the United Kingdom recalls that the 2008 Dormant Accounts Act, on the basis of which public monies are attributed to BSC, specifies that those monies must be utilised by a social investment wholesaler, thus guaranteeing that BSC will remain a wholesale institution.

(63) As regards the fact that the Merlin banks could get supernormal returns from their investment in BSC and therefore derive a (limited) profitability advantage, the United Kingdom contends that the terms on which each of the Merlin bank invest in BSC are […]. Although entitled to distribution on their preferential shares, the Merlin banks do not expect a financial return from their BSC investment in line with their usual commercial practice. The risk-adjusted returns are noticeably lower than those offered on comparable risk investments elsewhere in the financial sector. Moreover, they are below the costs of capital. […] […] In the context of the wider discussions on the project "Merlin", the major UK banks seek to improve their contribution to society in the wake of the recent financial crisis.[15]

(64) As regard competition distortions at the level of SIFIs that might potentially affect financial institutions investing in frontline social organizations, the United Kingdom contends that there will be no commercial competitors to intermediaries for the type of investment BSC is enabling. In addition, the United Kingdom committed that BSC will ensure through the investment process that SIFIs will not use investment from BSC to invest in frontline sector organisations that are able to obtain finance from elsewhere. The UK government is particularly keen to ensure that no existing private sector capital is displaced as such an outcome would be less effective. The UK authorities therefore consider that the aid to the SIFI would be compatible directly under Article 107(3)(c) TFEU.

(65) As regard frontline social sector organisations, who will be the final recipients of the aid (through the SIFIs), they usually compete with private sector firms in the market place. However, since aid to frontline social sector organisations will be delivered entirely under the existing General Block Exemption Regulation ("GBER")[16], the *de minimis* Regulation[17] and, in exceptional cases, under the market economy investor principle, the UK is not

[15] Project Merlin – Banks' statement, point 4.7. http://www.hm-treasury.gov.uk/d/bank_agreement_090211.pdf

[16] Commission Regulation N° 800/2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General block exemption Regulation), OJ L214, 9.8.2008, p. 3.

[17] Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to de minimis aid, OJ L 379, 28.12.2006, p. 5.

seeking new State aid exemptions. However, it provided a description of the procedure it will put in place to ensure compliance with those rules[18].

(66) The UK authorities seek clearance of the measure for a period of at least seven years. They argue that BSC needs to guarantee long-run support for the social finance market, particularly to long-term co-investors. Moreover, as the social investment market is so immature, investments can often take two years or more to create. Hence the need to have a sufficiently long State aid clearance for BSC, to give confidence to the emerging social finance market.

4. ASSESSMENT

4.1. Presence of State aid

(67) By virtue of Article 107(1) TFEU *"any aid granted by a Member 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 shall, in so far as it affects trade between Member States, be incompatible with the internal market."*

[18] The UK authorities have indicated that BSC will ensure that SIFIs respect the standard procedures both for de minimis and for block exemptions. Concretely, SIFIs delivering BSC funding to the frontline level will be required to:

(i) Ask all frontline social sector organisations applying for investments to identify the value of all other State aid they are receiving over the three year period;

(ii) Assess the aid intensity of the proposed investment by finding the difference between the (relevant) State aid reference rate and the interest rate charged to the frontline social sector organisation. That difference is then used to calculate the net present value of the investment for the entire period of the investment at the time of the issuance ;

(iii) Total (i) and (ii) to ensure that the value does not exceed 200,000 Euros over three years;

(iv) Write to the recipient outlining explicitly that they are receiving de minimis aid and the value of the award in Euros. The letter must also include the following paragraph: “Under EC Regulation 1998/2006 (de minimis aid regulation), this is a de minimis aid. There is a ceiling of €200,000 for all de minimis aid provided to any one firm over a 3-year period. Any de minimis aid awarded to you under this offer letter will be relevant if you wish to apply, or have applied, for any other de minimis aid. For the purposes of the de minimis regulation, you must retain this letter for 3 years from the date on this letter and produce it on any request by the UK public authorities or the European Commission”

SIFIs seeking to invest through GBER into the frontline level will be required to assess the value of the proposed investment to ensure that it falls under the relevant threshold. They will be further required to confer with investees to confirm the eligibility of the recipient frontline social sector organisation. The SIFIs will be required to notify the aid granted to the Commission within 20 working days and to publish details of the aid on its website.

The UK authorities have undertaken to ensure that the correct method for calculating the aid element, as laid down in the Commission's Reference Rate Communication, will be applied by the aid beneficiaries.

According to the UK authorities, it is conceivable that in some exceptional cases investments by SIFIs into the frontline level could be compatible on the basis of the market economy investor principle (MEIP). Under that scenario, funding would be provided on market terms, pari passu with a private co-investor. Such investments by SIFIs are permitted provided that the co-investor (i) is investing on purely commercial terms; (ii) is investing on identical terms, including an equal amount of collateral/security; (iii) would have invested without the support of the intermediary; (iv) is providing a material proportion of the investment (at least 30%). Any investment that respects the MEIP would not be regarded as State aid.

The UK authorities argue that the MEIP scenario is not likely to be used because there is no market for investment in the social sector.

(68) In order for a measure to constitute State aid within the meaning of Article 107(1) TFEU it has to fulfil four conditions. Firstly, the aid is granted by Member State or through State resources. Secondly, the measure confers a selective advantage to certain undertakings or the production of certain goods. Thirdly, the measure is liable to affect trade between Member States. Fourthly, the measure distorts or threatens to distort competition in the internal market.

4.1.1 State resources

(69) The concept of State aid applies to any advantage granted directly or indirectly, financed out of State resources, granted by the State itself or by any intermediary body acting by virtue of powers conferred on it. As has been stated by the Court[19], for the measures to be qualified as State aid within the meaning of Article 107(1) TFEU, they have to derive from the State's resources, either indirectly or directly and they have to be imputable to the State.

(70) In the case at hand, BSC will be co-financed by public and private resources[20]. As far as public resources are concerned, BSC will be financed with equity investments by Big Society Trust, which in turn is funded with the English share of dormant accounts through the dormant accounts scheme.

(71) As described above, the Reclaim Fund identifies money as surplus to what it needs to meet potential customer claims. Once the Reclaim Fund transfers that surplus money to the Big Lottery Fund, the money becomes public money and neither the Reclaim Fund nor the account holders have any claim over it. The transfer is irrevocable.

(72) The 2008 Dormant Account Act provides that the Big Lottery Fund shall distribute dormant accounts money for meeting expenditure that has a social (or environmental) purpose.

(73) State resources are generally considered to be involved where funds come from contributions made from the State, are attributed by a State decision and/or and are managed and apportioned in accordance with specific legislation, even if they are administered by institutions separate from the State. In BSC's case, the transfer of the funds from the Big Lottery Fund to BSC via Big Society Trust will be implemented through a State decision (from the competent Minister). Furthermore, while BSC will operate independently of direct State interference, investment decisions made by the BSC management will comply with the conditions set out in the 2008 Dormant Accounts Act as regards the social purpose of any investment made.

(74) On the basis of the above, the Commission concludes that the funding provided to BSC by way of injecting dormant account money, under the conditions notified by the UK authorities, constitutes State resources.

(75) The Commission also observes that those State resources are provided to BSC only because it will make investment in a specific sector. It also observes that the majority of the financial resources of the BSC will come from the State resources. It therefore concludes

19 See Case C-482/99 *France v Commission (Stardust Marine)* [2002] ECR I-4397.

20 The financing from private sources is described under point 2.6.1 above.

that the money injected by BSC into the SIFI and social financial instruments will constitute State resources (see Figure 1).

(76) Finally, since the SIFIs and social financial instruments will receive money only to invest into frontline social undertaking, it has to be concluded that the money injected by SIFIs into the frontline social organisations will contain State resources.

4.1.2 Selective economic advantage

(77) To constitute State aid, a measure must confer on recipients an economic advantage. To verify whether an undertaking has benefited from an economic advantage, the Commission applies the criterion of the "market economy investor/creditor principle". The assessment makes no distinction between the different types of beneficiaries in terms of their legal structure or ownership (public or private). The principles of non-discrimination and equality do not exempt public authorities or public companies from complying with EU competition rules.

(78) The State's investment of capital is considered State aid in the meaning of Article 107(1) TFEU if it would not have been provided by a private undertaking under the same market conditions. If the (monetary) compensation that the State receives in exchange for the equity investments is lower than what a private investor would have requested under such circumstances, the investment target receives an economic advantage.

(79) In the case at hand, due to the cascading funding architecture of the scheme (see Figure 1), the presence of an economic advantage could theoretically be localised at four levels[21]:
- the level of the Merlin banks;
- the level of BSC;
- the level of SIFIs and social investment funds;
- the level of frontline social sector organisations.

The Merlin banks level

(80) The Commission has to assess whether Merlin Banks obtain an economic advantage through their investment in BSC due to the fact that the State also participates in the capital investment by injecting public funds. Each of the four banks has agreed to invest GBP 50 million in return for shares.

(81) According to a consultancy report[22] the internal rate of return (IRR) expected for the Merlin banks will be […], i.e. below the market rate of return for equally risky investments (which would be between 7% and 11.5%). […] […] […].

(82) The Commission observes that the Merlin banks' investment is senior to the public funds (Big Lottery Fund contribution of dormant account money) in case of wind-down. That structure reduces the credit risk for the banks in case of a wind-down; therefore, the risk taken resembles the risk of a senior lender. However, the remuneration is not senior to that

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21 By analogy to point 3.2 of the Risk Capital Guidelines, OJ C 194, 18.8.2006, p. 2.

22 […]

on the public money and it will not be paid first. The remuneration on the Merlin banks' investment is not pre-determined as in the case of a loan, but consists of uncertain future distributions similar to those of ordinary shares. Therefore, the volatility of the future remuneration constitutes a risk. […]

(83) Therefore, the Commission agrees with the conclusion of the […] report that the dividend income which can be expected by the banks is not sufficient recompense for the risk of the hybrid instrument held by the Merlin banks. Consequently, the Commission considers that there is no advantage conferred to the Merlin banks. They are therefore not recipients of State aid within the meaning of Article 107(1) TFEU.

The BSC level

(84) The Commission has to assess whether the capital injection of public funds (dormant account money) confers an economic advantage to BSC.

(85) The remuneration on the dormant account money invested into BSC will be the same as that of the Merlin banks. As concluded above in respect of the Merlin banks, the expected remuneration is too low in respect of the risk of the instrument. The shares to be received by the State will, in case of wind-down, be junior to the shares which will be granted to the Merlin banks. They therefore will have a higher risk and would require a higher remuneration than the banks' shares to be line with market conditions. Having already concluded that the remuneration on the Merlin banks' share is below market rate, it can be deducted that the remuneration on the State's shares is (even more) below market rate. It is therefore clear that BSC could not have found similar capital on the market. That capital will allow it to operate. The Commission concludes that the injection of dormant account money will provide a selective economic advantage to BSC.

The level of intermediaries (SIFIs and funds)

(86) It is the key goal of the BSC project to develop the sector of SIFIs and social investment funds. The starting point of the project is that those SIFIs and social investment funds are underdeveloped because they can only attract limited money from investors. BSC will precisely invest where the market does not provide financing. While the expected return of certain investments in SIFIs and funds will be clearly positive (i.e. more than break even), it will always be below the rate which would theoretically be required by the market for a similar investment (i.e. investment by BSC on concessional terms). SIFIs and funds will therefore have an economic advantage because they get capital (including subordinated loans) from BSC that they would not get from the market otherwise, and, even if a theoretical market price could be determined, the rate charged by the BSC will be lower, allowing them to get cheaper capital financing. Thus, there is no doubt that investments by BSC into SIFIs and funds confer a selective economic advantage on them. As regards the funds, since a fund as such is only an investment vehicle, it has to be clarified that the advantage is to the promoter of the fund, i.e. the company managing the investment fund and charging a management fee on the assets of the funds.

(87) The Commission notes that part of the advantage will be retained and part will be passed through to the frontline social sector. Typically, in the case of investments in funds, most of the advantage will be directly transferred to the frontline social sector through additional lending and investments in that sector. In such a case, the fund is primarily an intermediary vehicle for the transfer of resources[23]. As regards capital investments in SIFIs they may have the effect of allowing the financing of the development of new products (i.e. social investments products). Such capital investments would therefore finance own expenses of the SIFIs and not directly flow to the frontline sector; of course, if, as planned, such new products succeed to attract more funding for the financing of the frontline sector, the frontline sector will ultimately benefit from those capital investments in the SIFIs. The point here is that it is not a direct pass through; unlike risk capital, the BSC aims also at developing the SIFI sector as such, and will provide capital which is not passed through directly.

The frontline social sector level

(88) As just explained, the State will capitalise BSC to support funds and SIFIs that develop investment products for the social sector and provide funding to frontline social sector organisations (see Figure 1). BSC will precisely analyse the use which the SIFIs and funds will make of its contribution and only contribute to SIFIs and funds which provide loans and capital to frontline social sector undertakings which can not obtain such financing from the market. BSC will not provide financing to SIFIs and funds which provide financing that the market would have provided otherwise. By design there will therefore be a selective advantage to the front line social sector, which will receive lending and capital which it would not have received from the market. Concretely, such support concerns the pricing and terms and conditions of loans and equity investment. But above all, the support consists in providing funding in the first place, since frontline social sector organisations experience difficulties in obtaining funding from commercial actors on the market.

4.1.3 Distortion of competition and effect on trade

(89) When aid granted by a Member State strengthens the position of an undertaking compared with other undertakings competing in intra-Union trade, the latter must be regarded as affected by that aid. In accordance with settled case law[24], for a measure to distort competition it is sufficient that the recipient of the aid competes with other undertakings on markets open to competition. Distortions of competition and effects on trade are assumed to be present when the measure is selective, that is, when the aid improves the market position of the aid beneficiary vis-à-vis its competitors.

The BSC level

(90) Since the effect of the BSC project is similar to a scheme, the Commission considers that BSC is a mere vehicle to channel funds to the intermediary level (SIFIs and social investment funds) which it seeks to develop. Its purpose is to transfer resources rather than

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23 By analogy to point 3.2 of the Risk Capital Guidelines.
24 Case T-214/95 Het Vlaamse Gewest v Commission [1998] ECR II-717.

being a beneficiary itself. BSC is not a bank, but a social investment wholesale institution. Its business model does not foresee any other activities than investments with a social character. In its investment policy, BSC is legally bound by the provisions of section 18 of the 2008 Dormant Account Act with regard to the use of its capital, since it disposes of the English portion of dormant account funds.

(91) The UK authorities provided evidence that commercial banks are currently almost absent from the social investment segment due to perceived limited expected returns, long investment horizon, their lack of experience and the difficulties of appropriately modelling risk and return. In particular as regards investments into SIFIs, BSC does not seem to be in direct competition with commercial banks. Therefore, it seems unlikely that BSC will crowd out private financial institutions which would seek to invest in SIFIs.

(92) Even if it is unlikely, it cannot be ruled out that BSC may crowd out commercial banks and wholesale investors who might have a potential business interest in the social sector. Consequently, BSC may distort competition between financial institutions. Since several foreign institutions are active on the UK financial services market, such distortion may affect trade between Member States.

(93) The Commission concludes that, even if there is probably little distortion of competition and of trade flows, nevertheless there is aid to the BSC.

The level of intermediaries (SIFIs and funds)

(94) Competition may take place between those SIFIs and social investment funds promoters which are supported by BSC (through the provision of funding or equity) and those SIFIs and funds promoters that do not enjoy such support. Therefore, some SIFIs and funds promoters get the opportunity to develop more quickly than others in view of the favourable conditions and/or larger amount of funding provided through the BSC scheme. Since some subsidiaries of foreign financial institutions are active on the UK asset management market and financial intermediaries market, that distortion of competition may affect trade between Member States.

(95) The Commission concludes there is aid to the SIFIs and social investment funds promoters.

The frontline social sector level

(96) Similarly, frontline social sector organisations which get support from SIFIs might strengthen their position vis-à-vis their competitors. Therefore, some frontline social sector organisations could get the opportunity to develop more quickly than others in view of the favourable conditions and/or more funding provided through the BSC scheme.

(97) Even if social sector organisations tend to operate on local markets, it cannot be excluded that (potential) foreign competitors might be affected by the aid and that the aid might have an effect on trade within the internal market. It is notably the case because, as defined above (see "The social sector in the UK"), the social sector not only covers undertaking having a specific legal form which are active in a specific economic sector; it also covers

firms active in competitive sectors that reinvest the surplus they generate into their activities undertaken with a social objective.

(98) The Commission concludes that there is aid to the frontline social undertakings.

4.1.4 Conclusion

(99) For the reasons set out above, the Commission takes the view that the public funding provided by the Big Society Trust to BSC and, subsequently, the investments made by the BSC into SIFIs and funds and further by SIFIs and funds into frontline social sector organisations involves State aid within the meaning of Article 107(1) TFEU.

4.2. Compatibility of the aid

4.2.1 Assessment scope

(100) The UK authorities acknowledge that the notified measure contains aid at the level of the frontline social sector organisations, i.e. at the end of the cascade of investments. They argue that the aid will be compatible on the basis of existing State aid rules – *de minimis* or the GBER – and therefore do not seek clearance for aid at that level. In the present decision, the Commission will therefore not assess the compatibility of that aid. This decision therefore does not prejudge the compatibility of that aid.

(101) The Commission will now assess the compatibility of the aid to BSC, the SIFIs and funds promoters, and the frontline social sector.

4.2.2 Legal basis for the assessment

(102) The Commission must establish if the aid identified above can be found compatible with the internal market. Article 107(2) and (3) TFEU provides for certain exemptions to the general rule of incompatibility set out in Article 107(1) TFEU.

(103) Article 107(2) TFEU is manifestly not applicable to this aid. As regards Article 107(3) TFEU, only Article 107(3)(c) TFEU could apply.

(104) The Commission has explained in guidelines how it will apply the exemption laid down in Article 107(3) TFEU to certain types of aid. It seems that the project at stake does not correspond to any of the types of aid covered by guidelines.

(105) As far as the Risk Capital Guidelines (RCG) are concerned, the granting of State aid is justified by the necessity to address market failures, in particular an existing funding gap[25]. That principle could be applied by analogy to the investments made by BSC. However, the RCG are limited to start-ups and early stage investment with expectations of significant

[25] See point 1.1. of the Community guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, OJ C 194, 18.8.2006, p. 2: "The existence of the equity gap may justify the granting of State aid in certain limited circumstances. <u>If properly targeted, State aid in support of risk capital provision can be an effective means to alleviate the identified market failures in this field and to leverage private capital"</u> (emphasis added).

profit potential without social considerations. It is likely that the frontline social sector organisations who are the final beneficiaries of the aid would not fulfil the criterion of start-up/early stage ventures. Furthermore, many BSC interventions do not expect to realise sizeable profits. Pursuant to point 3.2 of the RCG and unless proved otherwise, aid is presumed to integrally flow down to the investee. Consequently, the compatibility analysis is done once and only at that level. By contrast, as explained above, the equity and subordinated loans granted by the BSC to SIFIs aim to help those institutions to develop. For that kind of intervention, the pass-through to front line social undertakings will only be partial. For investments of the BSC in funds, the pass-through to front line social undertakings is assumed to be nearly total. Considering the above, the RCG are not applicable to the present case. The Commission also notes that it has in the past directly applied Article 107(3)(c) in its decision on the Joint European Support for Sustainable Investment In City Areas (JESSICA) – Northwest Urban Investment Fund, UK.[26]

(106) In the absence of specific guidelines devised for the type of aid measure notified by the UK authorities, the Commission will assess the compatibility of the BSC scheme directly under Article 107(3)(c) TFEU.

4.2.3 Assessment under Article 107(3)(c) TFEU

(107) Taking into account the fact that no specific instrument of secondary EU law appears directly applicable, the Commission has examined whether the measure could be approved on the basis of Art 107(3)(c) TFEU which provides that *"aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest"* may be considered to be compatible with the internal market.

(108) To examine the measure's compatibility directly under Article 107(3)(c) TFEU, the Commission has assessed its positive and negative effects. The Commission takes into account whether the aid measure is aimed at a well-defined EU objective, is an appropriate instrument, well-targeted and proportionate to the targeted objective and does not adversely affect trading conditions to an extent contrary to the common interest. Positive and negative elements will be weighted and balanced against each other.

(109) Where appropriate, the Commission will apply by analogy criteria of the RCG to the cascading funding architecture of the BSC scheme.

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26 Commission Decision in case *SA.32835 – United Kingdom, Northwest Urban Investment Fund (JESSICA)*, OJ C 281, 24.9.2011. BSC shares with JESSICA (and the RCG) the rationale of investing through SIFIs and/or market-driven instruments to leverage available public resources and help address market failures. An additional similarity of BSC with JESSICA is that both instruments are driven not only by the need to address market failures but also by equity considerations. Unlike JESSICA, BSC will invest in some individual projects (i.e. SIFI and funds) seen as clearly non profitable ex ante (to achieve its social objective).

4.2.4 Targeting an objective of European common interest

(110) The Commission must assess whether the frontline social sector organisations supported by SIFIs through BSC meet a clearly defined objective of common European interest, which is a necessary pre-condition for State aid compliance. Furthermore, the Commission needs to examine if the notified measure is suitable to attain that objective of common European interest.

(111) The measure is designed to facilitate the development of certain economic activities, notably in the social sector, which would not have been carried out by private operators without the involvement of the State. The overall aim of the measure is to increase welfare by remedying a market failure characterised by the sub-optimal amount of funding provided to the social sector. While social projects could generate wider positive economic benefits, private investors perceive that the risks of undertaking investments outweigh potential benefits.

(112) There is no reasonable doubt as to the existence of a market failure in the form of a funding gap in the social sector due to the following reasons:

- The social sector has traditionally been funded by public monies;
- Market failure arises from the intrinsic nature of the market. The social sector is characterised by important positive externalities that lead to a divergence between the "micro" financial return of investments (which can be sometimes negative) and their "macro" return at the economic and social level (which is always positive and justifies investment each time it outnumbers the negative financial return)[27];
- Asymmetric information creates investor uncertainty; risk-modelling may be more complex. The social sector funding market is highly specific and not as well-known as other more standard markets. Consequently, market actors may be deterred from invest in profitable social projects on a risk-adjusted basis just because they tend to over-estimate the risk and fail to identify the investment opportunity;
- Evidence suggests that compared to their peers social sector organisations are more likely to be rejected for certain types of private finance, particularly for risk capital and unsecured finance, and are one-third more likely to be rejected for private overdraft finance.[28]
- Finally, the finance gap is also driven by demand as frontline social sector organisations seek 9% less private repayable finance than their private sector peers. That difference is partly a due to the lack of supply of capital but also reflects a capacity and skills gap.

(113) Consequently, by applying regression models to official data, the UK authorities estimate the annual funding gap in the range of GBP 0.9 to 1.7 billion, which represents roughly

27 For instance, investing in a manufacture of shortbread employing ex-prisoners not only addresses the demand for biscuits but also helps decrease the number of second offenders.

28 Small Business Survey by the UK Department for Business, Innovation and Skills (BIS 2010).

5.5% to 10% of the total funding needs of the social sector (which is estimated at annual GBP 16 billion).

(114) The Commission concludes that that there is a market failure in the funding of the social sector. Therefore, by trying to remedy that market failure, the notified measure would - if successful - indeed increase welfare and therefore deliver an outcome in line with the requirements of Article 107(3)(c).

4.2.5 Well-designed to deliver the objective of European common interest

(115) In order to assess if the measure is well-designed to address the defined objectives, the Commission needs to assess if the notified measure will effectively remedy market failures, i.e. situations where social projects would not otherwise be delivered by the market and private investors would not have provided necessary funding.

(116) The Commission needs to assess whether the BSC scheme is well designed to address the market failures identified above. The medium-/long-term purpose of BSC is to capitalise and develop the social finance intermediary market in the UK. Specifically, BSC will enable SIFIs to become more financially robust and able to attract investment from a more diverse range of sources, to ultimately close the perceived funding gap. Furthermore, BSC will provide support SIFIs that are developing viable, innovative products to attract investment. Those SIFIs will then provide support to frontline social sector organisations and achieve social change at that level.

Aid to BSC

(117) The Commission notes that BSC is not a bank but a "social investment wholesale institution", a vehicle to manage the investment of public money, and as such indispensable to put in place the notified aid scheme. BSC is not competing with the commercial private sector due to its focus on social investment on the missing market, i.e. there is no wholesaler to compete with. State aid will be exclusively provided to unlock those projects where the market would not undertake the activities on its own. Besides, BSC has the role of a catalyst to stimulate an overall increase in the level of social investment due to enhanced private participation.

(118) Moreover, it is recalled that BSC will only invest in SIFIs and funds which cannot find financing on the market – or cannot find sufficient financing to be viable. To assess whether a SIFI can access market financing, BSC will apply a formally defined procedure drawing on qualitative elements[29]. In that qualitative assessment, the onus will be placed on the SIFIs to justify to the BSC why they cannot raise finance elsewhere (and demonstrate that they will not be investing in frontline social sector organisations that are able to raise finance elsewhere). The risk that the BSC will crowd out other investors is therefore very limited. The BSC seems therefore well designed to target the SIFIs and funds suffering from the market failure identified above.

[29] Since no market exists, it would indeed be difficult for the SIFIs to provide formal evidence for lack of funding, like a refusal letter. Hence the need to rely on qualitative criteria. See Footnote 34.

Aid to SIFIs

(119) If social investment is to happen at an appropriate scale, effective and efficient intermediation is vital. However, at present the social finance intermediary market is not yet mature and fails to respond to the financing needs of frontline organisations, leading to a funding gap. Therefore, the rationale of the BSC scheme is to foster and strengthen the social finance intermediary market, in particular by developing the following areas: capitalisation and balance sheet growth of SIFIs to enable on-lending to the frontline level; risk and working capital for the SIFIs' high risk business model; market mechanisms and infrastructure to encourage investment; and finally the provision of advice, skills and information by SIFIs to frontline organisations.

(120) On the basis of the above, the Commission concludes that the notified measure is well targeted to address the current shortcomings of the social finance intermediary market, which, if resolved, will allow attracting more funding to fund the social sector undertaking and thereby close the funding gap.

4.2.6 Proportionality

(121) The Commission must assess whether the aid provided through the measure is proportionate to the targeted objective and limited to the minimum necessary.

(122) First, the Commission notes that BSC interventions are devised to close a funding gap and address acknowledged market failures: BSC will not provide capital financing to SIFIs or funds which can find such financing on the market, but only to SIFIs and funds which can prove that they have no access to market funding. Also, as explained previously, BSC will not carry out any other type of lending or investments.

(123) Second, BSC's investment policy will be subject to precise diversification rules. Exposure to individual SIFIs will be capped at GBP 15 million initially and then at 10 % of the total BSC portfolio once BSC has reached the GBP 150 million investment threshold. The cap will subsequently be reduced by 0.5 percentage points for every GBP 25 million added to the portfolio up to 5% (corresponding to an increase of the portfolio to GBP 550 million). Those rules reconcile the objectives of maximising the impact of BSC's investments (by avoiding excessive dispersion of interventions) with basic prudential considerations and the goal of developing a market, i.e. fostering the largest possible number of actors.

(124) Third, capital and subordinated loans given to SIFIs will not be for free, they will seek a positive return albeit below market rates.[30] Those positive returns ensure that the aid element is kept at a minimum. When investing into SIFIs, BSC will mix profitable and clearly concessional investments in such a way that the overall balance remains positive at the level of BSC accounts, while reconciling the two main objectives – maximising social effects and being financially self-sufficient.

[30] BSC will not give grants, even though some loans will be made available at concessional terms.

(125) SIFIs with an intrinsically less profitable investment strategy, but with a higher social leverage, might thus get funding from BSC at more favourable terms than others which are able to pay a higher remuneration. Those potential differentiations between SIFIs are inherent in the main goal of BSC of developing the market and accelerating its maturation by helping SIFIs to grow. However, the corporate governance safeguards put into place ensure than the terms granted to SIFIs will be justified by objective criteria and their effective contribution to market development and/or social change[31].

(126) In conclusion, financing to a SIFI will be provided on concessional terms only if the business plan of the SIFI does not allow it to pay a higher remuneration[32]. The Commission therefore concludes that the aid is limited to the minimum in the sense that the price charged does not allow the SIFI to make excess profit.

4.2.7 Effect on trade and distortion of competition

(127) The Commission has to examine whether the aid provided through the measure leads to disproportionate distortions of competition and detrimental effects on trade within the internal market.

(128) As regards the capital injection of GBP 400 million into BSC and BSC's further investments into SIFIs, the UK authorities have provided evidence that there is currently no social investment wholesaler to compete with. That evidence indicates that commercial institutions are almost completely absent from that market.[33] The wholesale market for financing SIFIs is ignored by private entities because the cost is greater than the return.

(129) BSC will therefore face no competition because unlike BSC, commercial banks are not in a position to value and capture social benefits (i.e. the externality leading to a positive global marginal benefit, whereas marginal financial benefits remains close to zero or negative on

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[31] The notification indicates that " Any equity, quasi equity, risk/working capital or debt investment must be shown under rigorous stress testing to generate a sufficient financial and social return commensurate with the underlying risk assumed, over a time frame. This means that the BSC will need to balance the overall levels of financial risk it takes in pursuance of social objects with the need to generate sufficient financial returns to remain operationally viable." In practice, applications for investments will be reviewed by the investment team at BSC on a weekly basis. Investment decisions will be made by the credit committee on a monthly basis. The board of the BSC, which is made of independent members, is the ultimate level which will control that the balance is struck between reaching the social objectives and remaining self-funded. The UK authorities stress that granting financing at terms more favorable than what the SIFI could bear, would certainly not allow achieving that financial objective.

[32] The notification indicates that "*Internal risk assessment is fundamental to the investment process; we will stress test underlying assumptions to see the impact on financial and social key performance indicators. If our initial due diligence is compelling, we will complete a process of internal re-modelling of the business plan as a robustness check, complete stress-testing on key risk areas and finally explore areas for potential outperformance. This process will help to establish the correct key performance indicators (KPI's), both financial and social, which will form the basis for on-going monitoring and management of the investment.* ***In addition this will help us understand what the correct terms of the proposed investment should be***."(emphasis added)

[33] A Boston Consulting Group and Young Foundation survey (2011) found that only 1% of SIFI balance sheet funding was capitalised by banks and commercial institutions, while only 7% came from social institutions (such as trusts and foundations).

risk-adjusted terms). Given its main goal of creating/developing a market, BSC will develop investment processes to ensure that it will not capitalise SIFIs or funds for investments to the frontline social sector organisations where the private sector would already lend at viable rates (typically, the commercial banks provide to the frontline sector lending when they can offer collateral.)

(130) The 2008 Dormant Accounts Act specifies that the money from dormant accounts must be utilised by a social investment wholesaler, thus guaranteeing that BSC will remain a wholesale institution and not enter into any direct competition with any SIFIs or private investors who operate at retail level.

(131) BSC's business model contains safeguards as to avoid potential crowing out of commercial operators. As part of the investment process, BSC will require evidence from SIFIs and funds that they are unable to access the finance they are requesting from elsewhere.[34] BSC will also request that the SIFIs and funds in which it invests require evidence from the frontline social sector organisations in which they invest that they can not find the requested financing from the market. A key consideration for every investment will therefore be the existence (or lack of) other providers of capital to address any given capital request.

(132) Considering that (i) by design BSC should normally not lend in competition with commercial entities, which are currently absent from this market; (ii) BSC is a mere funding vehicle to set up an aid scheme to SIFIs/funds; (iii) BSC is planned to have no activities other than pursuing a social purpose; (iv) BSC will reinvest any surplus generated in pursuit of its social mission, and (v) BSC's relatively limited size (maximum GBP 400 million of dormant account money and maximum GPB 600 million balance sheet size), it can be assumed that there will be only limited distortions of competition on the banking market.

(133) The Commission notes that the UK authorities do not intervene directly (e.g. by means of providing grants) or set up a public fund that would effectively be in competition with other existing intermediaries and could potentially crowd out the market. Instead, public funds are invested through existing investment intermediaries and any qualified intermediary can participate. However, as indicated above, it cannot be excluded that some SIFIs get the opportunity, through better conditions and/or more funding, to develop more quickly than others in view of their perceived contribution to market growth and/or social change. That is inherent to the rationale of the BSC project.

(134) In view of the above-mentioned safeguards the aid to BSC and to the SIFIs and funds can be deemed to have overall limited distortive effects. In particular, thanks to the design of the measure, crowding out of other financial institutions by BSC and of other investors in frontline social sector undertakings by aided SIFIs and funds seems unlikely.

[34] BSC will assess each application from a SIFI against a set of criteria to determine whether market funding could be obtained. The criteria scrutinised are, among other things: liquidity of the investment; the business plan/business model; expected risk adjusted returns; social impact; percentage of profit reinvested etc. Likewise, SIFIs will scrutinise applications of frontline social sector organisations against the same criteria.

(135) However, the Commission notes that it is an innovative project, for which no similar precedent exists. All the above reasoning is based on an ex-ante assessment of the plan and not on experience based on the observations of the effect of similar projects.

(136) In conclusion, the Commission finds that aid to BSC and SIFIs and funds is compatible with the internal market on the basis of Article 107(3)(c).

4.2.8 Balancing test

(137) The Commission considers that the UK sufficiently demonstrated that the aid would change the behaviour of the beneficiaries in favour of achieving an objective in the common European interests. Accordingly, the Commission considers that the supported social projects have value for the EU.

(138) Given that the beneficiaries would not have carried out the projects without the aid and taking into consideration the common European interest, those positive effects for the EU appear to outweigh the potentially negative effects of the aid, which seems to be necessary for realising social investment projects.

(139) As to potential distortion of competition, the measure does not distort the proper functioning of the internal market and does not produce significant disparities between undertakings established in different Member States and/or in the location of the production factors within the EU.

5. CONCLUSION

(140) The Commission concludes that the measure notified by the UK authorities constitutes State aid within the meaning of Article 107(1) TFEU. The beneficiaries are BSC and the SIFIs and funds promoters supported under the scheme. The aid can be found compatible on the basis of Article 107(3)(c) TFEU.

(141) As regards the aid at the level of the frontline social sector undertakings, it is not covered by the present decision.

(142) Regarding the duration of the approval, the Commission considers that safeguards are required given that the UK has chosen a novel approach with regard to financing the social sector by means of developing the market for SIFIs. The Commission therefore needs to verify whether the assumptions made, notably regarding the future effect of that new system on competition and trade, are correct.

(143) As regards aid to the BSC, the approval by the present decision is limited to the notified capital injection of GBP 400 million of dormant account money. Any amount exceeding that limit requires a new notification under State aid rules. Similarly, the approval by the present decision is only valid as long as the balance sheet total of BSC remains smaller or equal to the GBP 600 million contained in the notification. As soon as that threshold is exceeded, the aid to the BSC would not be covered anymore by the present decision. Re-

notification would therefore be required if BSC's balance sheet were to exceed GBP 600 million.

(144) As regards aid to SIFIs (including infrastructures) and funds, the present decision finds compatible investments made by BSC during five years from the date of the present decision. Any investments granted (i.e. contractually committed) after five years would not be covered by the present decision. If it wishes to continue granting aid to SIFIs and funds promoters, the UK would have to notify a prolongation of the scheme. That approach will in particular allow the Commission to verify how BSC's investments are decided in practice, how the pricing is determined in concrete cases and how it is ensured that distortions of competition are limited at that level. It will also allow the Commission to verify if the notified measure will still be well targeted in view of a possible evolution of the social investment intermediaries market.

6. DECISION

(145) The Commission considers the capital injection of GBP 400 million of dormant account money into the BSC is compatible with the TFEU on the basis of Article 107(3)(c) and has accordingly decided not to raise objections to the notified measure. That approval is limited to a capital injection of dormant account money of maximum GBP 400 million. Any increase above that amount is not within the scope of this decision.

(146) The above approval ends once the total of the BSC balance sheet exceeds GBP 600 million.

(147) The Commission further considers that BSC's investments into SIFIs and social investment funds as described above are compatible with the TFEU on the basis of Article 107(3)(c) and has accordingly decided not to raise objections to the notified measure. That approval is limited to a time window of five years from the date of the adoption of the present decision. Any extension beyond that five-year period would require a formal notification from the UK authorities and approval by the Commission.

(148) The Commission reminds the UK authorities of their obligation to ensure compliance of aid to the frontline social sector organisations with existing State aid exceptions, notably the *de minimis* Regulation and the GBER. The present decision does not take a position on the compatibility of aid at the level of the frontline social sector organisations.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: http://ec.europa.eu/eu_law/state_aids/state_aids_texts_en.htm

Your request should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
Directorate for State Aid
State Aid Greffe
B-1049 Brussels
Fax No: (0032) 2-296.12.42

Yours faithfully,

For the Commission

Joaquín ALMUNIA,
Vice-President