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Subject: State Aid SA.44887 (2016/N) – United Kingdom – First Prolongation and Amendment of The Big Society Capital

Sir,

1. PROCEDURE

(1) On 20 December 2011, the Commission approved the Big Society Capital ("the BSC") until 20 December 2016 by its decision in State aid case SA.33683 ("the original decision")[1]. The Commission found the measure by which BSC received GBP 400 million from the UK authorities ("the measure") to be compatible with the common market, pursuant to Article 107(3)(c) of the Treaty on the Functioning of the European Union ("TFEU") in the original decision,

(2) After pre-notification contacts between March and July 2016, on 17 August 2016, the UK notified a prolongation of the BSC until 20 December 2026.

[1] Commission decision of 20 December 2011 in State Aid case SA.33683 (2011/N) "Big Society Capital", OJ C 50, 21.02.2012, p. 2.

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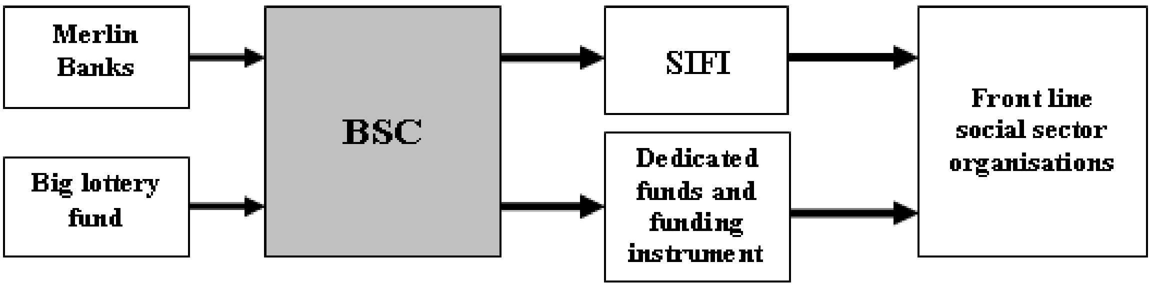
2. DESCRIPTION OF THE BSC AND ITS FUNDING

The BSC

(3) The UK authorities established the BSC to help frontline social sector organisations[2] increase their impact within society by improving their access to affordable finance. To achieve this, the BSC supports development and market growth for social investment products in the UK for both social and financial return by providing financing to Social Investment Finance Intermediaries (SIFIs) so they can become more robust, and accordingly lend and provide business support services to social sector organisations.

(4) The social investment products under the BSC were developed to stimulate the intermediary function between investors and social undertakings as this area was underdeveloped prior to the existence of the BSC. A description of the measure and other sources of funding are described in recitals (5) to (8) below.

Figure 1. Overview of the BSC



Funding from public resources

i. The BSC level

(5) The BSC is a statutory body created by virtue of section 18 of the Dormant Account Act 2008. Moreover, the BSC is not a bank, but a social investment wholesale institution. Further to the original decision, the UK government capitalised the BSC with dormant funds from English bank accounts for up to GBP 400 million[3]. The allocation mechanism for dormant account monies to the BSC involves two intermediary institutions: (i) the Reclaim Fund; and (ii) the Big Lottery Fund[4]. The above structure has not changed since the original decision. The Commission concluded at recital (140) of the original decision that funding to the BSC constituted State aid within the meaning of Article 107(1) TFEU and the aid was compatible on the basis of Article 107(3)(c) TFEU.

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[2] Primarily describe themselves as non-profit making organisations.

[3] The Dormant Accounts Act 2008 was passed to enable this funding source.

[4] The Reclaim Fund was established by Cooperative Financial Services and was authorised by the Financial Services Authority in March 2011. The Reclaim Fund is a private body which manages private funds and has the responsibility of deciding how much money should be transferred to the Big Lottery Fund.

(6) The BSC uses the total funding to either directly invest in SIFIs, or provide them with subordinated capital.

ii. The level of the intermediaries (SIFIs and funds)

(7) SIFIs are mainly social sector organisations which primarily describe themselves as non-profit making organisations; they provide a link between socially conscious investors and frontline social sector organisations. In addition, SIFIs are diverse in nature as they take a variety of legal forms ranging from trusts, to companies limited by guarantee, industrial and provident societies limited by shares, community interest companies, trust and limited liability partnerships. SIFIs and social finance instruments receive funding from the BSC solely for the purpose of investing into frontline social undertakings. Furthermore, the BSC will only provide funding to SIFIs and social finance instruments that provide loans and capital to frontline social sector undertakings which are unable to obtain such financing from the market – the BSC is unequivocal in respect of this approach. The above structure has not changed since the original decision Therefore, the Commission concluded at recital (140) of the original decision that funding to SIFIs and social finance instruments constituted State aid within the meaning of Article 107(1) TFEU and the aid was compatible on the basis of Article 107(3)(c) TFEU.

iii. The level of the frontline social sector

(8) As mentioned in recital (7) above, SIFIs and social finance instruments only provide funding to frontline social sector undertakings which are unable to obtain funding from the market. The Commission concluded at recital (99) of the original decision that financing at the level of the frontline social sector constituted State aid within the meaning of Article 107(1) TFEU. The aid at the level of frontline social sectors is not covered in the original decision, since the UK argued (at recital 100 of the original decision) that all support at this level was going to be *de minimis*[5] or covered by the General Block Exemption regulation (GBER)[6] and did not seek clearance with regard to this support. This position has not changed with regard to the present notification.

Funding from private sources

(9) HSBC Plc, Barclay's Bank Plc, The Royal Bank of Scotland Plc and Lloyd's Banking Group Plc (collectively referred to as "the Merlin banks") have each agreed to make a capital injection of GBP 50 million into the BSC. The Commission concluded at recital (83) of the original decision that the dividend income which could be expected from the Merlin banks in respect of their investment is insufficient recompense for the risk incurred by the banks. To this end, the Commission concluded that the Merlin banks were not recipients of State aid within the meaning of Article 107(1) TFEU.

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[5] Commission Regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty of the Functioning of the European Union to *de minimis* aid, OJ L 352, 24.12.2013, p.9.

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

(10) According to the UK, frontline social sector organisations were unable to access finance as private investors were unwilling to lend, due to misconceptions in respect of risk and returns. Therefore, the BSC was set up in order to address this market failure through the use of GBP 600 million it received from the private banking sector and State resources.

(11) A comprehensive description of the measure is at recitals (2) to (66) of the original decision.

3. AMENDMENTS NOTIFIED BY THE UK

(12) The primary objective of SIFIs is to provide, facilitate or structure financial investments to organisations that have a primary objective of achieving a positive social impact and to provide business support to those organisations.

(13) Taking into account the observations submitted by the UK in its notification dated 17th August 2016, the UK believes that the measure approved in the original decision requires a few amendments (see recitals (14) to (15) below) to allow the BSC to achieve its objectives. This is because despite demonstrable progress, a market failure still exists in respect of SIFIs gaining adequate financing from the market. Therefore, the UK asks that the measure be prolonged, and that the BSC receives additional State aid, private financing and flexibility in respect of its diversification policy so that it can adequately finance SIFIs and address the issue of market failure.

Increase of State funding

(14) According to the notification, the UK authorities seek to increase State aid funding beyond the original GBP 400 million cap to GBP 600 million in respect of the BSC.

Other amendments

(15) The UK authorities also seek to:

i. prolong the BSC for 10 years, until 20 December 2026;

ii. allow the BSC to fund itself by acquiring debt from private sources for up to GBP 300 million, i.e. apply for a loan; and

iii. allow the BSC Board to have more discretion in respect of its portfolio diversification policy by removing the cap which requires a reduction of 0.5 percentage points for every GBP 25 million added to the portfolio up to 5% (corresponding to an increase in the portfolio to GBP 550 million)[7].

[7] See recital 123 of the original decision.

4. ASSESSMENT

4.1. Existence of State Aid

(16) According to 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.

(17) For the reasons indicated in the original decision[8], the Commission found that the public funding provided by the Big Society Trust[9] to the 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. The notified amendments to the measure do not affect this assessment. Therefore, the measure – including the additional GBP 200 million State funding - still constitutes State aid within the meaning of Article 107(1) TFEU.

(18) An increase in the State aid amount is viewed as an increase in the aid amount to the BSC and the SIFIs and social finance instruments.

4.2. Compatibility

4.2.1 Legal basis for the compatibility assessment

(19) The Commission assessed whether the measure was compatible at the level of the BSC and the SIFIs and social finance instruments at recitals (100) to (144) of the original decision and concluded that it was compatible for five years.

(20) The Commission must establish whether the UK's request to increase the amount of aid in recital (14), the prolongation and the two further amendments described in recital (15) of this decision would adversely affect the conclusion in the original decision that the measure is compatible with the internal market.

(21) As there are no specific Commission guidelines applicable to the measure at stake (as modified by the notified amendments), the Commission has assessed the compatibility of the amendments against Article 107(3) TFEU.

(22) In particular, the Commission has examined whether the request to increase the aid amount in recital (14), the prolongation and the two amendments in recital (15) of this decision can be approved on the basis of Article 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.

(23) In its assessment, the Commission looked at the positive and negative effects of each of the amendments in order to verify if, and to what extent, they affect the

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8 See recitals 67-99 of the original decision.

9 The Big Society Trust is the holding company of BSC.

compatibility of the measure. In particular, the Commission assessed whether the BSC, as modified by the notified amendments, would remain (i) appropriate; (ii) necessary; and (iii) proportionate.

4.2.3 Compatibility assessment of the amendments

Appropriateness

(24) In its notification, the UK authorities requested that the measure be prolonged for ten years, until 20 December 2026.

(25) The UK authorities have identified that there is still a need for the BSC, and consequently, for the UK authorities to pay State aid to the BSC, as a financing gap for social sector organisations still exists, in addition to inefficiencies in the social investment market.

(26) The BSC envisages that it should be able to make approximately GBP 70 million worth of investment commitments within 10 – 20 organisations each year until 2026. However, since the inception of the BSC, the UK authorities have realised that there is often a significant time delay between the signature which authorises the investment commitment, and the actual use of the investment by the SIFI.

(27) Neither the UK authorities, nor the BSC can exercise control as to when the SIFI should use or 'drawn down' the investment once it has found a suitable social sector organisation to invest in. When a social sector organisation is deemed appropriate to receive the investment, it often needs to build its capacity[10] before it can actually receive the investment – this inevitably leads to a time delay.

(28) In addition, as mentioned in recital (53) of the original decision, the Reclaim Fund has a cautious approach in respect of releasing funds and tends to release funds on an ad hoc basis; therefore the release of funds from dormant accounts takes place over many years.

(29) The BSC forecasts its expected commitments and draw-downs over a 5-year period as outlined in Figure 2 below:

[10] For example, social sector organisations need to negotiate complex contracts.

Figure 2. Big Society Capital forecast (assuming GBP 600 million of capital)

Year / £m	Total Capital Inflow	Investments signed (gross of redemptions)	Investments drawn down (gross of redemptions)
2012	119.4	19.4	5.3
2013	106	28.7	8
2014	80	110	22.9
2015	51.5	105	63.3
2016	57.2	66.7	92.7
2017	87	80	73.4
2018	40.7	70	81.5
2019	46.1	70	77
2020	12.1	70	79.1
Cumulative	600	619.8	503.2

(30) The above table demonstrates that based on its most recent forecast, the BSC's capital will not be drawn down by 2020 (in 4 years). The Commission observes that the duration of ten years would be appropriate, as a shorter period would not be sufficient for the SIFI market to fully develop in respect of social investment. A ten year prolongation would provide the BSC with adequate time to scope for suitable investments, address the market gap, and allow for the delay experienced between the signature which authorises the investment commitment, and the actual use of the investment by the SIFI.

(31) The Commission notes that the financing gap concerning the social sector in the UK is much larger than originally expected; therefore, the UK authorities seek to increase the start-up capital which was originally made available to the BSC to address this issue.

(32) It has come to light to the UK authorities that the money available in dormant accounts is much greater than originally anticipated. The UK authorities inform the Commission that an increase in capital to the BSC could increase investment activity in the next ten years, which would help to address the financial gap experienced by social sector organisations.

(33) The UK authorities informed the Commission that one of the challenges faced since the inception of the BSC, is the BSC's inability to commit itself to

investments which are in excess of its capital funds. Therefore the UK authorities would like the BSC to take on private debt from private sources to fund itself, so that it has the option to commit beyond its capital funds if an investment requires this. The option to acquire private debt would address uncertain cash flow scenarios of the BSC's investments which would ultimately assist its prudent liquidity management. The Commission is therefore of the view that this amendment is appropriate to enable the BSC to meet its objectives of ensuring that SIFIs are sufficiently financed.

(34) It is anticipated that the quantum of potential private debt would be approximately GBP 200 – 300 million, which would be senior to equity holders; however, any private debt would be subject to the investment mandate agreed in the original decision.

(35) The Commission concludes that that the amendments to the BSC would be appropriate as a ten year prolongation is required to ensure that the SIFI market is able to fully develop in relation to social investment – this is the essence of the BSC's aim. Furthermore, the funding increase in respect of the measure is appropriate to ensuring that the BSC can close the large financing gap which is experienced by the social sector. The Commission also concludes that allowing the BSC to fund itself by acquiring private debt would enable it to address uncertain cash flow scenarios and such prudent financial planning is sensible and appropriate. Therefore, after assessing the notified amendments, the Commission is of the view that they do not adversely affect the compatibility assessment made in the original decision as regards the appropriateness of the measure.

Necessity

(36) The BSC has had a positive impact on the growth and development of the social investment market; however, the creation of the BSC has still not fully addressed the financing gap which still exists for SIFIs and frontline social sector organisations. Therefore, a market failure still remains, and in fact, the Commission observes that this could be even further defined as a 'missing market' as it creates no distortion of competition taking into account that the BSC is the only organisation operating in this way for social benefit. The market which the BSC addresses is not valued or contested by the private sector; in addition, the BSC does not have any profit-maximising wholesale competitors.

(37) In addition, the Commission notes that since the inception of the scheme, the UK authorities have committed themselves to assessing the social investment market and the BSC's performance through a range of key performance indicators. This, juxtaposed with the economic forecast concerning investments at Figure 1, assures the Commission that the prolongation of the measure for ten years is necessary.

(38) The Commission notes that the BSC can only continue to stimulate the social investment market if it has the ability to fund more SIFIs, social finance instruments and frontline social sector organisations. To this end, the UK's ability to increase its capital to the BSC from GBP 400 million to GBP 600 million would help the BSC to address the ongoing market failure in the social investment market.

(39) The UK authorities' request for the BSC to take on private debt from private sources to fund itself is essential to enabling the BSC to commit itself to investments which are in excess of its capital funds in instances when an

investment project requires this. Therefore, the Commission is of the view that the possibility to take on private debt from private sources is necessary for the BSC to function correctly.

(40) The Commission concludes that the prolongation of the BSC for ten years is necessary to ensure it can adequately address the financing gap which still exists for SIFIs and frontline social sector organisations. In addition, allowing the UK authorities to increase the measure from GBP 400 million to GBP 600 million and permitting the BSC to fund itself by acquiring private debt, is essential to ensuring that the BSC has sufficient funds to allow it to adequately finance SIFIs and frontline social sector organisations. Therefore, the Commission is of the view that the notified amendments do not adversely affect the compatibility assessment made in the original decision as regards the necessity of the measure.

Proportionality

(41) In respect of proportionality, the UK authorities explained that the significant delay between the signature which authorises the investment commitment, and the actual use of the investment by the SIFI prolongs the actual measure, to the extent the BSC's capital will not be drawn down by 2020 (in 4 years), or by 2021 (in 5 years)[11].

(42) The Commission notes that the purpose of the BSC is to close the financing gap experienced by the social investment market and address the ongoing market failure. The BSC will not provide capital financing to SIFIs or funds that can find financing on the market. In addition, the Commission notes that the BSC does not have profit-maximising wholesale competitors. The Commission observes that even with the increased funding of GBP 200 million, this would not be disproportionate in respect of the BSC achieving its objectives.

(43) Similarly to the request to increase State funding to GBP 600 million, the Commission notes that acquisition of private debt will only be used to further the objective of the BSC which is to close the financing gap experienced by the social investment market and address the ongoing market failure. Again, the Commission observes that even with the acquisition of private debt, this would not be disproportionate in respect of the BSC achieving its objectives.

(44) The UK authorities seek to allow the BSC Board to have more discretion in respect of its portfolio diversification policy by removing the cap which requires a reduction of 0.5 percentage points for every GBP 25 million added to the portfolio up to 5% (corresponding to an increase in the portfolio to GBP 550 million)[12].

(45) According to the UK authorities, an amendment to the diversification portfolio would ensure that the BSC could continue to further its objective to encourage a sustainable social investment market. Removing the cap referred to in recital (44) above, would provide the BSC board with the required flexibility it needs to manage risk areas as the market develops.

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[11] See recitals (24) to (30) of this decision.

[12] In the original decision the Commission considered the compatibility of the BSC with the internal market by considering the precise diversification rules at recitals (121) to (126).

(46) The Commission observes that, although the UK seeks the cap removal mentioned in recital (44), the diversification rules are still in place and stipulate that 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. That remaining diversification requirement seems sufficient to ensure that the BSC continues to develop several SIFI intermediaries and hence support the SIFI market in general, rather than supporting one specific SIFI. The Commission therefore concludes that the amendment at stake does not affect the assessment of the measure as regards proportionality.

(47) The Commission concludes that prolonging the BSC for ten years, the additional funding and the acquisition of debt from private sources would not be disproportionate in respect of the BSC achieving its objectives. In addition, the cap removal in respect of the diversification rules would also be appropriate as the diversification rules are still in place and stipulate that exposure to individual SIFIs would still be capped. Therefore, after assessing the above amendments, the Commission is of the view that they do not adversely affect the compatibility assessment made in the original decision as regards the proportionality of the measure.

Conclusions on the amendments

(48) On the basis of the above, the Commission finds that the notified amendments do not affect the compatibility assessment of the measure approved in the original decision. The measure, as modified with the notified amendments, remains appropriate, necessary and proportionate in line with Article 107(3) (c) TFEU.

(49) The BSC can therefore be prolonged until 20 December 2026. Any further prolongations or further amendments to the BSC will require the Commission’s prior approval and will have to be based on a review of the developments in financial markets and the effectiveness of the measure.

5. DECISION

(50) The Commission has accordingly decided to consider the measure approved in the original decision, as modified by the notified amendments, to be compatible with Article 107(3) (c) TFEU and does not raise objections any objections.

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Yours faithfully,
For the Commission

Margrethe VESTAGER
Member of the Commission

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Jordi AYET PUIGARNAU
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