

## Local Government Finance Circular No. 5/2014

Chief Executives and Directors of Finance  
of Scottish Local Authorities  
Convention of Scottish Local Authorities (COSLA)  
Audit Scotland

In 2014 Scotland Welcomes the World



Our ref: A8461348  
25 April 2014

Dear Chief Executive /Director of Finance,

### **COUNCIL BORROWING TO ON-LEND TO REGISTERED SOCIAL LANDLORDS**

A number of Councils have asked Scottish Ministers to consent to them borrowing to on-lend to a Registered Social Landlord (RSL) or a RSL subsidiary in their area as a way of unlocking capital investment in affordable housing.

Scottish Ministers have considered these requests and determined that they wish to offer all Councils a limited financial flexibility to allow them to borrow to on-lend to RSLs (or an RSL subsidiary). The flexibility being made available does not place any requirement on Councils to lend to RSLs.

Lending is not the core business of local government and there is no policy intent that Councils will generally provide the RSL sector with loan finance.

RSLs are currently facing specific difficulties in securing private loan finance which is impacting their ability to deliver new or additional affordable housing. The policy intent is to facilitate the delivery of new affordable homes by RSLs with Council on-lending being used for projects which have stalled or have not been able to proceed in a timely manner. For example, Council lending could help facilitate projects which have secured public sector funding but have stalled and cannot proceed in a timely manner due to a private lender requirement for the RSL to agree to the material re-negotiation of old debt.

It is also recognised that Council on-lending could provide the opportunity to develop sites that RSLs are seeking to develop through innovative routes such as the

National Housing Trust initiative for Registered Social Landlords (NHT for RSLs), or local innovative schemes which a Council wishes to promote.

The scheme being offered is subject to a number of conditions to ensure the lending is in accordance with the purpose of the scheme and the council has fully considered the risks associated with this type of activity.

### **Background to the scheme**

Information provided to the Scottish Government, supported by recent conversations with lenders and RSLs, suggests that RSLs are facing new business risks, including changes to existing lenders' positions regarding the sector. Whilst there does not appear to be evidence of a lack of private finance to lend to RSLs, when some RSLs approach their existing lenders with respect to financing new housing investment they are offered terms that are not as good as those available pre 2009. These new terms include reduced loan duration, and, in some cases, new lending can trigger a wider renegotiation of the terms and conditions attached to previous borrowing. Some RSLs are also limited in their possible level of new borrowing by their loan covenants. In response to these structural funding issues, RSLs are now tending to seek to secure new funds which do not disturb existing loan agreements nor expose them to unnecessary re-financing risk. A number of RSLs have indicated that on-lending by their local council could help, providing an alternative for part of their borrowing either directly to the RSL or through un-registered RSL subsidiaries.

The scheme being offered here is not designed to address the structural funding issues within the RSL sector - there is an expectation that RSLs themselves need to adjust to changed circumstances.

One of the strengths of the RSL sector is their ability to use their housing assets to secure private finance to provide affordable housing, rather than requiring public sector borrowing which increases UK National Debt which the UK Government seeks to control. In the longer term Scottish Ministers consider it essential that the general presumption remains that RSLs borrow from the private sector.

### **Statutory position**

A Council has statutory powers to provide financial assistance to Registered Social Landlords for housing purposes as provided in Scottish Housing Acts. Councils do not however have the statutory powers to borrow to fund that financial assistance.

A Council's statutory power to borrow to finance capital expenditure is limited to the capital expenditure of a Council (paragraph 1(1) of schedule 3 of the Local Government (Scotland) Act 1975 (the 1975 Act)). It does not allow a Council to borrow to on-lend to third parties even if the on-lending is to support capital investment being undertaken by a third party which is of benefit to the public in a local authority area.

Whilst there is a limitation placed on Councils, the 1975 Act (paragraph 1(2) of schedule 3) allows Scottish Ministers to consent to a Council borrowing for other

purposes subject to Ministers being satisfied that the expenses are of such a nature that they should be met from borrowing.

Scottish Ministers are providing consent to a Council borrowing for the purpose of lending to RSLs but this is conditional on a Council satisfying the conditions as set out in scheme below.

## **Investments**

Finance circular 5/2010 provides Scottish Ministers' consent for local authorities to make permitted investments. This consent recognises as an investment any loan issued to a third party. It recognises that some of these loans may be made for service reasons and for which specific statutory provision exists. The circular advises that Annual Strategies and Reports will need to recognise loans made for service reasons as investments. It suggests that local authorities may wish to categorise such advances, identifying the service reason together with details of those loans, particularly if the interest rate will impact the return on investment returns.

Loans made to RSL / RSL subsidiaries in reliance of this on-lending consent scheme must be treated as an investment in accordance with the Investment regulations.

It is also possible for a Council to lend to an RSL which does not rely on this on-lending consent scheme but is funded from cash backed reserves. This loan is also an investment.

Whilst the funding of the loan to an RSL or an RSL subsidiary may be different, the provision of the loan will have been made to achieve specific service objectives. In the case of lending to RSLs the objective will be the provision of housing.

A Council's net treasury position is determined by the relationship of the Capital Financing Requirement (its need to borrow) and its balances and reserves (potential to invest) As such capital investment, borrowing and the investment of money are inter-related.

Any loan to an RSL made under this on-lending consent scheme will be funded from borrowing. The capital control framework therefore requires the transaction to be recognised as capital in nature, increasing a Council's Capital Financing Requirement (CFR) and recognising an advance from the loans fund.

Where the loan is funded from cash backed reserves the loan will not be recognised as a capital transaction. There will be no loans fund advance and no increase in the CFR. A Council's investment strategy is required to set limits on each type of permitted investment. Separate limits must be placed on loans to RSLs / RSL subsidiaries funded from borrowing and loans to RSLs / RSL subsidiaries funded from usable cash reserves. The limits placed on loans to RSL/ RSL subsidiaries which are funded from usable cash reserves will naturally be limited as they will have to reflect, and be proportionate, to the value of current and future cash holdings taking in to account the value of external gross borrowing against the CFR. The Council's policy on the level of reserves held will be pertinent in setting limits on this type of investment, as will the value of earmarked reserves. Investing up to the

permitted investment limit will also impact on the Councils ability to reduce its reserves below the permitted investment limit set, particularly where the loan is a longer term loan. A Council should be able to demonstrate that over the period of the loan the investment remains funded from cash surpluses and does not impact on liquidity.

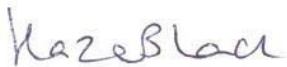
This scheme, and the requirements placed on Councils by this scheme, apply only to those loans made to RSLs which are funded from borrowing and made in accordance with this scheme. Councils may wish to consider the relevance of this guidance for loans made which are funded from cash reserves.

### **Interest rates**

The scheme sets out where a market interest rate must be applied, a market rate being defined in relation to rates set by the EU to ensure the loan does not provide a state aid. This will be the lowest interest rate that may be offered. The Scottish Government will not be issuing any further guidance on market interest rates. Councils are responsible for deciding the interest rate for any loan which balances service objectives against risk.

Any enquiries about the consent or its requirements should be addressed to me at: [hazel.black@scotland.gsi.gov.uk](mailto:hazel.black@scotland.gsi.gov.uk)

Yours faithfully



Hazel Black  
Head of Local Authority Accounting  
Local Government Division

## **CONSENT BY SCOTTISH MINISTERS FOR COUNCILS TO BORROW TO ON-LEND TO REGISTERED SOCIAL LANDLORDS – SUBJECT TO THE REQUIREMENTS SET OUT BELOW**

Scottish Ministers hereby consent, for the purposes of paragraph 1 (2) of Schedule 3 to the Local Government (Scotland) Act 1975 for local authorities to borrow to on-lend to a RSL or RSL subsidiary subject to the requirement to comply with the conditions of that consent which are set out below.

### **General**

1. The requirement to comply with the consent conditions applies to each individual proposal to on-lend to a specific RSL and /or RSL subsidiary.
2. Scottish Ministers consent does not provide any endorsement or approval of any proposal. A Council remains responsible for ensuring that any proposal complies with legislation, is financially viable and that it has the capacity to manage the risks associated with any proposal.
3. There is no requirement for an application to be submitted to Scottish Ministers for approval. This scheme has been designed so that a Council, by satisfying certain conditions, may assume Scottish Ministers' consent to borrow. This is a self-certification process.

### **Setting limits on the amount of on-lending**

4. The Scottish Ministers do not want, or necessarily expect, to set a limit on the amount of borrowing Councils undertake to on-lend to RSL/RSL subsidiaries. However, because of the broader interest in public borrowing Ministers may have to do this if take up was popular.
5. The Scottish Government will monitor the amounts being on-lent. The information will be collected from the capital returns Councils make to the Scottish Government.
6. Each Council is responsible for ensuring that any on-lending is affordable, prudent and sustainable as required by the CIPFA Prudential Code. Councils are also reminded that loans to third parties constitute an investment. The consent conditions for investments, as set out in Finance Circular 5/2010, must also be met when lending to RSL/RSL subsidiaries. Finance Circular 5/2010 can be found at: <http://www.scotland.gov.uk/Topics/Government/local-government/17999/FinCirc5-2010>

### **Consent conditions**

7. The requirements set out below are those matters Scottish Ministers' require a Council to satisfy before the Council can approve any borrowing to on-lend to an RSL/ RSL subsidiary.

### ***Purpose of the on-lending***

8. Scottish Ministers consent is to unlock new affordable housing investment. Scottish Ministers consent is therefore only available to support new capital investment in affordable homes. Councils have no consent from Scottish Ministers to on-lend to assist RSLs or any RSL subsidiary to refinance or restructure their debt portfolios.

9. The scheme is to facilitate the delivery of new affordable homes by RSLs with Council on-lending being made available for projects which have stalled or have not been able to proceed in a timely manner. For example, Council lending could help facilitate projects which have secured public sector funding but have stalled or have not been able to proceed in a timely manner due to a private lender requirement for the RSL to agree to the material re-negotiation of old debt.

10. Council may also lend to develop sites that RSLs are seeking to develop through innovative routes such as the National Housing Trust initiative for Registered Social Landlords (NHT for RSLs), or local schemes which a Council wishes to promote.

### ***Requirement for a Business Case***

11. A Council is required to produce a business case which sets out the proposal to borrow to on-lend to a RSL/ RSL subsidiary. The business case should address all the matters required by Scottish Ministers', and demonstrate compliance with this scheme. The Council business case is to form part of any proposal to be considered for approval by elected Members.

12. Where a RSL is seeking assistance from a Council their request should be supported by a business case which sets out the reasons why the Council should provide debt finance. Requests for assistance to unlock stalled projects must include sufficient and specific information to demonstrate the need for Council lending. This includes information on discussions with lenders and the financial impact of any requirement from the lender for the re-negotiation of debt. A Council is required to undertake its own due diligence on the proposal. The Council's own business case will, if it supports a proposal, set out why a project has stalled and is unlikely to proceed in a timely manner, and set out the specific reasons why the Council supports lending to the RSL. The RSL business case may not be used as a substitute for a Council business case.

13. Scottish Ministers consider the requirement for a Council to produce a written business case essential to demonstrate that the on-lending is necessary to unlock new capital investment in affordable housing, and that the Council has fully considered all the benefits and risks of this type of support. The business case should demonstrate that "but for" this support it is unlikely that new or additional affordable housing could be delivered in a timely manner.

14. A Council may choose to adopt a general policy to unlock affordable housing investment through the use of on-lending which reflects this on-lending scheme. However, Scottish Ministers consent to borrow is specific to individual lending

proposals to named RSL / RSL subsidiaries. A Council business case is therefore required for each individual proposal to on-lend to a specific RSL and/ or RSL subsidiary.

15. Reflecting the specific nature of a borrowing consent a business case should set out the RSL/ RSL subsidiary to be the recipient of the loan, the maximum value of the loan facility, the number and location of the housing units and the target completion date for those units. The business case may contain more than one location and target completion date, for example:

“12 units at [location] with a target completion date of [Month: Year]

25 units at [location] with a target completion date of [Month: Year]”

Scottish Ministers’ consent will be for the loan value and the housing units as set out in the Council’s proposal (supported by the Council business case) approved by elected Members. The loan to the RSL/RSL subsidiary may be made as a single loan or as a series of loans up to the maximum loan value as set out in the business case. The final value of any loan/ series of loans may not exceed the actual capital cost of the housing units.

16. Scottish Ministers’ consent applies to the loan value and housing units identified and approved by elected Members. Councils may, on occasion, need to amend schemes (either the number of housing units or the location, or both). The Council business case should set out the arrangements for any subsequent change in the number of units / locations. The arrangements for this change may include provision for this change to be delegated to officers. Delegated authority to officers may not however extend to any increase in the maximum loan value. Any change in loan value requires the formal approval of elected Members at Council or Committee.

17. Each business case forms part of any proposal submitted to elected Members and must be approved in line with the requirements set out below.

### ***Demonstration of Housing priorities***

18. Councils’ Local Housing Strategies (LHSs) provide direction to tackle housing need and demand and to inform the future investment in housing and related services across the local authority area. Strategic Housing Investment Plans (SHIPs), are the key statement of housing investment priorities in each local authority area.

19. The core purpose of the SHIP is to set out investment priorities in affordable housing over a five year period to achieve the outcomes set out in the LHS. The SHIP will include affordable housing supply through new provision, replacement, rehabilitation and re-modelling, including details of any provision local authorities themselves are planning. The SHIP reinforces the local authority as the strategic housing body and the importance of the outcomes and targets set out in the LHS.

20. Any proposal to on-lend to a RSL or a RSL subsidiary should support the housing development priorities as set out in a Council’s SHIP. The Scottish Government recognises that there may be occasions where a proposal is not reflected in the SHIP but it does fit with the LHS priorities such as meeting housing

need, promoting regeneration, tackling homelessness or sustaining rural or other communities. Scottish Government consent is not withheld if a proposal that does not align to a Council's current SHIP can demonstrate a strategic fit. The SHIP must be updated as soon as possible to reflect any new investment priorities arising from proposals.

### **Risk assessments to be included in the Business case**

21. A Council is expected to act prudently when considering any proposal to on-lend to an RSL or RSL subsidiary. This includes a consideration of the materiality of the Council loan/s in relation to the total loans of a RSL or RSL subsidiary. Prudent in this regard means ensuring that Council loan/s do not create any dependence on the Council and the attendant classification risk.

22. There are a number of risks that a body providing debt finance should satisfy themselves about through appropriate due diligence. The consideration of these risk assessments are to be included in the business case, together with details of how these risks are to be monitored, mitigated and managed. The Council business case should also contain details of a Council's exit strategy.

23. The risk assessment must consider both the financial and the non-financial impacts of any default. The risk of default includes the risk of non-payment, including the risk of non-payment by the RSL due to their inability to refinance a debt at term. The risk assessment should include consideration of the impact of default on the reputational risk to the wider RSL sector which is overseen by the Scottish Housing Regulator.

24. Councils may also on-lend to an un-registered RSL subsidiary. A Council should fully consider and assess how the proposal sits within the RSL group structure and ensure that they fully understand the boundaries of the locus of the Scottish Housing Regulator and the Office of the Scottish Charity Regulator and any regulatory consents which are required to allow the proposal to proceed. A Council's business case should fully consider these elements and the associated risks in their business case.

25. A Council with experience of developing a business case to on-lend to RSLs has provided some advice on risk assessment which may be of assistance. This is reproduced at Annex A.

### ***Conditions relating to interest rates***

26. The background of the scheme set out on page 2 of this circular identifies the challenges in terms of the current structure of housing association finances. Scottish Ministers wish to avoid encouraging RSLs to actively seek public borrowing solely due to lower interest rates, longer loan periods or conditions which are more attractive than those offered by private lenders. To partly address this behaviour/dependence risk Scottish Ministers have determined that where the on-lending is for the purpose of progressing projects which have stalled or have not been able to proceed in a timely manner but secured public sector grant funding, the interest rate of any loan must be at a market rate. This is the lowest interest rate a council may



offer, rates may be set higher. It is for each council to consider what interest rate is appropriate and prudent in relation to the purpose of the loan. The Council business case must include the reasons why the RSL/ RSL subsidiary is not borrowing from a private lender, together with the rationale for the interest rate and repayment terms being proposed for the council loan.

27. A market interest rate is one where the interest rate is equal to or higher than that calculated in accordance with the Commission notice on the method for setting the reference and discount rates.

([http://ec.europa.eu/competition/state\\_aid/legislation/reference\\_rates.html](http://ec.europa.eu/competition/state_aid/legislation/reference_rates.html)).

28. The scheme places no minimum interest rate on loans which support innovative investment models.

### **State aid**

29. To support innovative investment models a low interest rate or longer loan duration may be the key to unlocking new or additional housing investment. If a Council is proposing to offer a loan to a RSL or RSL subsidiary at less than a market interest rate, there is a requirement to obtain State aid advice. State aid advice is available from a number of sources, including the Scottish Government's State aid unit and legal opinions from lawyers. A Council must ensure that the party providing State aid advice is competent to do so.

30. The Council must either;

(i) Receive reasonable assurance from the advice they have obtained that the project is state aid compliant and that a project can come under the SGEI exemptions for affordable housing, or

(ii) If the activity does not meet the SGEI definition and the loans are below market rates, the aid provided may only be offered if it satisfies the requirements of the EC's de minimis regulation.

Where neither of the above can be satisfied there is no Scottish Minister consent for the on-lending. In such cases Scottish Ministers consent will only be available where the loan is offered at a market interest rate.

31. The Council's written business case must include a State aid assessment and details of the State aid advice received. This assessment is only required where a loan is to be offered at less than a market interest rate (as defined above).

32. Where the Council on-lending provides a State aid the Council must comply with all the reporting requirements of the European Commission.

33. The Scottish Government State aid unit has provided some indicative advice on local authority lending to RSLs. This is reproduced at Annex B. No reliance should be placed on this advice as State aid is a complex matter and the unique circumstances of each proposal to lend must be considered in detail.

### ***Loan fund advances and statutory repayments of debt***

34. The type of loan offered to a RSL / RSL subsidiary is a matter for a Council to determine. The rationale for the type of loan and the repayment terms must be included in the Council business case. The maximum lending period permitted under this scheme is 15 years. However, this does not mean that all loans should be for this duration. A Council business case should consider what is appropriate for each individual proposal and select a repayment period which meets the needs of the proposal.

35. The statutory loan fund advance must mirror the type of loan made to the RSL/ RSL subsidiary (maturity/ annuity/equal instalments).

36. The statutory fixed period within which the loans fund advances are to be repaid to the loans fund shall be equal to the repayment period of any loan made to the RSL / RSL subsidiary. The fixed period for any loan may not however exceed **15 years**. New loans may not be issued to re-finance maturing Council loans to an RSL/ RSL subsidiary.

37. The repayment of loan fund advances must mirror repayments due from the RSL/ RSL subsidiary.

38. Where the loan is to support projects which include a future sale of housing the loan fund advance must be repaid when the housing is sold.

39. If a RSL/ RSL subsidiary repays a loan earlier than the repayment term the loan fund advance must be repaid to mirror this repayment.

40. Councils must keep adequate loan fund records to demonstrate that there is no outstanding loan fund advance that is not matched by an external debtor.

41. There is a statutory requirement for loan fund advances to normally be either annuity or equal instalments, with the first repayment being due in the year following the advance. This on-lending scheme provides an exception. In permitting a Council to make maturity loans to RSLs, and by permitting the repayment of the loan fund advance to mirror the repayments due from the RSL/ RSL subsidiary, a financial flexibility is provided which is not usually available to Councils.

42. The consent to borrow effectively permits a Council to capitalise the loan made to the RSL/RSL subsidiary. It is therefore necessary to reflect this transaction as capital finance, and reflect this transaction in the '**Capital Financing Requirement**' of the Council as required by the Prudential Code. The long-term debtor, the RSL/RSL subsidiary, created to reflect the loan shall be recognised as relating to a capital transaction and be included when calculating capital expenditure and the capital financing requirement as required by the CIPFA Prudential Code.

### ***Council approval process***

43. The initial approval process may not be delegated to officers. Any proposal for a Council to borrow to on-lend to a specific RSL/RSL subsidiary must be approved

by elected Members at a Council or Committee meeting. The proposal to Members should include a confirmation that the proposal meets the conditions attaching to Scottish Ministers consent to borrow. Members should be asked to specifically approve the loan to the named RSL/RSL subsidiary, together with the loan value, the interest rate, the loan type, the repayment period, and the number and location of the housing units. Members may also approve in advance any delegation to officers to make any subsequent changes in the number or location of the housing units. Any subsequent change in loan value must however be approved by elected members at a Council or Committee meeting.

44. The Council business case for the loan to the RSL/RSL subsidiary must be submitted with any proposal to elected members seeking their approval to borrow and on-lend.

45. Formal approval of elected members to a proposal to borrow to on-lend completes the self-certification process. Provided that the proposal meets the conditions attaching to Scottish Ministers consent a Council has a formal statutory consent to the borrowing under paragraph 1(2) of schedule 3 of the Local Government (Scotland) Act 1975.

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## **COUNCIL BORROWING TO ON-LEND TO REGISTERED SOCIAL LANDLORDS**

### **Local Authority Lending to RSLs for Affordable Housing – Risk Consideration**

When developing a business case for on-lending, the local authority remains responsible for ensuring that any proposal complies with legislation, is financially viable and that it has the capacity to manage the risks associated with any proposal. It is recommended that a risk register is drafted to collate and monitor the risks identified for the on-lending proposal and to assist in developing mitigation strategies required to deal with each risk. The principles of risk management and mitigation are dealt with in detail in project management methodology.

Some risks that local authorities may wish to consider are listed below. Please note that this list is not exhaustive and that the responsibility for identifying and assessing risk lies with each local authority.

#### **Ensuring the Capital Sum is Secured**

A major consideration for any local authority considering an on-lending facility should be the full repayment of the loan sum by the RSL within the loan period. One way to mitigate this risk is to require the loan recipient to grant the authority a first-ranking security over the completed homes. A first-ranking security enables the local authority to force the sale of the homes in the event of the loan not being repaid; the proceeds from the sale would be used to repay the loan recipients creditors, with the local authority's loan having first ranking in this.

It should be noted that a first ranking security is based upon the value of the homes, not the development cost. Since the value of the homes would in most cases exceed the cost of development, this may offer additional mitigation from changes in property values (i.e. if a development costs 70% of the properties market value, properties would need to drop in value by over 30% before the value of the security would no longer be enough to cover the value of the loan).

A first ranking security over the value of the homes can only be established upon completion and valuation of the homes. Alternative arrangements would need to be put in place to protect a local authorities investment if loan funding is to be provided prior to the completion of homes (during the construction period). Provision of finance prior to the completion of homes may result in a higher risk proposal due to issues relating to securing the site in the event of default, and the lack of any income generated through rents. The local authority should be satisfied that would all risks can be satisfactorily mitigated.

#### **Risk of Challenge**

A local authority must assess and mitigate the risk of legal challenge either from when considering an on-lending facility. A challenge may come from unsuccessful applicants or parties who feel they have been excluded through the procurement and selection process. In order to safeguard against this, a clear procurement and

selection processes must be established and an accountable audit trail produced at each stage. Procurement advice at an early stage is essential, especially if local authority assets (such as local authority owned land) are granted or sold to the loan recipient.

### **Risks Arising From State Aid**

State aid is a complex subject matter and local authorities are encouraged to carefully consider Annex B of this paper, consult with the State Aid Unit and where appropriate, seek legal advice. If adopting a view that delivery of affordable or social housing is considered a SGEI, careful consideration will need to be given to the target group and the period of time which the homes can be considered affordable. This should be considered alongside the exit strategy, especially if the exit strategy involves sale of the homes in order to repay the loan.

If the intention is to establish that the interest on a loan facility is being provided at market rates, local authorities should consider the European Commission's Reference Rate Communication:

[http://ec.europa.eu/competition/state\\_aid/legislation/reference\\_rates.html](http://ec.europa.eu/competition/state_aid/legislation/reference_rates.html)

## **COUNCIL BORROWING TO ON-LEND TO REGISTERED SOCIAL LANDLORDS**

### **Local Authority Lending to RSLs for Affordable Housing – State Aid**

PLEASE NOTE: This annex is to provide an indication to Councils of the State aid matters which they will need to consider when providing loans to RSL/RSL subsidiaries. State aid is a complex matter and specific advice should be sought on the specific proposal the Council is considering. No reliance may be placed on this Annex alone.

The Scottish Government's State aid Unit are available to provide advice. Information on the State aid unit can be found at:

<http://www.scotland.gov.uk/Topics/Government/State-Aid/SAU>

Scottish Government Local Authority Finance directorate have requested State Aid advice in relation to Local Authorities providing a loan facility to registered social landlords (RSL's) for building of new houses.

The clearest way to ensure this is not the case would be to provide any loan facility at market interest rates, generally this negates the presence of State aid.

#### Services of General Economic Interest (SGEI)

An SGEI is a service of an economic nature that public authorities identify as being of particular importance to citizens, but which are not supplied by market forces alone, or at least not to the extent and under the conditions required by society. Their provision may therefore require public intervention. In most cases funding to support social affordable housing is regarded as an SGEI.

SGEI are carried out in the public interest under conditions defined by the State, which imposes a public service obligation on the provider(s). Since SGEI provision under such conditions may not generate a (sufficient) profit for the provider, public service compensation might be needed to offset the additional costs stemming from the public service obligation.

In this case it would have to be established that the functions being carried out and the loans for those specific activities meet the definition of an SGEI To administer an SGEI the following requirements must be met; there must be a public service obligation placed on the provider of the SGEI, there must be an act of entrustment between the public body and the beneficiary, setting out the parameters of the measure and there must be no over-compensation.

In this case there may also be an overcompensation factor if the loans are offered at sub-market interest rates. There's a specific case precedent, commonly known as the Dutch housing case, (State Aid No E2/2005 and N642/2009). In this case issues around the rates charged for loans are addressed and concludes that if these loans are at less than the market rates then overcompensation could be present and this could be deemed to lead to distortion (and possible illegal State aid).

If the activity being funded did not fall under the ambit of SGEI, we would conduct a general State aid assessment to ascertain the presence of aid in the proposed funding measure. Article 107(1) of the [Treaty of the Functioning of the European Union](#) (TFEU) lays down general prohibition on the provision of State aid by Member States. Derived from this wording come the five State aid tests we generally use to analyse whether State aid may be present in a public measure.

Before the State aid tests can be applied it is necessary to determine whether the measure provided to an undertaking/s engaged in economic activity

- Is the measure given to an economic undertaking? An undertaking is defined as any entity, regardless of its legal status, which is engaged in economic (commercial/competitive) activity and where there is a market in comparable goods or services.
- Economic activity means an activity which consists in offering goods or services on a given market and which could, at least in principle, be carried out by a private operator in order to make profits.

If these two initial assumptions are correct, the State aid test must then be applied to determine the presence of State aid (all must be met for State aid to be present).

They are as follows:

1. Is the measure granted from State resources? (central government, devolved administrations, regional and local Authorities), either directly or by companies and agencies established by the State to distribute public funds. This can be in the form of direct grants, tax exemptions etc. Funding which is allocated under State control will also be classed as a State resource even if those funds do not originate from a State budget. For example, lottery funding and structural funds money will also be classed as a State resource.

Yes - [The resources come from Local authorities, whose funds are provided via the State.](#)

2. Does the measure confer an advantage? An advantage is conferred when an aid measure relieves the burdens normally assumed in a recipient's budget and gives the recipient an economic advantage which it would not have obtained under normal market conditions. An advantage is a benefit that is granted to a recipient for free or on favorable (non-commercial) terms.

[If loans are made at market interest rates, truly reflecting the market, then there would be no advantage conferred. If the loan rates were sub-market, then the difference between the market rate and the rate offered may be State aid and may confer an advantage on the beneficiary.](#)

3. Is the measure selective? A selective measure is one that targets particular businesses, locations, types of firm e.g. small enterprises or a specific sector is

considered selective. A general measure affecting the whole of the Member State's economy e.g. a nation-wide fiscal measure is not considered a State aid.

Yes as it is only being provided to registered social landlords and subsidiaries of RSLs.

**4. Does the measure distort or have the potential to distort competition?**

Competition is distorted if the aid in question strengthens the competitive position of the recipient by reducing its costs in relation to its rivals. The undertaking's share of the market or the size of the distortion is irrelevant: small effects are sufficient to conclude distortion. The Commission interprets this very widely and it is for the member state to prove there is no distortion.

As with the second State aid test, if loans are made at rates which are reflective of market conditions, then there is no distortion of competition. Where the interest rates are sub-market, then there is potential for distortion and this test will be met.

5. Is the activity tradable between Member States? Most products and services are traded between Member States and therefore aid for any selected business or economic activity is capable of affecting trade between Member States even if the recipient undertaking itself does not trade with other Member States. Companies do not have to be involved in exporting goods themselves in order for there to be an effect on trade between Member States. It is enough that the product or service is subject to trade between Member States. The Commission's interpretation of this test is very broad. Consequently most activities are normally viewed as tradable.

The European Commission regards most activities as tradeable between Member States, even if the beneficiary is not actually engaged in intra-community trade. In this case, even though the projects are in distinct locales, the provision of housing is common across the EU and as such it is likely that the Commission would consider this test as met.

## **Conclusion**

If, as is likely, the activity falls under the SGEI description, then there is no State aid present in the public funding used to support this activity.

If this is not the case and any loans issued by the public sector are at market rates, then again, there is no State aid present.

If, however, the activity does not meet the SGEI definition and the loans are below market rates, then there is likely to be State aid in respect of the difference between the interest rate offered and the market rate. In that case, the aid could be offered under the EC's de minimis regulation, which permits aid of up to €200k per beneficiary over a three year fiscal period for almost any purpose. More information on de minimis aid is available on the State Aid Scotland website:

<http://www.scotland.gov.uk/Topics/Government/State-Aid/if-its-aid/deminimis>



It should be pointed out that the European Commission has sole competence over the presence, or otherwise, of State aid, and that any decision by a public funder to adopt a no-aid approach must be regarded as risk-based.