Competition Policy Newsletter

Italian guarantee scheme for ship-finance: Commission signals thorough review of guarantee schemes

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Introduction

On 6 April 2005 the European Commission, after an in-depth investigation, adopted a decision declaring that an aid scheme designed to cover the risk of loans for the construction and conversion of ships in Italian yards, is incompatible with the Common Market.

The Italian authorities had notified to the Commission, in May 2001, the adoption of a Decree implementing the Shipbuilding Guarantee Fund (‘the Fund’), already formally established by law in 1997, but never operational. In April 2003, the Commission opened a formal State aid investigation procedure as it had doubts about the compliance of the aid with the specific State aid rules for the shipbuilding sector.

This decision is noteworthy for two reasons. First, it provides important interpretative keys to the application of the EC State aid rules with regard to guarantee schemes. Second, it underlines the Commission’s readiness to conduct a thorough and accurate analysis of the legal and economic aspects of public guarantees.

Background

Shipbuilding is an economic sector that has historically been of interest for State aid review given on the one hand the existence of structural over-capacity, depressed prices and trade distortions in the world shipbuilding market and on the other hand the regional significance with shipyards as major employers in many coastal cities.

In addition, shipbuilding projects are usually capital-intensive, in particular if put in relation to a shipyard’s own capital base. In recent years the initiative ‘LeaderSHIP 2015’ (1) initiated a programme to ensure its long-term prosperity and identified the necessity of developing advanced financing tools in order to promote the competitiveness of the European shipbuilding industry. One element of this initiative emphasises that the extreme capital-intensity of shipbuilding projects results in ‘growing difficulties for the arrangement of the ship financing’ so that guarantees ‘are crucial for the financing needs of European shipyards’. To this end, it is reiterated that ‘in addressing these issues, some key principles have to apply: All instruments must be self-sustained and transparent. The applicable premiums must reflect the risk that is being run. The operation of the instruments has to be efficient, decisions should be clear and predictable. Any action proposed has to be in strict compliance with EU rules (…).’

On 26 November 2003, the Commission adopted a Framework on State aid to Shipbuilding (‘the Framework’) (2) replacing the old Shipbuilding Regulation (3). The guiding principle of the new text is the simplification of the State aid rules applicable to this sector, both as to the form and the substance of these rules. This instrument also marks the completion of the ‘normalisation’ process initiated by the 1998 Shipbuilding Regulation which provided for the phasing-out of operating aid.

Notably, the Framework on the one hand extended, as far as possible, horizontal State aid rules to this sector; and on the other hand, it recognised certain specificities that distinguish shipbuilding from other industries. Moreover, notification requirements have been eased compared to the 1998 Shipbuilding Regulation.

The Italian ship financing guarantee scheme

The Fund has been established in accordance with Art. 5 of Law no. 261 of 31 July 1997. Following a tender procedure, the financial, administrative and technical management of the Fund was entrusted to Mediocredito Centrale SpA (‘Mediocredito’). The Fund was intended to cover the risk of failure


to recover loans for the construction and conversion of ships, granted by banks to Italian and foreign shipowners, for works carried out in Italian shipyards. With this purpose, the Fund would provide second-priority end-financing guarantees to the above-mentioned shipowners.

The financing loan was required to have a duration of no more than twelve years and amount to no more than 80% of the contract price. In addition, the financing should have been guaranteed by a first mortgage on the vessel that was the object of the financing. In order to obtain the guarantee, shipowners needed to be assessed by Mediocredito as being economically and financially sound on the basis of the criteria specified in the Decree.

The guarantee could be granted up to a sum not higher than 40% of the loan and — within this limit — could cover up to 90% of the final loss incurred by the banks for capital, interests, and costs.

The one-off premium to be paid by the beneficiaries of the Fund was set at 2.3% of the guaranteed amount for 12-year loans (decreasing it proportionally for shorter loans). Such a one-off premium would be equivalent to a premium of 0.5% per annum on the outstanding guaranteed amount of a 12-year loan.

In the course of the proceedings, the Italian authorities informed the Commission services that they were considering introducing a mechanism of risk differentiation whereby different projects would be charged different premiums according to the risk involved in financing the project. This system would have taken as departing point the original 0.5% p.a. premium. Three different risk profiles were to be established. For a 12-year loan, the one-off premium to be paid by the beneficiaries would amount to 2.065% for the lowest risk category, to 2.603% for the medium risk category, and to 3.142% for the highest risk category. This would correspond to a premium ranging between 0.4563% p.a. of the guaranteed amount for the least risky projects and 0.6562% p.a. for the most risky ones.

However, this rather rough outline of the system was not elaborated further, and no other concrete details on its possible operability have ever been submitted by the Italian authorities.

**The precedents**

The Italian guarantee scheme was not the first such measure assessed by the Commission in the shipbuilding sector. Indeed, on 16 December 2003 the Commission approved some guarantee schemes operated in Germany’s five coastal Länder, aimed at providing public fallback guarantees with respect to credits granted for the financing of ships built in German yards (1).

The German schemes comprised two different types of guarantees: ‘construction financing guarantees’, which secured the pre-financing of the construction cost of the vessel by the yard, and ‘end financing guarantees’, aimed at financing the purchase of the completed ship after delivery.

The novelty of the measures proposed by the German authorities consisted in the introduction of a risk differentiation mechanism. While in the past, every guarantee was covered by one single premium, currently different premiums are charged for the different risks to be covered by the guarantee. For this purpose, Germany devised a rating system comprising different risk categories allowing allocation of projects according to their respective risks.

Thanks to the introduction of such a differentiation mechanism, the adequateness of the premiums charged to the beneficiaries and the other characteristics of the schemes, the Commission could conclude that the notified measures did not contain any State aid elements and thus raised no objections to their implementation.

**The applicable legislation**

The measure notified by the Italian authorities consisted in a guarantee scheme. The Commission outlined its approach on such type of measures in its Notice on the application of Articles 87 and 88 of the EC Treaty to State Aid in the form of Guarantees (‘the Notice on Guarantees’) (2).

The Notice on Guarantees explains clearly why — under certain conditions — a State guarantee can constitute State aid: ‘the State guarantee enables the borrower to obtain better financial terms for a loan than those normally available on the financial markets. Typically, with the benefit of the State guarantee, the borrower can obtain lower rates and/or offer less security. In some cases, the borrower would not, without a State guarantee, find a financial institution prepared to lend on any terms (…) The benefit of a State guarantee is that the risk associated with the guarantee is carried by the State. This carrying of a risk by the State should normally be remunerated by an appropriate premium. Where the State forgoes such a premium, there is both a benefit for the undertaking and a drain on the resources of the

(1) More information on this Decision can be found in the following article: K. Struckmann, M. Lienemeyer, The new German ship-financing guarantee schemes: Commission gives green light, Competition Policy Newsletter, 2004, No. 2, p. 105.

State. Thus, even if no payments are ever made by the State under a guarantee, there may nevertheless be a State aid under Article 87(1).

The Commission decision

The main issue in the present case was whether the premiums charged for the guarantees reflected the market price. In light of the general principles of State aid review, and on the basis of the provisions outlined above, it is evident that the underlying principle behind the Notice on Guarantees is that the benchmark to assess whether a guarantee is free of State aid, is the market. Indeed, if the State is obtaining remuneration for the guarantee that is equivalent to the one that a market economy operator would charge to equivalent companies, this would mean that the latter are not granted any advantage, and that the State would be acting like any private investor or creditor operating on the financial market. If, on the contrary, the price paid by the companies and the conditions applied to the guarantees are more favourable than those available in the market, then there exists a clear economic advantage for the beneficiaries, and therefore (other conditions being met) State aid within the meaning of the Treaty.

The Notice on Guarantees, in point 4.3, lays down six conditions that help the Commission to assess whether a State guarantee scheme constitutes State aid. (1) Thus, the Commission had firstly to consider whether the notified scheme fulfilled these conditions, given that this would have allowed it to immediately rule out that any aid element was involved in such scheme.

After a careful review of the elements submitted by the Italian authorities, the Commission could not positively establish that the some of the conditions required by the Notice were met. Italy was in fact unable to demonstrate that the planned premium could ensure the self-financing of the scheme and cover all administrative costs. As a consequence, the scheme could neither be considered in compliance with the market investor test nor to be in all probability self-financing and capable of covering all the costs.

In fact, the inadequacy of the proposed premium was evidenced by the documents submitted by the Italian authorities themselves. In 2003 they conducted a market survey with the aim of investigating how much credit institutions would charge their clients for similar guarantees. Several letters received from Italian banks and submitted to the Commission, evidenced that indeed all banks questioned would charge premiums higher than 0.5% p.a. or within a range of premiums higher than the range proposed by Italy.

This conclusion was also confirmed by other sources of information obtained in the past years by the Commission. For instance, the above-mentioned German schemes for ship finance which, unlike the Italian scheme, have been running for several years, showed that higher premiums were needed to ensure that the risk of defaults is in all probability covered. In fact, the German schemes carry premiums which vary between 0.8% and 1.5% p.a., according to the creditworthiness of the beneficiary (the average being around 1 %).

In addition, the Commission considered that the Fund was not based on a realistic assessment of the risks and also this element appears to exclude that the scheme could be held to be self-financing.

Indeed, the information available to the Commission indicates that ship financing is a sector in which it is possible to assess and price individual risks, and it appears that a functioning market for the granting of end-financing guarantees for ship-building does exist. Therefore, a ship financing guarantee scheme charging the same premium to all users, if it functions under the same conditions and restrictions as market operators, cannot be in all probability self-financing. This is so because it would always be possible, for the beneficiaries with lower than average risk, to find another guarantor willing to cover their risk at cheaper premiums than the average premium. Unless a system is compulsory, this would leave the guarantee scheme offered by public authorities with the higher than average risks, which would not be able to finance the system adequately. In light also of these considerations, in absence of a clear risk

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(1) According to point 4.3 of the Notice, a State provided guarantee scheme fulfilling all the following conditions does not constitute State aid under Article 87(1):

(a) the scheme does not allow guarantees to be granted to borrowers who are in financial difficulty;

(b) the borrowers would in principle be able to obtain a loan on market conditions from the financial markets without any intervention by the State;

(c) the guarantees are linked to a specific financial transaction, are for a fixed amount, do not cover more than 80% of each outstanding loan or other financial obligation (except for bonds and similar instruments) and are not open-ended;

(d) the terms of the scheme are based on a realistic assessment of the risk so that the premiums paid by the beneficiary enterprises make it, in all probability, self-financing;

(e) the scheme provides for the terms on which future guarantees are granted and the overall financing of the scheme to be reviewed at least once a year;

(f) the premiums cover both the normal risks associated with granting the guarantee and the administrative costs of the scheme, including, where the State provides the initial capital for the start-up of the scheme, a normal return on that capital.
differentiation mechanism, the notified guarantee system could not be held to be ‘in all probability self-financing’.

Finally, the Italian authorities had not provided the Commission with reliable and detailed estimates on all the administrative costs related to the planning, the setting-up and the running of the scheme. On this basis, the Commission could not establish whether all costs associated with the guarantee could be covered by the premiums to be collected.

The Commission was thus required to examine whether the notified aid could be considered compatible under Article 87(2) and (3) EC.

At the time of the notification, aid to the shipbuilding sector was regulated by Council Regulation (EC) No 1540/98 of 29 June 1998, establishing new rules on aid to shipbuilding (the “Shipbuilding Regulation”). According to the Shipbuilding Regulation aid to this sector would be permissible only under the conditions and for the objectives specified in such legal instrument. Also, operating aid in the shipbuilding sector was not permissible for shipbuilding contracts concluded after 31.12.2000. However, as mentioned above, on 1 January 2004 the new Shipbuilding Framework entered into force, confirming the prohibition of any operating aid within this sector.

According to the case-law and unless otherwise specified by transitory rules, notified State aids must be assessed according to the rules in force at the time the decision on their compatibility is adopted (1). In the case at stake, the aid was therefore to be assessed according to the shipbuilding Framework.

The decision to open proceedings was adopted when the Shipbuilding Regulation was in force and was therefore based on the Shipbuilding Regulation. Nevertheless, the jurisprudence of the Community Courts indicates that a reopening of the administrative procedure is not necessary when the relevant provisions of the two consecutive legal texts are not substantially different (2). This requirement was clearly fulfilled in the present case.

Consequently, only aid in compliance with the requirements indicated and for the purposes provided for in the Framework could be considered compatible.

Although the Italian authorities had never argued that the notified measure should be considered compatible aid, the Commission examined whether the aid measure could be considered in compliance with the requirements indicated and for the purposes provided for in the Framework. The Commission assessment revealed that none of the exceptions from the prohibition of State aid to the shipbuilding sector was applicable in the present case and, consequently, that the measure identified by the Commission as constituting State aid was not compatible with the common market. For these reasons, the Commission prohibited the implementation of the Italian guarantee scheme for ship finance.

**Conclusions**

The Commission decision instructive in many regards. Firstly, it shows the determination of the Commission to thoroughly assess, under State aid rules, complex guarantee schemes set up by the public authorities. Moreover, it provides important elements to understand the application of the EC State aid rules with regard to this form of security.

*Inter alia,* the decision indicates that also for guarantee schemes the benchmark to assess whether the measure contains aid is the market. Indeed, the conditions provided for in the Notice on Guarantees are assuring a — in some way tailor made — application of the market economy investor test for guarantee schemes.

In addition, the decision underlines that the amounts of premiums collected must in all likelihood be sufficient to enable the Commission to conclude not only that the risks of default are covered, but also that all costs associated with the set up and the management of the scheme are fully covered.

This can only be obtained by applying a risk differentiation mechanism which ensures that different projects bear different premiums, according to their own risks. Indeed, in recent years risk differentiation has become very prominent in the banking sector. The Basel II accord reflects a set of new rules on banking safety under which the amount of capital European banks should hold to shield them from financial risks will not be fixed as a lump sum, but depends on the risk of their creditors. Therefore, lending banks must assess carefully, on a case-by-case basis, the risk of non repayment of a loan they are planning to grant.

The present assessment is based on this rationale, and the Commission did not hesitate to require such — market — behaviour by Member States when they engage in public financing, which is claimed to be free of aid.

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(1) See judgement of the Court of First Instance of 18.11.2004 in case T-176/01, *Ferriere Nord SpA v Commission,* in particular points 134 to 140.

(2) See also the above-mentioned case T-136/01, points 74 to 82.