The new German ship-financing guarantee schemes: Commission gives green light

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Introduction

On 16 December 2003 the European Commission decided to approve a new German proposal of ship financing guarantees. The guarantees will be operated in Germany's five coastal Länder (Niedersachsen, Bremen, Hamburg, Schleswig-Holstein and Mecklenburg-Vorpommern) and provide public fallback guarantees with respect to credits granted for the financing of ships built in German yards.

The Commission approved the schemes for a period until 31 December 2006. Prior to that date, the Commission will review the functioning of the new system in light of the experience gained within the first three years.

The novelty of the German schemes consists in the introduction of risk differentiation. While in the past, every guarantee had been covered by one single premium, in the future different premiums will be charged for the different risks to be covered by the guarantee. Germany devised a complex rating system comprising six risk categories allowing allocation of projects according to their respective risks.

Background

Shipbuilding projects are capital-intensive as a shipyard's annual production value exceeds its own value as a going concern. This is also acknowledged by the EU initiative 'LeaderSHIP 2015' ([1]) by which the European shipbuilding industry has 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.

The initiative essentially 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. [...]'

According to the EU rules, public guarantees for ship financing may be considered as operating aid but under the Shipbuilding Regulation 1540/98 could be considered compatible until the end of 2000. Thereafter, guarantees for ship financing should in principle only be allowed if they can be considered as constituting no aid or containing no aid elements. General rules for assessment of whether a guarantee or a guarantee scheme contains aid are laid down in the Commission notice on the Application of Articles 87 and 88 of the EC Treaty to state aid in form of guarantees (hereinafter 'Notice on Guarantees'). ([2]) The Notice allows for guarantee schemes to be considered free of aid if they fulfil certain criteria.

Initially, the German guarantee schemes, which had so far been provided under the Shipbuilding Regulation contained a single premium system. With its notification of April 2003 Germany had amended the schemes and proposed an entirely new guarantee system introducing risk differentiation.

Indeed, in recent years risk differentiation has become very important in the banking sector. The Basel II accord reflects new rules on banking safety under which the amount of capital European banks should hold to shield them from financial risk will not be fixed as a lump sum but depend on

([1]) See http://europa.eu.int/comm/enterprise/maritime/shipbuilding_market/doc/leadership2015_en.pdf, Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee, and the Committee of the Regions, COM(2003) 717 final of 21.11.2003: LeaderSHIP 2015 – Defining the fututre of the Europan Shipbuilding and Repair Industry – Competitiveness through Excellence The initiative goes back to the Council conclusions of 14 May 2001 where the Council called upon 'the EU Shipbuilding industry to continue improving its competitiveness.'

([2]) OJ C 71 of 11.3.2000, p. 14.

the risk of the creditor. Therefore lending banks must in any event assess the risk of a non repayment of a loan. In particular credits to non-rated beneficiaries might be required to be backed by a relatively high amount of the granting bank's capital.

The German ship financing guarantee schemes

The schemes comprise two different types of guarantees essentially covering a different period of the time. Firstly, *'construction financing guarantees'* should secure the pre-financing of the construction cost of the vessel by the yard. They run until the delivery of the vessel and are provided to the financial institutions which grant the construction-financing loans to the shipyards. Secondly, *'end-financing guarantees'* shall finance the purchase of the completed ship after delivery. They are provided to the financial institutions which grant the end-financing loans to the ship owners. The secured loans have normally a maturity of 8 to 12 years.

End-financing guarantees

The system that Germany implemented for end-financing guarantees is based on risk assessment that is carried out in two stages. The first stage consists of an internal rating by the lending bank providing the loan to be guaranteed. In a predominant number of cases this rating will be done by using a rating system specifically designed for ship financing by one of the leading ship financing institutions, which was devised in the light of the Basel II accord.

In a second step the *Land* that is granting a guarantee will carry out an own risk assessment before finally allocating a particular guarantee into one of the six categories. Criteria to be considered are the management (Shipowner's market position, Company structure, Experience background),the profitability of the shipowner (Market development, Capacity to repay capital, Guarantee category area, Repayment and period, Currency risks) and further circumstances relevant to risk (risk increasing or decreasing aspects).

Since the best-rated credit risks do not require any guarantees and the worse ratings will not receive guarantees, in practice the schemes will provide guarantees to those credits which have been allocated into the middle risk levels by the bank's rating system. In practice only 'normal' risks therefore are covered by the guarantees provided under the schemes. Among them the low risk projects will be able to benefit from cheaper premiums compared to higher risk projects, which will in the future face higher premiums. In the end the spectrum of guarantees previously covered by one single premium (of 0.75% to 1% depending on the *Land* concerned) was spread over six risk categories with premium levels ranging from 0.8% to 1.5%.

In calculating the premium Germany essentially relied on the information of the last previous years (1989-2000), comprising on the one hand the scheme's revenues (from premiums, fees and from the sale of the assets of the failing undertakings) and on the other hand its costs (administrative costs and the costs of the claims).

Construction-financing guarantees

In the system foreseen by Germany for construction-financing guarantees the *Länder* make their own risk assessment on the basis of a scoring model. The eligible scores then, similar to the end-financing system, are spread over six guarantee premium categories.

Criteria to be considered are financing (secured construction-financing, project-surplus, payment terms), liquidity planning for the building period phase, processing and contractual performance (technical performance, timely performance) and additional factors influencing risk.

The commission raises no objections to the schemes

The Commission concluded that the assessed measures do not fall within the scope of Article 87(1) EC Treaty. It has applied the Notice on Guarantees and concluded that the schemes fulfil all six conditions in point 4.3, ensuring that a State guarantee scheme does not constitute State aid under Article 87(1). These conditions are:

(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.

From the information supplied on the guarantee system it can be assumed that all borrowers eligible under the schemes are in principle able to obtain the credits from the market and that companies in difficulties are excluded from the application, as they would fall within the high-risk non-eligible categories. Therefore, condition (a) and (b) of point 4.3 are clearly met.

As regards condition (c) of point 4.3 the schemes are meeting the required 80/20 ratio. The amount of the construction financing guarantees is indeed limited to 80% of the loan provided by the banks to the yard for the construction of the vessel. Moreover, as regards end-financing structure in shipbuilding the structure is a little more complex. It is foreseen that the shipowner provides a downpayment of 20% of the ship's price and obtains a loan for the financing of the remaining 80% of the ship's price. Around 75% of the loan provided is normally secured by a ship mortgage (i.e. the value of the ship as collateral is normally around 60% of its contract price).The guarantee covers 80% of the remaining 20% of the unsecured loan, meaning in practice 16% of the contract price of the vessel. The bank has thus to retain an own risk for the remaining 4%.

The most crucial test for the schemes to meet was whether they are 'in all probability self-financing', as stipulated in condition d) of point 4.3 of the Notice on Guarantees. In another ship financing case concerning Italy the Commission has opened formal proceedings under Article 88 (2) EC ([1]) indicating that it had doubts whether one-premium schemes could be considered in all probability self-financing. The decision states in point 32: 'Since the use of the scheme is not compulsory and at the same time it is possible to assess individual risks (as a market to provide such guarantees exists), the one premium guarantee system at hand would not appear to be in all probability self-financing. This is so because it would always be possible, for the potential beneficiaries, to find another guarantor willing to cover the risk of the companies with lower than average risk at cheaper premiums than the average premium. This would leave the guarantee scheme only with the higher than average risks.'

On the contrary, the risk differentiation applied by the new German schemes is a significant element for self-financing, because it ensures that all projects are charged with premiums that correspond to their respective risk. This has the effect that the potentially higher rate of default incurred with riskier projects is remedied by higher revenues through the higher premiums charged whereas the lower premiums charged to lower risks ensure that the scheme remains attractive also for these projects. The risk differentiation therefore allows for a broad population of the scheme and at the same time ensures that its revenues will cover the potential costs incurred.

The Commission concluded that the schemes could be viewed as 'self-financing' in the sense of the Notice on Guarantees as the revenues from the premiums could be expected to cover the cost of defaults and the administrative costs, i.e. the operating costs and not the capital costs. This follows from point 4.3 (f) of the Notice on Guarantees, which states that the premiums must cover 'the normal risks associated with granting the guarantee and the administrative costs of the scheme'. Furthermore, it is stipulated only 'where the State provides the initial capital for the start-up of the scheme, a normal return on that capital' must be included, which was not the case in the present schemes.

Finally, the last issue was how to define the Notice on Guarantee's concept of being in *all probability* self-financing. Although it could be argued that in order to draw such a conclusion one needs to consider a full economic cycle including all its 'probabilities', including a hypothetical economic downturn, the Commission decided to accept reliance on the information of the last previous years (1989-2000), where the scheme's revenues predominantly have been able to cover the costs and even to generate surpluses. It considered that, as the spread of premiums into six categories was established with view to this past experience and the increase in premiums charged to risks above average is likely to lead to an increase in revenues,

([1]) Aid C 28/03, OJ C 145 of 21.6.2003, p. 3, see in particular points 29 to 34.

the schemes will also in the future be able to cover their costs.

However, the Commission envisaged that the system had to be reviewed at some point. Therefore, the schemes were only approved until 2006. Thereafter, a review should be conducted on the basis of the data gained within the annual monitoring of the schemes.

The decision specified that within the yearly reports that are to be submitted for the constant review of State guarantees as foreseen in point 7 of the Notice on Guarantees the following data was to be provided for each risk category:

— revenues from the charged premiums (before costs and defaults and recoveries),

— total revenues (including recoveries),

— number and amount of defaults (displayed individually),

— administrative costs (excluding default payments),

— total costs (including default payments),

— total return (difference between total revenues and total costs),

— the cases where the final rating differed from the initial bank rating.

As on the basis of this data Germany will review the terms on which guarantees are granted and the overall financing of the schemes on a yearly basis, also condition (e) of point 4.3 is meet.

Conclusion

The decision to approve a new German proposal of ship financing guarantees introduces indeed a novelty in so far as the introduction of risk differentiation is concerned. Such differentiation must be welcomed as it is clearly a measure to align state guarantees to market conditions. Moreover, it will make sure that high-risk projects will in the future face premium payments commensurable with the risk that is being insured.

Furthermore, it can not be excluded that this case could serve as an example for the future assessment of guarantees schemes in the shipbuilding sector. The Commission will soon have this opportunity when it has to decide about the above mentioned Italian ship-financing guarantee system.