The following issue on the agenda is the

Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees. It was published in the OJ on 11 March 2000. (2000/C 71/07).

The notice is divided in 7 parts or chapters:

1) Introduction.
2) Applicability of Article 87(1), twofold, as regards the aid to the borrower (usually the aid beneficiary) but also with regard to the aid to the lender.
3) Amount of the aid.
4) Conditions excluding the existence of aid.
5) Compatibility of State aid in the form of guarantees with the common market.
6) Consequences of the infringement of Article 88(3)
7) Reports to be presented to the Commission by Member States

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1) INTRODUCTION

Guarantees are usually associated with a loan or other financial obligation to be contracted by a borrower with a lender.

The notice, however, covers all forms of guarantees, irrespective of their legal basis and the transaction covered, except for export credit guarantees, to which the notice does not apply.

Guarantees may be granted as individual guarantees or within guarantee schemes.

As already mentioned, if aid is involved, this aid in most cases benefits the borrower. However, in certain circumstances, there may also be an aid to the lender.

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2) APPLICABILITY OF ARTICLE 87(1)

Aid to the borrower

The State guarantee enables the borrower to obtain better financial terms for a loan than those normally available on the financial markets.

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.

State guarantees may facilitate the creation of new business or may help undertakings to pursue new activities or to remain active instead of closing down or being restructured. Therefore, State guarantees distort competition and generally fall within the scope of Article 87(1), if trade between Member States is affected and no market premium is paid.

Where the State forgoes an appropriate premium that compensates the risk carried, there is both a benefit for the undertaking which benefits from the guarantee and a drain on the resources of the State, even if no payments are ever made by the State.

The aid is granted at the moment when the guarantee is given. It is clear that whether or not a guarantee constitutes State aid, and, if so, what the amount of that State aid may be must be assessed at the moment the guarantee is given.

The more favourable funding terms obtained by enterprises whose legal form rules out bankruptcy or other insolvency procedures is also regarded as aid by the Commission.

The same applies to the acquisition by the State of a holding in an enterprise if unlimited liability is accepted instead of the usual limited liability.

Aid to the lender

Even if usually the aid beneficiary is the borrower it cannot be ruled out that under certain circumstances the lender, too, will benefit from the aid.

For example, if a State guarantee is given ex-post in respect of a loan or other financial obligation already entered into without the terms of this loan or financial obligation being adjusted, or if one guaranteed loan is used to pay back another, non-guaranteed loan.

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3) AMOUNT OF THE AID

The relevant factors to asses the aid element for an individual State guarantee include in particular:

- duration and amount of the guarantee and loan
- risk of default by the borrower
- price paid for the borrower for the guarantee
- nature of any security given
- cases where the State can be called upon to pay the debt

Cash grant equivalent of a loan guarantee (on a yearly basis):

a) Individual guarantees (standard method, in principle):

interest subsidy = market rate – rate obtained thanks to the State guarantee (after deduction of any premium paid)

b) Guarantee schemes:

outstanding sum guaranteed x risk factor (probability of default) – premium paid

c) However, the cash grant equivalent can be calculated by any other objectively justifiable and generally accepted method.

The risk factor should be based on the past experience of defaults on loans given in similar circumstances (sector, size of firm, level of general economic activity).

Where, at the time the loan is granted, there is a strong probability that the borrower will default, e.g. because he is in financial difficulty, the value of the guarantee may be as high as the amount effectively covered by that guarantee.

The Commission suggests that a percentage of at least 20 % not covered by a State guarantee will serve as an appropriate limit for inducing the lender to properly assess the creditworthiness of the borrower and to minimise the risk associated with the transaction. In this regard, several Member States already apply this rule.

The Commission will therefore, in general, examine critically any guarantees covering the entirety (or nearly the entirety) of a financial transaction.

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4) CONDITIONS EXCLUDING THE EXISTENCE OF AID

The Commission considers that the fulfilment of all the following conditions ensures that an individual State guarantee does not constitute State aid under Article 87(1):

(a) the borrower is not in financial difficulty;

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

(c) the guarantee is linked to a specific financial transaction, is for a fixed maximum amount, does not cover more than 80 % of the outstanding loan or other financial obligation and is not open-ended;

(d) the market price for the guarantee is paid (which reflects, amongst others, the amount and duration of the guarantee, the security given by the borrower, the borrower's financial position, the sector of activity and the prospects, the rates of default, and other economic conditions).

The Commission considers that the fulfilment of all the following conditions ensures that a State guarantee scheme 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 maximum amount, do not cover more than 80 % of each outstanding loan or other financial obligation 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.

Failure to comply with any one of the above conditions does not mean that such guarantee or guarantee scheme is automatically regarded as State aid.

If there is any doubt as to whether a planned guarantee or scheme does constitute State aid, it should be notified. Also high-risk guarantees (i.e. given to start-ups, small and medium size enterprises or innovative products or processes) are to be notified to the Commission.

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5) COMPATIBILITY OF STATE AID IN THE FORM OF GUARANTEES WITH THE COMMON MARKET

The Commission will accept guarantees only if their mobilisation is contractually linked to specific conditions. These conditions will have to be agreed at the initial examination by the Commission of the proposed guarantee, at the stage when it is granted.

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6) CONSEQUENCES OF THE INFRINGEMENT OF ARTICLE 88(3)

Article 88(3) states *"The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the common market having regard to Article 87, it shall without delay initiate the procedure provided for in paragraph 2 (decide on the abolishment or alteration of the aid). The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision"*.

Where Member States do not observe the obligations of prior notification and suspension laid down in Article 88(3), the aid element of the guarantee is to be qualified as unlawful in accordance with Article 1(f) of Council Regulation (EC) No 659/1999 of 22 March 1999.

If a national court is requested to order recovery of the unlawful aid, it must normally grant that application.

Therefore, lenders may have an interest in verifying, as a standard precaution, that the Community rules on State aid have been observed, whenever guarantees are granted.

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7) Reports to be presented to the Commission by Member States

In addition to the usual data on expenditure, the reports to be presented annually to the Commission should give data on the total amount of State guarantees outstanding, the total net amount paid in the preceding year by the State to defaulting debtors and the premiums paid for State guarantees in the same year. This information will help in calculating the rate of default and will be used to reassess the value of future guarantees and, if necessary, the premium to be paid in the future.