05 November 2007

MAJOR ISSUES OF THE ITALIAN POSITION

ON THE REVISED COMMISSION NOTICE ON STATE AID IN THE FORM OF GUARANTEES

Courtesy translation

Following to the multilateral meeting held on the 25th of September 2007, Italian authorities submit the present courtesy translation of the details of their major comments on the Revised Commission Notice on State Aid in the form of guarantees (**"Draft"**), also having regard to the informal exchange of views that has taken place on the 23rd of October 2007.

EXPORT CREDIT

The Italian Authorities consider, as expressed at the 23 October bilateral meeting and in accordance with the positions expressed by the other Member States at the 25 September multilateral meeting, that export credit insurance and guarantees should, as provided for by the regulation in force, be explicitly exempted from the scope of application and the last period of paragraph 1.4 be eliminated as a precondition.

It states that "*In the case of export credit guarantees, the relevant notice applies and may be complemented, where relevant, by the present notice.*". In light of the above, as done by all Member States, the Italian Authorities confirm their general reservation on the draft revised Commission Notice.

The following comments apply.

1. A different unilateral approach to the regulation of export credit weakens the Commission, when it plays the role of the European negotiator, on behalf of all EU Member States, in OECD and WTO negotiations.

Officially supported export credits are ruled by a comprehensive set of international rules that, stemming from agreements reached within the WTO and the OECD, have been included in the European legal system and made consistent with the State Aid regulations through specific legal instruments (Communication 97/C 281/03 as subsequently amended; see in this last regard Communication 2005/C 325/11).

Besides the effects described in the following points, changing "unilaterally" such set of international rules has effect on EU Member States only and clearly undermines the ability of the Commission, as the European negotiator on behalf of all Member States, to look after the

European interests in the above mentioned multilateral fora. It is clear indeed that the effectiveness of the activities that the Commission carry out within such international fora to support the European positions would be significantly lowered by issuing the Communication being discussed here, both since it would signal that the Commission itself does not consider the international legal framework as a central pillar and because, when negotiating, non European partners could object that the Commission could go ahead on its own anyway without needing them on board. This effect, as such extremely negative as the international set of rules, and in particular the arrangement reached within the OECD, is subject to frequent revisions and amendments, is even more negative in the light of the intense outreach efforts that the Participants to the OECD Arrangement, among which the Commission, are making to get the strategic goal of inducing the non Participant Countries, in particular the so called emerging countries, to adhere to the international rules: the blow that the Commission, through issuing the Communication being discussed here, would give to the primary role played by the international set of rules would undoubtedly translate into a reduced ability of the international community to emphasize the crucial importance of such rules with the emerging countries, thus making its effort hardly credible.

In other words and to sum up, going ahead at EU level only on export credits is detrimental both for the Commission to support the European position with the non European counterparts and, in the middle of a delicate enlargement process, for the strenght of the international rules with those that do not follow them. As a conseguence, against the objectives of the Draft, the international effort to harmonize the rules and strengthen fair competition (which gave rise to the international legal framework on export credits) is weakened both by the reduced strength of one of its main supporter, that is the European Union, and by the "fallout" of such reduced strength on the inclusion in the international legal framework of those countries that are not part to it, the emerging economies, which would continue to implement schemes of public support that are far from being inspired to fair competition principles.

2. <u>Unilateral application of State aid rules on export credits has makes European firms less competitive than other international competitors.</u>

Restricting regulations on export credits has direct and negative effects on the competitiveness of European firms. The above mentioned set of international rules, and in particular the OECD Arrangement, provide for a level playing field among Participants' systems of officially supporting export credits, thus levelling in financial terms their national firms.

Changing such rules for EU Member States only would undoubtedly break such balance, harming the European firms for the benefit of the non European ones. Moreover, also in this respect it is worth considering the issue represented by the emerging countries, as it is clear that changing unilaterally, and in a restrictive manner, the international rules would make the competitiveness of European firms vis-à-vis such countries firms worse, while the main efforts the whole community is making nowadays goes in the opposite direction, and could create an incentive for the non European countries that follow the international rules and for the emerging countries to team up, as the loss of competitiveness stemming from joining the international rules would be clearly reduced for the latter.

In other words, the same paradox outlined before emerges: a European legal initiative aimed at strengthening fair competition actually produces the opposite result by determining differences in treatment, moreover not in place so far, and all this while the whole international community is deploying the greatest effort ever to close the legal competition gap with the non participants, the emerging economies.

3. <u>Unilateral, though partial, modification of rules applicable to export credit causes legal uncertainty and high unpredictability</u>

Adopting new regulations on export credits would create legal uncertainty for the Export Credit Agencies and their clients, i.e. financial intermediaries and industrial firms. Rules must be clear-cut and certain in order to run a business properly and, much more than that, they must be recognized *ex ante*. Instead, it is clear that respecting two set of rules has, as a direct conseguence, that it would be impossibile to have the needed *ex ante* legal certainty, particularly given that one of those sets, the European, would apply "where relevant" and not in specific and predetermined circumstances. This is detrimental to the business world;

4. International agreements and norms originated in WTO and OECD guarantee the balance among the main international competitors.

The introduction in the community law of international agreements and norms originated in WTO and OECD guarantee a balanced treatment among the main international competitors, and therefore among a wider spectrum of international, that is recognized as an effective international discipline to avoid distorsions of competition.

Community law further regulates with its own norms the domain of State aid and guarantees. In this context the Commission Notice currently in force explicitly excludes from its scope of application the domain of export credit.

The Italian Authorities hold that the ratio for this specialty of regulation is fully valid and resides in the fact that the domain of export credit is regulated from the abovementioned international agreements and norms originated in WTO and OECD that guarantee the balance among the main international competitors, and therefore among a wider spectrum of international law subjects relevant to this domain than the ones that are subject to the EU.

The draft Commission Notice, in the event it should not include the present explicit exclusion of export credit from its scope of application:

- would break, unilaterally and to the detriment of EU operators, the balance in international competition reached by an international agreement and
- would allow non-EU members that are members to the OECD to put in place under the Consensus Agreement interventions that would be precluded to EU operators themselves, still participants to the very same Consensus Agreement but bound to further community law obligations, determining therefore for them an *uneven playing field*.

In such a case the Consensus Agreement would not produce the same effects for all its subjects of international law that are part to it and would not in fact discipline the domain of export credit in an effective manner in order to avoid distortions of competition.

It should finally be recalled that a third group of competitors of increasing importance, the non-OECD Members, are free of obligations whether it be of EU or of OECD origin, and in some cases they are not even bound by WTO rules, and they operate with a competitive advantage.

In light of the above, as done by all Member States, the Italian Authorities hereby request that export credit insurance and guarantees be explicitly exempted from the scope of application of the draft revised Commission Notice, as set forth in the current regulation, and the last period of paragraph 1.4 be eliminated.

TYPES OF GUARANTEE

Finality of juridical certitude and predictability about the Commission's future decisions, make advisable and useful typify the single form of guarantee, excluding from the text all kinds of *intention statements* to be considered formally and substantially *"patronage letters"* as they don't imply any obligation pertaining to precisely surety or guarantee.

The draft gives in particular at the point 1.2 some examples of kind of guarantee, including some atypical forms of guarantee such as *letters of comforts*, *side letters and oral commitments*. The same draft at the point 2.1. concerning "general remarks" specifies that *"The benefit of a State guarantee is that the risk associated with the guarantee is carried by the State"*.

The Italian representatives point out that the "comfort letter" is an anomalous form of guarantee, whose typical and peculiar function is different from that of the *fidejussion* or other usual guarantees.

In spite of the qualification as a guarantee, the "comfort letter" is quite different from the *fidejussion* or other usual guarantees.

Fidejussion consists on an agreement by which one person assumes the responsibility of assuring payment or fulfilment of another's debts or obligations, while the *Patronnant* doesn't properly assume any obligation by a comfort letter . The letter of comfort is not quite a guarantee: it is not a statement (or contract) to perform an obligation or discharge a liability of another person, should that person fail to do so. The letter of comfort. is usually a document issued by a parent company on behalf of a subsidiary operating in a different country. The parent company (company A) agrees to make every effort to ensure that company B (the subsidiary) will comply with the terms of a given contract, but <u>company A is not committed to perform B's obligations if B cannot do so or defaults</u>.

What *patronnant* intends properly to declare is his personal convincement that the subsidiary will fulfil his own obligations, which should have to and that should convince the creditor about subsidiary's trustworthiness .

Such consideration is valid especially in the event of weak "comfort letters". Such letters have, from a legal point of view, scarce weight and relevance. In fact they express nothing more than an intention or an intent to make subsidiary's commitment respected. Hence they are productive of a <u>"moral"</u> obligation, instead of a proper legal responsibility. Hence no rights of credit versus the *patronnant* will raise as consequence of the subsidiary's non fulfilment .

What substantially lacks in these cases is the typical profile of the risk transfer (the risk the borrower or beneficiary doesn't pay) to the State or to regional bodies or to companies controlled by them.

To sum up including comfort letters and, *a fortiori*, simple oral commitment, whereas no risk transfer is implied, in the case in point (guarantee ruled by the draft in exam) seems incongruent.

Only the forms of atypical guarantee unequivocally involving the risk transfer to the guarantor, which means the possibility to recognize and point out ex ante in the letter or statement appropriate elements suitable to concretize this *transfer*, could be included in the Commission notice.

Therefore Italian representatives ask the draft to provide a complete and unequivocal definition under both juridical and financial meaning of "*risk transfer* ".

<u>VALUATION OF GUARANTEES FOR SMEs</u>

<u>Italian authorities share the requirement to conform to the Basel 2 rules. Nevertheless, they retain the rating system doesn't fit for SMEs peculiarities.</u>

<u>Moreover, it is not understood the rationale behind the premia set forth by the Commission in the draft.</u>

RATING SYSTEM

Italian authorities underline that the rating system on which the safe harbour premium are based seems to be more consistent with large undertakings. On the contrary, SMEs, particularly start up enterprises, seems to be seriously disadvantaged. If we apply the system proposed by Commission in the draft, SMEs should be obliged to pay a high price for guarantees because they have a structural low rating.

PREMIA REPRESENTING THE SAFE HARBOUR

It is understood that the rationale behind the premia set forth by the Commission in the Draft Commission Notice is that they should provide a certain level of comfort to the Commission as they represent a safe harbour. It is also clear that premia should not allow any form of subsidy between the rating classes proposed in the table (i.e. arithmetic means cannot be used within a certain band). Nonetheless, the level of premia proposed is, according to our experience, higher than that observed in the market and in any case significantly distant from the outcome obtained by using the expected loss methodology, applied currently by banks and financial institutions.

Italy retains necessary adopting univocal and shared criteria in order to determine a fair and accurate level of premia. In order to provide the Commission with a specific proposal, Italy suggests the application of Basel II rules in order to determine a fair level of premia representing the safe harbour. Basel II has the advantage of being widespread, commonly accepted and universally valid (i.e. applicable to all European Countries).

The methodology is based on the principle that premia charged by any financial institution should allow covering of the following:

1. the expected loss of the transaction, plus
2. the administrative costs incurred in underwriting and managing the transaction, plus
3. compensation for the capital provisioned for the transaction (reserves).

1. The expected loss (EL) of the transaction is calculated as follows:
   EL = (Probability of Default) x (1 – Recovery rate)
   Whereby:
   - The Probability of Default (PoD) is related to the rating of the borrower and represents the probability that the borrower will default on its payment obligations in one year. The PoD associated with each rating level is based on statistical observations[1].
   - The Recovery rate represents the percentage of the credit that can be recovered when a default has occurred. Again, it is based on statistical observations recorded by banks and financial institutions. Banks and financial institutions set the recovery rate for European SMEs at 20%[2].

2. The administrative costs have been set at 5 basis points per annum, (e.g. a loan of € 1 million would imply administrative costs equal to € 500 per annum).

3. The compensation on capital provisioned for the transaction is calculated as (Reserve compensation rate) x (Reserves), and is therefore determined in two steps:
   3.a. determination of level of reserves
   3.b. determination of the compensation rate.

[1] Fitch - *Exposure Draft: Introducing the Fitch VECTOR Default Model Version 3.0*, Appendix 1 page 7, FitchRatings Criteria Report, 28 July 2006

[2] Fitch - *Exposure Draft: Introducing the Fitch VECTOR Default Model Version 3.0*, Appendix 2 page 8, FitchRatings Criteria Report, 28 Luglio 2006

3.a With respect to the reserves, the previous Basel agreement required a level of obligatory reserves by banks and financial institutions equal to 8% of the principal of the transaction. The new Basel II agreement provides for a more refined level of provisioning, weighted on the actual probability of default of the borrower (i.e. on the rating), whereby the reserves increase with the risk of the transaction. More in detail, Basel II requires that – out of the said 8% set forth in the previous Basel agreement - provisioning will be made as follows:

	From AAA to AA-	From A + to A-	From BBB+ to BB-	below BB-
Basel 2 weight	20%	50%	100%	150%
Reserve	2%	4%	8%	12%

3.b With respect to the compensation rate to be charged on the reserves, it is set at 400 b.p. as per the Commission's assessment of fair reward on credit assisted by a state guarantee.

According to the set methodology and to the assumptions indicated above, the "Safe Harbour" premia result as follows.

Table 1

S&P/Fitch	Expected Loss	Administrative Costs	Cost of Capital	Safe Harbour
AAA	0,00%	0,05%	0,06%	0,11%
AA+	0,00%	0,05%	0,06%	0,11%
AA	0,01%	0,05%	0,06%	0,12%
AA-	0,01%	0,05%	0,06%	0,12%
A+	0,02%	0,05%	0,16%	0,23%
A	0,02%	0,05%	0,16%	0,23%
A-	0,04%	0,05%	0,16%	0,25%
BBB+	0,05%	0,05%	0,32%	0,42%
BBB	0,14%	0,05%	0,32%	0,51%
BBB-	0,39%	0,05%	0,32%	0,76%
BB+	0,85%	0,05%	0,32%	1,22%
BB	1,43%	0,05%	0,32%	1,80%
BB-	2,94%	0,05%	0,32%	3,31%
B+	5,18%	0,05%	0,48%	5,71%
B	6,90%	0,05%	0,48%	7,43%
B-	9,94%	0,05%	0,48%	10,47%

As the distribution of the rating among European SME is different in the Member States, the "safe harbour" premia proposed by Italian authorities are indicated notch by notch, though the Commission approach is simpler, as it focuses only on seven "safe harbour" premia, each of them corresponding to small aggregations of different ratings.

Anyway, just in order to make possible comparing the “safe harbour” premia showed above to the ones proposed by the Commission, the same structure of the table contained in the draft is hereunder replied.

Table 2 shows:

- the draft safe harbour premia;
- the average of safe harbour premia as elaborated by Italian authorities.

Table 2

S&P/Fitch	Safe Harbour	
	Italian elaboration	Commission elaboration
AAA	0,11%	1%
AA+ AA AA-	0,12%	1%
A+ A A-	0,24%	1%
BBB+ BBB BBB-	0,57%	1%
BB+ BB	1,51%	2,2%
BB- B+	4,51%	4%
B B-	9%	7,5%

“SAFE HARBOUR” RELATED TO PERCENTAGE OF COVER

Italy requests that, in line with the in force Commission Notice, bonds and similar financial instruments remain excluded from the limit of 80%.

In the current Notice, bonds and similar financial instruments are excluded from the limit of 80%, while in the Draft Commission Notice the limit of 80% would be applicable to this category of financial instruments. We question the underlying rationale behind this change of approach, especially since it will be inconsistent with market practice (there is no statistical evidence of partial guarantees on financial instruments in the market).

More specifically, bond issues in capital markets are addressed mainly to retail investors, therefore a necessary condition is that they provide clarity, certainty and transparency on the risk underwritten by the investor. A partial guarantee would make bonds and financial instruments difficult to trade and would not allow for a straightforward risk assessment by the investors. In addition, bonds and financial instruments are standardised products, widespread on the major financial markets. These characteristics easily allow to verify compliance with the market economy investor principle (MEIP). In the light of the above, in comparison with guarantees issued on unregulated markets, bond and financial instruments offer a higher level of comfort that a 100% guarantee would not constitute State Aid.

Finally, it is requested that guarantees exceeding 80% should be notified to the Commission for approval. We wish to emphasize that this will no doubt lead a delayed response to the applicant with comparison to that received from non–EU competitors.

In summary, Italy requests that the proposed limit of 80% would not be applied to bonds and similar financial instruments, as per the prevailing notice.