

II

(Information)

INFORMATION FROM EUROPEAN UNION INSTITUTIONS AND BODIES

COMMISSION

Communication from the Commission on the revision of the method for setting the reference and discount rates

(2008/C 14/02)

(This communication replaces the previous notices on the method for setting the reference and discount rates)

REFERENCE AND DISCOUNT RATES

Within the framework of the Community control of State aid, the Commission makes use of reference and discount rates. The reference and discount rates are applied as a proxy for the market rate and to measure the grant equivalent of aid, in particular when it is disbursed in several instalments and to calculate the aid element resulting from interest subsidy schemes. They are also used to check compliance with the *de minimis* rule and block exemption regulations.

BACKGROUND TO THE REFORM

The main reason for re-examining the methodology for setting reference and discount rates is that the required financial parameters are not always available in all Member States, especially in the new ones ⁽¹⁾. In addition, the current method could be improved in order to take account of the debtor's creditworthiness and collaterals.

Therefore, this Communication presents a revised method for setting reference and discount rates. The proposed approach builds on the current arrangement, which is accepted by all Member States and practical to apply, to develop a new method that mitigates some of the current shortcomings, is compatible with the various financial systems in the EU (in particular in the new Member States) and remains simple to implement.

STUDY

A study by Deloitte & Touche ⁽²⁾, commissioned by DG Competition, proposes a system based on two pillars: a 'standard' approach and an 'advanced' approach.

⁽¹⁾ The current reference rates for these Member States are those communicated by the Member States as reflecting a suitable market rate. The methodology for arriving at these rates diverges from one Member State to another.

⁽²⁾ Available on the website of DG Competition:
http://ec.europa.eu/comm/competition/state_aid/others/

Standard approach

In this approach, the Commission publishes, each quarter, a base rate calculated on several maturities — 3 months, 1 year, 5 years and 10 years — and for various currencies. IBOR rates ⁽¹⁾ and ask swap rates are used or, in the absence of these parameters, government bond rates. The premium applied to obtain the reference rate for a loan is calculated according to the borrower's creditworthiness and collaterals. According to the rating category of the company ('rating' provided by rating agencies in the case of major companies or by banks in the case of SMEs), the margin applicable to the default case (normal rating and normal collateralisation ⁽²⁾) represents 220 basis points. The increase could be up to 1 650 in the case of 'low' creditworthiness and low collateralisation.

Advanced approach

This approach would allow Member States to appoint an independent calculation agent — a central bank for instance — in charge of publishing regularly a fair reference interest rate, for a higher number of maturities and on a more frequent basis than the standard approach. This approach would be justified by the knowledge and proximity of the financial and banking data available to this institution in comparison with the Commission. In that case, the Commission and an external auditor would validate calculation methods. In this approach, opting out, in certain cases, could be considered.

Weaknesses

Despite the economic relevance of the two methods, certain difficulties can be underlined.

Standard approach:

- it does not solve the problem of the lack of financial data in the new Member States and adds new, not readily accessible parameters,
- this standard method could favour large companies to the detriment of SMEs for which either no rating is available, or a less advantageous one exists (in particular because of information asymmetry with respect to the lender). It could give rise to multiple disputes on the subject of calculation methods for the premium to be applied according to creditworthiness and the level of collaterals,
- it does not simplify the task of Member States, in particular regarding calculations to check compliance with the *de minimis* rule and the block exemption regulations.

Advanced method:

- the advanced method could prove problematic when applied to aid schemes: the volatility of market rates might make the difference between the underlying rate of a loan scheme and the then valid reference rate so advantageous to the borrower that some measures would become incompatible with the State aid rules,
- a quarterly adjustment of the rates would complicate the handling of cases as the calculated aid amounts may vary considerably between the beginning of the assessment phase and the date of the final decision taken by the Commission,
- these arrangements seem overly complicated and may fail to ensure consistently fair treatment across Member States.

NEW METHODOLOGY

To avoid these difficulties, the Commission proposes a method that:

- is easy to apply (in particular for the Member States when dealing with measures falling under the *de minimis* or block exemption regulations),
- ensures equal treatment across Member States with minimum deviations from current practice and facilitating the application of reference rates for the new Member States,
- uses simplified criteria taking into account firms' creditworthiness instead of the mere size of undertakings, which seems a too simplistic criterion.

⁽¹⁾ Inter-bank offered rate on the money market.

⁽²⁾ Cases where the recipient shows a satisfactory rating (BB) and a loss given default rate between 31 % and 59 %.

Moreover, this method makes it possible to avoid adding uncertainty and complexity to calculation methods in a changing banking and financial environment due to the implementation of the Basel II framework, which could have a significant impact on the allocation of capital as well as on banks' behaviour. The Commission will continue to monitor this changing environment and, if necessary, provide further guidance.

COMMISSION NOTICE

The main reason for re-examining the methodology for setting reference and discount rates is that the required financial parameters are not always available in all Member States. In addition, the current method can be improved in order to take account of the debtor's creditworthiness and collaterals.

The Commission therefore adopts the following methodology for setting the reference rates:

— Calculation basis: 1-year IBOR

The base rate is based on 1-year money market rates, available in almost all Member States, the Commission reserving the right to use shorter or longer maturities adapted to certain cases.

Where those rates are not available, the 3-month money market rate will be used.

In the absence of reliable or equivalent data or in exceptional circumstances the Commission may, in close cooperation with the Member State(s) concerned and in principle based on data from that Member State's Central Bank, determine another calculation basis.

— Margins ⁽¹⁾

The following margins are to be applied in principle depending on the rating of the undertaking concerned and the collateral ⁽²⁾ offered.

Loan margins in basis points			
Rating category	Collateralisation		
	High	Normal	Low
Strong (AAA-A)	60	75	100
Good (BBB)	75	100	220
Satisfactory (BB)	100	220	400
Weak (B)	220	400	650
Bad/Financial difficulties (CCC and below)	400	650	1 000 ⁽¹⁾

⁽¹⁾ Subject to the application of the specific provisions for rescue and restructuring aid, as currently laid down in the Community guidelines on State aid for rescuing and restructuring firms in difficulty (OJ C 244, 1.10.2004, p. 2) and in particular point 25(a), which refers to 'a rate at least comparable with the rates observed for loans to healthy companies, and in particular at the reference rates adopted by the Commission'. Hence, for rescue aid cases, the 1-year IBOR increased with at least 100 basis points shall be applied.

Normally, 100 basis points are added to the base rate. This assumes (i) loans to undertakings with satisfactory rating and high collateral; or (ii) loans to undertakings with good rating and normal collateral.

⁽¹⁾ As follows from the study, the margin is largely independent of the maturity of the loan.

⁽²⁾ Normal collateral should be understood as the level of collateral normally required by financial institutions as a guarantee for their loan. The level of collaterals can be measured as the Loss Given Default (LGD), which is the expected loss in percentage of the debtor's exposure taking into account recoverable amounts from collateral and the bankruptcy assets; as a consequence the LGD is inversely proportional to the validity of collaterals. For the present communication it is assumed that 'High' collateralisation implies an LGD below or equal to 30 %, 'Normal' collateralisation an LGD between 31 % and 59 %, and 'Low' collateralisation an LGD above or equal to 60 %. For more details, on the notion LGD, see Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework — Comprehensive Version, available on: <http://www.bis.org/publ/bcbs128.pdf>

For borrowers that do not have a credit history or a rating based on a balance sheet approach, such as certain special-purpose companies or start-up companies, the base rate should be increased by at least 400 basis points (depending on the available collaterals) and the margin can never be lower than the one which would be applicable to the parent company.

Ratings do not need to be obtained from specific rating agencies — national rating systems or rating systems used by banks to reflect default rates are equally acceptable ⁽¹⁾.

The above margins may be revised from time to time to take account of the market situation.

— Update

An update of the reference rate will be carried out every year. The base rate will thus be calculated on the basis of the 1-year IBOR recorded in September, October and November of the previous year. The then fixed base rate will be in force as from the first of January. For the period from 1 July 2008 until 31 December 2008, the reference rate will exceptionally be calculated on the basis of the 1-year IBOR recorded in February, March and April 2008, subject to the application of the next paragraph.

In addition, to take account of significant and sudden variations, an update will be made each time the average rate, calculated over the previous three months, deviates by more than 15 % from the rate in force. This new rate will enter into force on the first day of the second month following the months used for the calculation.

— Discount rate: Calculation of net present value

The reference rate is also to be used as a discount rate, for calculating present values. To that end, in principle, the base rate increased by a fixed margin of 100 basis points will be used.

— The present methodology will enter into force as of 1 July 2008.

⁽¹⁾ For a comparison between the most commonly used credit rating mechanisms, see e.g. Table 1 in Working Paper No 207 of the Bank for International settlements:
<http://www.bis.org/publ/work207.pdf>