EUROPEAN COMMISSION

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COMMISSION LETTER TO MEMBER STATES

Subject: Reference/discount rates

Dear Sir,

For the purposes of Community monitoring of state aid as required by the EC Treaty, the Commission uses various parameters, including the reference and discount rates.

The reference/discount rates are used to measure the grant equivalent of aid that is disbursed in several instalments and to calculate the aid element resulting from interest subsidy schemes. They are also used in implementing the "de minimis" rule and for the repayment of illegal aid.

In its decision of 10 July 1996, which was communicated to you by letter of 2 August 1996, the Commission amended the method for setting and updating the reference/discount rates. Since 1 August 1996, the reference rate has been calculated on the basis of the rate on 10-year state bonds, as harmonized by the European Monetary Institute, plus a specific premium for each Member State.

The Commission also had a study carried out on the method of setting the reference rates in the context of aid schemes for businesses within the European Union. One of the objects of the study was to check the level of current premiums and to propose their revision if necessary, with a view to possible harmonization and closer alignment on markets. The study was also supposed to assess the desirability of replacing the EMI rates by the rates of yield on medium-term (five to seven year) state bonds.

The study was carried out by KPMG, Frankfurt, on the basis of a survey of over 70 banks in the 15 Member States. The main results of the study are set out below.

KPMG looked separately at the question of the choice of the base rate, currently the EMI rate, and of the calculation of the adjustment premiums.

Base rate

KPMG takes the view that, if it is to be used to determine the reference rate, the base rate must be:

- a market rate whose monthly movement can be easily followed;
- similar in maturity to ordinary public loans;
- used if possible by the banks for determining the charges on their loans to businesses.

The EMI rates do not fulfil all the above-mentioned conditions: they have a longer maturity (10 years) than most of the public loan regimes examined by the Commission, whose duration hardly exceeds five to six years. Nor are they used by the banks in determining the charges on their loans to businesses.

The fact that the reference rate does not correspond to the maturity of the loans examined by the Commission may lead to errors in aid assessment. For example, the rate on a public loan having a duration of five years may be lower than the EMI rate and yet not contain any aid element.

This phenomenon is partly offset by the adjustment premiums, as long as the yield curve does not vary over time.

As regards the base rate, the consultants recommend use of the five-year interbank swap rates instead of the EMI 10-year rates. This is because the five-year rates correspond more to the average capital-repayment period for ordinary public loans.

KPMG also recommends that the Commission follow the short-term rates (of the Libor one-year type) and the EMI 10-year rates.

Adjustment premiums

KPMG examined the suitability of the old reference-rate definitions which served as a basis for calculating the current adjustment premiums.

It concluded that these definitions are generally imprecise and heterogeneous as regards the maturity of the loans and their amounts. The amounts usually relate to the cost of indebtedness of firms (stock concept) rather than the cost of their new borrowings (flow concept).

Lastly, the statistics are in general aggregates that do not allow precise measurement of the aid elements contained in the interest subsidy schemes or, *a fortiori*, in individual awards of aid.

As regards the level of the premiums to be applied to the base rate, KPMG have provided brackets that take account of the diversity of situations, notably the different debtor risks, and of the amount of the loan.

In the case of smaller loans (less than ECU 5 million), generally contracted by SMEs, KPMG observed wide differences from one Member State to another and wide disparities within one and the same country. In its view, such disparities are due to the diversity of the risks covered and to the lack of transparency/competition on the relevant markets.

KPMG did not find that such disparities existed in the case of large loans, generally contracted by large firms on highly competitive markets. In the case of this type of loan, KPMG recommends the use of a single premium of 0.75 to 1 percentage point for all the Member States except Italy, Portugal and Greece.

In view of these factors, the Commission has decided that a single adjustment premium of 0.75 point (75 basis points) should be applied to all Member States except Italy, Portugal and Greece. This premium corresponds to the average level of premiums for loans of an amount in excess of ECU 5 million.

This choice is based on the following considerations:

- large loans run a greater risk of significantly affecting intra-Community trade;
- the premiums noted for this type of loan are sufficiently homogeneous to be used. Conversely, the premiums noted for smaller loans correspond to situations which are too diverse, in terms of debtor risk, to be used as references;
- the choice of a single, moderate, premium for most of the Member States reduces the risk of dispute or discrimination. It anticipates the achievement of Economic and Monetary Union, which should result in greater competition in banking and a levelling down of interest rates, including those for SMEs.

Commission decision

In view of the above factors, the Commission has decided that the reference rate should in future be calculated on the basis of the five-year interbank swap rate (one-year interbank swap rate in the case of Greece) plus a premium of 75 basis points (200 basis points in the case of Italy and Portugal and 300 basis points in the case of Greece).

The new system will enter into force on 1 August 1997. As from that date, the reference rates will be determined as follows:

- the indicative rate is defined as the five-year interbank swap rate (offer rate) in the relevant currency (Athibor 1-year rate, in drachmas, in the case of Greece) plus an additional premium of 75 basis points (200 basis points in the case of Italy and Portugal and 300 basis points in the case of Greece);
- the reference rate is deemed equal to the average of the indicative rates recorded in September, October and November of the previous year;
- the reference rate is adjusted again in the course of the year if it differs by more than 15% from the average of the indicative rates recorded over the last known three months.

Under this method, the reference rate for your country is **XXX %** as from 1 August 1997. At each updating, the Commission will inform you of the adjusted rate and will post it on the Internet at the following site.

Yours faithfully,