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FINANCIAL MARKETS LAW COMMITTEE ISSUE 131: STATE AID GUARANTEES

The Financial Markets Law Committee ("FMLC") has recently undertaken work relating to the Draft Revised Commission Notice on the Application of Articles 87 and 88 of the EC Treaty on State Aid in the form of guarantees. I write, therefore, to comment on the Draft Notice and to express the views of the Committee.

The role of the Financial Markets Law Committee, established and sponsored by the Bank of England, is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed. It is from this perspective that I address the Commission's Consultation on the Draft Revised Notice.

State guarantees play a key role in the wholesale financial markets in relation to the issue of debt securities, ie bonds or similar instruments. Where bonds are issued to provide funding for projects or undertakings of national or public importance, it is common for the State to provide a guarantee which supports the issuer's obligations under the instruments. Debt securities issued in this way will eventually reach a multitude of investors through a distribution network of intermediaries and will be frequently traded. It is extremely important that changes to the State Aid regime in relation to guarantees do not give rise to unintended consequences which may have a negative impact on the primary or secondary markets affected.

In the course of its work on State Aid and guarantees, the Committee has uncovered a number of uncertainties in the Draft Revised Notice which, it believes, have the potential to affect, or even undermine, the markets in State-guaranteed debt securities. Paragraphs below provide details of the issues that are of particular concern.

Guarantees which favour certain credit institutions

Paragraph 2.3.2 of the Draft Revised Notice contrasts State guarantees which are made available through the wholesale financial sector with those that are made available through one or more selected credit institutions. In the latter cases, the Draft Notice warns, the Commission cannot rule out the possibility that the specific advantage constituted by the State guarantee will amount to State Aid to the lender. In the case of the issue of debt

securities, the ultimate lender is the investor. However, the securities in question may be sold to the investor through one or more banks arranging the issue and, in addition, one or more intermediaries. The financial institutions involved as arranger, intermediary and/or investor are likely to vary from issue to issue. In any given case they are likely to have been appointed, in the case of arrangers, through a process of competitive tendering. Yet, a particular guarantee cannot be said necessarily to favour credit institutions or beneficiaries throughout the whole financial sector.

In the view of the FMLC this provision of the Draft Notice significantly expands the possibility that, in general, a State guarantee might be considered aid to the lender(s) and requires further elaboration in order to avoid giving rise to misunderstanding, even in the case of traditional or conventional bank lending. However, the manner of its potential application to the guarantees underpinning bond issues is particularly obscure. Careful guidance on the application of this principle in such cases is required to forestall any negative impact on the markets in question.

Specifically, the phrase "made available through the whole financial sector" is unclear in its application to financial institutions which arrange and intermediate the issue of guaranteed debt securities. The FMLC believes that any implication to the effect that the tendering process by which an arranger is normally selected by the issuer should be subject to the full EC Public Procurement Rules under Directive 2004/18/EC would create confusion in view of the specific exclusion for financial services relating to securities issues in Article 16(d) of that Directive. The procurement process itself would also prove unduly cumbersome in certain cases and might prove to be a significant impediment to the operation of the market in the relevant debt securities. Guidance should be given to the effect that this is not the intention of the paragraph.

The FMLC would be grateful for clarification of the intended application of the Notice in these circumstances.

Retroactive invalidity

Paragraph 7 of the Revised Draft Notice invites Member States to adjust their existing guarantee measures to the stipulations of the present Notice and the changes which it reflects to the European regime as a whole. It is essential, in the view of the FMLC, that the Revised Notice confirms and reminds Member States that the changes which it reflects do not apply retroactively to State guarantees granted prior to its publication. The essential virtues of ascertainability and predictability in a legal framework are undermined most seriously of all by the retroactive application of laws or regulation. The law at any time should be reasonably clear and accessible. Clarity and accessibility are required to allow participants in markets to plan their conduct in the knowledge of their obligations and of the consequences of their actions. The principle of certainty is seriously undermined by the retroactive application of law or regulation.

A closely related point is the situation where a State guarantee, which is lawful at the time it is provided, becomes illegal subsequently by means of a change in circumstances over which the lender(s) have no control. For example, this might occur where a full market price is paid for the guarantee and the guarantee is approved by the Commission but subsequently a Member State or the borrower/issuer fails to meet any conditions imposed by the Commission or takes some other action which undermines the legitimacy of the Guarantee. In the view of the FMLC there is no justifiable reason why the lender should bear the risk in such circumstances and the possibility that he may do so undermines the principle of certainty which states that a person should be allowed to rely upon the undertakings which have been given to him insofar as their fulfilment may be outside his own control. As far as the lenders are concerned, the possibility of subsequent invalidation or illegality is much the same as the possibility of retroactive illegality owing to a change in legal circumstances.

The FMLC would be grateful for clarification to the effect that the new regime will not apply retroactively to State guarantees and that lenders will be allowed to continue to rely on Guarantees which were valid and legal at inception throughout the life of the Guarantee.

That concludes the points which the FMLC wishes to raise with the European Commission in the context of its remit to address issues of legal uncertainty. The FMLC is aware that the

International Capital Market Association ("ICMA") has raised similar points in its comments on the Draft Revised Commission Notice and the FMLC endorses that response insofar as it addresses issues of legal uncertainty.

If you would like to discuss any of these matters further with members of the FMLC, Committee members would be delighted to visit you or members of your team in Brussels for that purpose. Moreover, the Committee has an established record of assisting government and other public sector institutions with information about the legal structure and environment for wholesale capital markets operations. If members of your team would, at any point, like further information about the use of State guarantees to support capital markets operations, from a market-based or operational perspective, please do not hesitate to get in touch with the Committee Secretariat at the Bank of England.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Alamy' followed by a large flourish that resembles a stylized 'S' or 'G'. A horizontal line is drawn underneath the signature.

Lord Woolf

Copies to Alain Alexis
Jurgen Foecking
Pascal Schloesslen