

COMMISSION DECISION

of 20 October 2004

on State Aid implemented by Germany for Landesbank Schleswig-Holstein — Girozentrale, now HSH Nordbank AG*(notified under document number C(2004) 3930)***(Only the German text is authentic)****(Text with EEA relevance)**

(2006/741/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular the first subparagraph of Article 88(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on the Member State and other interested parties to submit their comments pursuant to the provisions cited above ⁽¹⁾ and having regard to their comments,

Whereas:

I. PROCEDURE

- representing private banks established in Germany, informed the Commission that, among other things, WKA and WAK, together with their entire assets, had been transferred to LSH with effect from 1 January 1991. At the same time, WKA's and WAK's tasks had been transferred to the recently set-up Investitionsbank Schleswig-Holstein ('IB'). IB operated as a special division of LSH. This increased the own funds at LSH's disposal and, in the BdB's view, distorted competition in its favour since the parties had not agreed remuneration consistent with the market-economy investor principle. In its second letter, the BdB accordingly lodged a formal complaint and called on the Commission to initiate proceedings against Germany under Article 93(2) of the EC Treaty (now Article 88(2)).
- (1) The subject of these proceedings is the transfer of Wohnungsbaukreditanstalt des Landes Schleswig-Holstein ('WKA'), Wirtschaftsaufbaukasse Schleswig-Holstein AG ('WAK') and the special-purpose real-estate reserve by the Land of Schleswig-Holstein to Landesbank Schleswig-Holstein — Girozentrale ('LSH'). There are a further six cases in which proceedings have been initiated against Germany in connection with transfers of assets to Landesbanks, and in particular to Westdeutsche Landesbank Girozentrale ('WestLB').
 - (2) By letter of 12 January 1993, the Commission asked Germany for information on a DEM 4 billion capital increase for WestLB resulting from the incorporation of the housing organisation Wohnungsbauförderanstalt ('WfA') and on similar increases in the own funds of the Landesbanks of other Länder. It asked which Landesbanks had benefited from a transfer of public enterprises and for information on the reasons for those transactions.
 - (3) Germany replied by letters dated 16 March and 17 September 1993. The Commission requested further information by letters of 10 November and 13 December 1993, to which Germany replied by letter of 8 March 1994.
 - (4) By letters of 31 May and 21 December 1994, the Bundesverband deutscher Banken e.V. ('BdB'), an association representing private banks established in Germany, informed the Commission that, among other things, WKA and WAK, together with their entire assets, had been transferred to LSH with effect from 1 January 1991. At the same time, WKA's and WAK's tasks had been transferred to the recently set-up Investitionsbank Schleswig-Holstein ('IB'). IB operated as a special division of LSH. This increased the own funds at LSH's disposal and, in the BdB's view, distorted competition in its favour since the parties had not agreed remuneration consistent with the market-economy investor principle. In its second letter, the BdB accordingly lodged a formal complaint and called on the Commission to initiate proceedings against Germany under Article 93(2) of the EC Treaty (now Article 88(2)).
 - (5) The complaint also related to similar transfers of assets to Landesbank Berlin, Westdeutsche Landesbank, Norddeutsche Landesbank, Hamburger Landesbank and Bayerische Landesbank. In February and March 1995 and December 1996 several banks associated themselves individually with the complaint lodged by their association.
 - (6) By letters of 6 August 1997 and 30 July 1998, the BdB informed the Commission of two further transfers of assets, to Landesbank Schleswig-Holstein in Schleswig-Holstein and Landesbank Hessen-Thüringen in Hessen. According to the BdB, the Land of Schleswig-Holstein intended to transfer the real estate it owned to IB as a special-purpose reserve forming part of LSH's equity capital. The BdB referred in this context to Section 20 of a bill amending the Schleswig-Holstein Investment Bank Act (version as at 26 June 1997), which stipulates that the real-estate assets, after deduction of liabilities, should be considered to constitute a special-purpose reserve forming part of LSH's equity capital. The BdB also referred to the comments on Section 20 contained in the explanatory memorandum to this bill, which state that the special-purpose real-estate reserve constitutes part of the bank's liable equity capital according to the principles of the Banking Act (Kreditwesengesetz). The stated objective of 'mobilising Land assets in order to create liquidity without loss of disposal or

⁽¹⁾ OJ C 76, 28.3.2003, p. 2.

decision-making authority on the Land's part' would not be achieved if LSH were actually to pay the market price for the real estate transferred to it.

- (7) The Commission first examined the transfer of assets to WestLB but announced that it would review the transfers to the other banks in the light of the findings in that case ⁽²⁾. By Decision 2000/392/EC ⁽³⁾, it finally declared in 1999 that the aid measure (the difference between the remuneration paid and the normal market remuneration) was incompatible with the common market and ordered that the aid should be recovered. This decision was annulled by the Court of First Instance of the European Communities on 6 March 2003 ⁽⁴⁾ as insufficient reasons had been given for two of the factors used to calculate the appropriate remuneration, but it was confirmed in all other respects.
- (8) On 1 September 1999 the Commission sent Germany a request for information on the transfers of assets to the other Landesbanks. By letter of 8 December 1999, Germany supplied information on the transfer of WKA and WAK to LSH, supplementing that information in a letter of 22 January 2001. Germany replied to a further request for information dated 22 February 2001 by letter of 3 May 2001.
- (9) By letter of 13 November 2002, the Commission informed Germany of its decision to initiate the formal investigation procedure laid down in Article 88(2) of the EC Treaty in respect of the transfer of WKA, WAK and the special-purpose real-estate reserve of the Land of Schleswig-Holstein to LSH. At the same time, it launched the investigation procedure in respect of similar transfers of assets to Norddeutsche Landesbank — Girozentrale, Bayerische Landesbank Girozentrale, Hamburgische Landesbank — Girozentrale and Landesbank Hessen-Thüringen. It had already opened an investigation into the transfer of Wohnungsbaukreditanstalt to Landesbank Berlin back in July 2002.
- (10) The decisions initiating the procedure were published in the Official Journal of the European Union ⁽⁵⁾. The Commission called on interested parties to submit comments.
- (11) By letter of 11 April 2003, LSH submitted its comments on the initiation of the procedure in the LSH case.
- (12) By letter of 14 April 2003, Germany commented on the decision to initiate the procedure.
- (13) By letter of 29 July 2003, the BdB submitted comments on all the decisions taken on 13 November 2002 to initiate the investigation procedure.
- (14) The Commission asked for further information on 11 September 2003, and Germany replied on 29 October and 6 November 2003, commenting also on BdB's comments on LSH. On 30 October 2003, Germany forwarded comments by the Land Government of North Rhine-Westphalia and by WestLB on the BdB's statement concerning the five Landesbank cases opened in November 2002.
- (15) The Commission sent further requests for information on 7 and 30 April, 19 May and 12 August 2004, to which Germany replied on 1 and 28 June, 27 May, 23 June, 27 August and 30 September 2004.
- (16) On 19 July 2004 the complainant (BdB), the Land of North Rhine-Westphalia and WestLB AG submitted a provisional agreement on the appropriate remuneration for the transferred assets. In their view, this remuneration should form the basis of the Commission Decision. The Commission received the final version of this understanding on 13.10.04. On 29 September 2004, the BdB, the Land of Schleswig-Holstein and HSH Nordbank — which was formed from LSH and Hamburgische Landesbank in 2003 — submitted a provisional understanding on the appropriate remuneration for the transferred assets. These parties and Germany subsequently addressed several letters to the Commission. The definitive version of the understanding on the transfer of the special-purpose assets to LSH reached the Commission on 14.10.04. Similar understandings reached in the other cases involving transfers of assets to Landesbanks — except Landesbank Hessen-Thüringen — were also submitted to the Commission.

II. DETAILED DESCRIPTION OF THE MEASURES

1. LANDESBANK SCHLESWIG-HOLSTEIN — GIROZENTRALE

- (17) Landesbank Schleswig-Holstein — Girozentrale (LB Kiel), with its head office in Kiel, had a group balance-sheet total of EUR 145 500 million (as at 31 December 2002), making it one of Germany's 15 largest banks. Founded in 1917 as the bank of the Province of Schleswig-Holstein, it was a publicly owned credit institution operating in the form of a public institution (Anstalt des öffentlichen Rechts).
- (18) From 1994 LSH was owned by the WestLB group (39,9 %), the Land of Schleswig-Holstein (25,05 %), the Sparkassen- und Giroverband für Schleswig-Holstein (25,05 %) and Landesbank Baden-Württemberg (10 %). This ownership

⁽²⁾ OJ C 140, 5.5.1998, p. 9.

⁽³⁾ OJ L 150, 23.6.2000, p. 1; actions challenging that decision have been brought by Germany (Case C-376/99), by North Rhine-Westphalia (Case T-233/99) and by WestLB (Case T-228/99). The Commission has also brought proceedings for infringement of the Treaty (Case C-209/00).

⁽⁴⁾ [2003] ECR I-435.

⁽⁵⁾ Norddeutsche Landesbank: OJ C 81, 4.4.2003, p. 2; Bayerische Landesbank: OJ C 81, 4.4.2003, p. 13; Hamburgische Landesbank: OJ C 81, 4.4.2003, p. 24; Landesbank Hessen-Thüringen: OJ C 73, 26.3.2003, p. 3.

structure resulted from a transfer of capital holdings from the Land of Schleswig-Holstein and the Sparkassen- und Giroverbands für Schleswig-Holstein to WestLB and Landesbank Baden-Württemberg on 1 January 1994. Prior to this transfer, the Land and the Sparkassen- und Giroverband each held 50 % of the shares.

- (19) On 2 June 2003, LSH and Hamburgische Landesbank merged to form HSH Nordbank AG, a public limited company (Aktiengesellschaft). For tax and balance-sheet purposes, the merger had a retroactive effect as of 1 January 2003.
- (20) According to its annual report for 2002, LSH's core capital ratio was 6,5 % and its equity ratio 10,3 %. Its income-to-equity ratio stood at 10,4 % in 2002.
- (21) Under Section 42 of the Schleswig-Holstein Savings Bank Act (Sparkassengesetz für das Land Schleswig-Holstein), LSH was required to perform the tasks of a government-owned bank, a central savings bank and a commercial bank. It had to manage the Land's banking operations, support the savings banks in carrying out their tasks and issue municipal loans. As a government-owned bank, it granted credit to public authorities and participated — sometimes in a consortium with private banks — in the placement of Land loans and note loans. It also operated as an all-purpose commercial bank.
- (22) Employing over 2 500 staff, LSH had a regional base and an international focus, viewing the north of northern Germany and the Baltic Sea area as its core banking region. It had its own branches, representative offices and holdings and was an international product and sector specialist in transport, shipping and real-estate finance, bank finance and — increasingly — in syndication and as a player on the international capital markets.

2. TRANSFER TO LSH OF WKA'S AND WAK'S ASSETS AND THE SPECIAL-PURPOSE REAL-ESTATE RESERVE

2.1. SETTING-UP AND DEVELOPMENT OF INVESTITIONS-BANK SCHLESWIG-HOLSTEIN

- (23) Under the Schleswig-Holstein Investment Bank Act (Investitionsbankgesetz: 'IBG') of 11 December 1990, IB was set up with effect from 1 January 1991 as a public institution with organisational and economic independence. It is therefore refinanced on behalf of and with the involvement of LSH.
- (24) IB is the central development institution providing economic and structural policy back-up in Schleswig-Holstein. Its product range covers economic and housing assistance, support for environmental and energy projects, municipal and agricultural assistance, and project

management for the Land and municipal authorities ⁽⁶⁾. It also assists infrastructure projects in the Baltic area.

- (25) By the Act of 7 May 2003, which came into force on 1 June 2003, IB was split off from LSH's assets, with legal effect from 1 June 2003 and with retroactive effect on the balance sheet as of 1 January 2003, and set up as an independent public-law institution (Anstalt des öffentlichen Rechts) under the name 'Investitionsbank Schleswig-Holstein' with its head office in Kiel. The assets assigned to Investitionsbank Schleswig-Holstein, including all asset and liability items, were transferred to the hived-off Investitionsbank Schleswig-Holstein by means of universal succession. Despite the retroactive effect on the balance sheet as of 1 January 2003, LSH was able to continue to use IB's capital to underpin its competitive business in the same manner until 1 June 2003.
- (26) The real-estate administration body Liegenschaftsverwaltung Schleswig-Holstein ('LVSH') was also set up as an independent public-law institution, with its head office in Kiel, with legal effect from 1 June 2003 and with retroactive effect on the balance sheet as of 1 January 2003. The special-purpose real-estate reserve was therefore hived off to LVSH on 1 June 2003. At the same time, all assets and liabilities were transferred to Investitionsbank Schleswig-Holstein by means of universal succession. Despite the retroactive effect on the balance sheet as of 1 January 2003, LSH was able to continue to use the special-purpose real-estate reserve to underpin its competitive business in the same manner until 1 June 2003.

2.2. TRANSFER OF WKA TO LSH

- (27) By the Act of 31 March 1950, WKA was set up as a public institution under the name 'Landestreuhandstelle für Wohnungs- und Kleinsiedlungswesen in Schleswig-Holstein'. Its purpose was to support the Land, particularly by financing public and low-tax residential construction and in providing the public with suitable housing. Its assets were made up of so-called special assets and own funds. By law, the special assets had to be used for the specific purpose of financing social-housing operations. WAK's own funds were not subject to this requirement. WKA used its own funds to grant building loans at particularly low interest rates ⁽⁷⁾.
- (28) Under Section 2(1) of the IBG, WKA and its entire assets were transferred, minus the costs of the liquidation, to LSH with effect from 1 January 1991. Section 2(1) of the IBG thus provided for the merger of WKA and LSH. Under Section 14(1) of the IBG, all of the tasks and responsibilities of WKA referred to in Annex 1 to the IBG were transferred to IB with effect from 1 January.

⁽⁶⁾ See its annual report for 1998, p. 1.

⁽⁷⁾ Communication from Germany, 8.12.99, p. 84.

2.3. TRANSFER OF WAK TO LSH

- (29) WAK was a special credit institution set up by the Land as a public limited company (Aktiengesellschaft) with the task of providing financial assistance to the projects of commercial businesses and other measures designed to strengthen the economic and communications structure.
- (30) Section 3 of the IBG authorises the Minister for Finance to take over all of WAK's assets, including all of its rights and obligations. This was necessary because, as a public limited company, WAK could not be merged with LSH in the same way that WKA was. WAK's assets were therefore initially transferred to the Land by means of universal succession under Section 359 of the Public Limited Company Act (Aktiengesetz) so that they could subsequently be transferred to LSH. In financial terms, this was the same as WAK being incorporated into LSH.
- (31) The Ministry of Finance made use of this authorisation and accepted the offer made by WAK's executive board on 19 November 1990 to transfer the assets on 2 January 1991. An 'incorporation agreement' of 2 January 1991 between the Land and LSH regulated the transfer of WAK's assets, including all rights and obligations, with effect from 1 January 1991 ⁽⁸⁾.
- (32) Under Section 14(1) of the IBG, IB continued to perform all of WAK's tasks, which are listed in Annex 2 to the IBG.

2.4. TRANSFER OF THE SPECIAL-PURPOSE REAL-ESTATE RESERVE TO LSH

- (33) Under Section 17(2) of the IBG, the Schleswig-Holstein Ministry of Finance and Energy was authorised to transfer real estate to IB. This involved IB becoming the legal and economic owner of the real estate in question. According to Germany, IB may not, however, freely dispose of the real estate transferred to it. Instead, the real-estate assets as a whole, including any gains made on them, had to be used for a specific purpose.
- (34) Under Section 20(1) of the IBG, the transferred real-estate assets were accordingly designated as a special-purpose real-estate reserve. Under Section 20(2), proceeds from these assets had to be used to maintain, acquire and construct real estate. However, they could also be used — subject to a decision by the Land Government — for the tasks of the Investitionsbank or be returned to the Land.
- (35) The Land of Schleswig-Holstein has sold a total of [...] (*) properties to IB in several lots. The purchase price for each

property was based on the market value, as determined beforehand by an expert evaluation.

- (36) In each case the Land of Schleswig-Holstein transferred part of the price it received to LSH via the 'special-purpose real-estate reserve'. The effect of these transfers on LSH's own funds as shown in the balance sheet was as follows: the purchase of the first lot of properties by IB increased LSH's own funds as shown in the balance sheet at 31 December 1999 by DEM [...] million. On 31 December 2000 the special-purpose real-estate reserve had increased to a total of DEM [...] million following the purchase of a second lot of properties. Following the purchase of the third lot, it reached a total of DEM [...] million on 31 December 2001 and remained at the same level on 31 December 2002 ⁽⁹⁾.
- (37) Germany submits that the special-purpose real-estate reserve did not perform either a financing or a business-expansion function for LSH. It could not be used for business activities as it had not been recognised by the Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen — 'BAKred') ⁽¹⁰⁾ as core capital for supervisory purposes.

3. CAPITAL REQUIREMENTS UNDER THE OWN FUNDS AND SOLVENCY DIRECTIVES

- (38) Pursuant to Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions ⁽¹¹⁾ (the 'Solvency Directive') and Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions ⁽¹²⁾ (the 'Own Funds Directive'), which amended the German Banking Act (Kreditwesengesetz, or KWG), banks must have a level of own funds equal to 8 % of their risk-adjusted assets. At least 4 percentage points of this amount must consist of what is termed core capital, or 'tier 1' capital, meaning items of capital which are at the credit institution's disposal without restriction and immediately to cover risks or losses as soon as they arise. In determining the total own funds available to a bank for supervisory purposes, the core capital is of decisive importance because additional capital, or 'tier 2' capital, is accepted as underpinning for risk-bearing transactions only up to the amount of the available core capital.
- (39) By 30 June 1993 ⁽¹³⁾ German banks had to adapt ⁽¹⁴⁾ their own funds to the new requirements of the Solvency Directive and the Own Funds Directive. Even before the Solvency Directive was transposed into German law, many

⁽⁹⁾ Communication from Germany, 30 September 2004.

⁽¹⁰⁾ Now the Federal Agency for the Supervision of Financial Services (Bundesanstalt für Finanzdienstleistungsaufsicht — 'BaFin').

⁽¹¹⁾ OJ L 386, 30.12.1989, p. 14; replaced by Directive 2001/12/EC of the European Parliament and of the Council (OJ L 126, 26.5.2000, p. 1).

⁽¹²⁾ OJ L 124, 5.5.1989, p. 16; replaced by Directive 2000/12/EC.

⁽¹³⁾ In fact, the new own funds requirements should have entered into force on 1 January 1993; they were introduced late in Germany.

⁽¹⁴⁾ Under the Solvency Directive, credit institutions must have own funds equivalent to at least 8 % of their risk-adjusted assets, whereas the previous German legislation required a ratio of 5,6 %; however, this ratio was based on a narrower definition of own funds than that which has applied since the entry into force of the Own Funds Directive.

⁽⁸⁾ Communication from Germany, 8.12.99, p. 89.

(*) Confidential information.

Landesbanks had relatively weak own-funds positions. They now had to strengthen their own-funds base as a matter of urgency in order to avoid restrictions on their business expansion and indeed to maintain their current level of activities. However, because the budgetary situation was tight, public shareholders were unable to provide any fresh capital but neither were they prepared to contemplate privatisation and to raise additional capital on the capital markets. It was therefore decided to undertake transfers of assets and capital: in WestLB's case, for example, there was a transfer of the assets of the housing organisation Wohnungsbauförderungsanstalt des Landes Nordrhein-Westfalen ('WfA'), and in LSH's case there was a transfer of the assets of WKA and WAK, followed later by the real estate.

4. EFFECTS OF THE TRANSFERS ON LSH

4.1. TRANSFER OF WKA'S AND WAK'S ASSETS TO LSH

(40) According to Germany, WKA's own assets and WAK's assets were placed in IB's special-purpose reserve. This took IB's capital up to a total of DEM 1 306,05 million (IB special-purpose reserve of DEM [...] million made up of WKA's capital (DEM [...] million) and WAK's capital (DEM [...] million), plus the special housing reserve of DEM [...] million)⁽¹⁵⁾. The provisional opening balance sheet at 1 January 1991 showed total equity capital of DEM 1 558 million. The final audit at 1 January 1991 corrected this amount to DEM 1 306,05 million⁽¹⁶⁾.

(41) BAKred had acknowledged by letter of 15 August 1991 that LSH's liable equity capital had increased by DEM 1 559,44 million as a result of IB's capital reserve. Germany pointed out that the final audit indicated that the recognised equity capital was only DEM 1 306,05 million and that, from 15 August 1991, LSH had only that amount of additional liable capital at its disposal⁽¹⁷⁾.

(42) Because the special-purpose reserve was earmarked for promotion-related tasks, even though it constituted own funds, it was not, however, at LSH's unrestricted disposal. Of the IB special-purpose reserve of DEM 1 306 million, DEM 288 million was assigned in 1991 to IB's promotion-related tasks. Germany states that, for the period 1991-2003, the following amounts were available to LSH for use in competitive business or were actually used by LSH as a liability basis.

Figure 1:

Transferred IB capital and capital amounts available for and actually used in competitive business (annual average values)

DEM million

	1991 (4 months)	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (5 months)
Total IB capital	1 306,0	1 312,2	1 337,9	1 387,0	1 472,0	1 563,0	1 665,9	1 763,0	1 814,0	1 817,0	1 849,2	1 923,9	1 967,6
Recognised for supervisory purposes	1 306,0	1 312,2	1 337,9	1 387,0	1 472,0	1 563,0	1 665,9	1 763,0	1 814,0	1 817,0	1 849,2	1 923,9	1 967,6
Used by IB	288,0	299,0	383,9	363,0	380,0	391,0	401,9	417,0	[...]	[...]	[...]	[...]	[...]
Amount available to LSH	1 018,0	1 013,1	954,0	1 024,0	1 092,0	1 172,0	1 264,0	1 346,0	[...]	[...]	[...]	[...]	[...]
Actually used by LSH	0	0	347,0	326,0	161,0	508,0	815,0	1 104,0	[...]	[...]	[...]	[...]	[...]

(43) Germany states that, at 31 December 1990, LSH had core capital of DEM 581 million and additional capital of DEM 100 million. The promotion-related assets of DEM 1 306 million therefore increased the total equity capital base of DEM 681 million by around 190 %.

(44) Assuming that DEM 1 013 million was available for LSH's competitive business in 1992, its 100 % risk-lending capacity, based on the then applicable solvency ratio of 5,6 % laid down in the Banking Act, was enhanced by at least DEM 18 000 million.

(45) Assuming also that, since the Community solvency ratio of 8 % has been applicable, between DEM 1 024 million (1994) and DEM [...] million (2002) has been available for LSH's competitive business, its 100 % risk-lending capacity has been enhanced by DEM 12 800 million (1994) and by over DEM [...] million (2002) respectively. In 1999 it had

⁽¹⁵⁾ Communication from Germany, 8.12.99, p. 90.

⁽¹⁶⁾ Communication from Germany, 8.12.99, p. 91.

⁽¹⁷⁾ Communication from Germany, 8.12.99, p. 94.

as much as DEM [...] million available, representing an increase in capacity of at least DEM [...] million.

- (46) In reality, the permissible credit volume could have been expanded even more because the risk-adjusted assets of a bank are not normally deemed to bear a 100 % risk ⁽¹⁸⁾. This is also true for LSH since inter alia it conducts its refinancing business with savings banks and its lending business with municipalities. On the basis of a realistic risk adjustment, which in LSH's case is probably below 50 %, it should be possible to double the above-mentioned business expansion to over DEM 30 000 million.

4.2. TRANSFER OF LAND-OWNED REAL ESTATE TO LSH

- (47) According to Germany, BAKred refused, by letter of 25 May 1999, to recognise the special-purpose real-estate reserve as core capital for supervisory purposes, deeming it to constitute a capital reserve but not equity capital. In its view, the transferred property and the special-purpose

- (50) LSH has paid the following remuneration ⁽²²⁾:

reserve formed immediately after its acquisition by LSH were 'deductible' at any time ⁽¹⁹⁾.

- (48) Following this refusal, LSH did not, according to Germany, again seek BAKred's recognition of this reserve as core capital, not even in view of the current proceedings concerning the amount of remuneration. The consequence of this is, in Germany's view, that the special-purpose real-estate reserve cannot be used by LSH for its commercial business or by IB in its own business ⁽²⁰⁾.

5. REMUNERATION FOR THE OWN FUNDS TRANSFERRED

5.1. REMUNERATION FOR WKA'S AND WAK'S ASSETS

- (49) LSH paid remuneration for the transferred IB capital, but only to the extent of the liable amount actually used. According to available information, a flat-rate remuneration of DEM 900 000 was agreed for 1993. For 1994 and 1995 a so-called 'profits advance' (Gewinnvorab) of 0,5 % was charged on those portions of the special-purpose reserve used for competitive business, in addition to a flat-rate remuneration of DEM 750 000 (1994) and DEM 200 000 (1995). For 1997 to 2002, the profits advance was set at [...] % of the portion of IB's capital used for competitive business ⁽²¹⁾. No remuneration was paid for 1991 or 1992.

Figure 2:

Remuneration paid on transferred IB capital (after tax)

DEM million

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Remuneration paid (after tax)	0	0	0,9	2,4	1,0	2,5	5,0	6,6	[...]	[...]	[...]	[...]	[...]

- (51) According to Germany, however, the new Solvency Directive was not the only reason for the transfer of WKA's and WAK's assets. The purpose of transferring the special-purpose residential property assets without allowing them to be used as liquid capital was to enable the assets to be used as efficiently as possible by, on the one hand, broadening the capital base or further promotion-related activities and, on the other, putting the assets to a commercial use. The Land felt that merging WKA and WAK with LSH was the appropriate financial solution, even

compared with the option of setting up a legally independent promotion institution ⁽²³⁾. It also enabled LSH's financial strength to be enhanced in the event of a sale of its shares. At the same time, the merger secured LSH's long-term equity-capital base in the face of more stringent Community requirements ⁽²⁴⁾. The prospect of increasing its liable equity capital was, according to Germany, a major factor in the decision to transfer WKA's and WAK's assets to LSH.

⁽¹⁸⁾ See footnote 3; paragraph 64 of the Decision.

⁽²²⁾ Communications from Germany, 14 April 2003 (Annex 1) and 30 September 2004.

⁽¹⁹⁾ Letter from BAKred, 25.5.99.

⁽²⁰⁾ Communication from Germany, 3.5.01, p. 2.

⁽²¹⁾ Communications from Germany of 8 December 1999, p. 96, and 29 October 2003, p. 18.

⁽²³⁾ Communication from Germany, 8.12.99, p. 86.

⁽²⁴⁾ Communication from Germany, 8.12.99, p. 88.

5.2. REMUNERATION FOR THE REAL ESTATE

- (52) Germany states that LSH paid no remuneration to the Land of Schleswig-Holstein for the assets transferred in the form of the special-purpose real-estate reserve ⁽²⁵⁾.

LSH could achieve the full extent possible of any increase in its business volume only if it refinanced the additional lending in full on the capital market. The Land could not therefore expect the same return as a provider of liquid capital, and the appropriate remuneration had to be reduced accordingly.

III. GROUNDS FOR INITIATING THE PROCEDURE

- (53) In its decision of 13 November 2002 initiating the procedure, the Commission concluded that the transfer of WKA and WAK and the placing of EUR [...] million in a special-purpose real-estate reserve of the Land of Schleswig-Holstein probably constituted state aid to LSH within the meaning of Article 87(1) of the EC Treaty.

- (54) The starting point for its investigation was the principle of the market-economy investor. According to this principle, it is not the fact that undertakings are publicly owned and receive funding from the public authorities which constitutes state aid. The provision of public money confers an advantage only if funds are made available to such a public undertaking on terms which it would not have obtained under normal market conditions.

- (55) In the present case, the Commission regarded the economic advantage conferred on LSH by the injection of own funds as consisting in particular in the increase in its commercial, competitive lending capacity (by dint of the business-expansion function of equity capital). Under normal market conditions, the capital contribution would be remunerated in line with the value of the contributed capital, taking account of its function and the risk incurred. One method of determining the normal market remuneration for the contributed capital was thus to take the long-term risk-free rate (for 10-year Federal bonds) and apply to it a risk premium corresponding to the higher risk of equity capital. As Germany had already indicated that the rate of remuneration for a long-term, risk-free investment of assets stood at around 9 % per annum ⁽²⁶⁾ at the end of 1990, when the transfer of assets took place, the Commission had serious doubts as to whether the flat-rate remuneration paid and/or an extra 0,5 % or [...] % per annum for the equity capital actually used could be deemed normal for the market, irrespective of any necessary risk premium.

- (56) The Commission also doubted whether a market-economy investor would have agreed to limit remuneration to the portion of the funds actually used.

- (57) However, the Commission had already acknowledged in its decision to initiate the procedure that the contributed capital's lack of liquidity should not be disregarded when determining the normal market remuneration. Although the bank's non-liquid equity capital permitted an increase in the volume of its lending, it had to be borne in mind that

- (58) The Commission could not see that the Land of Schleswig-Holstein, when transferring WKA's and WAK's assets, had ensured that it was going to participate to an appropriate extent in the distribution of the bank's profits and the increase in its value. In particular, the Land did not insist on a change in the ownership structure in its favour, which it would have had to do in order to ensure that dividend payments and increases in value were consistent with the level of invested capital. Moreover, since 1 January 1994 the Land had not increased but reduced its share of this increase in value.

- (59) The Commission therefore concluded in its decision to initiate the procedure that the measures in favour of LSH, which conducts business mainly at regional level but also operates nationally and internationally, constituted state aid within the meaning of Article 87(1) of the EC Treaty. As none of the exemptions provided for in Article 87(2) and (3) or Article 86(2) of the EC Treaty applied in the present case, the state aid appeared not to be compatible with the common market.

IV. COMMENTS BY GERMANY AND LSH

- (60) It was submitted that IB's capital had been of only limited use to LSH since, unlike ordinary core capital, it failed to perform — or performed only to a limited extent — three important functions: (a) the financing function, which would have been at LSH's disposal only if WAK and WKA had been transferred in full; (b) the guarantee function, which was severely restricted as IB's capital was subordinate in liability to LSH's other equity capital (moreover, a replenishment commitment ensured that IB's capital would not be used even in the event of LSH becoming insolvent); (c) IB's capital was also of only limited use for generating business because, first, part of it had to be deducted for use as cover for the Land's real estate transferred to IB and, second, the portion of IB's capital available to LSH had shrunk in recent years because of IB's own expansion of business.

- (61) The conclusion reached was that the transfer of IB's capital should not be regarded as a normal capital investment and that the special circumstances of the case reduced the remuneration which the Land was entitled to expect as appropriate.

⁽²⁵⁾ Communication from Germany, 29.10.03, p. 2.

⁽²⁶⁾ In LSH's annual report for 1990, values of between 8,8 % and over 9 % are mentioned (p. 28). In the annual report for 1991, values for that year of between 8,4 % and 9,17 % are mentioned (page 27). Since the transfer of WAK's and WKA's assets occurred on 1 January 1991, any agreement on a normal market remuneration would have been tailored to the normal returns for 1990.

(62) It was also submitted that there is no state aid within the meaning of Article 87(1) of the EC Treaty in the present case. First, at the time when IB's capital was transferred, the relationship between the Landesbank and its guarantors was still determined primarily by the special guarantee arrangements enjoyed by publicly owned banks in Germany (i.e. Anstaltslast (institutional liability) and Gewährträgerhaftung (guarantor liability)). Anstaltslast should be taken to mean an obligation on the part of the guarantors to furnish the institution with the financial resources it needs to perform its tasks and hence ensure that it is capable of functioning for the duration of its existence. That was precisely the purpose of the transfer of IB's capital. To reduce Anstaltslast to a mere obligation on the guarantor to keep the institution out of bankruptcy would be inconsistent with the historical understanding of this established guarantee arrangement. Second, LSH argues that it provides services of general economic interest. Third, the average return requirement is said to be at variance with Article 87(1) EC, read in conjunction with Article 295 EC, since imposing such a special requirement on the public investor infringes the principle of equal treatment of private and public undertakings arising from Article 295 EC.

Appropriate remuneration according to the principle of the market-economy investor

- (63) Three different economic approaches were discussed which could be used to calculate the normal market remuneration for a capital injection: the insurance premium approach, the risk profile approach and the share capital approach.
- (64) The starting-point for the insurance premium approach is the fact that the transfer of WAK's and WKA's assets to LSH was subject to restrictions and that, because of their special purpose, the liquidity remained entirely with the Land. As a result, remuneration is said to be payable only for the risk to the Land that IB's capital might be used in the event of the Landesbank becoming insolvent.
- (65) Under the risk profile approach, the point of reference for determining the appropriate market remuneration is the risk underlying an investment in a bank's liable equity capital. In this respect, the transfer of assets such as IB's capital is compared with capital market instruments that are similar to the Land's investment in terms of economic profile, and the normal market remuneration is determined as a result.
- (66) The share capital approach is much more complex and prone to errors but, if applied properly, it should yield the same result as the other two approaches. The following comments were made on the basic interest rate used and the individual premiums and discounts applied:
- (67) Minimum return after tax: Given current earnings in the banking sector, and especially public banks, the 12 % rate applied is said to be too high. The basic rate should be 11 % at most. Reference is made here to various expert reports submitted in the WestLB case.
- (68) Risk premium: It is argued that the 1,5 % risk premium in Decision 2000/392/EC is unwarranted and should be dropped altogether. The capital injection in LSH totalled only DEM 1 600 million, compared with DEM 5 900 million in the WestLB case (a substantial financial investment). Moreover, from the investor's standpoint, what matters is not the size of the investment, but the risk structure. The failure to increase voting rights is not pertinent in the LSH case as additional rights would not have secured any greater influence. The third argument raised, namely the lack of fungibility of IB's capital, is also dismissed as inaccurate since IB's capital was transferred to LSH for an unlimited period, but not irrevocably.
- (69) Discount for lack of liquidity: The liquidity cost is said to reside in the fact that, because of the restrictions on the transfer, LSH received IB's capital only as subordinated capital but had to obtain the corresponding liquidity on the capital market, since the liquidity of IB's capital remained with the Land. The additional interest on the outside funds — up to the amount of the risk-free interest rate — should therefore be deducted in full from the return demanded by the Land as an investor. In the WestLB case, the Commission applied a deduction of around half as much, citing as justification the reduction in the bank's taxable income and the resulting lower level of corporation tax liability. This approach is said to be incorrect. In material terms, the corporation tax payable on a standard investment is an advance payment on the investor's income or corporation tax. Accordingly, under German corporation tax law, it is not levied on the undertaking.
- (70) Corporation tax credit procedure: LSH argues that, if the Commission wishes to abide by its share capital approach, it must either subtract the tax credit balance from the return of a comparable private investor or add a corresponding fictional tax credit balance to the Land's return.
- (71) Owner effect, coupon effect, discount for fixed remuneration: LSH mentions other economic effects that lead to a reduction in what can be regarded as an 'appropriate' remuneration for IB's capital.
- (72) It was also argued that it was irrelevant for the purposes of state aid legislation how the Land of Schleswig-Holstein arranged a remuneration from LSH for the transfer of IB's capital. In assessing the remuneration paid to the Land, account must be taken of the synergy gains achieved through the transfer. The transfer of IB's capital enabled the Land to obtain a higher price than would have otherwise been possible for holdings in LSH acquired by WestLB and Landesbank Baden-Württemberg.

(73) It was also claimed that the special-purpose real-estate reserve did not perform either a financing or a business-generating function for LSH since it was not recognised by BAKred as core capital for supervisory purposes. No remuneration need therefore be paid for the assets transferred to LSH as a special-purpose real-estate reserve since the transfer conferred no economic advantage on LSH for which a market-economy investor would have demanded a remuneration.

(74) To sum up, the transfer of the housing-promotion assets of the Land of Schleswig-Holstein to LSH was said not to constitute state aid. A hypothetical private investor would have undertaken a similar transfer. The Land received for the transfer to LSH an appropriate remuneration in line with market conditions.

V. COMMENTS BY THE BDB

(75) The BdB submits that LSH did not pay an appropriate remuneration for the transferred core capital and was therefore in receipt of state aid.

(76) In its comments of 29 July 2003 on the procedures initiated in respect of the Landesbanks on 13 November 2002, the BdB states that the question of whether the remuneration was appropriate should be determined using the method employed by the Commission in Decision 2000/392/EC.

(77) The first step is therefore to compare the capital provided with other equity instruments. The second step is to determine the minimum remuneration which an investor would expect for a real equity-capital investment in the Landesbank. Finally, a calculation must be made of any premiums and discounts applied by virtue of the particularities of the transfer.

Comparison with other equity instruments

(78) In its comments the BdB came to the conclusion that the transfer of housing-construction and promotion-related assets in all five of the above Landesbank cases, i.e. also in the case of LSH, can be compared to an injection of share capital.

(79) Nearly all the Landesbanks are said to have required fresh core capital from 1992 onwards in order to meet the stricter requirements arising from the Solvency Directive. Without these increases in capital, the Landesbanks would have had to scale down their business. It can therefore be concluded, the BdB argues, that the capital injected can be compared only with equity instruments that were recognised as core capital ('tier 1 capital') and available in Germany in the year of the transfer. This immediately

excluded from any comparison non-voting preference shares, profit participation rights and perpetual preferred shares. In Germany these three equity instruments are recognised not as core capital but as additional capital ('tier 2 capital'). Moreover, perpetual preferred shares did not exist in Germany at the beginning of the 1990s.

(80) At the time of the respective transfers, only share capital and silent partnership reserves were recognised as core capital in Germany. Any comparison with silent partnership contributions could be ruled out across the board. First, unlike share capital, silent partnership contributions were valid for a limited period only or could be terminated and had to be paid back to the investor on maturity. An investor could not therefore expect to receive the same remuneration for a silent partnership contribution as for equity instruments recognised for supervisory purposes for an unlimited period.

(81) Second, although in some cases it was asserted that the transferred capital was subordinate in liability to share capital pursuant to agreements between the Landesbanks' owners, this did not necessarily mean a lower risk for the investor. In all cases the transferred capital made up a significant proportion of the total core capital, sometimes even more than 50 %. This made it extremely likely that the injected capital could be drawn on — at least in part — in the event of losses ⁽²⁷⁾.

(82) Third, the BdB submits that the difference in quality between silent partnership contributions and share capital is confirmed by the definition of core capital for supervisory purposes adopted by the Basle Committee for Banking Supervision. According to this definition, silent partnership contributions must be recognised for supervisory purposes as no more than lower tier 1 capital, which may account for no more than 15 % of the requisite core-capital ratio. In other words, where the core-capital ratio is 4 %, 3,4 % must be made up of nominal capital and open reserves (e.g. the special-purpose reserves transferred to the Landesbanks). Furthermore, banks only ever took up subordinate equity instruments such as preference shares or profit participation rights in small volumes. Under pressure from the rating agencies, such instruments hardly ever accounted for more than 10 % of a bank's total core capital — a very different situation from that in the cases under examination. Against this background, silent partnership contributions could not be used for large volumes invested by a single investor.

⁽²⁷⁾ Moreover, a risk or liability premium was paid primarily because of the risk of loss in the event of insolvency. If this were to happen, the capital would be irretrievably lost. In the event of ongoing (partial) losses, i.e. outside insolvency, there was always a chance that the equity capital might be replenished through profits.

Minimum remuneration for a share-capital investment in a Landesbank

- (83) The BdB argues that all methods of determining an appropriate remuneration (return) for the provision of share capital start from a risk-free return and add a risk premium.

They can be traced back to the following basic principle:

$$\begin{aligned} &\text{Expected return on a high-risk investment} \\ &= \text{risk-free return} + \text{risk premium for the risky investment} \end{aligned}$$

- (84) To determine the risk-free return, the BdB used the returns on long-term government bonds, fixed-rate securities issued by state bodies being the form of investment with the least or no risk ⁽²⁸⁾.
- (85) To derive the risk premium, the BdB first worked out the 'market risk premium', i.e. the difference between the long-term average return on shares and that on government bonds. In its comments of 29 July 2003, it assumed in the first place a long-term market risk premium of a uniform 4,6 %.
- (86) It then determined the beta value for the Landesbanks, i.e. the individual risk premium for the banks by which the general market-risk premium was to be adjusted. The BdB stated that it had determined the beta values statistically, which means that it estimated them on the basis of a historical data sample. The BdB initially concluded that all the beta values for all the Landesbanks and periods considered were greater than one ⁽²⁹⁾.
- (87) On the basis of a risk-free basic interest rate of 9,74 % and a beta factor for LSH of 1,1105, the BdB calculated the expected minimum remuneration for an investment in the share capital of LSH to be 14,85 % per annum at the time when IB's capital was transferred on 31 December 1990.

Premiums and discounts on account of the particularities of the transactions

- (88) The BdB also noted that the Commission's deduction pursuant to Decision 2000/392/EC from the minimum remuneration to take account of the lack of liquidity of Wfa's assets had been upheld by the Court of First Instance. It therefore saw no reason to depart from this method in the present case, with the result that a deduction for liquidity should also be made here. The amount of the

discount for lack of liquidity would be calculated, using the WestLB method, on the basis of net refinancing costs (gross refinancing costs minus the applicable corporation tax).

- (89) In the BdB's view, three aspects of the transfer increased its risk compared with a 'normal share capital investment': the in part exceptionally high volume of assets transferred, the failure to issue new shares in the company and the related forgoing of additional voting rights, and the lack of fungibility of the investment, i.e. the impossibility of withdrawing the invested capital from the company again at any time.

Capital basis and elements of remuneration

- (90) Lastly, the BdB argued that, in calculating the appropriate remuneration in LSH's case, the entire amount recognised as core capital should be taken into account, and not just the part which was actually used. It backs up this argument by stating that a market-economy investor would never agree to limit his remuneration to the portion of funds actually used. For a private investor bearing the risk of losing his investment, it is irrelevant whether the credit institution actually uses the injected capital to expand its business. What matters to the investor is that he himself can no longer invest that amount and obtain a corresponding return.
- (91) The BdB also argued that a remuneration of 0,3 % should have been paid for the special-purpose real-estate reserve, which has not yet been recognised by BAKred as own funds for supervisory purposes. Although this amount was not recognised as core capital, it too was available to the Landesbank's creditors to cover losses, and both investors and rating agencies take as a reference not only a bank's core capital, but also the economic equity capital shown on the balance sheet. The 0,3 % per annum guarantee commission (Haftungsprovision) applied by the Commission in its WestLB decision, which it calculated by comparing the amount of capital with a guarantee, is equally appropriate in this case.

⁽²⁸⁾ To offset the effects of inflation, the rate of return on a long-term government bond should be determined for each transfer period, initially disregarding the inflation expectations. In estimating the long-term, risk-free basic interest rate, the estimation of the expected long-term average inflation rate of 3,60 % was then added to the 'real basic interest rate' at the relevant moment.

⁽²⁹⁾ For the purposes of comparison, the BdB also gives the theoretical beta values calculated using the Capital Asset Pricing Model (CAPM), which, as it indicates, differ very little from the empirically determined values.

VI. GERMANY'S RESPONSE TO THE BDB'S COMMENTS AND FURTHER COMMENTS BY GERMANY

- (92) In its response of 29 October 2003 to the BdB's comments, Germany rejected the argument that remuneration should also be paid for the IB capital that is recognised for

supervisory purposes but not used. It contended that this part of IB's capital conferred no economic advantage on LSH and therefore required no remuneration. Not all of a bank's additional liable capital recognised for supervisory purposes was automatically of economic use or conferred an economic advantage. Moreover, the capital transferred to LSH was not liquid share capital but non-liquid assets which performed an — at most — limited guarantee function and so could not be used by LSH for investment or lending purposes.

- (93) Germany also contested the argument that remuneration should be paid for the portion of transferred capital not recognised for supervisory purposes (in LSH's case, the special-purpose real-estate reserve). It argued that, since that capital is assigned to a specific long-term purpose, it forms part of a circular financial circuit and has not conferred any advantage on LSH by increasing its solvency. Germany added that the rating agencies concentrate exclusively on capital recognised for supervisory purposes as liable core capital. Accordingly, it did not see why the banking supervisory authorities and creditors should regard the special-purpose real-estate reserve as a lasting reservoir of value.
- (94) Germany submitted that IB's capital is closest in nature to perpetual preferred shares, profit participation certificates and silent partnership contributions.
- (95) Germany argued that in 1994 LSH's guarantors agreed on a proportionate replenishment commitment which would ensure that, in the (unlikely) event of LSH becoming insolvent, IB's capital would not be called on. Accordingly, an investor in a Landesbank faced a risk which might require remuneration in that the transferred capital might be lost as a result of ongoing losses. However, an investor was protected from that risk by the existence of the subordination agreement.
- (96) The BdB's calculation of the minimum remuneration was said to be wrong for a number of reasons: incorrectly defined factors in the CAPM calculation, the unrealistic assumption of the guaranteed fixed remuneration and incomprehensible discounts and premiums.
- (97) Germany also took a critical view of the CAPM used by the BdB to determine the minimum return for share-capital investments in the Landesbanks. It criticised not only the suitability of the CAPM for determining the expected return on an investment which should yield a fixed remuneration, but also the factors employed (risk-free interest rate, market-risk premium and beta value).
- (98) It objects to the BdB's method of determining the risk-free interest rate, i.e. using a real interest rate based on a

reference date, arguing instead for the use of an average value over the longest possible period. Germany applied an arithmetic mean of the annual total returns of the REX10 between February 1970 and December 1990, which yielded a result of 6,91 %.

- (99) Germany rejected the figure of 4,6 % used by the BdB for the market-risk premium, proposing 3,0 % instead.
- (100) The banks listed in the CDAX used by the BdB to determine the beta value for LSH are said to give rise to distortions: first, the five largest commercial banks together account for a very high proportion of the CDAX banks (76 %); second, there are differences in business profile. Instead, the correct beta value for LSH should be determined by taking a comparable group, namely IKB, BHF Bank and Vereins- und Westbank, resulting in a beta value of 0,7894.
- (101) Germany therefore concluded that the minimum remuneration for an investment in the share capital of LSH at 31 December 1990 (taking account of the beta factor of 0,7894, the market-risk premium of 3 % and the base rate of 6,91 %) was 9,28 %.

VII. COMMENTS BY THE LAND OF NORTH RHINE-WESTPHALIA AND WESTLB

- (102) On 30 October 2003 Germany forwarded a response from the Land of North Rhine-Westphalia and WestLB to the decision to initiate the investigation procedure in which they disputed the statement that the assets transferred to the Landesbanks, including LSH, could be compared to share capital. They argued that silent partnership reserves and 'perpetuals' had in fact been recognised as core capital in Germany since 1991. They added that remuneration for an investment depended not on how it was classified by the banking supervisory authorities, but on its risk profile. Since the assets were junior-ranking, the risk pattern had more in common with silent partnership contributions or 'perpetuals' than with share-capital investments.
- (103) WestLB had no objections to the CAPM method for calculating the minimum remuneration for a share-capital investment, WestLB had no objections to the CAPM method for calculating the minimum remuneration for a share-capital investment but felt that the beta values determined by the BdB — at well over 1 — were inappropriate. A beta factor of more than 1 meant that a company's shares represented a higher risk than the market as a whole. Yet the risk of investing in a Landesbank was well below the overall market risk because of the institutional liability (Anstaltslast) and guarantor liability (Gewährträgerhaftung) which it enjoyed and which were not challenged at the time.

- (104) Moreover, they argued that, in the specific case of the Landesbanks, it was a mistake to use as a benchmark the return expected at the time that the assets were transferred to the banks. Although this was generally a sensible approach to adopt in relation to the private-investor test, Although this was generally a sensible approach to adopt in relation to the private-investor test, it here meant using as a basis the returns expected in 1991. But for an investor to receive in 2003 the return expected in 1991, which was much higher than the returns actually achieved, flew in the face of all economic realities. Permanently and systematically applying a rate of return of around 12 % placed the Landesbanks at an unjustifiable disadvantage compared with private competitors.
- (105) As regards the discount for the lack of liquidity of the transferred assets, WestLB and the Land of North Rhine-Westphalia considered that the rate for risk-free government bonds should be deducted in full from the basic return. They argued that the Landesbanks had received no liquidity as a result of the asset transfers. It was not defensible in economic terms to reduce this rate by the tax savings since the pricing of capital market instruments was independent of the tax situation. Otherwise the price of a capital market instrument would have to differ according to tax considerations.
- (106) Finally, the fact that the assets' lack of liquidity did not pose a risk to the liquidity position should be seen as reducing the risk — and hence the remuneration — and should be taken into account by applying a corresponding deduction. Likewise, a discount should be granted on account of the 'owner effect' since an investor who already owned shares in a company took a different view of an additional investment from that of a new investor.
- VIII. UNDERSTANDING BETWEEN THE BDB, THE LAND OF SCHLESWIG-HOLSTEIN AND HSH NORDBANK**
- (107) On 8 October 2004, the Commission was informed of the outcome of an understanding between the complainant (the BdB), the Land of Schleswig-Holstein and HSH Nordbank, which was formed from LSH and Hamburgische Landesbank in 2003. Although their basic legal positions remained unchanged, the parties to that understanding concurred on what they themselves regarded as suitable parameters for determining an appropriate remuneration. The parties asked the Commission to take account of this understanding in its decision.
- (108) First, the parties determined a minimum remuneration for a hypothetical investment in the share capital of LSH on the basis of the CAPM, which produced an appropriate remuneration for the special-purpose reserve of around 9,29 % per annum. To arrive at this figure, the parties used the long-term risk-free interest rate calculated on the basis of the REX10 Performance Index of Deutsche Börse AG and the beta factor estimated on the basis of a study by KPMG of 26 May 2004 commissioned by the Landesbank. In concrete terms this yielded a risk-free basic interest rate for LSH of 6,61 % at the time of the transfer (31 December 1990). A beta factor of 0,670 was applied on the basis of KPMG's study. A uniform market-risk premium of 4 % was set for all the Landesbanks.
- (109) A deduction was then determined for the capital's lack of liquidity on the basis of the risk-free interest rate of 6,61 % as gross refinancing costs. To determine the net refinancing costs, the standard tax burden on LSH at the time of the transfer was set at a flat rate of 50 %, producing a liquidity discount of 3,31 %.
- (110) Lastly, a premium of 0,3 % was added to allow for the failure to issue voting rights.
- (111) Altogether this produced an appropriate remuneration for the special-purpose reserve of 6,28 % per annum after taxes for the portion of the promotion-related assets available for use in LSH's competitive business. This remuneration was payable as of the end of the month when the assets were recognised as core capital (31 August 1991).
- (112) According to the understanding, the aid element, which HSH Nordbank must pay back, resides in the difference between the actual remuneration paid by LSH and the remuneration determined as appropriate (6,28 %).
- (113) The parties also agreed on a guarantee commission of 0,3 %, payable not only on the liable capital used by IB itself, but also on the special-purpose real-estate reserve. Furthermore, HSH Nordbank raised no objection to the suggestion that, for the period of the transfer up to the end of the month when the assets were recognised as core capital by BAKred (1 January 1991 — 30 August 1991), a guarantee commission of 0,3 % is also payable on the sum of DEM 1 306,05 million shown on the balance sheet.
- (114) During negotiations on the understanding, it was argued for the first time that, in addition to the remuneration for IB's capital already mentioned, a further remuneration element consisted of IB's annual surplus, which was paid to the Land of Schleswig-Holstein as a dividend on the basis of Section 17(2) IBG (1990 version) or Section 19(2) IBG (1998 version). In accordance with these legal provisions, the annual surplus from the IB's special-purpose reserve was paid out to the Land (in each case on the basis of a corresponding decision by the Landesbank's bodies). Under a rule laid down in the respective budgetary law of the Land of Schleswig-Holstein, these payments were intended for the purposes of the IB, i.e. for the Land's promotion-related tasks, and transferred back to IB accordingly. This arrangement served to respect the budgetary sovereignty of the Land Parliament, as it should be the parliament, not the executive arm that had decision-making power over these funds. In economic terms, this was a 'pay out and

claw back' arrangement which did not prevent the amounts being counted as dividend payments.

(115) Moreover, the cycle was broken by the suspension of the special purpose by a number of individual laws accompanying the budget, each relating to the annual surplus. In these cases the dividends paid out were not reinvested in IB. As the special purpose was suspended, the surplus in those

(116) The table below shows the IB dividend payments to the Land:

Figure 3:

IB dividend payments to the Land of Schleswig-Holstein (DEM million)

	DEM million												
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
IB dividend payments to the Land	0,0	0,0	1,1	2,6	1,5	2,5	3,5	47,5	[...]	[...]	[...]	[...]	[...]

(117) Accordingly, these dividend payments from the annual surplus must be taken into account in calculating the aid element and were indeed included by the parties to the understanding in their calculations.

IX. ASSESSMENT OF THE MEASURES

1. STATE AID WITHIN THE MEANING OF ARTICLE 87(1) OF THE EC TREATY

(118) Article 87(1) of the EC Treaty states that, save as otherwise provided in the Treaty, any aid granted by a Member State or through state resources which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods is incompatible with the common market, insofar as trade between Member States is affected.

1.1. STATE RESOURCES

(119) With the transfer of assets described above, the Land of Schleswig-Holstein opted for a form of capital increase based on the concept of transferring the assets and real estate of WKA and WAK to LSH in order to strengthen its equity-capital base. Although the resources transferred were not at LSH's unrestricted disposal, as the special-purpose reserve was earmarked for promotion-related tasks, the assets were recognised by the supervisory authority and could therefore be used to provide cover for the liabilities of LSH, which was in competition with other credit institutions. There can therefore be no doubt that state resources were transferred to LSH.

⁽³⁰⁾ See footnote 4.

years was paid entirely to the Land of Schleswig-Holstein to finance expenditure from the Land budget. It should be borne in mind here that the lion's share of the dividend payments discussed here concerns amounts that, for that reason, were not transferred back to IB but remained entirely with the Land.

1.2. FAVOURING OF A PARTICULAR UNDERTAKING

(120) In order to verify whether the transfer of state resources to a publicly-owned undertaking favours the latter and is therefore liable to constitute state aid within the meaning of Article 87(1) of the EC Treaty, the Commission applies the 'market-economy investor principle'. The European Court of Justice and Court of First Instance have accepted and developed this principle in a number of cases, most recently in the judgment of the Court of First Instance of 6 March 2003 in the WestLB case, which is of relevance to the present case ⁽³⁰⁾.

(a) Market-economy investor principle

(121) According to the market-economy investor principle, no state aid is involved where funds are made available on 'terms which a private investor would find acceptable in providing funds to a comparable private undertaking when the private investor is operating under normal market-economy conditions' ⁽³¹⁾. In contrast, the undertaking is being favoured within the meaning of Article 87(1) of the EC Treaty if the agreed remuneration and/or the financial position of the undertaking are such that a normal return on investment cannot be expected within a reasonable period of time.

(122) The market-economy investor principle applies here even though LSH was a profitable company at the time the promotion-related assets were transferred. Although the principle has previously been applied mainly to under-

⁽³¹⁾ Commission communication to the Member States on the application of Articles 92 and 93 of the EEC Treaty and of Article 5 of Commission Directive 80/723/EEC to public undertakings in the manufacturing sector (OJ C 307, 13.11.1993, p. 3, point 11). Although this communication deals expressly with manufacturing, the principle doubtless applies likewise to all other sectors of the economy. As regards financial services, this has been confirmed by a number of Commission decisions, e.g. *Crédit Lyonnais* (OJ L 221, 8.8.1998, p. 28) and *GAN* (OJ L 78, 16.3.1998, p. 1).

takings in difficulties, this does not mean that its application is restricted to that category of undertakings.

(123) There is no provision to the effect that, if a company makes a profit, this rules out a priori the possibility that the provision of capital contains elements of state aid. Even if a company is profitable, a market-economy investor might refrain from injecting (further) capital if he cannot expect an appropriate return on his capital contribution (in the form of dividends or an increased value of the investment). Should the company not show the appropriate expected return at the time of the investment, a market-economy investor would call for measures to increase the return. Therefore, the market-economy investor principle is applicable in the same way to all public enterprises, whether profitable or loss-making. The Commission's position in this respect was confirmed by the European Court of First Instance in its judgment in *WestLB* ⁽³²⁾.

(124) It follows that the key question in examining this case is whether a market-economy investor would have transferred capital that had the same characteristics as the Land of Schleswig-Holstein's promotion-related assets and real estate and under the same conditions, especially in view of the expected return on the investment.

(125) According to Germany, the chief considerations here were to draw together all the Land's promotion-related activities and continue them in a more economic and more efficient manner, to optimise deliberation on and completion of promotion-related tasks and to create the conditions for the flexible use of funds. This reorganisation was combined with an increase in LSH's capital base, which helped secure its long-term capacity for expansion, given the foreseeable changes in solvency requirements. Furthermore, the Land intended to make a fundamental change in its business orientation by managing its own real estate and the real estate used by the various Land departments and institutions with the aim of reducing inefficiency.

(126) Even if a market-economy investor already holds shares in an undertaking, he will look into other investment options outside that undertaking. As a rule he will then choose to invest further resources in the public undertaking only if he can expect a reasonable return on the investment of the fresh capital contributions. So, in determining whether a capital injection constitutes state aid, one must in principle disregard the shareholder's prospects of long-term profitability or efficiency and synergy aspects. Whatever the motives behind it, a capital injection by a shareholder should be measured instead according to whether the investor can expect a normal return within a reasonable period.

(127) The Court of First Instance has raised no objections to this interpretation of the market-economy investor principle, which the Commission has already applied in Decision 2000/392/EG ⁽³³⁾. It has also adopted as a guiding principle that even a private investor who already owns share capital in an undertaking is not normally content with the fact that an investment does not cause him a loss or produces only limited profits. Instead he will always seek to obtain an appropriate return on his investment according to the particular circumstances and the satisfaction of his short-, medium- or long-term interests ⁽³⁴⁾.

(128) In the light of the market-economy investor principle, the key question in examining this case is whether a market-economy investor would have transferred capital that had the same characteristics as the Land of Schleswig-Holstein's promotion-related assets and under the same conditions, especially in view of the expected return on the investment

(b) *Article 295 of the Treaty*

(129) Article 295 lays down that the system of property ownership in the various Member States must not be affected. But this cannot justify any infringement of the Treaty's competition rules.

(130) In connection with the Landesbank proceedings, Germany has argued that the resources transferred could not have been used in any other profitable manner than by transferring them to a similar public institution. Consequently, the transfer represented the commercially most sensible use of those assets. It is therefore argued that any remuneration for the transfer, i.e. any additional return on the assets transferred, would be sufficient to justify the transfer in the light of the market-economy investor principle.

(131) This line of argument cannot be accepted. It may be true that the transfer of the promotion-related assets to LSH, which subsequently allowed LSH to use the capital for solvency purposes, was the most commercially sensible use. However, as soon as such public funds and assets are used for commercial competitive activities, they must be subject to normal market economy rules. This means that the State, once it decides to use certain assets (also) commercially for public purposes, must demand a remuneration in line with the normal market remuneration.

(c) *No change in ownership structure*

(132) One way for a market-economy investor in a bank to secure a normal market remuneration is to have an appropriate share in the bank's profits and increases in its value. This can be achieved by means of a change in the structure of ownership in line with the capital injection, giving the investor an appropriate share in the dividends and in a possible increase in value as a result of enhanced

⁽³²⁾ See footnote 4; paragraphs 206 et seq. of the decision.

⁽³³⁾ See footnote 3; paragraphs 161 et seq. of the decision

⁽³⁴⁾ See footnote 4; paragraphs 241 and 314 of the decision.

earning capacities. Therefore, one way of ensuring an adequate return on the capital provided would have been to increase the Land's participation in LSH accordingly, provided that the bank's overall profitability corresponds to the normal rate of return that a market-economy investor would expect from his investment. This would have avoided the discussion of whether the agreed rate of remuneration on that part of the funds actually used to underpin competitive business is appropriate. However, this course was not adopted by the Land.

(133) In this regard Germany argues that, for the purposes of state aid law, it is irrelevant how the Land of Schleswig-Holstein arranged a remuneration from LSH for the transfer of IB's capital, as the capital injection was not necessarily linked to acquisition of a share in profits and voting rights. It also points out that the transfer of IB's capital to LSH enabled the Land to obtain a higher price than would have otherwise been possible for holdings in LSH acquired by WestLB and Landesbank Baden-Württemberg.

(134) However, if a redistribution of shares were not feasible, a market-economy investor would, in the Commission's view, have embarked on the investment only if agreement had at least been reached on an appropriate direct remuneration. Normally a market-economy investor is not content to avoid losses or to obtain a limited return on his investment, but attempts to maximise the return on his assets according to the circumstances in question and his interests⁽³⁵⁾. So a private investor who already holds shares in the beneficiary undertaking will usually insist on either a change in ownership structure or an appropriate fixed remuneration. Otherwise he would forgo part of the additional returns achieved as a result of the capital injection, as the other shareholders would also profit from higher dividends and an increase in the undertaking's value without having made a corresponding contribution.

(135) There is therefore nothing to indicate that a market-economy investor would have forgone an appropriate direct remuneration in a situation comparable to the transfer of promotion-related assets to LSH, where no shift in share structure was achievable and the owner of the other half of the shares did not make a corresponding capital contribution directly connected with the capital injection.

(d) Capital basis for the remuneration

(136) As with its approach in the WestLB case, the Commission will determine the appropriate remuneration for the promotion-related assets transferred and the special purpose real-estate reserve on the basis of their commercial benefit to LSH, while drawing a distinction in the present case between the 'business-expansion function' and the (mere) 'guarantee function' of the promotion assets made available as equity capital for the bank's business activities.

(137) The 'business-expansion function' of capital refers to the expansion of business potential by means of risk-bearing assets following the recognition for supervisory purposes of a bank's additional equity capital. In this regard the starting point for determining the normal market remuneration is the remuneration that would be demanded by a private investor providing a bank with core capital. Where the capital provided is shown in the balance sheet as equity but is not recognised as core capital for supervisory purposes or is intended to underpin promotion-related activities, it is not available for expanding business. However, equity is also important for reasons other than banking supervision. Its availability to the bank's creditors at least for the purposes of covering liabilities ('guarantee function') means that its economic function can still be compared to that of a surety or guarantee. The amount of equity shown in the balance sheet is an indication for the bank's lenders of its soundness and thus influences the conditions under which the bank is able to raise outside funds. The normal market remuneration of the 'guarantee function' of capital is calculated according to the return which a private guarantor would have demanded from a credit institution comparable to LSH in size and risk strategy.

(138) On 1 January 1991, the Land of Schleswig-Holstein transferred to LSH the capital of IB, which, according to the final audit, came to DEM 1 306 million. The capital transferred increased in value year on year, amounting to DEM 1 967,6 million in 2003.

(139) On the balance-sheet date of 31 December 1999 the Land also transferred the special-purpose real-estate reserve to LSH, thereby increasing the equity capital shown on the balance sheet by DEM [...] million. After two further transfers, this special-purpose reserve totalled DEM [...] million at 31 December 2002.

(140) Each year the full amount of the capital transferred from IB was recognised as additional core capital by BAKred⁽³⁶⁾. However, it was not entirely at LSH's disposal for underpinning its competitive business. As in the WestLB case, part of the special-purpose reserve was also used for promotion-related tasks by IB itself. Accordingly, this part of the special-purpose reserve was not at LSH's disposal for expanding competitive areas of its business, although it did have a guarantee function. The same applied to the special-purpose real-estate reserve, which was not recognised as core capital by BAKred, but served as a guarantee for the bank.

(141) The Commission believes that the extent to which the capital provided was actually used cannot be a factor in determining the appropriate remuneration. All that matters is the possibility of using the capital to expand business. Even a private investor would not be happy with a

⁽³⁵⁾ See footnote 4; paragraphs 320 and 335 of the decision.

⁽³⁶⁾ Contrast this with the WestLB case, in which only part of the established cash value of the housing-promotion assets shown in the balance sheet as own funds was recognised as equity capital for supervisory purposes.

remuneration dependent on the capital being used. In this regard the Commission agrees with the BdB's observation that, for the market-economy investor who runs the risk of losing his investment, it is irrelevant whether the credit institution actually uses the injected capital to expand its business. As the BdB rightly points out, all that matters to the market-economy investor is that he himself can no longer use the amount transferred to engage in economic activity and hence achieve corresponding returns. So the fact that LSH used the injected capital in full between 1999 and 2003 is irrelevant to the question of the capital basis being examined.

(142) Moreover, for the purposes of determining the remuneration for the business-expansion function of the capital, the most important point in time is when the special-purpose reserve was recognised by BAKred as core capital. According to Germany, it was only from that time on that the capital could be used to cover risk-bearing assets.

(143) However, insofar as the capital had already been shown in the balance sheet as own funds, it also had at least a guarantee function, as explained above in more detail. The same applies to the amount used by the IB itself and to the special-purpose real-estate reserve. These points must also be taken into account in determining the appropriate remuneration.

(e) *Comparison with other equity instruments*

(144) As explained above, the starting point for determining the normal market remuneration in this case is the remuneration that would be demanded by a market-economy investor providing a bank with equity capital.

(145) It is beyond dispute that the promotion-related assets transferred to LSH cannot be compared directly to other transactions. The transfer might resemble certain instruments in some respects, but there are also enough differences compared with each instrument to assign only a limited value to this comparison. Consequently, as in the WestLB case⁽³⁷⁾, the appropriate remuneration can be determined only by comparing the asset transfer with various equity instruments normally found on the markets, in order to determine by analogy which instrument is most similar to it and is therefore the benchmark for determining the remuneration.

(146) The complainant submits that the promotion-related assets concentrated in the special-purpose reserve can be compared only to share capital. The special-purpose reserve was recognised by BAKred as core capital ('tier 1' capital) and can therefore be compared only with equity instruments that were recognised as core capital in Germany in the year of the transfer. However, Germany considers that the only purpose of comparison with various equity instruments is to determine which risk profile (and hence which range of remuneration) is closest to that of the investment from an investor's point of view. IB's capital is therefore said to be closest in nature to perpetual preferred shares, profit participation certificates and silent partnership reserves.

(147) It should be borne in mind that the instruments used by Germany for the comparison normally provide a bank with only a very limited part of own funds. They are additional instruments, supplementing the 'basic equity capital', which consists mainly of share capital and open reserves. By contrast, the promotion-related assets transferred to LSH virtually tripled its own funds for solvency purposes. Even if one takes account only of the increase in the amount usable by LSH to underpin its commercial business, this still represents an increase of over 50 %. As the BdB points out, the other instruments referred to were usually issued up to a much lower level. It would not have been possible to increase LSH's capital in the same way, and on a permanent basis, by one of the instruments compared.

(148) In this connection, it should also be stressed that the relatively wide range of innovative equity instruments now available to credit institutions in several countries for use as original own funds and additional own funds did not exist in Germany back in 1991, when IB's capital was transferred or in 1993, when LSH had to comply with new, stricter capital requirements. Some of these instruments have been developed in the meantime, while others already existed but were not accepted in Germany. In practice, the main instruments which were available and used were profit participation certificates and subordinated loans (both of which are additional own funds, the latter being accepted only since 1993). It is therefore inappropriate to compare IB's capital to such innovative instruments, most of which have developed in the meantime and some of which were available only in other countries.

(149) As to the two instruments which, as the closest benchmarks, play the central role in Germany's comparison, namely perpetual preferred shares and profit participation certificates, a number of specific points should be stressed. Perpetual preferred shares constitute original own funds (core capital) in some countries but are still not accepted as such in Germany. Profit participation certificates constitute only additional own funds, whereas IB's capital qualifies as original own funds. The latter is therefore of much greater use to LSH because it can be used to raise additional own funds (such as profit participation certificates) up to the

⁽³⁷⁾ See footnote 3; paragraph 19 of the decision.

same amount in order to increase the bank's own funds. Moreover, if profitable years followed loss-making ones, profit participation certificates would be replenished before IB's capital. In addition, IB's capital is available to LSH without any time limitation, while profit participation certificates are usually issued for a period of ten years. It is also worth recalling the enormous, atypical size of the capital injection and the fact that the ranking in the event of losses must be seen in this context. Since the share of IB's capital is rather large, it will be used relatively quickly when major losses occur.

(150) For all these reasons, the Commission believes that, because of the peculiarities of IB's capital, the comparison with innovative equity instruments submitted by Germany is not a suitable way to determine the appropriate remuneration to be paid for IB's capital. Moreover, in the understanding of 8 October 2004, the parties assumed that the transaction was akin to a share capital injection.

(151) Furthermore, the Commission agrees with the BdB that the risk to the investor is not reduced by the subordination agreement in the covering agreement between LSH's shareholders whereby IB's capital is to be used only after other equity capital of LSH. The injected capital makes up a significant proportion of the total core capital, making it extremely likely that it will be drawn on — at least in part — in the event of losses.

(f) **Liquidity costs**

(152) LSH's argument regarding the liquidity costs can in principle be accepted. A 'normal' capital injection into a bank supplies it both with liquidity and with an own funds base which it requires for supervisory reasons to expand its activities. In order to use the capital in full, i.e. to expand its 100 % risk-adjusted assets by a factor of 12,5 (i.e. 100 divided by a solvency ratio of 8), the bank must refinance itself on the financial markets 11,5 times over. Put simply, the difference between 12,5 times the interest received and 11,5 times the interest paid minus other costs of the bank (e.g. administration) gives the profit on the equity⁽³⁸⁾. Since the promotion assets did not provide LSH with initial liquidity because they and all the income from them remained earmarked by law for business and housing promotion, LSH faced additional funding costs equal to the amount of the capital if it was to raise the necessary funds on the financial markets to take full advantage of the business opened up by the additional capital, i.e. to expand risk-adjusted assets by 12,5 times the capital amount (or to

maintain existing assets at that level)⁽³⁹⁾. Because of these extra costs, which do not arise in the case of equity capital provided in liquid form, the appropriate remuneration must be reduced accordingly. A market-economy investor could not expect to be remunerated in the same way as for a cash injection.

(153) However, in the Commission's view, the entire refinancing interest rate does not have to be taken into account. Refinancing costs constitute operating expenses and therefore reduce taxable income. This means that the bank's net result is not reduced by the amount of additional interest expenses incurred. These expenses are offset in part by reduced corporation tax. Only the net costs should be taken into account as an additional burden on LSH because of the special nature of the capital transferred. The Commission therefore accepts that LSH incurs additional 'liquidity costs' to the extent of 'refinancing costs minus corporation tax'⁽⁴⁰⁾.

(g) **Appropriate remuneration**

Appropriate remuneration for the amount available for competitive business

(154) There are no doubt different ways of calculating the appropriate remuneration for the amount available for competitive business. All the methods for calculating the remuneration for capital made available follow the same basic principles, however. Taking these basic principles, the Commission here does the calculation in two steps: first, it determines the minimum remuneration that an investor would expect for a (hypothetical) investment in the share capital of LSH. It then examines whether, in view of the particularities of the transaction at issue, the market would have agreed on a premium or a discount, and if so, whether it can produce a sufficiently robust quantification of that amount.

Determination of a likely minimum remuneration for an investment in the share capital of LSH

(155) The return expected on an investment and the risk involved are important determining factors in the investment decision of a market-economy investor. In order to determine their level, the investor incorporates all available firm-related and market-related information into his calculation. He bases himself on historical average rates, which, generally speaking, are also a point of reference for a firm's future efficiency, and inter alia on an analysis of the

⁽³⁸⁾ Of course, in reality the situation is much more complex because of off-balance-sheet items, different risk weightings of assets or zero-risk items, etc. However, the principal reasoning holds.

⁽³⁹⁾ The situation does not change if one takes into account the possibility of raising additional own funds up to the same amount of original own funds (a factor of 25 instead of 12,5 for original own funds).

⁽⁴⁰⁾ As confirmed by the Court of First Instance, see footnote 4; paragraphs 321 to 331 of the decision.

company's business model for the investment period in question, the strategy and quality of management or the relative prospects for the sector in question.

(156) A market-economy investor will make an investment only if it offers him a higher return or a lower risk than the next best alternative use of his capital. Accordingly, he will not invest in a company whose expected returns are lower than the average of other companies with a comparable risk profile. In this case it can be assumed that there are sufficient alternatives to the investment that promise a higher expected return for the same risk.

(157) There are various methods of determining an appropriate minimum return. They range from differing variants of the financing approach to the CAPM method. In describing these various approaches, it makes sense to draw a distinction between two components, namely a risk-free return and a project-specific risk premium:

Appropriate minimum return on a high risk investment

=

risk-free base rate + risk premium for the risky investment.

The appropriate minimum return on a high-risk investment can therefore be described as the sum of the risk-free rate of return and the additional risk premium for assuming the specific investment risk.

(158) The basis for any determination of return is thus the existence of a default-risk-free form of investment with an assumed risk-free return. Normally the risk-free base rate is determined using the expected return on fixed-rate securities issued by state issuers (or an index based on such securities), as they represent forms of investment with comparably low risks. However, the difference between the various methods lies in the method of determining the risk premium: -

— Financing approach: An investor's expected return on capital represents, from the point of view of the bank using the capital, future financing costs. Under this approach, the historical capital costs incurred by comparable banks are determined first. The arithmetic average of the historical capital costs is then compared with the future expected equity capital costs and hence with the investor's expected-return requirement.

— Financing approach with Compound Annual Growth Rate: at the heart of this approach stands the use of the geometric rather than the arithmetic mean value.

— CAPM: the CAPM is the best-known and most frequently tested model of modern finance, by which the return expected by an investor can be determined using the following equation:

Minimum return on capital =

risk-free base rate + (market-risk premium × beta)

The risk premium for the equity investment is obtained by multiplying the risk premium on the market by the beta factor (market-risk premium × beta). The beta factor is used to quantify the risk of a company relative to the overall risk of all companies.

The CAPM is the predominant method of calculating investment returns in the case of large listed companies. However, since LSH is not a listed company, it is not possible directly to infer its beta value. The CAPM can be used only on the basis of an estimate of the beta factor.

(159) In its comments of 29 July 2003, the BdB, using the CAPM, concluded that the minimum remuneration to be expected for an investment in the capital of LSH at 31 December 1990, when the transfer took place, was 14,85 % per annum. Germany raised objections in principle to the use of the CAPM. It also argued that the BdB started from a high beta value and was incorrect in its calculation of the risk-free base rate, and that the market-risk premium of 4,6 % was too high. Had the BdB applied the CAPM correctly, it would have arrived at a much lower minimum remuneration for a hypothetical investment in the share capital of LSH. In their understanding on the normal market remuneration, the Land of Schleswig-Holstein, HSH Nordbank and the BdB concluded that a minimum remuneration of 9,29 % was appropriate.

(160) In their calculations, the parties based themselves on the CAPM and applied a risk-free basic interest rate of 6,61 %. Determination of this interest rate was based on the assumption that special-purpose assets were to be made available to LSH on a permanent basis. The parties thus decided not to use a risk-free rate obtaining on the market at the time of the capital injection for a fixed investment period (e.g. 10-year return on government bonds), since such an approach would disregard the reinvestment risk, i. e. the risk that it would not be possible to invest again at the level of the risk-free interest rate once the investment period had expired. In the view of the parties, a total return index was the best way of taking the investment risk into account. They opted, therefore, for the REX10 Performance Index of Deutsche Börse AG, which tracks the performance of an investment in Federal loans over a period of ten years. The index series used in the present case contains the relevant end-of-year results of the REX10 Performance

Index since 1970. The parties then calculated the rate of return per annum, which reflects the trend tracked by the REX10 Performance Index in the period 1970 to 1990 and, in this way, arrived at the risk-free base rate of 6,61 %.

(161) Since LSH's capital injection was made available on a permanent basis, the method of determining the risk-free basic interest rate appears appropriate in this specific case. Moreover, the REX10 Performance Index is a generally recognised source of data. The risk-free basic interest rate calculated thus appears appropriate here.

(162) The beta factor of 0,670 was estimated on the basis of a KPMG report on adjusted beta factors for all listed credit institutions in Germany that is available to the Commission. In the light of the report and of LSH's business profile, this beta factor may be regarded as appropriate.

(163) The Commission also regards the market-risk premium of 4,0 % as acceptable. The so-called general long-term market-risk premium, i.e. the difference between the long-term average return on a normal share portfolio and the return on government bonds, has already been applied on several occasions in the WestLB case, which resulted in Decision 2000/392/EC. In the corresponding report on the procedure, a range of some 3 % to 5 % was applied, depending on the method, the period under examination and the basic relevant data. A report prepared for BdB calculated figures of 3,16 % and 5 %. Another report on WestLB drawn up in the first procedure produced figures of 4,5 % and 5 %, while Lehman Brothers, also for WestLB, calculated a figure of 4 %. Against this background, the Commission here sees no reason to depart from the market-risk premium used in the understanding. On the basis of the CAPM, the Commission considers there to be no doubt that the minimum remuneration determined by the parties can be regarded as appropriate.

(164) The Commission has no reason to believe that, in the case under consideration, the minimum remuneration determined by the parties for a hypothetical share-capital investment cannot stand up to a market test. Accordingly, it sets the minimum remuneration for the special-purpose reserve at 9,29 % per annum (after corporation tax and before investor tax).

Return discount for lack of liquidity

(165) The long-term risk-free rate (10-year German Federal government bonds) at the end of 1990 was 8,98 %. LSH claimed that its actual refinancing costs on the basis of its financial structure at the time of the transfer were 9,2 %. In their understanding the parties apply a long-term risk-free

rate of 6,61 % ⁽⁴¹⁾. They also agree to adopt a flat 50 % tax rate. On this basis, they arrive at a net refinancing rate of 3,31 % and a corresponding deduction for liquidity.

(166) In view of that understanding and the fact that the amount in question falls below the range previously cited by Germany, the Commission sees no reason to regard this amount as inappropriate and consequently uses it as a basis for determining the aid element.

Return premium on account of the particularities of the transfer

(167) In practice, when remuneration is determined, atypical circumstances which depart from a normal investment in the share capital of the company concerned generally give rise to discounts or premiums. It must therefore be examined whether the particularities, and especially the specific risk profile of the transfer of IB's capital, constitute grounds for adjusting the minimum remuneration determined of 9,29 % which a private investor would expect for a (hypothetical) investment in the capital of LSH and whether the Commission can produce a methodically robust quantification of that adjustment. In this connection, three aspects should be considered: first, the non-issuance of new shares in the company with the associated voting rights; second, the exceptional volume of the asset transfer; and third, the non-marketability of the assets.

(168) The transfer did not provide the Land with any additional voting rights. By forgoing voting rights, an investor renounces a say in decisions taken by the bank's board. If the Land's voting rights had been increased, it would have possessed more than 50 % of those rights, thereby becoming the majority shareholder. To compensate for this acceptance of a higher risk of loss without a corresponding increase in influence over the company, a market-economy investor would demand a higher remuneration (even if the potential risk were cushioned by internal agreements with the other shareholders). On the basis of the higher remuneration for preference shares compared with ordinary shares and in agreement with the complainant, BdB, the Land of Schleswig-Holstein and LSH, who, as a result of their meetings in August and September 2004, regard a rate of 0,3 % per annum (after tax) as reasonable, the Commission considers a premium of at least 0,3 % per annum (after corporation tax) to be appropriate. The parties to the understanding also regard a 0,3 % premium as appropriate to take account of the failure to issue voting rights.

(169) The size of the amount transferred and its effect on LSH from the point of view of the Solvency Directive has already been mentioned. Through the transfer of IB's capital, LSH's core capital was increased substantially without any acquisition or administration costs. A market-economy investor would probably have demanded a premium for an injection of capital as large in relative and absolute terms as the IB assets. On the other hand, in the light of the exceptional capital requirements of credit institutions in the EU laid down by the Solvency Directive,

⁽⁴¹⁾ The parties use as a basis the risk-free interest rate calculated according to the REX10 Performance Index of Deutsche Börse AG.

a capital injection of some DEM 1 300 million in one of the largest German all-purpose banks must not be regarded as completely alien to any normal business decision. Moreover, where an investment involves a large volume of assets, this suggests a similarity with share capital. When the transfer took place at the end of 1990, large silent partnership contributions were atypical on the market. So if the volume of assets transferred is used to justify a further premium in the case of an investment that is similar to share capital, this means that the volume is being unduly taken into account twice over. The Commission therefore feels that it cannot be proved with sufficient certainty that a market-economy investor would have required a particular premium for an injection of capital as large in relative and absolute terms as in this case. Accordingly, it is not imposing a premium linked to the volume of the asset transfer, something which works in LSH's favour. Similarly, the understanding between the parties assumes that no premium should be applied on account of the high volume of assets transferred.

(170) Lastly, attention must be drawn to the non-marketability of the assets, i.e. the impossibility of withdrawing the invested capital at any time from the company. Normally, an investor can sell an equity instrument on the market to third parties, thereby terminating his investment. A normal transfer of capital takes place as follows: the investor brings in assets (either in cash or in kind), which are entered on the assets side of the balance sheet. As a rule, these are matched on the liabilities side by a tradable interest registered in the name of the investor, taking the form, in the case of a limited company for example, of shares. The investor can sell these shares to a third party. He cannot withdraw the assets he originally brought in since these now form part of the company's liable equity capital and are no longer at his disposal. But by selling the shares — at the prevailing exchange price — he can realise their economic countervalue. His assets have thereby become fungible. Because of the special circumstances surrounding the transfer of IB's assets, this option was not available to the Land. However, the Commission does not see any reason for a further premium. Although the Land was unable to realise the economic countervalue by trading freely in the investment, it could at any time have withdrawn the special-purpose reserve from LSH by law and achieved possibly higher returns by reinvesting it in other institutions. Here too the understanding between the BdB, the Land of Schleswig-Holstein and HSH Nordbank assumes that no premium should be applied on account of the lack of fungibility.

(171) Overall, the Commission therefore considers a premium of 0,3 % per annum (after corporation tax and before investor tax) to be appropriate for forgoing additional voting rights.

Overall remuneration

(172) In view of all of the above observations and in agreement with the complainant (BdB), the Land of Schleswig-Holstein

and LSH, the Commission comes to the conclusion that an appropriate remuneration would be 6,28 % (after corporation taxes), i.e. a 9,29 % normal return on the investment in question, plus 0,3 % for the particularities of the transaction and minus 3,31 % for the financing costs which LSH incurred on account of the lack of liquidity of the assets transferred.

Appropriate remuneration for IB's capital up to the time when it was recognised by BAKred, for the amount used by IB and for the special-purpose real-estate reserve

(173) As stated above, IB's capital was already of material value to LSH before it was recognised by BAKred as core capital within the meaning of the Banking Act (KWG), as it appeared on the balance sheet as equity right from the time of the transfer. The same applies to the amount used by IB and to the special-purpose real-estate reserve. Its economic function can be compared to that of a guarantee or liability. A market-economy investor would demand an appropriate remuneration in return for incurring a risk of this sort. Germany initially regarded as inappropriate the basic rate of 0,3 % per annum recognised by the Commission in Decision 2000/392/EC⁽⁴²⁾ for the guarantee function enjoyed by LSH. In Decision 2000/392/EC, a premium of a further 0,3 % per annum was added on top of that rate because, firstly, guarantees are normally tied to certain transactions and limited in time (which was not the case in WestLB) and, secondly, the amount of over DEM 3 400 million made available to WestLB was higher than that normally covered by such bank guarantees.

(174) Since WestLB and LSH are fundamentally comparable and for want of any other points of reference, the Commission assumes that this rate corresponds to the remuneration that LSH would also have to have paid on the market for a guarantee in its favour.

(175) Here too the understanding between the BdB, the Land of Schleswig-Holstein and LSH assumes that a premium of 0,3 % is justified. The Commission therefore considers that a premium is justified in the case of LSH and lays down a rate of 0,3 % per annum as appropriate remuneration for the guarantee function of the capital from the time when the transferred amount appeared on the balance sheet (1 January 1991) up to its recognition by BAKred. The parties used a rate of 0,3 % per annum after tax as a basis in the table calculating the aid element annexed to the text of their understanding.

No account to be taken of IB dividend payments

(176) Germany argued that the IB dividends paid to the Land from 1993 to 2002, amounting to DEM 99,9 million, should be deducted from the remuneration payable.

⁽⁴²⁾ See footnote 3; paragraph 221 of the decision.

However, payments made or increases in value achieved after the investment cannot be taken into account when applying the principle of the market-economy investor, who, on the basis of the information available to him at the time of the investment, either expects an appropriate return or agrees a direct remuneration. Dividends or increases in value which cannot be calculated in advance are not relevant.

(177) The Commission therefore considers that the IB dividend payments should not be deducted from the remuneration to be paid in this case.

(h) **SYNERGY EFFECTS**

(178) LSH considers that an assessment of the remuneration paid to the Land must take account of the synergy gains achieved through the transfer. However, it is clear that the actual purpose of the transfer was to provide LSH with the equity base needed to comply with the new solvency rules. Synergy gains were seen as a positive side-effect but were certainly not the main driving force behind the transaction at the time.

(179) Furthermore, if such synergies and cost savings accrue to IB, this will help the WKA and WAK (and hence the Land) by reducing costs, but cannot be regarded as consideration paid by LSH for the provision of the original own funds. Since these synergies neither reduce the usability of the transferred capital for LSH nor increase LSH's costs from the transfer, they should also not influence the level of remuneration for the equity provided which a market-economy investor can demand from the bank. Even if there were an actual benefit accruing to the Land as a result of synergies, any competitor would have been forced by competition to 'pay' to the Land on top of the appropriate consideration for the equity provided, a 'remuneration' in the form of benefits for the financial instrument (IB's capital).

(188) The following table shows the calculation of the aid element:

(180) Moreover, following a merger operation, synergy effects normally arise in both merged entities. It is difficult to understand why LSH should not profit at all from such advantages.

(i) **Legislative amendment on 1 June 2003**

(181) Germany stated that IB was split off from the assets of LSH with legal effect as of 1 June 2003. The special-purpose real-estate reserve was split off from LSH with legal effect as of 1 June 2003.

(182) After 1 June 2003 LSH was, therefore, no longer able to underpin risk assets resulting from its competitive business with special-purpose assets or to use the latter as a guarantee.

(183) The Commission therefore accepts that the favourable treatment was brought to an end with the hive-off of the special-purpose assets on 1 June 2003.

(j) **Aid element**

(184) As calculated above, the Commission comes to the conclusion that LSH should have paid a remuneration of 6,28 % per annum after tax for the special-purpose reserve that was recognised by BAKred as core capital, and 0,3 % after tax for the difference between this part and the amount shown as equity on LSH's balance sheet, as well as for the special-purpose real-estate reserve.

(185) This remuneration should have been paid from 1 January 1991 until the favourable treatment was brought to an end on 31 May 2003.

(186) LSH paid a remuneration only on the amount it could use to underpin its commercial business.

(187) The aid element can be calculated as the difference between the actual payments and the payments which would correspond to market conditions.

Figure 4:

Calculation of the aid element (DEM million)

	1991 (*)	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (5 months)
Total IB capital	1 306,0	1 312,2	1 337,9	1 387,0	1 472,0	1 563,0	1 665,9	1 763,0	1 814,0	1 817,0	1 849,2	1 923,9	1 967,6
1. Amount available to LSH	1 018,0	1 013,1	954,0	1 024,0	1 092,0	1 172,0	1 264,0	1 346,0	[...]	[...]	[...]	[...]	[...]
2. Amount used by IB	288,0	299,0	383,9	363,0	380,0	391,0	401,9	417,0	[...]	[...]	[...]	[...]	[...]
3. Amount between 1.1.1991 and 30.8.1991	870,7	—	—	—	—	—	—	—	—	—	—	—	—
4. Special-purpose real-estate reserve	—	—	—	—	—	—	—	—	—	[...]	[...]	[...]	[...]

	DEM million												
	1991 (*)	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 (5 months)
Remuneration of 6,28 % (after tax) on point 1	21,3	63,6	59,9	64,3	68,6	73,6	79,4	84,5	[...]	[...]	[...]	[...]	[...]
Remuneration of 0,3 % (after tax) on point 2	0,3	0,9	1,2	1,1	1,1	1,2	1,2	1,3	[...]	[...]	[...]	[...]	[...]
Remuneration of 0,3 % (after tax) on point 3	2,6	—	—	—	—	—	—	—	—	—	—	—	—
Remuneration of 0,3 % (after tax) on point 4	—	—	—	—	—	—	—	—	—	[...]	[...]	[...]	[...]
Total remuneration in line with market conditions	24,2	64,5	61,1	65,4	69,7	74,8	80,6	85,8	[...]	[...]	[...]	[...]	[...]
Actual remuneration (after tax)	0	0	0,9	2,4	1,0	2,5	5,0	6,6	[...]	[...]	[...]	[...]	[...]
Aid element	24,2	64,5	60,2	63,0	68,7	72,3	75,6	79,2	[...]	[...]	[...]	[...]	[...]

(*) For balance-sheet purposes IB's capital was transferred as of 1 January 1991. It was available to LSH as a guarantee function for the first eight months of 1991. After recognition by BAKred, i.e. for the last four months of 1991, it was also available for use to underpin competitive business.

Since 1 January 1999, marks have been converted into euros at a rate of EUR1 = DEM 1,95583. The figures in DEM must be converted accordingly.

(189) Accordingly, the aid element for the period from the granting of the aid up to and including 31 May 2003 comes to DEM 845,6 million, which must be converted to EUR 432,3 million.

1.3. DISTORTION OF COMPETITION AND EFFECT ON TRADE BETWEEN MEMBER STATES

(190) As a result of the liberalisation of financial services and the integration of financial markets, banking within the Community has become increasingly sensitive to distortions of competition. This development is intensifying in the wake of economic and monetary union, which is dismantling the remaining obstacles to competition in the financial services markets.

(191) LSH had a regional base and also carried on international banking business. It defined itself as an all-purpose commercial bank, central bank for the savings banks and the bank of the Land and its municipalities. Despite its name, tradition and legally stipulated tasks, LSH was much more than a mere local or regional bank.

(192) These facts clearly show that LSH offered its banking services in competition with other European banks outside Germany and, since banks from other European countries are active in Germany, inside Germany.

(193) It should also be pointed out that there is a very close relationship between a credit institution's equity capital and its banking activities. It is only when it has sufficient recognised equity capital that a bank can do business and expand its commercial activities. As the state measure provided LSH with such equity capital for solvency

purposes, it directly influenced the bank's business possibilities.

(194) It is clear, therefore, that aid given to LSH distorts competition and affects trade between Member States.

1.4. CONCLUSION

(195) On the basis of all these considerations, it can be stated that all the criteria of Article 87(1) of the EC Treaty are met and hence that the transfer of the special-purpose reserve involves state aid within the meaning of that Article.

2. COMPATIBILITY WITH THE COMMON MARKET

(196) An assessment must also be made as to whether that aid can be considered compatible with the common market. It should be noted in this respect that LSH invoked only the exemption laid down in Article 86(2) of the EC Treaty in relation to any aid elements present in the transfer of IB's capital and of the real estate.

(197) None of the exemption clauses of Article 87(2) of the EC Treaty is applicable. The aid does not have a social character and is not granted to individual consumers. Nor does it make good the damage caused by natural disasters or exceptional occurrences or compensate for the economic disadvantages caused by the division of Germany.

(198) Given that the aid has no regional objective — it is designed neither to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment nor to facilitate the development of certain economic areas — neither Article 87(3)(a) nor (c) of the EC Treaty, as regards the

latter's regional aspects, is applicable. Nor does the aid promote the execution of an important project of common European interest. It is not aimed either at promoting culture or heritage conservation.

(199) Since the economic survival of LSH was not at stake when the measure was taken, there is no need to consider whether the collapse of a single large credit institution like LSH could lead to a general banking crisis in Germany, something which might possibly justify aid to remedy a serious disturbance in the German economy under Article 87(3)(b) of the EC Treaty.

(200) Under Article 87(3)(c) of the EC Treaty, aid may be found compatible with the common market if it facilitates the development of certain economic activities. This might, in principle, also apply to restructuring aid in the banking sector. However, in the case at hand the conditions for the application of this exemption clause are not met. LSH is not described as an undertaking in difficulty whose viability must be restored with the support of state aid.

(201) Article 86(2) of the EC Treaty, which allows exemptions from the Treaty's state aid provisions under certain conditions, is in principle also applicable to the financial services sector. This was confirmed by the Commission in its report on services of general economic interest in the banking sector⁽⁴³⁾. LSH argued that it provided services of general economic interest and that to the extent that any sums contributed by the Land of Schleswig-Holstein were used for purposes of its public-service tasks or services of general interest, such sums did not constitute unlawful state aid. However, LSH does not meet the necessary formal conditions: no precise indication is given of the specific tasks which it carries out in providing services of general economic interest, and in particular of the specific costs generated by such tasks. It is therefore clear that the transfer was effected in order to enable LSH to comply with the new own funds requirements and with no regard to any services of general economic interest. Accordingly, this exemption clause does not apply either in the case at hand.

(202) Since no exemption from the principle of the ban on state aid pursuant to Article 87(1) of the EC Treaty applies, the aid in question cannot be found compatible with the Treaty.

3. NO EXISTING AID

(203) Contrary to what was argued by Germany and LSH, the capital injection cannot be regarded as being covered by the existing state aid scheme for Anstaltslast and Gewährträgerhaftung.

(204) Gewährträgerhaftung is a default guarantee offered to creditors in the event that the bank's assets are no longer

sufficient to satisfy their claims, and this is not the case here from the outset. The capital injection is not intended to satisfy the Landesbank's creditors and the bank's assets have not been exhausted.

(205) Nor does Anstaltslast apply. Anstaltslast requires the guarantor, the Land of Schleswig-Holstein, to provide LSH with the resources it needs to function properly for as long as the Land decides to maintain it in existence. However, at the time of the capital injection, LSH was far from being in a situation where it was no longer able to operate properly for lack of sufficient resources. The capital injection was not needed in order to keep the Landesbank in operation. Rather, the capital injection was made in order to enable the Landesbank to increase its capital in the light of the tighter rules on core capital/own resources ratios introduced on 30 June 93 so as to avoid an otherwise necessary reduction in its business volume/risk assets and (in addition) to enable it to expand in future. This conscious economic calculation by the Land as joint owner also enabled LSH to seize future opportunities in its competitive business. The 'necessity requirement' for Anstaltslast does not apply to such a normal economic decision by the Land as joint owner of the bank. Since there is no other existing aid scheme under Articles 87(1) and 88(1) of the EC Treaty, the capital injection ranks as new aid within the meaning of Article 88(3) of the EC Treaty and must be investigated accordingly.

X. CONCLUSION

(206) The Commission finds that the Federal Republic of Germany has unlawfully implemented the aid in question contrary to Article 88(3) of the Treaty. This aid is therefore illegal.

(207) The aid cannot be regarded as compatible either under Article 87(2) or (3) or under any other provision of the EC Treaty. The aid is therefore declared incompatible with the common market and must be discontinued and the aid element of the measure illegally put into effect must be recovered by the German Government,

HAS ADOPTED THIS DECISION:

Article 1

The state aid of €432,3 million which Germany granted to Landesbank Schleswig-Holstein Girozentrale, now HSH Nordbank AG, from 1 January 1999 to 31 May 2003 is incompatible with the common market.

Article 2

Germany shall take all necessary measures to recover from the recipient the aid referred to in Article 1 and unlawfully made available to the recipient.

⁽⁴³⁾ This report was presented to the Ecofin Council on 23 November 1998 but has not been published. It can be obtained from the Competition Directorate-General of the Commission and can also be found on the Commission's website.

Article 3

Recovery shall be effected without delay and in accordance with the procedures of national law provided that they allow the immediate and effective execution of the Decision.

The aid to be recovered shall include interest from the date on which it was at the disposal of the recipient until the date of its recovery.

Interest shall be calculated in accordance with the provisions of Chapter V of Commission Regulation (EC) No 794/2004 ⁽⁴⁴⁾.

Article 4

Using the questionnaire set out in the Annex, Germany shall inform the Commission, within two months of notification of this Decision, of the measures taken to implement it.

Article 5

This Decision is addressed to the Federal Republic of Germany.

Brussels, 20 October 2004.

For the Commission

Mario MONTI

Member of the Commission

⁽⁴⁴⁾ OJ L 140, 30.4.2004, p. 1.

ANNEX

INFORMATION REGARDING THE IMPLEMENTATION OF THE COMMISSION DECISION

1. Calculation of the amount to be recovered

- 1.1. Please provide the following details regarding the amount of unlawful state aid that has been put at the disposal of the recipient:

Date(s) of payment ^(*)	Amount of aid ^(*)	Currency	Identity of recipient

(^o) Date or dates on which the aid or individual instalments of aid were put at the disposal of the recipient; if the measure consists of several instalments and reimbursements, use separate rows.

(^{*}) Amount of aid put at the disposal of the recipient, in gross grant equivalent.

Comments:

- 1.2. Please explain in detail how the interest payable on the amount to be recovered will be calculated.

2. Recovery measures planned or already taken

- 2.1. Please describe in detail what measures have been taken and what measures are planned to bring about the immediate and effective recovery of the aid. Please also explain which alternative measures are available in national legislation to bring about recovery of the aid. Where relevant, please indicate the legal basis for the measures taken or planned.
- 2.2. By what date will the recovery of the aid be completed?

3. Recovery already effected

- 3.1. Please provide the following details of aid that has been recovered from the recipient:

Date(s) (^o)	Amount of aid repaid	Currency	Identity of recipient

(^o) Date or dates on which the aid was repaid.

- 3.2. Please attach supporting documents for the repayments shown in the table at point 3.1.