

PROCEDURES RELATING TO THE IMPLEMENTATION OF COMPETITION
POLICY

EUROPEAN COMMISSION

STATE AID — GERMANY

State aid C 15/09 (ex N 196/09), N 333/09, N 557/09

Hypo Real Estate, Germany — Extension of formal investigation procedure and temporary approval
of capital injections

Invitation to submit comments pursuant to Article 88(2) of the EC Treaty

(Text with EEA relevance)

(2010/C 13/13)

By means of the letter dated 13 November 2009 reproduced in the authentic language on the pages following this summary, the Commission notified Germany of its decision to initiate the procedure laid down in Article 88(2) of the EC Treaty concerning the above mentioned measure.

Interested parties may submit their comments on the measure in respect of which the Commission is initiating the procedure within one month of the date of publication of this summary and the following letter, to:

European Commission
Directorate-General for Competition
State Aid Greffe
Office: SPA3, 6/5
1049 Bruxelles/Brussel
BELGIQUE/BELGIË

Fax +32 22961242

These comments will be communicated to Germany. Confidential treatment of the identity of the interested party submitting the comments may be requested in writing, stating the reasons for the request.

PROCEDURE

On 7 May 2009, the Commission initiated the formal investigation procedure with respect to State aid measures in favour of Hypo Real Estate (HRE). (Decision C(2009) 3712 final). The Decision of 7 May 2009 was withdrawn and replaced by Decision C(2009) 5888 final of 24 July 2009. Thereafter, the German authorities notified various capital injections and proposed a deeper restructuring of HRE compared to that foreseen in the initial restructuring plan. The German authorities also informed the Commission that Germany intends to carry out additional state support for the bank.

FACTS

At the end of September 2008, HRE faced a liquidity shortage which would have put the bank into insolvency. On 1 April 2009 Germany notified a restructuring plan for HRE.

Germany provided HRE first with some rescue measures (State guarantees amounting to EUR 35 billion, SoFFin guarantees amounting to EUR 52 billion) and thereafter three capital injections were provided. In addition, Germany intends to provide further capital, further guarantees and the transfer of assets into a wind-down institute.

The restructuring plan foresees that HRE focuses on two core fields: commercial real estate and public finance. Refinancing should mainly be carried out via covered bonds (*Pfandbriefe*). HRE currently foresees that its core bank, Deutsche Pfandbriefbank, will, at the end of 2010, have a balance sheet total of maximum EUR [120-130] (*) billion, equal to a reduction by approximately [69-72] % compared to the balance sheet of HRE group on 31 December 2008 (approximately EUR 420 billion).

(*) Confidential information.

ASSESSMENT

The compatibility of the aid is assessed under Article 87(3)(b) EC.

The Commission comes to the conclusion that the capital injection amounting to EUR 60 million carried out in March 2009, the capital injection amounting to EUR 2 959 632 240 that was decided by a meeting of HRE's shareholders on 2 June 2009, and the capital injection amounting to EUR 3,0 billion which will be injected in November 2009, can be temporarily found compatible with the common market until a final decision on the restructuring plan is reached.

In addition, the formal investigation procedure will be extended to restructuring measures aid including the capital injection amounting to EUR 2 959 632 240 and EUR 3 billion as well as to several measures to be granted in the future (guarantees of EUR 20 billion as well as the capital injections amounting to a maximum of EUR 4 billion). The Commission will assess the continuation of all previous emergency aid measures as well as the already granted capital injections and the newly granted measures in view of the existing restructuring plan as restructuring aid in the context of the Restructuring Communication of 22 July 2009.

The Commission reiterates doubts on the viability of HRE. At present, doubts regarding funding, short- and long-term profitability and business growth persist, taking the updated restructuring plan into account. In addition, the Commission doubts whether the reduction of [69-72] % of the balance sheet is sufficient to compensate for the very significant amount of aid and whether the terms for reprivatisation, according to which the reprivatisation shall take place at the latest in 201[...], provided that Germany can obtain an economically acceptable price, are an appropriate means to limit distortions of competition.

TEXT OF LETTER

The Commission wishes to inform Germany that it has decided to extend the proceedings laid down in Article 88(2) of the EC Treaty which was opened by Decision C(2009) 3712 final of 7 May 2009 (withdrawn and replaced by decision C(2009) 5888 final of 24 July 2009), and has decided to temporarily find compatible with the Common Market several capital injections.

1. PROCEDURE

- (1) On 2 October 2008, the Commission approved emergency rescue aid for Hypo Real Estate (HRE) amounting to EUR 35 billion, registered under Case number N 44/08.

- (2) On 1 April 2009 Germany notified a restructuring plan for HRE, registered under Case number N 196/09. The plan discloses the assumption that Germany will overall inject EUR 10 billion capital into HRE.

- (3) Germany notified by letter dated 17 April 2009 a capital injection of EUR 60 million, having acquired on 30 March 2009 20 million new shares at their nominal value. By this letter, Germany also notified a prolongation of guarantees amounting to EUR 52 billion provided by the "Special Fund Financial Market Stabilisation" (SoFFin). These measures were registered under Case number N 196/09.

- (4) On 7 May 2009, the Commission initiated a formal investigation procedure ⁽¹⁾.

- (5) On 3 June 2009 the German authorities notified by letter dated 29 May 2009 a capital injection amounting to EUR 2 959 632 240 into HRE and the related acquisition of HRE shares through SoFFin (this measure was registered under Case number N 333/09). The German authorities mention that they notify this measure on a precautionary basis but consider it to be covered by the approved German bank rescue scheme ⁽²⁾.

- (6) On 24 July 2009 the Commission, asked the German authorities to provide additional information regarding this capital injection. Germany sent additional information on 3 and 4 September 2009.

- (7) On 17 August 2009 the German authorities informed the Commission (registered under Case number C 15/09) that Germany intends to prolong until 18 November 2009 previously granted SoFFin guarantees amounting to EUR 52 billion for HRE (which were granted before 1 April 2009). Simultaneously, the German authorities submitted updates for the restructuring plan, which also proposed a deeper restructuring of HRE.

- (8) By letter dated 13 October 2009, the German authorities informed the Commission that HRE urgently needs a capital injection amounting to approximately EUR [2-4] (*) billion (registered under Case number N 557/09).

⁽¹⁾ Commission Decision of 7 May 2009, replaced by Decision of 24 July 2009 in Case C 15/09 (ex N 196/09), OJ C 240, 7.10.2009, p. 11.

⁽²⁾ Commission Decision of 12 December 2008 in Case N 625/08 (OJ C 143, 24.6.2009, p. 1).

(*) Confidential information.

- (9) The German financial supervisory authority, BaFin⁽³⁾, stated in a letter of [...] that without additional capital HRE would no longer comply with the regulatory minimum capital requirements. In this letter it is also stated that bank supervisory procedures (e.g. [...]) would be necessary should HRE not comply with the rules for own capital.
- (10) On 20 and 21 October 2009, the German authorities notified to the Commission other intended State measures for HRE, informed the Commission about a further prolongation of the already existing SoFFin guarantees, and provided another update of the restructuring plan (registered under case number N 557/09).
- (11) On 26 October 2009 the German authorities supplemented (registered under case number N 557/09) their notification of 21 October 2009, by providing clarification regarding State support for the bank. Regarding the proposed capital injection notified by letter dated 13 October 2009, the German authorities clarified that this capital injection will amount to EUR 3,0 billion and that Germany intends to inject it in November 2009.
- (16) The field of “Public Sector & Infrastructure Finance” pools mainly the public sector business. In addition, the field contains the infrastructure- and asset-based-finance portfolios.
- (17) The field of “Capital Markets & Asset Management”, which is intended to be discontinued, pools the capital markets and the asset management business of the group.
- (18) As at 30 June 2009 HRE had nearly 1 600 employees and a balance sheet total of EUR 386.4 billion. For the year 2008 HRE’s reported losses amount to EUR 5,5 billion, and for the first half of the year 2009 the bank reported losses amounting to EUR 1,1 billion.
- (19) In the course of time, HRE was taken into 100 % German State ownership.

2. DESCRIPTION

2.1. The beneficiary

- (12) In October 2003 HRE was established as a spin-off of parts of the commercial real estate financing of the HVB Group. In 2007, HRE took over the Dublin-based DEPPA Bank plc and extended its business to public sector and infrastructure finance.
- (13) HRE currently consists of the following main companies: Hypo Real Estate Holding AG, Deutsche Pfandbriefbank AG and DEPPA Bank plc.
- (14) HRE has its seat in Munich, Germany. Currently the business of HRE is structured in three fields: “Commercial Real Estate”, “Public Sector & Infrastructure Finance”, and “Capital Markets & Asset Management”. It is active in Europe, Asia, North America and South America. HRE is one of the largest issuers of covered bonds (*Pfandbriefe*⁽⁴⁾).
- (15) The field of “Commercial Real Estate” combines mainly the international and German businesses of the commercial real estate financing including customer derivatives from Deutsche Pfandbriefbank AG.
- (20) As part of Germany’s overall strategy to gain full control over HRE by acquiring the totality of shares in several steps, SoFFin bought 20 million new HRE shares on 30 March 2009 at their nominal value of EUR 3 per share, resulting in a capital injection of EUR 60 million. The issuance of these shares took advantage of capital approved in advance by the regular annual shareholders’ meeting.
- (21) The acquisition of these shares gave SoFFin a 8,65 % share of HRE’s equity capital.
- (22) According to the German authorities, this capital injection was a precondition of KPMG, HRE’s independent auditor of annual accounts, to certify the annual financial statements of 2008 under the going-concern principle. Without such certified financial statements, the German supervisory authority would have had to initiate bank supervisory procedures.

2.2. The measures to be temporarily found compatible with the Common Market

2.2.1. Capital injection amounting to EUR 60 million

2.2.2. Capital injection amounting to EUR 2 959 632 240

⁽³⁾ “Bundesanstalt für Finanzdienstleistungsaufsicht”.

⁽⁴⁾ Pfandbriefe are a type of covered bonds. The Pfandbrief has two kinds of securitization. In addition to a liability taken over by the bank itself it is collateralized by specific assets such as property mortgages or public sector loans as laid down in the German Pfandbrief Act (“Pfandbriefgesetz”).

- (23) On 2 June 2009, a meeting of HRE’s shareholders approved the issuance of 986 544 080 new shares to be acquired by SoFFin. That means that SoFFin injected capital amounting to EUR 2 959 632 240 into HRE. The price per issued share is EUR 3, which is the nominal value per share. According to the German authorities, SoFFin subscribed the shares at the minimum possible price, which is the nominal value per share (EUR 3).
- (24) Taking the acquisition of new shares into account, SoFFin reached a capital participation amounting to 90 %.

2.2.3. Capital injection amounting to EUR 3,0 billion

(25) On 26 October 2009, the German authorities informed the Commission that Germany will inject EUR 3,0 billion capital into HRE in November 2009.

(26) Germany intends to structure the EUR 3,0 billion capital injection as follows:

— EUR 2 billion shall be injected into the reserves (“freie Rücklagen”), partly into HRE Holding, partly into Deutsche Pfandbriefbank. According to the German authorities no fixed coupon can be requested for this EUR 2 billion capital injection, as this amount is injected into the reserves. After the squeeze-out of minority shareholders, HRE is in 100 % ownership of Germany/SoFFin. Therefore, according to the German authorities, Germany/SoFFin is entitled to the earnings/dividends which HRE would distribute.

— EUR 1 billion shall be carried out as a silent participation in Deutsche Pfandbriefbank, with a profit-related coupon of 10 % p.a.

(27) The German authorities submit that HRE needs the capital injection of EUR 3 billion to absorb the anticipated losses in DEPFA plc and Deutsche Pfandbriefbank. This capital injection is also needed in order to comply with regulatory minimum capital requirements for HRE, DEPFA plc. and Deutsche Pfandbriefbank.

(28) The supervisory authority, BaFin, in a letter of [...] points out that a collapse of HRE group would have considerable negative effects on the national and international financial markets, with the potential to cause major disruptions and to eliminate the trust that has recently resurged.

2.3. The updated restructuring plan

(29) The business plan for HRE has been updated several times, with the most recent update notified on [...] and [...] October 2009.

(30) Germany provides the above-mentioned capital measures for the restructuring of HRE. Moreover, the guarantees already granted, which have been prolonged through the presentation of the restructuring plan (EUR 35 billion was granted under the rescue decision and EUR 52 billion was granted under the German rescue package before the restructuring plan was notified), are part of the restructuring.

(31) Further, Germany intends to take the following State aid measures, which will be granted as restructuring aid at a later stage (registered under case number N 557/09):

— guarantees of EUR 10 billion as liquidity buffer, EUR 8 billion for the rescheduling of the secured notes and EUR 2 billion for refinancing a possible winding-down solution;

— capital injections amounting to a maximum of EUR 4 billion

(32) [...], HRE intends to make use of a wind-down-institute for a balance sheet scope of up to EUR 210 billion. Germany notes that the exact scope and design of the wind-down-institute has not yet been agreed.

(33) According to Germany's current intention, the core bank of HRE, Deutsche Pfandbriefbank, would by 31 December 2010 have a balance sheet total of maximum EUR [120-130] billion. Compared to the balance sheet total of HRE group on 31 December 2008 (approximately EUR 420 billion) this represents a reduction by approximately [69-72] %. ⁽⁵⁾ By 31 December 2014, Deutsche Pfandbriefbank would reach a balance sheet total of maximum EUR [160-180] billion. Compared to the balance sheet total of HRE group on 31 December 2008 this represents a reduction by approximately [57-62] %.

(34) Germany committed to ensure that Deutsche Pfandbriefbank will be re-privatised by 31 December 201[...] at latest, provided it can sell the bank at conditions which it considers are economically acceptable for Germany.

(35) HRE still intends to focus its business on commercial real estate and public finance, as already foreseen in the initial restructuring plan, notified on 1 April 2009. In public finance, HRE intends to generate an average net margin amounting to [...] % for new business. According to a study of Booz & Company this margin is plausible, although at the upper end of the assumed range. According to a study of the audit firm PricewaterhouseCoopers, the basic assumptions are ambitious but not implausible.

3. POSITION OF GERMANY

(36) The German authorities point out that they notified the capital measures on a precautionary basis, considering that all three capital injection are considered to be covered by the authorised German banking rescue package pursuant to § 7 of the “Finanzmarktstabilisierungsfondsgesetz” (FMStFG) and by the authorisation of this measure by Commission decision of 12 December 2008. Therefore, the German authorities argue that they constitute existing State aid.

⁽⁵⁾ The balance sheet total reductions are based on the assumption, that certain non-strategic assets are transferred from the Pfandbriefbank into a wind-down-institute.

- (37) Germany asks for temporary approval of the capital measures until a decision on the restructuring plan has been taken.
- (38) In addition, regarding the capital injection of 60 million, Germany points out that according to German law shares must not be issued at a price below the nominal value. HRE's shares were issued at a nominal value of EUR 3 per share. Therefore, according to the German authorities, SoFFin paid the legal minimum price for the shares.
- (39) Regarding the capital injection and the related acquisition of shares by SoFFin of EUR 2,96 billion, Germany notes that they were sold at a price of EUR 3 per share which is the nominal value and hence the minimum issue price. According to Germany, the issuance of new shares at a price below EUR 3 was not possible.

4. ASSESSMENT

4.1. Existence of State aid under Article 87(1) of the EC Treaty

- (40) In the opening decision⁽⁶⁾ the Commission came to the preliminary conclusion that all measures granted so far (i.e. the guarantees and the capital injection amounting to EUR 60 million carried out in March 2009) constitute State aid within the meaning of Article 87(1) of the Treaty. With regard to the capital injection in the form of new shares, the Commission considered that the funds for the acquisition of those shares were provided by SoFFin, an entity set up by the German government under the German rescue package⁽⁷⁾, and that the capital injection provided a selective advantage, enabling HRE to obtain capital more favourably than on the market. The measure therefore constitutes State aid. The same assessment applies to the capital injections amounting to EUR 2,96 billion carried out in June 2009 and the capital injection amounting to EUR 3,0 billion carried out in November 2009.

4.2. Compatibility of the aid

4.2.1. Application of Article 87(3)(b) of the EC Treaty

- (41) Article 87(3)(b) EC Treaty enables the Commission to declare aid compatible with the Common Market if it is "to remedy a serious disturbance in the economy of a Member State". The Commission recalls that the Court of First Instance has stressed that Article 87(3)(b) EC

Treaty needs to be applied restrictively and must relate to a disturbance in the entire economy of a Member State⁽⁸⁾. As the breakdown of a systematically relevant bank can directly affect the financial markets and indirectly the entire economy of a Member State, the Commission currently bases its assessment of State aid measures in the banking sector on this provision in light of the ongoing fragile situation on the financial markets.

- (42) Germany considers HRE to be a bank with systemic relevance for the financial market. BaFin has confirmed that the own capital of the bank would fall short of the regulatory requirements if the bank does not receive further capital and that bank supervisory procedures would be initiated if the bank does not receive further capital. The Commission will therefore assess the State aid measures for HRE under Article 87(3)(b) of the EC Treaty⁽⁹⁾.
- (43) Germany has granted capital injections into HRE on the basis of the FMStFG, approved under the German rescue scheme, and hence does not consider a notification necessary. However, the Commission points out that these capital injections need to be notified individually because they are part of a restructuring plan, and therefore need to be assessed in that context and not as an emergency measure under the German banking rescue scheme. In general, the Commission considers that the German banking rescue scheme does not allow Germany to grant aid which is subject to a restructuring plan, but that such measures rather need to be notified individually.
- (44) Given that Germany asks for temporary approval of the capital measures until a decision on the restructuring plan has been taken, the Commission will assess the temporary compatibility of the measures until a decision on the restructuring plan is taken. If the measures are compatible it would not need to take position on whether the measures were already compatible under the German rescue aid scheme, as claimed by the German authorities⁽¹⁰⁾.

⁽⁶⁾ Decision C(2009) 3712 final of 7 May 2009 (withdrawn and replaced by decision C(2009) 5888 final on 24 July 2009).

⁽⁷⁾ Commission Decision of 27 October 2008; N 512/08 *Rettungspaket für Kreditinstitute in Deutschland* replaced by Commission decision of 12 December 2008; N 625/08 *Rettungspaket für Finanzinstitute in Deutschland*.

⁽⁸⁾ Cf. See, in principle, Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG Commission* [1999] ECR II-3663, paragraph 167. Followed in Commission Decision in case C 47/96, *Crédit Lyonnais*, OJ L 221, 8.8.1998, p. 28, point 10.1, Commission Decision in Case C 28/02 *Bankgesellschaft Berlin*, OJ L 116, 4.5.2005, p. 1, point 153 *et seq* and Commission Decision in Case C 50/06 *BAWAG*, OJ L 83, 26.3.2008, p. 7, point 166. See Commission Decision of 5 December 2007 in case NN 70/07, *Northern Rock*, OJ C 43, 16.2.2008, p. 1, Commission Decision of 30 April 2008 in case NN 25/08, *Rescue aid to WestLB*, OJ C 189, 26.7.2008, p. 3, Commission Decision of 4 June 2008 in Case C 9/08 *SachsenLB*, OJ L 104, 24.4.2009, p. 34.

⁽⁹⁾ Cf. § 47 Commission Decision of 12 December 2008 in case N 625/08 *Rettungspaket für Finanzinstitute in Deutschland*, OJ C 143, 24.6.2009, p. 1.

⁽¹⁰⁾ Similar Commission decision of 7 May 2009 in case N 244/09 *Commerzbank*.

4.2.2. Temporary compatibility of the capital measures

- (45) Under the Banking Communication⁽¹¹⁾ any aid or aid scheme must comply with general criteria for compatibility under Article 87(3) of the Treaty, viewed in the light of the general objectives of the Treaty and in particular must be appropriate, necessary and proportional.
- (46) The Banking Communication contains general conditions for support measures in the financial crisis, inter alia for recapitalisations. Those principles have to be applied to State aid schemes and *mutatis mutandis* for individual cases. The conditions have been complemented and clarified in the Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, of 5 December 2008⁽¹²⁾ (Recapitalisation Communication).
- (47) Capital injections into banks are in principle suitable to help banks to resist the consequences of the financial crisis, providing a cushion to absorb losses, to fulfil regulatory capital requirements, to ensure lending to the real economy, and to prepare a bank's return to long-term viability or its orderly winding up⁽¹³⁾.
- (48) HRE is in a process of restructuring, and Germany has already provided a restructuring plan which was subsequently updated. This is currently being assessed by the Commission. However, in cases where financial stability is at stake and urgent remedial action is needed to keep the ailing bank afloat — as in the present case, confirmed by the national financial supervisory authority - it can be accepted that it is necessary to temporarily grant emergency aid prior to the final assessment of the revised restructuring plan.

Capital injections

- (49) The capital injection of EUR 60 million had only limited scope, resulting in a 8,65 % share of HRE's equity capital which did not give Germany a major influence on the bank. According to the German authorities, the capital injection was necessary for the annual financial statements of 2008, to be certified under the going-concern principle. The Commission considers that the measure was necessary in order to avoid initiation by BaFin of bank supervisory procedures.

⁽¹¹⁾ Commission Communication on "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis", OJ C 270, 25.10.2008, p. 8.

⁽¹²⁾ Communication from the Commission — Recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, OJ C 10, 15.1.2009, p. 2.

⁽¹³⁾ Recapitalisation Communication, points 4 and subsequent; Cf. Commission decision of 13 October 2008 in case N 507/08 Financial Support Measures to the Banking Industry in the UK, OJ C 290, 13.11.2008, p. 4.

- (50) The capital injection of EUR 2 959 632 240 was, according to Germany, necessary to ensure compliance with regulatory requirements regarding the minimum level of capital as well as to meet equity capital ratio expectations by the markets. According to the Interim Report as of 30 June 2009, HRE had a core capital (Tier 1) ratio of 6,9 % and an own funds (Tier 1 and 2) ratio of 9,5 % per 30 June 2009. Nevertheless, those ratios would have been lower if losses accumulated in the first half of 2009 had already been taken into account.

- (51) By letter of [...], BaFin points out, that HRE would need additional capital, and that bank supervisory procedures (e.g. [...]) would be initiated, if the bank does not comply with own capital rules. Therefore, the Commission considers that the capital injection amounting to EUR 3,0 billion which Germany intends to inject in November 2009, is necessary in order to avoid bank supervisory procedures (e.g. [...]).

- (52) With regard to the silent participation of EUR 1 billion, SoFFin will receive a profit-related coupon of 10 %. This level of remuneration is in line with point 44 of the Recapitalisation Communication, which stipulates that where the price cannot be set to levels that correspond to the risk profile of the bank, it would nevertheless need to be close to that required for a similar bank under normal market conditions. It is clear that HRE would not get capital at an economically justifiable remuneration level on the market in the current circumstances. However, given that HRE is in difficulty, it should thus pay at least a reasonable price. 10 % has already been accepted as an acceptable level⁽¹⁴⁾.

- (53) With respect to capital injections carried out by acquiring share capital and the injection into the reserves, SoFFin as 100 % HRE owner is, according to the German authorities, entitled to a shareholder's usual remuneration. For a distressed bank no market-conform remuneration can be expected, at least in the short-term, for such provision of capital. In line with the Recapitalisation Communication such a situation requires a thorough and far-reaching restructuring. However, for ordinary shares a fixed coupon cannot be arranged.

- (54) On the basis of the considerations above, and taking into account the approved German rescue scheme for financial institutions, the Commission comes to the conclusion that the capital injections are appropriate, necessary and proportional, and can be considered compatible with the Common Market on a temporary basis until a final decision is taken on the restructuring plan of HRE.

⁽¹⁴⁾ See Commission decision of 12 May 2009 in case N 615/08, *BayernLB*.

4.2.3. Extension of the Procedure regarding the restructuring aid

- (55) The formal investigation procedure will be extended to restructuring measures aid including the capital injection amounting to EUR 2 959 632 240 and EUR 3 billion as well as to the measures to be granted (the guarantees of EUR 10 billion as liquidity buffer, EUR 8 billion for the rescheduling of the secured notes and EUR 2 billion for refinancing a possible winding down solution; as well as the capital injections amounting to a maximum of EUR 4 billion).
- (56) The Commission cannot exclude at this stage that additional aid might be given by the transfer of assets to a wind-down-institute, considering a capital relief effect that is not properly compensated for.
- (57) The Commission will assess the continuation of all previous emergency aid measures as well as the already granted capital injections and the newly granted measures in view of the existing restructuring plan as restructuring aid. The compatibility of the restructuring aid is assessed on the basis of the restructuring plan in the context of the Restructuring Communication of 22 July 2009⁽¹⁵⁾. Although the decision⁽¹⁶⁾ of 24 July 2009 made reference to the Guidelines on State aid for rescuing and restructuring firms in difficulty, the Commission has clarified in point 49 of the Restructuring Communication that all aid notified to the Commission before 31 December 2010 will be assessed as restructuring aid to banks pursuant to that Communication instead of the Guidelines on State aid for rescuing and restructuring firms in difficulty. The Commission has doubts that the newly introduced restructuring measures as well as the previous measures can be considered as compatible restructuring aid under the Restructuring Communication.

4.2.3.1. Doubts on the viability of HRE

- (58) In the decision⁽¹⁷⁾ of 24 July 2009 the Commission already mentioned doubts on the viability of HRE. At present, the Commission still has doubts regarding the viability of HRE, taking the more detailed figures in the updated restructuring plan into account, questioning whether the intended restructuring is sufficient to allow restoration of long-term viability on the basis of the State aid received and planned. In this context, the Commission also needs to assess the impact of the intended wind-down-institute on the restructuring. The Commission has identified three problematic aspects that could affect the long-term sustainability of HRE's business model and intends to investigate those further:

(59) Funding: HRE intends to fund its operations mainly through German covered bonds (Pfandbriefe). However, [25-40] % of its refinancing operation relies on unsecured lending and money markets. The cyclical and volatile nature of HRE's business, together with the long asset duration, threatens this approach. HRE would have to provide further evidence that this funding approach is suitable for public finance under all market circumstances, not just in good times.

(60) Short- and long-term profitability: the updates of the business plan rise doubts regarding HRE's managing of its profit and loss expectations. In the base case scenario of the restructuring plan notified on 1 April 2009, HRE planned losses for the whole year 2009 amounting to EUR 0,949 billion. However, actual losses in the first six months of 2009 already exceeded this figure (actual: EUR 1,1 billion⁽¹⁸⁾). The expected losses for the whole year 2009 have in the meantime been updated to approximately EUR 2,5 billion, which underlines that the assumptions made in the restructuring plan are fragile.

(61) In its revised business plan, HRE wants to remain active in two fields: Commercial Real Estate and Public Finance. In the latter, HRE estimates to run new business on an average net margin of [...]%. HRE claims that this is a conservative estimate, and that its margin will likely be higher in reality. Nevertheless, the Commission notes at this stage that the intended margin in the area of public finance is very low and that market pressure may further reduce achievable margins.

(62) In detail, the calculation provided by HRE is based on a return simulation for EUR [1-2] billion of new business, focused on regional finance in Germany, together with regional and local business in France and Spain. By making margin assumptions on each business line, HRE simulates an average asset margin of about [0,65-0,75] % over the interbank offered rate.

(63) On the liability side, HRE expects to refinance about 90 %⁽¹⁹⁾ of the public financing business using Pfandbriefe, at an average spread of [...] % over the interbank offered rate. While this theoretically leaves a positive margin, sufficient to cover costs, the Commission sees some threats to this business model:

⁽¹⁵⁾ Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, OJ C 195, 19.8.2009, p. 9.

⁽¹⁶⁾ Decision C(2009) 5888 final.

⁽¹⁷⁾ See footnote 16.

⁽¹⁸⁾ The losses in the first 6 months of 2009 were largely influenced by "provisions for losses on loans and advances" of EUR 1,077 billion (in the first 6 months of 2008 there were "provisions for losses on loans and advances" of EUR 0,07 billion).

⁽¹⁹⁾ The 90 % ratio of covered bond financing only applies to the public finance business. On average, HRE's business model (combining Commercial Real Estate and Public Finance) foresees a covered bond refinancing of about 65 %

- First, because of the inherent maturity mismatch between assets and liabilities, it might be difficult to maintain the intended net credit margin should markets be in a distressed shape again at the moment of refinancing. The maturity mismatch stems on the one hand from the difficulty to issue covered bonds at precisely the same maturity as the underlying assets, and on the other hand from the amount of 10 % that is not refinanced using covered bonds;
- Second, if the markets for public finance (e.g. in France or Spain) were to normalise quicker than expected, budgeted asset side margins might drop faster than the refinancing spread for HRE issued covered bonds. In its business plan, HRE is counting on profitable businesses in French and Spanish regional markets. However, as soon as markets normalise, fierce competition could step in, eating out a large part of budgeted profitability.
- (64) Additionally, in its core market, Germany, margins are already under pressure. Consequently, this is where HRE generates the smallest average margin compared to its other country markets.
- (65) According to a study by the consulting firm Booz & Company, submitted by Germany as supporting evidence, the margin of [...] % is plausible yet at the upper end of the assumed range. According to a study of the audit firm PricewaterhouseCoopers, the basic assumptions are ambitious but not implausible. The Commission interprets these statements as indicating that the margins are in principle achievable but will probably be lower than [...] %.
- (66) In the field of commercial real estate, HRE intends to achieve a higher average net margin of [...] % - [...] %. The Commission's main concern regarding this business target relates to the cost of capital which might be underestimated. Recent events confirm that the business is capital intensive, both through substantial effective write-downs and high risk weighted asset ratios.
- (67) Business growth: HRE intends to generate a considerable amount of new business. The Commission doubts that HRE can easily achieve this, as it will face fierce competition for the same opportunities. However, the present pick-up in business (the bank achieved positive margins on *new* business in 2009, but earnings generated there do not compensate losses stemming from the *existing* portfolio) might give a distorted picture with regard to the potential to return to viability once the

substantial State support measures, specifically guarantees and State ownership, are removed or entirely compensated for.

4.2.3.2. Measures to limit distortions of competition

- (68) According to point 31 of the Restructuring Communication, when assessing the measures to limit distortions of competition, the Commission needs to take account of the amount of the aid both in absolute terms (including the aid element in guarantees) as relative to the bank's risk-weighted assets. HRE received an extremely large amount of aid. On this basis, even if in line with the current plan HRE reduces its balance sheet by [69-72] % by end of 2010, the Commission continues to doubt that the measures to limit distortions of competition are sufficient.
- (69) The Commission further doubts whether the terms for a reprivatization of Deutsche Pfandbriefbank according to which the reprivatization shall take place at the latest in 201[...], provided that Germany can obtain an economically acceptable price, are an appropriate means to limit distortions of competition. In addition, the Commission doubts whether the reprivatization by 31 December 201[...] is appropriate. In line with point 15 of the Restructuring Communication, restructuring should last not more than five years. Therefore, the Commission would expect that Deutsche Pfandbriefbank is reprivatized at the latest in 201[...]. Moreover, it should be reprivatized with a divestiture trustee, [...].

5. DECISION

The Commission has decided to temporarily find compatible with the Common Market the capital injection amounting to EUR 60 million carried out in March 2009, the capital injection amounting to EUR 2 959 632 240 carried out in June 2009, and the capital injection amounting to EUR 3,0 billion to be carried out in November 2009 in favour of HRE until the Commission has taken a final decision on the restructuring plan.

In the light of the foregoing considerations, the Commission has decided to extend the proceedings laid down in Article 88(2) of the EC Treaty with respect to the following State aid measures in favour of HRE: The capital injection amounting to EUR 2 959 632 240 carried out in June 2009, the capital injection amounting to EUR 3,0 billion to be carried out in November 2009, guarantees of EUR 10 billion as liquidity buffer, EUR 8 billion for the rescheduling of the secured notes and EUR 2 billion for refinancing a possible winding down solution and capital injections amounting to a maximum of EUR 4 billion.

Germany is requested to forward a copy of this letter to the potential recipient of the aid immediately.

The Commission wishes to remind Germany that Article 88(3) of the EC Treaty has suspensory effect, and would draw your attention to Article 14 of Council Regulation (EC) No 659/1999, which provides that all unlawful aid may be recovered from the recipient.

The Commission warns Germany that it will inform interested parties by publishing this letter and a meaningful summary of it

in the Official Journal of the European Communities. It will also inform interested parties in the EFTA countries which are signatories to the EEA Agreement, by publishing a notice in the EEA Supplement to the Official Journal of the European Communities, and will inform the EFTA Surveillance Authority by sending a copy of this letter. All such interested parties will be invited to submit their comments within one month of the date of such publication.'
