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Subject: State aid N 625/2008 – Germany
Rescue package for financial institutions in Germany

Dear Sir,

PROCEDURE

(1) On 27 October 2008 the Commission approved aid scheme No N 512/2008 (Rescue package for financial institutions in Germany) by means of Decision C(2008) 6422.

(2) On 11 December 2008 Germany notified the Commission of amendments to the aid scheme, which concern, in particular, the remuneration for capital injections in line with the Commission Communication on recapitalisation of 5 December 2008[1]. Other measures are, however, also affected. In the interests of clarity, the Commission is replacing the Decision of 27 October 2008 with this new Decision.

I. DESCRIPTION OF THE AID SCHEME

1. Legal basis

(3) In order to stabilise the financial market the Federal Republic of Germany passed the Financial Market Stabilisation Act (Finanzmarktstabilisierungsgesetz – "FMStG") on

[1] See the Commission Communication on recapitalisation of 5 December 2008.

His Excellency Mr Frank-Walter Steinmeier
Federal Minister for Foreign Affairs
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18 October 2008. To finance the measures a Financial Market Stabilisation Fund (Finanzmarktstabilisierungsfonds – "Fund") was established, backed by Germany. Borrowing by the Fund will be financed by issuing bonds up to a maximum amount of €100 billion. Further details regarding the administration of the Fund and the corresponding framework conditions are set out in an accompanying statutory order, the Financial Market Stabilisation Fund Order (Finanzmarktstabilisierungsfonds-Verordnung – "FMStFV"), which entered into force on 20 October 2008.

(4) There is no legal right to benefit from the measures. The German authorities confirm that the date referred to in Section 13(1) of the FMStG, namely 31 December 2009, will apply only on condition that the crisis lasts until then and the German Government notifies to the Commission an extension of the authorisation within six months of its entry into force.

(5) The German authorities pledge to report to the Commission on the support measures every six months.

2. Object of the aid scheme

(6) The object of the FMStG is to stabilise the financial market. It seeks to create a sustainable mechanism for overcoming financial institutions' current cash-flow difficulties and to strengthen the stability of the German financial market. The aid scheme consists of three elements:

A. *Recapitalisation of companies*: Participation in companies in the financial sector. Acquisition of shares, silent participations or other items constituting equity up to a maximum of €80 billion.

B. *Risk assumption*: Within the limits of the joint ceiling referred to at A of a total of €80 billion, temporary assumption, whether by acquisition or otherwise, of the risk associated with the risk positions acquired by financial sector companies before 13 October 2008, including in particular receivables, securities, derivative financial instruments, rights and obligations under loan commitments or warranties and participations, in each case including the related collateral.

C. *Guaranteeing of liabilities*: Provision, in return for an appropriate remuneration, of a guarantee up to an amount of €400 billion for financial sector companies' newly issued bonds and liabilities with a term of up to 36 months.

(7) The FMStG was adopted against the background of a dramatic worsening of the existing tensions in the financial markets and of the resulting global turbulence. Germany has not been immune to these international developments. The direct effects of the crisis and the difficult market environment result in a tight liquidity situation for financial institutions. The viability of the German financial system, which makes an important contribution to the functioning of the entire economy and hence to growth and employment in Germany, is suffering under the impact of the current crisis in the financial markets. The central task of the FMStG is therefore to ensure temporary support for the financial system and to restore confidence among market players.

3. The beneficiaries

(8) Access to the aid scheme is reserved for companies in the financial sector, i.e. essentially banks and insurance companies (hereinafter "financial institutions")[2]. Besides German financial institutions, German subsidiaries of foreign financial institutions can also take part.

(9) There is, however, no legal right to benefit from the planned measures. Instead, under Section 4 of the FMStG, the Federal Ministry of Finance takes a decision at the request of a company, according to its best judgment and in the light of how important the company covered by the stabilisation measure is for financial market stability, and in the light of the urgency of the situation and the principle of the most effective and most economical use possible of the Fund's resources. The German authorities have given a commitment that the importance of financial sector companies for financial market stability within the area of validity of the Act will be assessed in particular in the light of their balance-sheet total, the level of deposits, the part they play in the nation's payments system, and their general importance for maintaining confidence in the stability of the financial market. Nevertheless, smaller financial institutions should also be able to benefit from stabilisation measures in the interests of financial market stability. The German authorities, however, undertake to ensure that covert discrimination against individual financial institutions should be averted, regardless of whether or not this concerns a subsidiary of a financial institution with its headquarters in a Member State of the European Union.

(10) Under Sections 2 and 4 of the FMStFV, the guarantee provision and the risk assumption will be directed only at solvent financial sector companies, which in principle presupposes that beneficiary companies are sufficiently capitalised. The German authorities have given a commitment that only credit institutions with a core capital ratio (Tier-1 ratio) of at least 7%[3] can avail themselves of a guarantee provision or a risk assumption – even allowing for a recapitalisation pursuant to Section 3 of the FMStFV. If the financial institution does not have a core capital ratio of 7% at the time the measures are approved, a guarantee provision or an assumption of risks is possible only if the owners provide a credible commitment that a core capital ratio of 7% will be achieved within no more than three months following the measures being approved, and take all necessary steps to this end. The German authorities undertake to ensure that financial institutions may take advantage of guarantees and risk assumption at first only until the agreed deadline for achieving the above-mentioned core capital ratio, and that suitable measures are taken if the owners do not fulfil their obligation. In particular, a restructuring plan will be submitted within six months in the event of the owners not

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2 Pursuant to Section 2 of the FMStG, such companies comprise financial institutions within the meaning of Section 1(1)(b) of the Banking Act, insurance companies and pension funds within the meaning of points 1 and 2 of Section 1(1) of the Insurance Supervision Act, investment companies within the meaning of the Investment Act and the operators of stock or futures exchanges and their respective parent companies, in so far as these are financial holding companies, mixed financial holding companies or supervised financial conglomerate companies having their registered office in Germany. Financial sector companies also include private bodies vested with authority over public *Landesbanken*, even where such bodies are not financial holding companies. In addition, under point 5 of Section 2(2) or Section 4(1) of the FMStFV, guarantees or risk assumptions can be effected for or by special purpose vehicles, in so far as they have assumed only or mainly risk positions from financial sector companies within the meaning of Section 2(1) of the FMStFG.

3 Formerly 8%.

fulfilling their obligation. This commitment also applies to financial sector companies which are not credit institutions[4].

(11) With regard to companies which seek recapitalisation pursuant to Section 3 of the FMStFV, the German authorities have given a commitment that as a rule only companies which undertake to bring their capital base into line with the above-mentioned requirements will be eligible for recapitalisation. Beneficiary financial institutions will also have to ensure as part of the review of their commercial policy under the first point of Section 5(2) of the FMStFV that they do not fall short of the minimum regulatory capital under Basel II plus 2 percentage points, a requirement which will be regularly reviewed as part of the reporting obligations.

4. Description of the measures

A. Recapitalisation of companies

(12) Under Section 7 of the FMStG, the Fund can participate in the recapitalisation of financial sector companies in any suitable form. In particular, it can in return for a capital contribution acquire shares or silent participations and other items constituting the equity of such companies, including those created by the legislation of the relevant *Land*.

(13) Under Section 9 of the FMStG, the ceiling for participation in equity components is set at a total of €80 billion. Under the third point of Section 3(2) of the FMStFV, the ceiling for participation in respect of individual financial sector companies is set in principle at €10 billion. If the ceiling for participation in respect of individual companies is exceeded, a restructuring plan is to be submitted within six months for banks that are not fundamentally sound. Otherwise, the fact that a bank is fundamentally sound must be demonstrated to the Commission in accordance with point 40(a) and (b) of the Communication on recapitalisation.

(14) Under the first point of Section 3(2) of the FMStFV, the Fund is to receive a normal market remuneration. As a rule, a form of remuneration will be sought which takes precedence over the profit-sharing rights of the other shareholders in the beneficiary company, particularly in the form of a preference dividend or an interest payment.

(15) In this connection, the German authorities have given a commitment that only shares which have not been acquired by existing shareholders or placed on the market will be acquired. In the case of ordinary shares, the Fund will require a discount on the price prevailing before the capital increase was announced.

(16) The Fund will require a market-oriented remuneration for all other capital instruments in accordance with the first point of Section 3(2) of the FMStFV. The German authorities pledge that the market-oriented remuneration for equity instruments will be in line with the Commission's and the ECB's recommendations of 5 December 2008 and 20 November 2008 respectively. This means that remunerations will amount to (a) between 7.0% and 9.3% on average for fundamentally sound financial institutions, according to the institution's risk profile and the structure of the capital instrument and (b) at least 10% on average for banks that are fundamentally unsound, according to the institution's risk profile and the structure of the hybrid capital. Regarding capital

[4] See Section 3(1) of the FMStFV for more details.

instruments of a hybrid nature that can be considered core Tier 1 capital, it can be assumed there will be a fixed (profit-linked) remuneration of at least 9.0% over a period of five years for fundamentally sound financial institutions. If this remuneration should not be achieved, there must be corresponding compensation for this in the form of other, secure remuneration components or, if these are not secure, the compensation must be appropriate to the risk. It is possible to deviate from the minimum remuneration if the Financial Market Stabilisation Fund effects the capital injection together with significant private investor involvement (at least 30%) on the same terms. Public undertakings within the meaning of the Transparency Directive (Commission Directive 2006/111/EC) do not count as private sector companies within the meaning of this paragraph.

(17) Under the fifth point of Section 5(2) of the FMStFV, companies which are supported by a recapitalisation measure must in principle first repurchase the shares or sell them to a third party before these companies may once more distribute dividends to their shareholders. The German authorities pledge that the ban on dividends will be disregarded only when there are sufficient incentives for fundamentally sound institutions to redeem the State's investments. The following constitute sufficient incentives:

(a) A structure for remuneration in which, in addition to a risk-adjusted and market-oriented pricing within the meaning of the previous paragraph, step-up clauses in respect of the amount to be redeemed, or dividends, or a higher nominal interest rate or a higher dividend-linked additional remuneration have been agreed upon. In any case, the total expected annual return over a period of five years should be increased by 0.5 percentage points annually, with unsecure remuneration components being evaluated conservatively and in line with the risk.

(b) A temporary ban on dividends enables the annual 0.5 percentage points mentioned in (a) to be reduced by 0.1 percentage points for each year of the ban, up to a maximum of 0.5 percentage points.

(c) Limiting the distribution of dividends to 20% of the annual net profit for the duration of the stabilisation measure enables the annual 0.5 percentage points mentioned in (a) to be reduced by 0.2 percentage points.

(d) Combinations of some of the elements from (a), (b) and (c), provided that the resulting exit incentive is just as strong.

(18) The stabilisation measures are, moreover, combined with various behavioural safeguards designed in particular to increase the accountability of the present owners and management. Thus, under Section 5(2) of the FMStFV, financial institutions participating in the recapitalisation will be required:

(a) to review their commercial policy and its sustainability. In this connection the Fund may seek to ensure that especially risky lines of business are reduced or abandoned;

(b) to take account of the borrowing requirements of domestic industry, and in particular of small and medium-sized enterprises;

(c) to limit the remuneration of their executives and shareholders to that which is reasonable; “reasonable” implies in principle a cash remuneration of €500 000 a year;

(d) not to pay any bonuses as long as the company is benefiting from stabilisation measures.

(19) The German authorities have also given a commitment that beneficiary companies will have to fulfil further appropriate conditions with respect to their activities in order to

avoid distortions of competition within the meaning of Section 5(5) of the FMStFV due to the stabilisation measures, for example, by banning advertising to the public using references to the stabilisation measure.

(20) Lastly, the German authorities have given a commitment that companies supported by a recapitalisation measure will present a restructuring plan six months after the recapitalisation if the company does not undertake to buy back the shares within six months or, in the case of the crisis continuing, within the six months following the first six months.

(21) It is, however, not necessary to present a restructuring plan if the financial institution is classified as being fundamentally sound at the time of the measures being approved and during the term of the stabilisation measure. In these cases the financial institution must draw up an overview within six months that sets out the plans for redeeming the recapitalisation. The German authorities pledge that all the information justifying a company being classified as fundamentally sound will also be disclosed, in accordance with the Communication on recapitalisation.

B. Guaranteeing of liabilities

(22) Under Section 6 of the FMStG, the Fund may provide certain guarantees for liabilities of financial sector companies up to an amount of €400 million.

(23) Guarantees may be provided for new bonds – i.e. those issued between the entry into force of the FMStG and 31 December 2009[5] – and liabilities (i.e. debt capital and non-Tier 1 and -Tier 2 capital) created by financial sector companies and maturing in up to 36 months.

(24) If the maturity of the guarantees may exceed 36 months under Section 6 of the FMStFG, the German authorities pledge that guarantees with a longer maturity which does not, however, exceed sixty months will be granted only in justified exceptional cases and up to a certain amount (one third). The six-monthly reports must include an update on the granting of such guarantees and the justification in each case.

(25) A remuneration of an appropriate amount per year is to be charged for the provision of guarantees. Within the meaning of Section 2 of the FMStFV, the German authorities have given a commitment that such remuneration will be regarded as being market-oriented if it includes a margin consisting as a rule of a guarantee premium of 0.5 %, plus in cases of liabilities with a maturity of more than one year a risk premium corresponding to the individual financial institution's credit default swap spread for senior debt (being not less than the median of the financial institution's five-year credit default swap spread between 1 January 2007 and 31 August 2008). According to the German authorities' commitments, the minimum amount of the premium will be not less than the amount described by the European Central Bank in points 3 to 8 of its recommendations of 20 October 2008.

(26) Where guarantees granted for liabilities are collateralised through valuable securities, a basic remuneration of 0.25% for a guarantee amounting to 70% of the economic (fair)

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5 The German authorities have, however, given a commitment that the above-mentioned date of 31 December 2009 will apply only on condition that the crisis lasts until then and that they will notify the Commission of any extension within six months of the Act's entry into force.

value of the securities applies in respect of the above-mentioned minimum remuneration, instead of the basic remuneration of 0.5%. The German authorities pledge that the value of the securities will be checked regularly and that the remuneration will be adapted correspondingly if the value of the security changes.

(27) The German authorities have also given a commitment to ensure that financial institutions will avoid distortions of competition as part of their activities within the meaning of Section 5(5) of the FMStFV by refraining in particular from advertising to the public using references to the provision of the guarantee. Financial institutions will also have to review their commercial policy and its sustainability. The Fund may seek to ensure that especially risky lines of business are reduced or abandoned (Section 5(3) of the FMStFV).

(28) The German authorities also pledge that a restructuring or liquidation plan will be presented for the company benefiting from the stabilisation measure within six months of demands being made on the Fund through a guarantee.

C. Risk assumption

(29) Finally, under Section 8 of the FMStG, the Fund may acquire or otherwise secure risk positions acquired by financial sector companies before 13 October 2008, including in particular receivables, securities, derivative financial instruments, rights and obligations under loan commitments or warranties and participations, in each case including the related collateral. The same applies to special purpose vehicles which have assumed the risk positions of a financial sector company.

(30) Under Section 9 of the FMStG, a joint ceiling totalling €80 billion is to apply to the risk assumption and to the participation in equity items. Under the sixth point of Section 4(2) of the FMStFV, the ceiling for the risk assumption in respect of individual financial sector companies is set in principle at €5 billion. If the ceiling for the participation of individual companies is exceeded, the German authorities assure the Commission that, in so far as the amount also exceeds 2% of the risk-weighted assets of the financial institution, a restructuring plan will be submitted within six months for banks that are not fundamentally sound. The fact that a bank is fundamentally sound is to be demonstrated in this case to the Commission in accordance with point 40(a) and (b) of the Communication on recapitalisation. The German authorities have also pledged to present a restructuring plan within six months if the risk assumption exceeds 2% of a company’s balance sheet total in cases where a restructuring plan has not yet been presented and the company involved is not fundamentally sound. In the case of fundamentally sound companies this ceiling is 3%. If both a risk assumption and a recapitalisation are carried out for an institution, the values of 2% and 3% apply correspondingly to the accumulated amount.

(31) The risk assumption by the State may take place until 31 December 2009[6]. The German authorities also commit themselves to ensuring that, no longer than 36 months after the risk assumption, a redemption that includes compensation in respect of the value at acquisition is effected, or that a remuneration corresponding to the risk is secured and notified to the Commission.

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[6] The German authorities have, however, given a commitment that the above-mentioned date of 31 December 2009 will apply only on condition that the crisis lasts until then and that they will notify the Commission of any extension within six months of the authorisation's entry into force.

(32) In the context of the first point of Section 4(2) of the FMStFV, it is made clear that the risk assumption will be effected at the value shown by the seller in the interim report, annual report or annual accounts or at a lower value of the risk positions against transfer of the debt instruments. If, however, at the time of redemption the price is lower than the purchase price, i.e. if any loss of market value occurs upon expiry of the agreed term, the company must as a rule compensate for the loss of value.

(33) The German authorities have also given a commitment in the context of Section 4 of the FMStFV that an appropriate remuneration will be paid to the Fund for the liquidity made available through the risk assumption, being, however, not less than a premium corresponding to the 12 month Euribor rate plus 0.5% on the amount made available, plus a risk premium corresponding to the individual financial institution’s credit default swap spread for senior debt (being not less than the median of the financial institution’s five-year credit default swap spread in the last 12 months), provided that a redemption obligation with compensation in respect of the value at acquisition has been agreed. In all other cases of a risk being assumed, the remuneration will be decided on a case-by-case basis to be established in the context of individual notification, and will therefore be subject to the Commission's approval. The income from the risk positions assumed is to flow into the Fund, but will count towards the remuneration.

(34) A commitment has also been given that the duration of the risk assumption will not exceed that of the risk positions and that, should it prove impossible to effect redemption or compensatory payments for losses of market value upon expiry of the agreed term, a restructuring plan will be presented within six months in so far as no such plan has yet been presented.

(35) Lastly, the extensive behavioural safeguards governing recapitalisation will apply correspondingly to the risk assumption, with the exception of paragraph 18(b).

II. COMMENTS FROM GERMANY

(36) The German authorities acknowledge that the notified scheme has the nature of an aid measure. They stress, however, that the Federal Government has sought to make the individual measures as market oriented as possible.

(37) The German authorities point out that the package of measures is urgently needed in order to shield the German and European financial markets from damage due to the financial market crisis that has been steadily brewing since the summer of 2007. The insolvency of financial institutions and the resulting systemic risk would have dramatic consequences. Initially there would be “very severe disturbances in the money markets” in Germany and the European Union. This would be followed by “considerable disruption” of payment transactions, for example in the case of transactions involving foreign exchange, securities or derivatives.

(38) The German authorities consider the aid scheme to be compatible with the common market inasmuch as it helps to “remedy a serious disturbance in the economy of a Member State” within the meaning of Article 87(3)(b) of the EC Treaty.

(39) A letter from the German Bundesbank of 14 October 2008 confirms that the aid scheme is necessary to avert damage to the German and European financial markets.

(40) The German authorities take the view that the notified aid scheme does not involve any undue distortions of competition or any adverse spill-over effects for other Member States. The aid scheme is open to all German financial institutions and German subsidiaries of foreign financial institutions in Germany and is therefore non-discriminatory.

III. ASSESSMENT

1. Existence of aid

(41) Article 87(1) of the EC Treaty states that any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

(42) The Commission agrees with the German authorities that the recapitalisation of financial institutions, the guarantees and the risk assumption for financial institutions affected by the crisis constitute aid to those institutions within the meaning of Article 87(1) of the EC Treaty.

(43) The recapitalisation, the guarantees for new liabilities and the risk assumption will enable the beneficiaries to secure the necessary capital and liquidity on more favourable terms than would otherwise be possible in the light of the prevailing conditions in the financial markets. Since this confers an economic advantage on the beneficiaries and strengthens their position vis-à-vis their competitors in Germany and in other Member States, these measures distort competition and affect trade between Member States. The advantage is selective since it benefits only beneficiaries under the scheme and is provided through state resources.

(44) It should be noted in particular that no market economy investor would have undertaken the recapitalisation, carried out the risk assumption or provided the guarantee. With regard to the recapitalisation, the Commission would point out that a market economy investor expects a reasonable return on his investment[7]. However, if a company is in difficulty or is active in a sector of the economy which is stricken in the way that the banking sector currently is, it is normally not justified to assume a reasonable return[8]. For the current scheme this is confirmed by the fact that the State is only investing because no market economy operator was willing to invest on a comparable scale on similar terms. Regarding the guarantee, the Commission is convinced that in the current circumstances of financial crisis no private investor would have been willing to provide so significant a guarantee on the participating financial institutions' bonds and other liabilities[9]. The same applies to the risk assumption, as this relates to covered risk

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7 See Joined Cases T-228/99 and T-233/99 *Westdeutsche Landesbank Girozentrale v Commission* [2003] ECR II-435, paragraph 314.

8 The Commission has set out this position in various communications: the Communication on the application of Articles 92 and 93 of the EEC Treaty to public authorities' holdings (Bulletin EC 9-1984) and the Communication 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).

9 See paragraph 32 of the Commission Decision of 10 October 2008 in Case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published. See paragraph 74 of the Commission Decision of 21 October 2008 in Case C 10/2008 *IKB*, not yet published.

positions for which no private investor would likewise be willing to pay the price applying at the time[10].

2. Compatibility of the financial support measures

a) Application of Article 87(3)(b) of the EC Treaty

(45) Germany intends to provide fresh capital and operating aid in the form of guarantees under a scheme in favour of financial institutions. Given the present circumstances in the financial market, the Commission considers that it is acceptable to examine this measure directly under the Treaty rules and in particular under Article 87(3)(b) EC.

(46) Article 87(3)(b) empowers the Commission to declare aid compatible with the common market if it is intended "to remedy a serious disturbance in the economy of a Member State". The Commission would point out that the Court of First Instance has expressly stated that Article 87(3)(b) of the EC Treaty needs to be applied restrictively so that the aid may not benefit only one firm or one sector of the economy, but must serve to remedy a disturbance in the whole economy of a Member State[11].

(47) The Commission considers that the present scheme concerns the entire German banking industry. It does not dispute the analysis of the German authorities that the current global financial crisis has made access to liquidity more difficult for financial institutions across the board and has also eroded confidence in financial institutions' creditworthiness. If the issues of lack of liquidity and lack of confidence are not addressed, it will result not only in difficulties for the banking sector but, owing to that sector's pivotal role in providing financing to the rest of the economy, will also have a systemic effect on the German economy as a whole. The Commission does not dispute that the present scheme is designed to address the problems of the lack of liquidity and lack of confidence that are currently striking German financial institutions. Therefore it finds that the scheme aims at remedying a serious disturbance in the German economy.

b) Conditions for the application of Article 87(3)(b) of the EC Treaty

(48) According to the 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[12], it must be stressed in the context of the application of Article 87(3)(b) of the EC Treaty that an aid measure or scheme may be declared compatible with the common market only if it satisfies the general criteria for compatibility under Article 87(3) of the EC Treaty viewed in the light of its general objectives and in particular Articles 3(1)(g) and 4(2), which imply compliance by such measures with the following conditions[13]:

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[10] See paragraph 88 of the Commission Decision of 21 October 2008 in Case C 10/2008 *IKB*, not yet published.

[11] See in principle Joined Cases T-132/96 and T-143/96 *Freistaat Sachsen and Volkswagen AG v Commission* [1999] ECR II-3663, paragraph 167. Confirmed in the Commission Decisions in Cases C 47/1996 *Crédit Lyonnais* (OJ L 221, 8.8.1998, p. 28, paragraph 10.1), C 28/2002 *Bankgesellschaft Berlin* (OJ L 116, 4.5.2005, p. 1, paragraphs 153 *et seq*.) and C 50/2006 *BAWAG*, not yet published, paragraph 166. See the Commission Decision of 5 December 2007 in Case NN 70/2007 *Northern Rock* (OJ C 43, 16.2.2008, p. 1), the Commission Decision of 30 April 2008 in Case NN 25/2008 *Rescue aid for WestLB* (OJ C 189, 26.7.2008, p. 3), and the Commission Decision of 4 June 2008 in Case C 9/2008 *Sachsen LB*, not yet published.

[12] See http://ec.europa.eu/comm/competition/state_aid/legislation/banking_crisis_paper.pdf , or OJ C 270, 25.10. 2008, p.8.

[13] See paragraph 41 of the Commission Decision of 10 October 2008 in Case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published; paragraph 45 of the Commission Decision of 13 October 2008 in Case N 507/2008

a. *Appropriateness:* The aid measure must be precisely targeted at its objective, i.e. in this case remedying a serious disturbance in the entire economy. This would not be the case if the measure is not appropriate to remedy the disturbance.

b. *Necessity:* The aid measure must, in its amount and form, be essential to achieve the objective. This means that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or a measure in a less distortive form (e.g. a temporary and limited guarantee instead of a capital injection) were sufficient to remedy a serious disturbance in the entire economy, the measure in question would not be necessary. This is confirmed by settled case law of the European Court of Justice[14].

c. *Proportionality*: The positive effects of the measure must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measure's objectives. This follows from Articles 3(1)(g) and 4(1) of the EC Treaty, which provide that the Community shall ensure the proper functioning of an internal market with free competition. Therefore, Article 87(1) of the EC Treaty prohibits all selective measures granted by a State or through state resources that are capable of distorting trade between Member States. Any derogation under Article 87(3)(b) of the EC Treaty which authorises state aid must ensure that such aid is limited to that which is necessary to achieve its stated objective, limiting to a minimum consequential distortions of competition.

c) Assessment of the recapitalisation scheme

(49) The objective of the recapitalisation scheme is to ensure that financial institutions are sufficiently strongly capitalised to withstand potential losses. The Commission has already observed in several cases that fair-value assessments of securities can in the ongoing financial turmoil have such detrimental effects on a bank's balance sheet that its capital risks falling below the minimum levels required[15]. This has given rise to fears about the creditworthiness of financial institutions. The German Government accordingly intends to undertake a public sector equity participation. This is in principle an appropriate means to strengthen the financial institutions and thus to restore market confidence[16].

(50) In addition, the Commission notes that the scheme is in principle not aimed only at companies in difficulty but applies also to companies whose capital base is only to be strengthened against possible losses. The provision of capital is thus intended to prevent

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Guarantee scheme for banks in the United Kingdom, not yet published; paragraph 58 of the Commission Decision of 13 October 2008 in Case N 481/2008 *Guarantee scheme for banks in Ireland*, not yet published.

14 See judgment in Case 730/79 *Philip Morris* [1980] ECR 2671. This judgment was recently reaffirmed by the European Court of Justice in its judgment of 15 April 2008 in Case C-390/06 *Nuova Agricast v Ministero delle Attività Produttive*, where the Court held that: "As is clear from the judgment of 17 September 1980 in Case 730/79, *Philip Morris/Commission* [1980] ECR 2671, paragraph 17, aid which improves the financial situation of the recipient undertaking without being necessary for the attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market."

15 See the Commission Decision of 30 April 2008 in Case NN 25/2008 *Rescue aid to WestLB*, OJ C 189, 26.7.2008, p. 3.

16 See the fourth paragraph of the Commission Communication on recapitalisation of 5 December 2008, and the Commission Decision of 9 December 2008 in Case N 557/2008 *Measures under the Law on the stability of the financial markets and on strengthening the interbank market for credit institutions and insurance companies in Austria*, not yet published.

companies which are fundamentally sound from falling into difficulties as a result of the ongoing crisis. The scope of the recapitalisation scheme therefore seems appropriate to strengthening the German banking sector and to contributing to the revival of interbank lending in Germany.

(51) A recapitalisation measure should also ensure that the real economy is provided with sufficient credit[17]. This is achieved by obliging institutions to take account of the borrowing requirements of domestic industry, and in particular of small and medium-sized enterprises[18].

(52) The recapitalisation scheme is limited to the minimum necessary in scope and time.

(53) As regards scope, the Commission noted previously that a recapitalisation measure might be suitable for restoring confidence in the banking sector[19].

(54) With regard to the scope of the measure, the Commission notes positively that Germany has limited the size of the recapitalisation scheme and that the scheme initially applies for six months.

(55) As regards proportionality, the irreversible nature of capital injections entails the need that the scheme must establish some clear behavioural safeguards which the Member State must monitor and enforce in order to ensure their observance and to take steps to avoid undue distortions of competition[20].

(56) The Commission regards an appropriate remuneration for the capital provided by the State, which is based as far as possible on the market price, to be the best safeguard for the proportionality of a capital injection measure[21]. In addition to this, it should be made sufficiently attractive to banks to repay the capital injections as soon as the market conditions allow[22].

(57) On this basis it is acceptable if the State, as regards its participation in the ordinary share capital through share purchases, aligns itself as much as possible on the behaviour of a market economy investor by providing that the issue price of the shares should be fixed on the basis of a market-oriented valuation (see paragraph (15) above).

(58) In addition, a remuneration measure that allows a market-oriented remuneration to be achieved as far as possible is also necessary for other forms of recapitalisation. The

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[17] See the third paragraph of the Commission Communication on recapitalisation of 5 December 2008 referring to the ECOFIN Council of 2 December 2008 and alluding to a relevant policy change that specifically enables improvements to be made to existing decisions.

[18] The Commission also considers there to be sufficient safeguards that correspond to the guidelines in paragraph 39 of the Commission Communication on recapitalisation of 5 December 2008, paragraph 3. The German authorities have stated that this is laid down in principle by means of concrete guidelines. The Commission expects to receive detailed information on this in the context of the six-monthly reports.

[19] See the Commission Decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published, paragraphs 46 *et seq.*, and the Commission Decision of 9 December 2008 in Case N 557/2008 *Measures under the Law on the stability of the financial markets and strengthening the inter-bank market for credit institutions and insurance companies in Austria,* not yet published.

[20] See in particular the 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, paragraph 27.

[21] See paragraph 11 of the Commission Communication on recapitalisation of 5 December 2008.

[22] See in particular paragraph 39 of the Commission Communication on the application of state aid rules to measures taken in relation to financial institutions in the context of the current financial crisis, and paragraph 11 of the Commission Communication on recapitalisation of 5 December 2008.

Commission takes as its basis here the Communication on recapitalisation, which provides for an average minimum remuneration for fundamentally sound companies in a corridor of 7 to 9.3%[23].

(59) In this connection the Commission acknowledges that, in line with the Communication on recapitalisation[24], the German authorities have agreed to set a market-oriented remuneration of an average between 7.0% and 9.3% for fundamentally sound financial institutions, depending on the financial institution's risk profile and the structure of the capital instrument, for the granting of equity to financial institutions, unless the Fund provides the capital injection together with a significant private sector involvement on the same terms[25]. The Commission considers this to be an acceptable entry-level price within the meaning of paragraphs 26 *et seq*. of the Communication on recapitalisation[26].

(60) In particular, the Commission welcomes the clarification regarding the assumption that there will be a (profit-linked) fixed remuneration of at least 9.0% over a period of five years for fundamentally sound financial institutions' capital instruments of a hybrid nature that can be considered as core Tier 1 capital, and that, should this remuneration not be achieved, there must be corresponding compensation for this in the form of other, secure remuneration components or, if these are not secure, the compensation must be appropriate to the risk. The Commission considers this to be an acceptable entry-level price within the meaning of paragraph 28(a) of the Communication on recapitalisation.

(61) The Commission also acknowledges that Germany has created additional incentives above and beyond the entry-level price for the financial institutions to redeem the State's capital, namely a restriction on the payment of dividends. The Commission particularly welcomes the flexible yet targeted structure of this restriction that results either in a ban on the payment of dividends or an increase of the entry-level price. It considers this an adequate incentive within the meaning of paragraph 32 of the Communication on recapitalisation for redeeming the State's capital as quickly as possible.

(62) In addition, the German authorities promise to provide the necessary reports for carrying out checks within the meaning of the Communication on recapitalisation on whether a company is fundamentally sound when the stabilisation measures were agreed and during the period they apply. Thus, it is ensured that the financial institution has to draw up an overview within six months that reveals the plan for the redemption of a recapitalisation. The German Government pledges that, in accordance with the Communication on recapitalisation[27], all the information justifying a company being classified as fundamentally sound will also be disclosed.

(63) As a result, the Commission is able to accept this remuneration for fundamentally sound financial institutions as being proportional, since it is possible to view the incentives for the bank to repay the capital to the State as being strong enough.

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23 See paragraphs 27 *et seq.* of the Commission Communication on recapitalisation of 5 December 2008.

24 See the Commission Communication on recapitalisation of 5 December 2008.

25 The Commission notes here that the competition-distorting effect of the state aid is reduced if a significant number of private investors (at least 30%) underwrite the capital injections on the same terms as the State. A remuneration comparable to that for private investors is then acceptable because a scheme that has to be regarded overall as aid since no private investor would take part in the total amount of the recapitalisation is nevertheless sufficiently market-oriented in terms of the remuneration.

26 Likewise, the Commission Decision of 9 December 2008 in Case N 557/2008 *Measures under the Law on the stability of the financial markets and on strengthening the interbank market for credit institutions and insurance companies in Austria*, not yet published.

27 If it should transpire that a bank is not fundamentally sound, the Commission expects a higher remuneration and the submission of a restructuring plan, as described below.

(64) For the rest, the Commission has also stated clearly in the Communication on recapitalisation that the Eurosystem recommendations of 20 November 2008 apply only to fundamentally sound companies and that a higher remuneration or more stringent requirements must be demanded in the case of other banks[28].

(65) The German authorities have complied with this by means of the obligation to ensure, in line with the Communication on recapitalisation, that a remuneration of at least 10% on average is required for banks that are not fundamentally sound according to the institution's risk profile and the structure of the hybrid capital.

(66) In the case of banks that are not fundamentally sound the paying out of dividends is also strictly prohibited, with a relaxation or lifting of this prohibition being possible only in the context of a notified restructuring plan. The German authorities pledge that a restructuring plan will be presented[29] for such companies six months after the measure takes effect if the company does not undertake to buy back the shares within six months or, in the case of the crisis continuing, within the six months following the first six months.

(67) In this connection it is natural that there should be restrictions on the growth of such companies in the light of the restructuring to be undertaken[30].

(68) The Commission views these additional provisions as being sufficient to take into account the special situation regarding the recapitalisation of banks that are not fundamentally sound[31].

(69) In addition, the above-mentioned behavioural commitments ensure that the financial institutions do not give rise to any undue distortions of competition[32]. In that context, the fact that the law requires the financial institutions to review their operations and to limit to a certain extent the remuneration of their executives and shareholders is also viewed favourably.

(70) On the basis of the above, the recapitalisation scheme can be considered compatible with the common market.

d) Assessment of the guarantee scheme

(71) The objective of the guarantee scheme is to provide a safety net for investors in newly issued debt of participating financial institutions in Germany, so that such financial institutions can have sufficient access to liquidity. This is a reaction to the international market conditions in which even sound financial institutions are having trouble gaining access to liquidity. The Commission has established that such a guarantee scheme

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28 See paragraphs 43 *et seq.* of the Commission Communication on recapitalisation of 5 December 2008.

29 These plans are the cornerstone of the Community Guidelines on State aid for rescuing and restructuring firms in difficulty (OJ C 244, 1.10.2004, p. 2), which articulate the Commission's understanding of how Article 87(3)(c) of the EC Treaty is to be applied to this type of aid. For any aid to a firm in difficulty, it is in the common interest that the firm returns to long-term viability and that this is sufficiently scrutinized by means of the restructuring plan.

30 See also in principle paragraph 35 and footnote 18 of the Commission Communication on recapitalisation of 5 December 2008.

31 Likewise, the Commission Decision of 9 December 2008 in Case N 557/2008 *Measures under the Law on the stability of the financial markets and on strengthening the inter-bank market for credit institutions and insurance companies in Austria*, not yet published.

32 Paragraph 53 of the Commission Decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published.

should help to overcome these difficulties by allowing a revival of interbank lending and considers it therefore to be an appropriate means[33].

(72) The scheme is directed, moreover, at suitable recipients inasmuch as only solvent companies are eligible for support. However, a guarantee can be granted only if the owners pledge at the same time that a core capital ratio of 7% will be achieved, and take all necessary steps to this end. The Commission considers this to be appropriate, as recapitalisation measures by the State can possibly be avoided in this way[34]. Thus, the Commission considers that the design of the present scheme is appropriate to address the problem of refinancing currently faced by German financial institutions[35].

(73) As regards necessity, the guarantee mechanism, whereby a safety net is established to cover all newly issued debt of financial institutions in Germany, is limited to the minimum necessary in scope and time.

(74) As regards scope, the Commission does not dispute that the guarantee scheme is needed to restore confidence among lenders[36]. A guarantee on retail deposits would not be sufficient as it would only avoid runs on the banks but not restore confidence among institutional lenders. Moreover, the Commission notes positively that Germany is limiting the guarantee to the form of financing that is experiencing the greatest problems at the moment, namely short-to-medium-term interbank financing. Firstly, subordinated debt is not guaranteed. Secondly, existing debt is not covered but only newly issued debt and only such debt that is short and medium term. Thirdly, Germany has also limited the scope of the guarantee scheme so that financial institutions initially have only a window of six months to assume new liabilities that are covered by the guarantee.

(75) The fact that the Act does not exclude covered bonds, the guarantee applying instead to all bonds[37], is not problematic as the level of the remuneration ensures that there should be recourse to the guarantee for such bonds only in exceptional circumstances.

(76) The German guarantee will apply in principle to new liabilities for up to three years. However, the guarantee should now be able to apply in justified exceptional cases for five years. However, the German authorities have given an assurance that this may occur only up to a certain amount (up to one third). In addition, the six-monthly reports must include an update on the granting of such guarantees and the justification in each case. Since extending the guarantee to five years remains the exception and must be

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33 See paragraph 42 of the Commission Decision of 10 October 2008 in Case NN 51/2008 *Guarantee scheme for banks in Denmark,* not yet published; paragraph 56 of the Commission Decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published; paragraph 59 of the Commission Decision of 13 October 2008 in Case N 481/2008 *Guarantee scheme for banks in Ireland*, not yet published.

34 The Commission does not object to reducing the core capital ratio from 8% to 7% in relation to the original scheme, since this was also accepted in other cases (Commission Decision of 9 December 2008 in Case N 557/2008 *Measures under the Law on the stability of the financial markets and on strengthening the inter-bank market for credit institutions and insurance companies in Austria*, not yet published).

35 See paragraph 45 of the Commission Decision of 10 October 2008 in Case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published; paragraph 56 of the Commission Decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published; paragraph 59 of the Commission Decision of 13 October 2008 in Case N 481/2008 *Guarantee scheme for banks in Ireland*, not yet published.

36 See paragraph 47 of the Commission Decision of 10 October 2008 in Case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published.

37 A different system governs the guarantee in Denmark (see the Commission Decision of 10 October 2008 in Case NN 51/2008 *Guarantee scheme for banks in Denmark*, not yet published), where the guarantee, had it been applicable to such debt instruments, would have automatically extended to them.

justified, the necessity of such a scheme is reasonable also in the light of earlier decisions[38]. The Commission views the scheme in a positive light overall since the issuance period is shorter than two years (i.e. initially six months)[39]. This means that already after six months the guarantee cannot be used any more for newly issued debt, unless the Commission agrees to an extension.

(77) As regards proportionality, the distortion of competition is minimised by various safeguards. Above all, the aid amount is minimised through a market-oriented premium. Thus, it can be assumed that financial institutions will on average pay an adequate premium in this way. The premium to be paid by financial institutions corresponds to at least the amount described by the European Central Bank in points 3 to 8 of its recommendations of 20 October 2008. The European Central Bank bases its recommendation on a provision premium of 0.5% as a rule and a risk premium corresponding to the credit default swap spread of the individual financial institution. This premium can be considered proportionate, as it corresponds in its broad lines to previous decision-making practice[40]. The Commission notes, moreover, that the premium is based on the calculations in the European Central Bank's recommendations, the objective of which is to propose a generally appropriate premium for all countries in the euro area.

(78) For the rest, Germany has stipulated, where guarantees granted for liabilities are collateralised through valuable securities, a basic remuneration of 0.25% for a guarantee amounting to 70% of the economic (fair) value of the securities applies in respect of the above-mentioned minimum remuneration, instead of the basic remuneration of 0.5%. The value of the securities will be checked regularly and the remuneration adapted correspondingly if the value changes. The Commission already considered this kind of scheme to be appropriate in earlier decisions[41], hence there are no misgivings in this case either.

(79) Finally, the scheme includes several strong behavioural constraints which help to ensure that participating financial institutions do not expand their activities under the scheme and thus do not receive more support than is necessary for re-establishing their long-term viability[42]. It is, however, no longer considered necessary to restrict the extension of the activities both at the level of individual financial institutions and at the level of all participating financial institutions, as long as this does not result in a displacement of capital flows[43]. There have been no signs of this happening in Germany in recent weeks, or, in the light of the widespread introduction of comparable guarantee schemes, in other Member States either.

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[38] Paragraph 44 of the Commission Decision of 29 October 2008 in Case N 533/2008 *Guarantee scheme for banks in Sweden,* not yet published. Paragraph 78 of the Commission Decision of 9 December 2008 in Case N 557/2008 *Measures under the Law on the stability of the financial markets and strengthening the inter-bank market for credit institutions and insurance companies in Austria*, not yet published.

[39] Paragraph 60 of the Commission Decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published. Paragraph 24 of the Commission Communication on the application of state aid rules to measures taken in relation to financial institutions in the context of the current financial crisis.

[40] See paragraph 61 of the Commission Decision of 13 October 2008 in Case N 507/2008 *Guarantee scheme for banks in the United Kingdom*, not yet published.

[41] Paragraph 44 of the Commission Decision of 29 October 2008 in Case N 533/2008 *Guarantee scheme for banks in Sweden*, not yet published; paragraph 42 of the Commission Decision of 12 November 2008 in Case N 567/2008 *Guarantee scheme for banks in Finland*, not yet published.

[42] A similar principle is contained in point 44 of the Community Guidelines on State aid for rescuing and restructuring firms in difficulty (the "R&R guidelines").

[43] See footnote 18 of the Commission Communication on recapitalisation of 5 December 2008.

e) Assessment of the risk assumption

(80) As in the case of the guarantee scheme, the objective of the risk assumption is to ensure that financial institutions have sufficient access to liquidity. In addition, the temporary assumption of the risk positions should enable tied-up equity to be released.

(81) This is a reaction to the international market conditions which are making it difficult even for healthy financial institutions to gain access to liquidity, in particular because the market for certain covered bonds has dried up. The Commission has established not only that a guarantee scheme is appropriate to restoring interbank lending, but also that a risk assumption can be an effective way of supporting ailing financial institutions[44]. The risk assumption is thus also an appropriate means of overcoming the current difficulties.

(82) The scheme is directed, moreover, at suitable recipients inasmuch as only solvent companies are eligible for support. The Commission therefore considers, as in the case of the guarantee, that the approach taken by the present scheme is appropriate to resolving the refinancing problem currently facing German financial institutions.

(83) As far as necessity is concerned, the mechanism consisting of a per se temporary assumption of certain risk positions of financial institutions in Germany is limited to the minimum strictly necessary in scope and time.

(84) One variant of the risk assumption is designed as a *de facto* repo transaction. It is organised in such a way that the seller sells the risk position for the same price as that for which the asset subsequently has to be *de facto* sold back to the seller or a third party, for the seller must offset the loss to the State in the event of any loss of value upon expiry of the agreed term or, exceptionally, present a restructuring plan within six months. In this respect, it is not so much the risk underlying the bond that is relevant, since the actual risk is the risk of the debtor defaulting. This makes the risk assumption comparable to a guarantee, the only difference being that it is not a third party but the State itself that is making liquidity available. It must therefore be ensured that the State is properly remunerated for the costs of the guarantee and of providing the liquidity[45].

(85) The German authorities now also propose another variant in which no compensation is provided. Here, too, they pledge that a remuneration corresponding to the risk will be guaranteed, and that each such scheme will be notified to the Commission so that its compatibility can be checked.

(86) A restriction in scope is also achieved through the ceiling of €5 billion stipulated in point 6 of Section 4(2) of the FMStFV. The fact that the ceiling may be exceeded as long as an amount of 2% (or 3% in the case of fundamentally sound companies) of the institution's risk-weighted assets is not exceeded, without a restructuring plan having to be submitted, seems reasonable since the extension ought not to be significant and is transparent, and since special support for fundamentally sound companies is desired given their special role as lenders to the real economy. The Commission also explicitly welcomes the fact that the German authorities have now also stipulated a ceiling in

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44 See the Commission Decision of 30 April 2008 in Case NN 25/2008 *Rescue aid to WestLB*, OJ C 189, 26.7.2008, p. 3.

45 Paragraph 40 of the Commission Communication on the application of state aid rules to measures taken in relation to financial institutions in the context of the current financial crisis.

combination with the recapitalisation, since the values of 2% and 3% of the institution's risk-weighted assets should apply correspondingly to the cumulated amount.

(87) The risk assumption will apply for a maximum of three years. As indicated above, the Commission considers that two years is the longest period necessary to ensure the stability of the financial system through a revival of interbank lending with the help of such a scheme. Notwithstanding this, the Commission views positively the additional safeguard in the present scheme in that the window for assuming risk is shorter than two years (i.e. again six months initially).

(88) As regards proportionality, here too the distortion of competition in the case of the first variant (paragraph 84 above) is minimised by various safeguards. Above all, the aid amount is minimised through a market-oriented premium. It can be assumed that financial institutions will in this way pay an adequate premium on average. Banks will thus have to pay at least the 12-month Euribor rate plus 50 basis points and the median of the 5-year CDS spread over the 12-month period ending on 23 October 2008 for each financial institution.

(89) Finally, the scheme includes the same behavioural safeguards as the recapitalisation, which ensure that participating financial institutions do not expand their activities under the scheme and thus do not receive more support than is necessary for re-establishing their long-term viability.

f) General requirements for the compatibility of aid schemes under Article 87(3)(b)

(90) First, the Commission notes that the German authorities have given a commitment to report to the Commission every six months on the support measures.

(91) Secondly, the Commission notes that all the measures are temporary and hence are shaped in accordance with the European state aid rules, being limited initially to a period of six months with a possibility of extension should the crisis persist.

DECISION

This Decision replaces Commission Decision C(2008) 6422 of 27 October 2008.

The Commission concludes that the amended measures also constitute a state aid scheme within the meaning of Article 87(1) of the EC Treaty.

Since the above-mentioned new aid measures also fulfil the conditions under Article 87(3)(b) of the EC Treaty, this aid measure is also compatible with the common market, with the result that the Commission raises no objections to it.

The Commission would recall that, according to the commitment given by Germany, the measure is limited in duration to six months and that an extension is possible only if an application to this effect is first submitted to the Commission.

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Belgium
Fax: (32-2) 296 12 42

For the Commission

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