EUROPEAN COMMISSION

Brussels, 18.12.2008
C(2008) 8820 final

Subject: **State aid N 602/2008 – The Belgian Aid to KBC Group NV.**

Sir,

I. PROCEDURE

(1) On 27 October 2008 the Belgian authorities contacted the Commission regarding their intention to make a capital injection of € 3 500 000 000 through special securities issued by KBC Group NV and fully subscribed by the Belgian State (hereinafter "the Measure). Further information was provided informally in the course of November. The Belgian authorities formally notified the Measure to the Commission on 1 December 2008. On 2 December the Belgian authorities informed the Commission that certain elements of the foreseen transaction were being renegotiated with KBC. Some information on the result of these renegotiations has been provided to the Commission on 5 December 2008. The amended Term Sheet describing the Measure was received by the Commission on 11 December 2008. On 12, 15 and 16 December 2008 KBC and the Belgian authorities provided further information and updated behavioural commitments to the Commission. The Belgian authorities and KBC intend to close the transaction on 19 December 2008.

II DESCRIPTION OF THE MEASURES

1. The Beneficiary

(2) The KBC Group NV (hereafter "KBC") is the holding company of the KBC Bank, KBC Insurance and KBL European Private Bankers (i.e. KBL EPB). KBC is an integrated bankinsurance group, catering mainly for retail customers, small and medium-sized enterprises (SMEs) and private banking clientele. KBC is one of the three main financial institutions in Belgium. Besides its activities in Belgium, central

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and eastern Europe, KBC is present in Russia, Romania, Serbia, several Western European countries and to a lesser extent in the US and Southeast Asia.[1]

(3) KBC is publicly quoted. As of 31 December 2007, the majority of the shares (54.3%) were held by a number of large shareholders: KBC Ancora[2] (23.2% of the ordinary shares), Cera (7.1%), MRBB (12.0%), and other core shareholders (12.0%). KBC group companies[3] hold 4.3% of the ordinary shares and the free float constitutes 41.4%.[4]

(4) At the end of 2007, total assets on the balance sheet of KBC amounted to EUR 355.6 billion. With a market value of EUR 23 billion on 1 August 2008, KBC ranks among the 20 largest financial groups in Europe.[5]

(5) KBC's management structure consists of the following five main business units[6]:

1. Belgium Business Unit: it groups all the banking and insurance activities in Belgium. This includes the retail and private banking activities of KBC Bank in Belgium, the activities of KBC Insurance in Belgium and the activities of a number of Belgian subsidiaries.

2. The Central & Eastern Europe and Russia (CEER) Business Unit: it comprises all group banking and insurance activities (i.e. retail banc assurance and merchant banking) pursued in Central and Eastern Europe and in Russia.

3. Merchant Banking Business Unit: it groups the services provided to bigger SMEs and corporate customers, and all market activities worldwide (including Belgium, but not Central and Eastern Europe and Russia).

4. European Private Banking Business Unit: it comprises the activities of both the KBL European Private Bankers group (KBL EPB) and the insurance company, VITIS Life.

5. Shared Services & Operations Business Unit: it provides support to and serves as a product factory for the other business units. It encompasses a number of divisions that deliver products to the group's other business units.

(6) Profit contribution of the five business units is as follows (1H2008)[7]: Belgium Business Unit: 52%, CEER Business Unit: 32%, Merchant Banking Business Unit:

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1 "Communication to the European Commission for reasons of legal certainty of the investment by the Belgian State in KBC Group NV"

2 KBC Ancora is an enterprise quoted on the Belgian stock exchange. KBC Ancora has taken the form of a partnership limited by shares or 'SCA'. In the case of KBC Ancora there is only one managing and hence fully liable member, namely Almancora Société de gestion SA, which is also the statutory manager of the company, and its mandate can consequently be terminated only in exceptional circumstances. The choice of SCA as KBC Ancora's legal form thus reflects the function of the company within the Cera group. It allows KBC Ancora to ensure KBC Group's anchoring, in collaboration with Cera, MRBB and the other Shareholders.

3 Does not include shares in the trading books of KBC Securities, Ligeva and KBC Financial Products (included in the free float).

4 "Communication to the European Commission for reasons of legal certainty of the investment by the Belgian State in KBC Group NV"

5 "Communication to the European Commission for reasons of legal certainty of the investment by the Belgian State in KBC Group NV"

6 www.kbc.com

14%, European Private Banking Business Unit: 8%, Shared Services & Operations Business Unit: 6%.

(7) In Belgium KBC's position is as follows (market shares 2007): funds […][*], home loans […], commercial credit to companies […], commercial credit to small companies […], commercial credit to natural persons […], credit cards […], current accounts […] deposit accounts […], bank cards […], life insurance ("Branch 23") […] and damage insurance […].[8]

2. The events triggering the Measure

(8) According to the Belgian state KBC is faced with financial distress as the consequence of the global financial crisis.[9] The 3rd quarter 2008 results of KBC showed losses of EUR 906 million. Specifically, KBC has made provisions for losses in the following areas[10]:

- impairments on Lehman Brothers and Washington Mutual of EUR 172 million (net);
- impairments on shares of EUR 161 million (net);
- revaluation of the Collateralized Debt Obligations[11] (CDO) portfolio of EUR 1.1 billon (net), taking into account the latest downgrades in ratings by Moody’s and anticipating future downgrades.
- In addition, the exposure of KBC to the Icelandic banks is estimated at EUR 277 million.

(9) In the case of KBC, the current capital base can absorb the losses and still stay above the regulatory capital requirements. Therefore, KBC has no solvency problem in the strict regulatory sense. However, taking into account the 3rd quarter 2008 losses, its current capital surplus is at its lowest level in 5 years and recapitalisation is required to raise its capital to reassure financial markets. Moreover, in line with the current trends on stock markets, the level of capital that was deemed adequate for financial institutions like KBC has been increased significantly.

(10) In order to prevent a loss of confidence in KBC which would also undermine confidence in other Belgian financial institutions, thus affecting the financial stability of Belgium, a capital injection in the company was deemed necessary. The injection does not only aim at the protection of the deposit holders but seeks to ensure the continuous operation of KBC, a systemically relevant bank, among others through the sustained granting of loans to the real economy. The form of capital chosen for the injection is core Tier 1 capital, i.e. capital that from a loss-absorption perspective is equal to shareholders equity, does not carry the risk that it has to be redeemed when

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7 Profit after tax by Business Unit, % based on 1 Half of 2008.

* Business secret

8 "Communication to the European Commission for reasons of legal certainty of the investment by the Belgian State in KBC Group NV"

9 "Communication to the European Commission for reasons of legal certainty of the investment by the Belgian State in KBC Group NV"

10 In its press release of 15 December 2008 KBC announced that the Group does not have any direct exposure to Madoff Investment Securities LLC, and that its indirect exposure is immaterial.

11 Collateralized debt obligations ("CDOs") are a type of asset-backed security and structured credit product. CDOs are constructed from a portfolio of fixed-income assets.

the institutiont needs it most (permanence) and is able to absorb losses on a going concern basis.

3. The Measure

Description of the securities issued

(11) The Measure takes the form of an injection of in total EUR 3 500 000 000 of Core Tier 1 capital represented by 118 644 067 registered securities issued by KBC Group NV and fully subscribed by Federale Participatie- en Investeringsmaatschappij NV van publiek recht (FPIM)/Société fédérale de Particpations et d'Investissements SA d'intérêt public (SFPI), an entity of public law fully owned by the Belgian State. The issue price is EUR 29.50 per security, thus including a (substantial) premium.

(12) These perpetual securities will produce a coupon payable each year equal to the higher of

- EUR 2.51 per security (equivalent to a coupon of 8.5%), non cumulative, payable annually in arrears[12]
- 110% of the dividend paid on the ordinary shares for the fiscal year 2008
  120% of the dividend paid on the ordinary shares for the fiscal year 2009
  125% of the dividend paid on the ordinary shares for the fiscal year 2010 and onwards

The coupon will only be paid if a dividend is paid on the ordinary shares[13] and will be paid in scrip securities in case a scrip dividend is distributed on ordinary shares. Furthermore, Interest on the Securities will only be due and payable, on a non-cumulative basis, if and when a dividend is approved, provided always that the Issuer's capital adequacy position is and remains satisfactory both before and after the payment in the opinion of the Belgian Banking Finance and Insurance Commission(hereinafter CBFA). KBC has already announced that it will not propose a dividend for 2008.

[12] Exceptionally for the year 2009: if the Issuer decides to pay an interim dividend in 2009, then KBC will pay to the Securities Holder an interest equal to EUR 1.25 per Security, payable on the payment date of the interim dividend but no later than 31 December 2009, the remainder being due and payable on the tenth banking day following the Annual General Meeting in 2010.

[13] Past dividend policy of KBC

	Total
1998 financial year	1.093
1999 financial year	1.23
2000 financial year	1.42
2001 financial year	1.48
2002 financial year	1.52
2003 financial year	1.64
2004 financial year	1.84
2005 financial year	2.51
2006 financial year	3.31
2007 financial year	3.78

(13) No voting rights in KBC's General Meetings are attached to the securities. The securities are deeply subordinated, ranking pari passu with the ordinary shares (meaning that it is fully loss-absorbing).

(14) The State has no right to dissolve or annul the Measure. The security is only transferable with the permission of KBC and the Belgian Banking, Finance and Insurance Commission.

(15) There are two redemption scenarios for these securities, both of which are at the initiative of KBC. All of these options are conditional on the agreement of the CBFA.

(16) In the first scenario, the Issuer's call option, KBC has the right to redeem all or some of the issued securities at a price of EUR 44.25 per security (being 150% of the issue price), plus payment of any accrued interest, any time after the issue date.

(17) In the second scenario, the Securities Contribution Right, at any time after 3 years KBC can require the state to convert its stake into ordinary shares on a one for one basis. If KBC triggers this conversion option, the Belgian State has the choice to opt for the alternative redemption of the securities plus payment of accrued interest[14]. Under this scenario the redemption price in year 4 will be equal to 115% of the issue price, and will increase in each following year by 5 percentage points to a maximum of 150% of the issue price (in year 11). In this way the capital of the state is protected ("floor protection") and KBC will have the incentive to reimburse the State or convert the securities into ordinary shares as soon as possible.

Use of proceeds

(18) EUR 2.25 billion of the proceeds of the issue will be used to increase the Core Tier 1 capital of KBC's banking activities. The measure will boost the Tier 1 capital ratio of KBC from 8.9% to 10.7% and boost its core Tier 1 ratio from 6.6% to 8.2%.

(19) EUR 1.25 billion of the proceeds will be used to increase the solvency capital of KBC's insurance activities. As a result, the solvency ratio of KBC Insurance will rise from 176% to 280%, compared to KBC's internal threshold of 200% of legally required solvency. This was in line with the ratio pertaining in 2007 (i.e. 265%), and can be compared to the average solvency rate of the insurance companies under supervision of the CBFA for the last five years, which was 250%[15].

Corporate Governance and remuneration

(20) Subject to applicable law and to corporate governance practices, generally accepted under applicable stock listing regimes, the Belgian State will have the right to nominate two Board members at the next Annual General Meeting to be held in 2009. The Supervisory Board approval items listed below require approval by those two investor's nominees:

[14] As is normal with interest accruing instruments (representing the pro rata part of the interest due).

[15] In this context the Commission notes that KBC Insurance's average solvency over the last five years was 346%.

1. the issue or acquisition of its own shares by the Issuer (other than related to the Securities and other than as part of regular hedging operations and the issuing of shares according to employment schemes);
2. […];
3. acquisition by the Issuer or any of its subsidiaries of a participating interest in the capital of another company amounting to one-quarter or more of the Issuer's consolidated capital and reserves as disclosed in its consolidated balance sheet of the previous quarter (or a material increase or decrease of such participating interest;
4. investments involving an amount equal to one-quarter or more of the Issuer's consolidated capital and reserves as disclosed in its consolidated balance sheet of the previous quarter ;
5. a proposal to wind up the Issuer;
6. filing of a petition for bankruptcy or moratorium for the Issuer;
7. proposal for split-off, dissolution of the Issuer;
8. […];
9. a change of the remuneration policy […]; and
10. [...].

(21) One of the nominees will also have a seat on the KBC Group's (including KBC Bank NV and KBC Verzekeringen NV) Audit Committee, Remuneration Committee and Nomination Committee.

(22) As part of the transaction, KBC commits to develop a sustainable remuneration policy for the Executive Committee and Senior Management.. KBC's Executive Committee and senior management incentive schemes will be linked to long-term value creation taking account of risk and restricting the potential for "rewards for failure". The KBC's Executive Committee, KBC Bank NV's and KBC Verzekeringen NV's Executive Committees will forego all bonuses for 2008 (cash as well as options and share rewards). KBC's Executive Committee limits exit schemes or statutory compensation for dismissal to twelve months' fixed salary.

4. Position of Belgium

(23) Belgium contends that its investment in KBC does not constitute state aid.

(24) Belgium considers KBC to be a fundamentally sound institution. It has no solvency problem in the strict regulatory sense. However, the combination of recent losses and the prospect of future losses, along with the higher solvency levels currently demanded by the financial markets, means that KBC requires recapitalisation.

(25) Belgium considers that the capital injection is necessary to address market concerns, in order to assure continued lending to the real economy, and that it is done on terms that are market conform.

(26) The design of the measure, using securities rather than ordinary shares, was chosen so that the core Tier 1 capital of KBC could be quickly boosted in line with market

requirements. The modalities of this ‘quasi-equity’ investment instrument have been constructed as to allow it to qualify as core Tier 1 capital in accordance with the Committee of European Banking Supervisors (“CEBS”) guidelines. The CBFA has by its decision of 26 October 2008 endorsed the qualification of the instrument as core Tier 1 capital.

(27) KBC is a company with good medium-term prospects. Its underlying activities (i.e. excluding the losses due to the financial crisis) have generated a profit of about EUR 2 billion in the first 3 quarters of 2008. Furthermore the liquidity position of KBC remains strong. Its loan to deposit ratio is well below 100% and its deposit inflow remains steady. It has a relatively small exposure to interbank lending. It has a significant liquidity buffer that could enable it to weather a liquidity crunch over the next few months.

(28) The Belgian authorities also contend that the fact that no private investors are involved in the capital increase of KBC does not imply that the measure is not in line with the private investor principle.

(29) Furthermore, it is argued that the price paid for the securities is market conform. The interest rate is higher than the historic cost of debt and is adequate. Furthermore, the securities holder can benefit from "floor protection". In the view of the Belgian authorities, it can therefore be reasonably expected that the overall return (coupon yield and repurchase/contribution option combined) on the investment will be in excess of 10%.

(30) In the case that the Commission considers that the measure constitutes aid, the Belgian authorities claim that the measure is compatible with the common market because it is necessary to remedy a serious disturbance in the Belgian economy pursuant to Article 87(3)(b) of the EC Treaty. A letter sent by the National Bank of Belgium dated 27 November 2008 confirms the systemic importance of KBC for the entire Belgian financial system and the economy as a whole. The Belgian authorities also consider that the measure does not involve any unduly adverse spill-over effects on other Member States or undue distortions of competition.

(31) Belgium, along with KBC, has provided the following commitments.

(32) KBC shall endeavour, market circumstances permitting, to maintain its lending policy to the real economy.

(33) KBC shall endeavour, market circumstances permitting, to maintain its existing dividend policy. As an exceptional measure, KBC will propose not to pay any dividend for fiscal year 2008.

(34) KBC has committed to maintain its solvency ratio of core Tier 1 at a minimum of […]%.

(35) KBC commits that it will refrain from mass marketing invoking the Measure as an advantage in competitive terms.

(36) The Belgian Authorities have committed to use their best endeavours to achieve an overall return on the securities in excess of 10%. The Belgian Authorities consider that there is a high likelihood that such remuneration will materialise through a

combination of coupons at 8.5% (possibly more depending on the level of dividends paid out), and the repurchase option.

(37) The Belgian Authorities have undertaken to renotify the Measure under Art 88(3) EC if either of the following situations arise which make it less likely that the overall return in excess of 10% p.a. is achieved:

(i) If KBC does not pay a dividend for a period of two consecutive years or for three years in the next five years; or

(ii) If after a period of one year where the share price remains on average above 150% of the issue price of the securities, KBC has not repurchased, or committed to do so within 3 months, at least 20% of the original investment of the state.

Unless it can be shown that either of the above scenarios is caused by normal market events or that the overall return will nevertheless be in excess of 10% per annum, the Belgian Authorities will renotify the Measure to the European Commission. The European Commission, without calling into question the capital injection, which has been declared compatible with the common market, can in particular require additional behavioural constraints.

(38) The Belgian Authorities and KBC have committed to jointly submit a report for review of the European Commission within six months from the recapitalisation, containing information provided in paragraph 40 of the Commission Communication on "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition" ("the Communication on recapitalisations")[16].

III. ASSESSMENT

1. Existence of State Aid

(39) The Commission first has to assess whether the measures constitute State aid within the meaning of Article 87 (1) EC. According to this provision State aid is 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, in so far as it affects trade between Member States.

(40) Contrary to the position of the Belgian Authorities, who contend that they are acting in line with the private investor principle, the Commission considers that the measure described above constitutes State aid to KBC pursuant to Article 87 (1) EC Treaty.

(41) Given that KBC is active in the financial sector, which is open to intense international competition, any advantage from State resources to KBC would have the potential to affect intra-Community trade and to distort competition.

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[16] Commission Communication on "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition", adopted on 05.12.2008, available on: http://ec.europa.eu/competition/state_aid/legislation/specific_rules.html#financial

(42) Since Belgium is directly investing EUR 3.5 billion to acquire the securities, it is also clear that if any advantage is granted through the Measure, State resources are involved.

(43) Finally, it has to be examined whether the Measure leads to a selective advantage to KBC for it to constitute State aid.

(44) Belgium explained that it was necessary for KBC to reinforce its capital position through a measure that would qualify as core Tier 1 capital.

(45) Normally, if the core Tier 1 ratio needed to be reinforced, an ordinary share issuance would have been the typical way forward. Instead however, a unique, novel, hybrid capital instrument with mixed equity/debt characteristics was used. Indeed, Belgium is of the view that the securities should be considered as 'quasi-equity', comparable to ordinary shares. Therefore it is necessary to compare the characteristics and the return of this security to both ordinary shares and other types of hybrid capital to assess whether the Belgian state is acting in line with the private investor principle.

(46) Comparing the instrument to equity, the Commission notes that the security, unlike shares, has no voting rights, with only some limited corporate governance rights. Furthermore, Belgium can only transfer the securities with written consent of KBC. Finally, the potential capital appreciation on the securities is explicitly limited to 50%, and can only be realised at the initiative of KBC, which would not be the case for an investment in the form of ordinary shares.

(47) On the other hand, it has an enhanced coupon stream relative to that of ordinary shares, and has a limited downside (since any repurchase will be at a premium, of between 115%-150% of the issue price), which is not available for ordinary shares. However, the payment of the enhanced coupon as well the exercise of the exit option is again always at the initiative of KBC.

(48) Given the importance of the capital injection, which equates to approximately 24% of the total core capital of KBC as of the end of the 3rd quarter of 2008, the Commission is of the view that no private investor would have injected such a significant proportion of the capital of a company without seeking to have more influence over the management of the bank, particularly since its own return is dependent on the decisions of the board, for example in relation to dividends.

(49) Furthermore, the issue price of the securities represented a 10.5% premium on the share price of KBC on the day the transaction was announced.[17] In this time of heightened uncertainty with regards to the banking sector, it is unlikely that a private investor would pay a (substantial) premium.[18] Given that the securities could in time be converted on a one-to-one basis, this premium on the share price represents an advantage to KBC.

[17] The Commission notes that in view of the closing price of EUR 25.60 per share on 16 December 2008, this premium would have increased to 15.2%, which is substantial.

[18] In recent cases investors have received a discount on current share prices when banks have sought to increase their capital. For example, on 28 November 2008 Banco Santander raised new capital through means of a rights issue, where the subscription price was a 46% discount to the closing share price of 7 November (last day of trading before the announcement of the rights issue).

(50) Comparing the instrument to other hybrid capital instruments (for example typical preference shares), the more deeply subordinated status of the security must be taken into consideration. Belgium contends that the headline coupon of at least 8.5% exceeds the historic cost of hybrid tier 1 capital of 6.9% (in the period 1 January 2007 to 31 August 2008). However, given the uncertain outlook for the financial sector, any private investor would have demanded a higher coupon than the historic cost of debt that applied before the current financial turbulence. For example, recent data show that, reflecting current distressed market conditions, the current yield for hybrid Tier 1 capital is in the vicinity of 15% or more[19]. Furthermore, unlike typical hybrid securities, the coupon is only paid if KBC decides to pay a dividend to ordinary shareholders. In this regard, the fact that KBC has stated that it will not pay a dividend in 2008 shows the greater uncertainty of return that the holders of these securities face, which would normally require a higher return. While there is potential for a capital gain due to the repurchase premium, this premium is again dependent on KBC exercising it.

(51) In addition, in pricing the appropriate coupon on the securities, other considerations were taken into account by the Belgian state that no private investor would consider. It explicitly did not take into account current market prices as a reference for the yield required on the securities, as it felt that these were evidence of a market failure. While the Commission accepts that current secondary debt markets are distressed, it would not be the behaviour of a private investor to ignore current market conditions and instead apply historic market yields, which are much lower than current yields, to decide his required return. The use of lower historic returns to determine the coupon on the securities therefore grants an advantage to KBC.

(52) Combining the preceding points, in the view of the Commission, KBC has received an advantage. Its core Tier 1 capital has been strengthened under conditions that it would not have obtained on the market. Its shareholders' stakes or operational control are not diluted, although certain decisions will require approval by the state's nominees, as outlined in point 23. It would not be considered in default if it does not pay the annual coupon since it only has to pay interest in the event that it decides to pay dividends and it can repurchase the securities at a time of its choosing. Without the State intervention, KBC could not have raised such financing in such a short time frame at comparable conditions, especially taking into account the very volatile market circumstances.

(53) The Commission therefore comes to the conclusion that the Measure provides a selective advantage to KBC and that it consequently constitutes State aid in the sense of Article 87(1) EC.

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19 For example JP Morgan, Europe Credit Research, 27.10.2008; Merrill Lynch data on euro denominated tier 1 debt from at least investment grade rated financial institutions, publicly issued in the Eurobond market or in the domestic market of Member States' having adopted the euro. Data are provided by ECOWIN (ml: et10yld)

2. Compatibility of the aid with the common market

Compatibility under 87(3)(b) EC Treaty

(54) The Belgian authorities state that in their opinion the Measure does not constitute State aid. However, should the Commission consider the Measure to involve State aid, they invoke Article 87(3)(b) EC Treaty as a basis for compatibility.

(55) 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 tackle a disturbance in the entire economy of a Member State[20].

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

(56) In line with 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" ("the Communication on the financial crisis")[21], in order for an aid or aid scheme to be compatible under Article 87(3)(b) EC Treaty, it must comply with general criteria for compatibility under Article 87(3) EC Treaty, viewed in the light of the general objectives of the Treaty and in particular Articles 3(1)(g) and 4(2), which imply compliance with the following conditions[22]:

a. *Appropriateness*: The aid has to be well targeted in order to be able to effectively achieve the objective of remedying a serious disturbance in the 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 necessary to achieve the objective. That implies 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 measures in question

20 Cf. in principle case Joined Cases T-132/96 and T-143/96 Freistaat Sachsen and Volkswagen AG Commission [1999] ECR II-3663, para. 167. Confirmed in Commission Decision in case C 47/1996, Crédit Lyonnais, OJ 1998 L 221/28, point 10.1, Commission Decision in Case C28/2002 Bankgesellschaft Berlin, OJ 2005 L 116, page 1, points 153 et seq and Commission Decision in Case C50/2006 BAWAG, OJ L 83 of 26.3.2008, point 166. See Commission Decision of 5 December 2007 in case NN 70/2007, Northern Rock, OJ C 43 of 16.2.2008, p. 1, Commission Decision of 30 April 2008 in case NN 25/2008, Rescue aid to WestLB, OJ C 189 of 26.7.2008, p. 3, Commission Decision of 4 June 2008 in Case C9/2008 SachsenLB, not yet published.

21 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", adopted on 13.10.2008, OJ C 270 of 25.10.2008, pages 8–14.

22 Cf. Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, OJ C 273 of 28.10.2008, at point 41.

would not be necessary. This is confirmed by settled case law of the Court of Justice.[23]

c. *Proportionality*: The positive effects of the measures must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measures' objectives. This follows from Article 3 (1) g EC Treaty and Article 4 (1) and (2) EC Treaty, which provide that the Community shall ensure the proper functioning of an internal market with free competition. Therefore, Article 87 (1) EC Treaty prohibits all selective public measures that are capable of distorting trade between Member States. Any derogation under Article 87(3)(b) EC Treaty which authorises State aid must ensure that such aid must be limited to that necessary to achieve its stated objective.

(57) The fourth chapter of the Communication on the financial crisis, as well as the Communication on recapitalisations, then translate these general principles into conditions specific for recapitalisation schemes. The principles contained therein apply *mutatis mutandis* also to individual cases. In the next paragraphs, the Commission will therefore assess the compatibility of the notified measure with these criteria.

Importance of KBC for the Belgian economy

(58) In view of the specific position of KBC in Belgium (and worldwide), as described above, the Commission recognizes the importance of KBC for the Belgian economy. This is also confirmed in a letter from the National Bank of Belgium ("NBB") which states that KBC, being the third largest Belgian bankinsurance company, has a pivotal role within the Belgian financial system, and the Belgian economy as a whole. A loss of confidence in such a core institution would have led to a further disturbance in the financial systems. Therefore, the Commission considers that a public sector capital intervention in KBC is an appropriate means to strengthen and thus restore market confidence in the Belgian financial sector.

(59) The recapitalisation is an emergency measure to support the financial institution through the crisis, which is subject to regular review as provided in the Communication on the financial crisis and the Communication on recapitalisations. In this context, a distinction is made between fundamentally sound financial institutions[24] and institutions that are additionally suffering from more structural solvency problems.

(60) The Commission notes positively that Belgium and KBC have committed to submit a report within six months showing among others how KBC has used the funds provided and how it complies with the commitments mentioned in paragraphs (32) to (35).

[23] Cf. Case 730/79, *Philip Morris* [1980] ECR 2671. This line of authority has recently been reaffirmed by the Court of Justice in. Case C-390/06, *Nuova Agricast v Ministero delle Attività Produttive* of 15 April 2008, where the Court held that, "As is clear from Case 730/79 […], 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 […]."

[24] Belgium maintains that this is the case for KBC.

Limitation of the aid to the strict necessary

(61) Capital interventions must be done on terms that minimise the amount of aid. This relates to the amount of the measure as well as to the conditions at which it is provided.

(62) As regards the total amount of the recapitalisation, the injection of EUR 3.5 billion represents less than 1% of the balance sheet total of KBC Group as of 30 September 2008. Additionally, KBC had to make provisions for certain investments and revalue its CDO portfolio, which contributed to a loss of EUR 906 million for the third quarter of 2008. As a result, it was necessary for KBC to reinforce its capital position, which was at its lowest level in five years.

(63) The Measure will help KBC Bank to improve its core Tier 1 capital ratio from 6.8% to 8.2% and Tier 1 capital ratio from 9.1% to 10.7%. This increased level of capital is required to reassure markets of the solvency of KBC and to serve as an additional buffer for an upcoming economic recession and future losses.

(64) Where the solvency ratio of KBC Insurance, calculated according to the Insurance Group Directive, is concerned, it will improve from 176% for the 3rd quarter of 2008 to 283% after the capital injection. According to the CBFA, the average solvency rate of insurance companies under its supervision for the last five years was around 250%. However, the Commission notes that the average solvency ratio of KBC Insurance over that same period of time was substantially higher, i.e. 346%. Consequently, the level of solvency to be achieved after the recapitalisation of KBC Insurance is not excessive, especially in view of the fact that KBC is an integrated bankinsurance company in which one activity could affect the other. The capital injection in the insurance arm of KBC will thus provide a cushion to absorb further losses on its securities portfolio.[25]

(65) Taking into account the above analysis, the Commission is satisfied that this capital injection of EUR 3.5 billion is the minimum necessary to remedy concerns about the stability of KBC and thus the Belgian financial system.

(66) As regards the remuneration of the measure, the Commission is of the opinion that the return on this security can best be compared to a hybrid form of capital, given that the securities also have features similar to hybrid capital, like remuneration through a coupon and the fact that they are non-dilutive, which has a positive effect on the shareholders stake in the company. However, given the additional equity-alike elements of the security and its therefore more uncertain return, its expected return should normally be higher than that expected from other forms of capital under the applicable solvency regulations.

(67) The Commission acknowledges that setting the remuneration as high as the current clearing level of 15% or more would restrain the financial institutions from using such measures. Moreover, it is the Commission's intention to adjust to long term market conditions and not to impose the current unfavourable conditions on the financial institutions today. Following the methodology laid out in the Communication on

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25 As a result of the capital injection, the double leverage of KBC Group will we maintained at the same level, preserving future lending capacity to 115% gearing ratio.

recapitalisations, in its recent decision on the recapitalisation of the Dutch bankinsurer SNS REAAL the Commission has accepted as sufficient an expected overall return of 9.3% via mechanisms that are very similar to those used in the case of KBC.[26] Conform to this methodology, and in view of the prevailing market conditions, a return on tier 1 capital instruments for a Belgian bank in excess of 8.8% would currently be acceptable[27].

(68) Therefore, in view of the specificities and in particular the risk profile of the securities, the Commission considers that an expected overall return of 8.8% would be acceptable in the present case.

(69) Belgium considers that there is a high likelihood that an overall return in excess of 10% will materialise through a combination of coupons at 8.5% (possibly more depending on the level of dividends paid out), and the repurchase option by KBC at a level at EUR 44.25 per security, being 150% of the issue price. Indeed, Belgium has submitted various scenarios showing that the possible return can be considerable, depending largely on the performance of the Belgian and global economy and hence KBC's future stock performance.

(70) As regards the payment of coupons, assuming that the company's financial performance recovers within the next years, KBC will likely pay out some dividend within the next three years. KBC itself has provided the Commission with estimates, showing a coupon yield of […] the fiscal years 2009-2011. This would imply an average coupon yield of […]%. […], the Commission notes that these […].

(71) As regards the repurchase option, the higher the company's share price, particularly when it is above EUR 44.25, the stronger the incentive for the shareholders to redeem the instrument. This incentive is based on the fact that the instrument is always more expensive than common equity and that there will be an added incentive for KBC, on behalf of its shareholders, to remove any perceived dilution overhang linked to the fact that the instrument is convertible into common equity..

(72) In assessing the expected overall return, the Commission considers a combination of various likely dividend and repurchase scenarios. It notes that it is more prudent to assume that, in a year where a dividend is paid, the Belgian state would receive just the minimum coupon of 8.5%. Assuming that dividends are paid every year but that the State only receives the 8.5% coupon, and that the entirety of the investment is redeemed in a single transaction, then the total returns generated by the State would be 22% per annum if the repurchase occurred after 3 years, while if redemption was to occur after 5 years, returns would drop down to 15.8% per annum. In the event that no dividends were to be paid during the relevant periods, the returns would drop to 14.5% and 8.4% respectively. In the case that KBC does not pay dividends and where the

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26 See Commission decision of 10.12.2008 in the case N 611/2008 *Aid to SNS REAAL N.V.*

27 Points 27 and 46 of the Communication "The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortion of competition" state that the return may be calculated based on the ECB recommendations. According to these recommendations, the upper bound of the rate corridor should be calculated as follows: average EMU benchmark 5-year bond yield over the last 20 business days + country specific add-on + equity risk premium + add-on fee. Based on the risk-free rate as of 08.12.2008, for a financial institution based in Belgium, this formula would give the following result: 2.7%+0.12%+5.0%+1.0% = 8.82%.

stock price does not exceed 150% of the issuance price, the return of course would be substantially lower.

(73) Taking the above scenario analyses into account, the Commission considers that the expected return on the State's investment is likely to be in excess of 8.8%. It recalls that it is the nature of deeply subordinated capital that some uncertainty to the return remains and it is exactly for this reason as well as in view of the type of instrument that the expected return should be above 8.8%. It also notes positively the commitment of KBC and Belgium set out in paragraph 34 above regarding the payment of dividends. As an additional safeguard, the Commission also notes the Belgian authorities have committed to renotify the measure in the event that this return does not occur.

(74) As provided for by the Communication on the financial crisis, the aid must be limited to the minimum necessary so as not to allow the beneficiary to engage in aggressive commercial activities that would imply undue distortions of competition. Consequently, the Commission positively views the overall remuneration of the Measure, the commitment of KBC to refrain from mass marketing invoking the Measure and the requirement to provide a report within six months of the recapitalisation, as required under paragraph 40 of the Communication on recapitalisations. In addition the Commission notes positively the commitments of KBC set out in paragraphs (32) and (34) concerning the continuation of lending to the real economy and the maintenance of a minimum solvency ratio.

3. Conclusion

(75) Therefore, the Commission can conclude that the measure conforms to the conditions laid down in the Communication on the financial crisis and the Communication on recapitalisations.

IV. DECISION

(76) The Commission comes to the conclusion that the provision of capital by the Kingdom of Belgium in the conditions described above constitutes State aid pursuant to Article 87(1) EC Treaty.

(77) The Commission considers that this measure fulfils the conditions to be considered compatible with the Common Market pursuant to Article 87(3)(b) EC Treaty. Consequently, the Commission raises no objection against the notified aid and authorizes it as emergency intervention in the face of the current financial crisis for a period of 6 months.

Considering that recapitalisations should be subject to regular review, after the 6 months period, the Commission takes note of Belgium's commitment to submit a report to the Commission on the implementation of the measure within six months from the recapitalisation.[28] In the context of the review the Commission will then analyze, amongst others, the need for the continuation or a revision of the behavioural safeguards.

[28] In line with the requirements under point 40 of the Commission Communication on recapitalizations.

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Your request should be sent by registered letter or fax to:

- European Commission
  Directorate-General for Competition
  State aid Greffe
  Rue de la Loi/Wetstraat, 200
  B-1049 Brussels
  Fax No: (+32)-2-296.12.42

Yours faithfully,

For the Commission

Neelie KROES
Member of the Commission