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**PUBLIC VERSION**

**WORKING LANGUAGE**

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**Subject: State aid N 400/2009, Germany**

**Liquidity guarantee for IKB**

Sir,

## 1. PROCEDURE

(1) On 6 July 2009, Germany notified to the Commission its intention to grant guarantees for liabilities up to EUR 7 billion to IKB Deutsche Industriekreditbank AG (hereinafter 'IKB').

(2) State aid in the amount of EUR 9 billion had already been granted previously to IKB in the form of risk shields, capital injections and liquidity facilities, approved by Commission Decision of 21 October 2008 in case C 10/2008[1]. A further aid, guarantees for liabilities up

[1] Commission Decision of 21 October 2008, C 10/2008, *State aid granted by Germany for the restructuring of IKB Deutsche Industriebank AG*, http://ec.europa.eu/competition/state_aid/register/ii/doc/C-10-2008-WLWL-en-27.02.2008.pdf

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to EUR 5 billion, was approved by the Commission Decision of 22 December 2008 in case N 639/2008 [2].

(3) The German authorities and the Commission services held several telephone conferences, and Germany provided additional information. Following discussions with the Commission, Germany provided several commitments on 5 August 2009.

(4) Germany also communicated to the Commission a restructuring report due on 31 July 2009. The restructuring report was taken into account by the Commission when assessing the notified measure. The assessment of the restructuring itself, however, is not subject of this decision. Thus, the Commission does not assess the implementation of the restructuring and compliance with the Commission Decision of 21 October 2008 in case C 10/2008 as such in this decision.

## 2. DESCRIPTION OF THE AID

### 2.1. The beneficiary

(5) The beneficiary IKB is a medium-sized private bank which has its headquarters in Düsseldorf. It was taken over by the US investment fund LSF 6 Europe Financial Holdings, L.P. Dallas (hereinafter 'Lone Star'), in an open tender procedure following a bail-out by Germany's Kreditanstalt für Wiederaufbau (hereinafter 'KfW') and the German banking associations in August 2007. Lone Star holds about 91.5 % of the shares.

(6) IKB is a commercial bank servicing corporate clients in Germany and Europe. Its main customers are small- and medium-sized companies, as well as multinational enterprises and project partners. IKB is in the midst of a restructuring process which had become necessary after huge portfolio investments in structured securities had brought the bank close to insolvency in 2007. The bank intends to focus more strongly on SMEs and to extend its offerings to include services such as M&A, restructuring consulting, derivatives and capital market services.

(7) As of 31 March 2009, IKB's balance sheet total amounted to EUR 44.7 billion. The bank had a risk position of EUR 26.655 billion (including risk-weighted assets amounting to EUR 24.718 billion) and Tier 1 capital amounting to EUR 2.276 billion resulting in a Tier 1 ratio of 8.1 % (up from 6 % as of 31 March 2008). IKB's ratings are at the lowest level of investment grade with negative outlooks.

(8) IKB's last year results were still impaired by extraordinary effects and its core business was not profitable due to the current economic circumstances. According to the preliminary IFRS consolidated financial statements for the financial year 2008/09 which ended on 31 March 2009, IKB's loss amounted to € 580 million. The loss is mostly the result of further losses on portfolio investments, heavy fair value losses on securities and derivatives due to

[2] Commission Decision of 22 December 2008, N 639/2008 on a liquidity guarantee to IKB, http://ec.europa.eu/community_law/state_aids/comp-2008/n639-08.pdf

the severe interest rate volatility and a sharp rise in risk premiums. As a consequence of the recession, significantly higher provisioning for loan losses was required. For the financial year 2009/10, the bank expects further significant expenses for loan losses and for the ongoing restructuring required by the Commission.

### 2.2. First series of measures (risk shield, recapitalisation, liquidity)

(9) Traditionally, IKB's core business was to provide long-term financing, private equity or leasing to medium-sized companies. In order to increase its earning and to diversify, however, it invested heavily, directly and indirectly, in structured securities. Most of these securities, which amounted to EUR 18.3 billion, were held by special purpose vehicles which had been off-balance and were reported for the first time only in the restated annual report for the financial year 2006/07. IKB's direct and indirect exposure largely resulted from the acquisition of subordinated debt issued by these vehicles or liquidity facilities and other forms of credit enhancement.

(10) As the vehicles could no longer obtain funding in the capital markets due to the evolving financial crisis in mid-2007, liquidity facilities were drawn and IKB faced an acute liquidity crisis itself which threatened its existence. Only a complex bail-out orchestrated by the German authorities and executed by the Government-owned KfW with contributions from all three pillars of the German banking system could prevent bank resolution procedures which would otherwise have been initiated by the German regulatory authority.

(11) The measures in favour of IKB included two risk shields, capital injections and the provision of liquidity. The total aid granted was about EUR 9 billion. The measures were approved by the Commission under State aid rules in the form of a restructuring decision on 21 October 2008[3], subject to conditions according to which, inter alia, IKB was obliged to reduce a significant part of its business activities – first and foremost to exit its portfolio investment business –, to abandon real estate financing and to close down some of its foreign presences. Restrictions were put in place to limit the aid's potential for distortion of competition. Additionally, there are reporting requirements to enable the Commission to monitor the restructuring process including the return to viability.

### 2.3. Second measure (liquidity)

(12) The rescue phase was terminated with the acquisition by Lone Star in August 2008. However, the insolvency of the US investment bank Lehman Brothers in September 2008 not only resulted in sharp increases in credit spreads for banks but made funding extremely difficult. The interbank market became almost non-existent and the German Pfandbrief[4] market dried up as well. As a consequence, it became more and more difficult for IKB to fund itself and thus to obtain the liquidity required for continuing its business activities and for the implementation of the restructuring plan.

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3 Commission Decision of 21 October 2008, C 10/2008, S*tate aid granted by Germany for the restructuring of IKB Deutsche Industriebank AG*, http://ec.europa.eu/competition/state_aid/register/ii/doc/C-10-2008-WLWL-en-27.02.2008.pdf

4 The Pfandbrief is a specific type of covered bond under German law of a very high credit quality.

(13) Therefore, IKB applied to the German 'Sonderfonds Finanzmarktstabilisierung' (hereinafter: 'SoFFin')[5] for the grant of a liquidity guarantee of EUR 12 billion in total on 27 November 2008. The aid was granted under the German rescue package for financial institutions. Based upon an agreement concluded between IKB and SoFFin[6], IKB received a first tranche of guarantees up to EUR 5 billion for the issuance of bonds, subject to the approval by the European Commission. In exchange, IKB pays a fee of 1.0 % p. a. The Commission approved the grant of the liquidity guarantee on 22 December 2008[7]. The measure was considered necessary to resolve IKB's acute liquidity constraints that resulted from the financial crisis. The guarantee fee was found to be in line with the benchmarks set by the German rescue package and the European Central Bank's and the Commission's recommendations.

## 2.4. The notified third measure (additional liquidity)

(14) In the meantime, funding conditions for banks in general have eased. Rescue packages and individual State aid granted to banks and the extended funding provided by the ECB have prevented a further deterioration and helped re-establish market confidence to a certain extent. The majority of German banks is able to attract more deposits than in the past. The 'Pfandbrief' market in Germany reopened. Credit spreads for banks have come down significantly and several banks have tested the capital markets' willingness to procure funding, albeit to a limited extent. The interbank market shows signs of revival and even unsecured lending is provided again.[8]

(15) IKB, however, has only partly been able to profit from this more benevolent environment. In 2009, IKB issued State guaranteed bonds amounting to EUR 5 billion. It has not been able to place unsecured bonds in the markets or amongst its customers. It has neither a license required for the issuances of 'Pfandbriefe' nor sufficient assets fulfilling the collateral requirements for the issuance of such covered bonds. Deposit-taking is limited to institutional investors due to the bank's business model. Furthermore, a cap on the full protection usually offered by the voluntary deposit protection scheme of the Association of German Banks provides a further disincentive for potential depositors. Nevertheless, the bank has been able to increase short-term deposits significantly. IKB utilized securitization as a means to create assets it could then deploy as collateral for ECB funding. However, it has already used all eligible assets for this purpose except for a buffer necessary to provide for potential short-term liquidity needs. The capacity for issuing State guaranteed bonds provided under the second measure has also been fully utilized.

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5 In order to overcome the liquidity shortage of the financial institutions and to strengthen the stabilization of the German financial market, Germany adopted the 'Finanzmarktstabilisierungsfondsgesetz'. For the implementation of the measures of this law, the 'Sonderfonds Finanzmarktstabilisierung' (SoFFin) had been created.

6 'Vertrag über die Übernahme von Garantien zwischen dem Sonderfonds Finanzmarktstabilisierung (SoFFin) als Garant und der IKB Deutsche Industriebank AG als Kreditnehmer.'

7 Commission Decision of 22 December 2008, N 639/2008 on a liquidity guarantee to IKB, http://ec.europa.eu/community_law/state_aids/comp-2008/n639-08.pdf

8 Compare i.a. European Central Bank, *The Euro Area Bank Lending Survey*, 29 July 2009; Bank for International Settlements, *An Assessment of Financial Sector Rescue Programmes*, July 2009; IKB Information, *Barometer – Konjunktur- und Zinsperspektiven*, Juli 2009.

(16) According to IKB's projections and scenario analysis performed for liquidity management purposes, the bank is going to run into liquidity problems shortly and will face an ongoing funding gap for the next six months which is likely to amount to EUR 7 billion overall.

(17) In order to deal with the imminent risk of illiquidity, IKB applied to SoFFin for a second tranche of guarantees for liabilities up to a volume of EUR 7 billion. Guarantees amounting to EUR 4 billion to be granted shall have a maximum term of 36 months, and shall expire on 31 December 2012 at the latest. Guarantees amounting to EUR 3 billion shall have a maximum term of 60 months, and shall expire until 31 December 2014. Bonds shall be issued within 6 months. Instruments which qualify as subordinated debt cannot be covered.

(18) Germany confirms that the above terms of the guarantees are required to fund IKB's long-term lending and to help it avoid an unsound level of maturity mismatches between its assets and liabilities. Germany confirms that the additional measure is subject to the same general conditions as the previous measure approved by the Commission. Remuneration, however, has been increased. Whereas the commitment fee of 0.1 % p.a. remained unchanged, the current guarantee fee to be paid by IKB is 1.337 % p.a. for terms up to 36 months and 1.703 % p.a. for terms up to 60 months. This rate is computed as follows (as there is no CDS spread for IKB): 0.448 % p.a. (reflecting the CDS spreads of A-rated banks, plus 0.472 % p.a. (reflecting the additional risk of a BBB-rated bank, based upon probabilities of default established by a rating agency's study), plus a flat rate of 0.5 % p.a.

## 3. COMMENTS BY GERMANY

(19) Germany requests urgent approval of the notified measure in order to prevent the initiation of supervisory action leading to bank resolution. Without the measure being granted the bank would face an imminent danger of illiquidity.

(20) Germany does not contest that the measure constitutes aid. However, due to the risk that IKB could become illiquid and, therefore, insolvent and the serious consequences this would entail for Germany's financial system leading to a serious disturbance in the German economy, Germany argues that the measure is compatible with the common market under Article 87(3)(b) of the Treaty.

(21) Germany commits that it will notify a revised restructuring plan within three months that takes into account both the changes to the economic conditions which could not have been anticipated in the original plan and the Commission Decision of 21 October 2008 in case C 10/2008, as well as the fact that repeated additional liquidity support has become necessary in the meantime. Germany further commits that guaranteed liabilities will only be employed to avert the risk of illiquidity, to allow IKB to sustain liquidity buffers which are required by the regulatory authority and principles of sound liquidity management, and to continue lending to the real economy. In particular, IKB will not engage in proprietary trading[9] or buy back its own liabilities.

[9] Trading activities for client's accounts as well as commonly accepted trading activities to control the balance sheet total are still admissible.

## 4. ASSESSMENT

### 4.1. Existence of State aid

(22) Article 87(1) of the EC Treaty provides that, save as otherwise provided in the Treaty, 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.

(23) In agreement with the German authorities the Commission considers that the notified guarantee for liabilities in favour of IKB constitutes State aid within the meaning of Article 87 (1) EC Treaty. It should be noted in particular that no market investor would grant IKB the same amount of liquidity under the current circumstances. In particular, IKB will not engage in proprietary trading or buy back its own liabilities[10].

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

(24) Article 87(3)(b) empowers the Commission to decide that aid is compatible with the common market if it is intended 'to remedy a serious disturbance in the economy of a Member State'. The Commission acknowledged in its recent approval of the prolongation of the German rescue package[11] that, overall, the threat of a serious disturbance in the German economy continues and that measures supporting banks are suitable to address that threat.

(25) In particular, the Commission accepts Germany's confirmation that IKB is a systemically relevant bank given the volume of funding it received from other German banks and the significance of its lending activities for specific markets. The Commission further notes that the measure is intended to avert an imminent danger of illiquidity which would trigger bank resolution procedures by the competent regulatory authority. The Commission, therefore, concludes that such a failure would entail serious consequences for the German financial sector and the real economy. The aid must therefore be assessed under Article 87(3)(b) of the EC Treaty.

(26) However, IKB benefited already from restructuring aid which was approved by the Commission. In principle, as set out in the Community Guidelines on State aid for rescuing and restructuring firms in difficulty, restructuring aid should lead to the restoration of viability of the undertaking in the longer term without additional State aid. Such additional State aid is permissible only under exceptional circumstances, subject to an individual notification.[12] This principle has been confirmed by the Commission in its Communication on the return to viability and the assessment of restructuring measures in the financial

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[10] See footnote 9.

[11] Commission Decision of 22 June 2009, N 330/2009**,** *Prolongation of the German bank rescue scheme*,http://ec.europa.eu/competition/state_aid/register/ii/by_case_nr_n2009_0330.html#330.

[12] Communication from the Commission Community Guidelines of 1 October 2004, OJ C 244, *State Aid for Rescuing and Restructuring Firms in Difficulties*, p. 2, comp. paragraphs 70 and following.

sector in the current crisis under the State aid rules.[13] Pursuant to paragraph 7 of that Communication, provision of additional aid during the restructuring period remains a possibility if justified by reasons of financial stability. Any additional aid, however, must remain limited to the minimum necessary to ensure viability, and might entail the need for additional measures to limit distortions of competition.

(27) The Commission recalls that the additional aid was notified individually and is granted to fight off a threat to financial stability. It further notes that Germany committed to notify a revised restructuring plan for the Commission's assessment which duly takes into account that the economic conditions have changed in the meantime and the fact that additional liquidity support has become necessary since the restructuring plan was approved by the Commission. It concludes, therefore, that the general principles for assessing compatibility with State aid rules can be applied.

(28) In line with the Banking Communication[14,] in order for such aid to be compatible, any aid or aid scheme must comply with the general criteria for compatibility under Article 87(3) of the Treaty. Viewed in the light of the general objectives of the Treaty and in particular Articles 3(1)(g) and 4(2) thereof, this implies that the measures have to be appropriate, necessary and proportionate.

(29) The three Communications concerning State aid to banks[15] translate these general principles into specific compatibility conditions depending on the instrument chosen. The notified measure needs to be assessed under the Banking Communication.

## 4.3. Assessment of the compatibility of the measure

(30) Section three of the Banking Communication sets out criteria for the compatibility of guarantees with State aid rules.[16] First, it confirms that such aid needs to be appropriate, necessary and proportionate. Furthermore, the Banking Communication defines the range and maturities of instruments eligible for guarantees.

(31) The Commission found the second measure to be compatible with the common market under Article 87(3)(b) of the EC Treaty[17]. The notified measure is to a large extent identical

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13 Commission Communication, *The Return to Viability and the Assessment of Restructuring Measures in the Financial Sector in the Current Crisis under the State Aid Rules*, http://ec.europa.eu/competition/state_aid/legislation/restructuring_paper_en.pdf.

14 Commission Communication of 25 October 2008, OJ C 270, *Application of the State Aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*, p. 8.

15 Commission Communication of 25 October 2008, OJ C 270, *Application of the State Aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*, p. 8; Commission Communication of 15 January 2009, OJ C 10, *Recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition*, p. 2; Commission Communication of 26.3.2009, OJ C 72, on the treatment of impaired assets in the Community banking sector, p. 1.

16 Commission Communication of 25 October 2008, OJ C 270, *Application of the State Aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*, p. 8, paragraphs 17and following.

17 Commission Decision of 22 December 2008, N 639/2008 on a liquidity guarantee to IKB, http://ec.europa.eu/community_law/state_aids/comp-2008/n639-08.pdf

to that first guarantee for liabilities granted by SoFFin, and the funding situation of the bank has become even more dramatic.

(32) As regards the material and temporary scope of instruments covered by the measure, the Commission notes that guarantees are for bonds to be issued by IKB with terms ranging up to 60 months. The latter's' volume is limited to the overall amount of EUR 3 billion. Bonds are included in the eligible instruments identified in paragraphs 19 and following of the Banking Communication. The Banking Communication focuses, however, on short- and medium-term instruments and expresses the Commission's view that guarantees should be as short as possible. However, the paragraph 22 of the Banking Communication allows for exceptions to this principle subject to closer scrutiny as to their justification. Accordingly, the Commission had approved such longer terms in previous decisions[18] where it was adequate and guarantees with a term beyond three years were limited in size.

(33) In the case of IKB, the Commission finds that the terms 60 months are justified given the maturity structure of IKB's lending. They are crucial in particular to avoid an unsound level of maturity mismatches between assets and liabilities which would expose the bank to additional interest rate and liquidity risk. Additionally, the Commission notes that the volume of guarantees for liabilities exceeding 36 months is limited, taking into account both liquidity measures amount up to EUR 12 billion overall[19]. The Commission finds that the types and the terms of the instruments covered by the guarantees are thus in line with the Banking Communication.

(34) As regards necessity, the Commission first notes that IKB faces an imminent danger of illiquidity and has a structural funding deficit despite increased efforts to rise funding, in particular amongst its institutional depositors. It increased collateral eligible for ECB funding through securitization and issued the entire volume of bonds covered by SoFFin guarantee. The Commission notes that despite these efforts liquidity reserves have been utilized down to a reasonable buffer and additional liquidity of the volume notified is necessary to cover immediate liquidity demands and to enable the bank to continue extending loans to the real economy. In this regard, the Commission notes Germany's commitment to ensure that liquidity obtained under the measure is used only for the above purposes and that IKB is prohibited from any proprietary trading activities[20] or buying back outstanding liabilities (including capital instruments). Therefore, the Commission concludes that the aid is limited to the amount necessary to ensure the viability of IKB and to prevent potential abuses.

(35) Limiting aid to the minimum is further ensured by appropriate pricing of the guarantees.

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18 Commission Decision of 22 December 2008, N 655/2008, NORD/LB – Secured guaranteed medium-term note programme, OJ C 63; Note of 7 August 2009, *DG Competition's review of guarantee and recapitalisation schemes in the financial sector in the current crisis*, paragraph 25, http://ec.europa.eu/competition/state_aid/legislation/review_of_schemes_en.pdf.

19 I.e. EUR 5 billion approved in December 2008 and EUR 7 billion subject to this decision.

20 See footnote 9.

(36) To achieve proportionality, liquidity guarantees require a fee in line with the Recommendations of the ECB on government guarantees for bank debt[21]. For banks with CDS data, pricing for guarantees for debt with maturities over one year should comprise a premium based upon the median value of 5 year CDS spreads over a sample period from 1 January 2007 to 31 August 2008 or the median value of the 5 year CDS spreads during the same sample period for the rating category of the bank concerned, whichever is the lowest, plus an add-on fee of 50 basis points. For banks without CDS data, but with a credit rating, an equivalent CDS spread should be derived from the median value of 5 year CDS spreads during the same sample period for the rating category of the bank concerned, based on a representative sample of euro area large banks, to be defined by the Eurosystem.

(37) As IKB does not have a CDS spread, spread data provided by the Eurosystem was used for the calculation of the fee as required. The fee was computed using first the available CDS spread for A-rated banks. Second a further premium, which is based upon published probabilities of default for certain rating categories, is added to reflect the additional risk of a BBB-rated creditor. Finally, the required add-on fee was also added.[22] Pricing is thus in line with the relevant ECB requirements. Proportionality is, therefore, achieved.

(38) On the basis of the above, the Commission considers the notified measure in the form of a guarantee to be in line with the criteria set out by the Banking Communication and is compatible with the common market under Article 87(3)(b) EC Treaty.

## 5. DECISION

The Commission concludes that the measure notified by Germany on 6 July 2009 concerning guarantees up to 7 billion EUR for the issuance of bonds by IKB within 6 months constitutes State aid within the meaning of Article 87(1) EC Treaty.

The Commission finds that the measure is compatible with the common market as rescue aid pursuant to Article 87(3)(b) of the EC Treaty and raises no objection thereto.

Furthermore, the Commission notes Germany's commitment to notify a revised restructuring plan and the commitment to ensure that the aid can only by used to restore viability and enable the bank to continue lending to the real economy.

If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter to agree to the disclosure to third parties in the authentic language on the Internet site. http://ec.europa.eu/community_law/state_aids/index.htm.

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21 Recommendations of the Governing Council of the European Central Bank on Government Guarantees for Bank Debt of 20 October 2008.

22 For more detail see paragraph 18 above.

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

For the Commission

Neelie KROES
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