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In the published version of this decision, some information has been omitted, pursuant to articles 24 and 25 of Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, concerning non-disclosure of information covered by professional secrecy. The omissions are shown thus […].		**PUBLIC VERSION** **This document is made available for information purposes only.**

Subject: State aids n° C 15/2009 (ex N 196/2009) & N 380/2010; Extension of scope of formal investigation procedure, winding-up institution, additional SoFFin guarantees for HRE; Hypo Real Estate, Germany

Sir,

The Commission wishes to inform Germany that it has decided to extend the scope of the on-going investigation procedure with respect to an impaired asset measure (winding-up institution) for Hypo Real Estate (HRE) and with respect to SoFFin[1] guarantees of up to EUR 40 billion. It has also decided to temporarily authorise SoFFin guarantees of up to EUR 40 billion, and to temporarily authorise the establishment of an impaired asset structure (winding-up institution) for HRE.

1. PROCEDURE

(1) On 2 October 2008 the Commission temporarily authorised a State guarantee for HRE. On 7 May 2009 the Commission opened an in-depth investigation into aid measures for HRE,

[1] Sonderfonds Finanzmarktstabilisierung.

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mainly based on doubts regarding HRE's viability. On 13 November 2009, the scope of this investigation was extended, in order to cover additional aid measures for HRE, and at the same time the Commission temporarily authorised several capital injections. On 21 December 2009, the Commission temporarily authorised guarantees of EUR 18 billion for HRE. On 19 May 2010, the Commission temporarily authorised a capital injection of EUR 1.85 billion for HRE.

(2) On 2 September 2010 the German authorities notified to the Commission an additional SoFFin guarantee (liquidity guarantee) of EUR 20 billion for HRE.

(3) On 10 September 2010 the German authorities notified to the Commission an additional SoFFin guarantee (settlement guarantee) of up to EUR 20 billion for HRE.

(4) On 10 September 2010 the German authorities notified an impaired asset measure (winding-up institution) for HRE.

(5) On 10 September 2010 the German authorities notified a capital injection of SoFFin of up to EUR [2,050,000,000 – 2,150,000,000][*] for HRE. This Decision does not cover that capital injection.

(6) On 10 September 2010 Germany informed the Commission that it exceptionally accepts that the Commission Decision be adopted in the English language.

(7) Between 3 and 21 September 2010 the German authorities sent to the Commission further information. Among the information provided is a statement by Deutsche Bundesbank dated 15 September 2010 regarding the necessity of settlement guarantees for the transfer of assets.

(8) On 21 September 2010 Germany committed to submit until 1 November 2010 at latest, all requested data in the context of the procedure which would put an auditor in a position to confirm the real economic value as per 31 March 2010 regarding the transfer of impaired assets to the FMS Wertmanagement. Germany will submit to the Commission, until 15 December 2010 at latest, the report on the confirmation of the State aid element in the transfer and the data quality as well as the validation by the supervisory authority. Germany also commits to submit to the Commission as soon as possible, but no later than 1 November 2010, all further information for the assessment of the restructuring aid and, in particular the restoration of viability.

2. DESCRIPTION

2.1. The beneficiary

(9) HRE was established in October 2003 as a spin-off of parts of the commercial real estate financing of the HVB Group. In 2007, HRE took over the Dublin-based DEPFA Bank plc.,

[*] Confidential information

which was a major acquisition in terms of HRE's balance sheet. HRE has its headquarters in Germany.

(10) At the end of September 2008, HRE faced a liquidity shortage which would have put the bank into insolvency. HRE was unable to obtain short-term financing, in particular for its subsidiary DEPFA Bank plc., because the interbank lending markets had dried up in the aftermath of the Lehman Brothers bankruptcy. DEPFA Bank plc.'s strategy of funding a large portion of its public finance portfolio (public bonds) on a short-term basis - based on the belief that secured and unsecured funding sources would always be available - put the whole HRE Group at risk. Moreover, interest rate and foreign exchange movements as well as spread developments have been significant drivers of volatility of HRE's liquidity needs, exacerbating the group's liquidity shortfall during the months after the Lehman collapse.

(11) Since autumn 2009, HRE has been entirely owned by the Federal Republic of Germany as a consequence of State capital injections and a squeeze-out of minority shareholders. HRE currently consists of the following main companies: Hypo Real Estate Holding, pbb Deutsche Pfandbriefbank and DEPFA Bank plc.[2]

(12) pbb Deutsche Pfandbriefbank concentrates on two business fields: "Real Estate Finance" and "Public Sector Finance". It does business in Europe, Asia, North America and South America. HRE is one of the largest issuers of covered bonds (Pfandbriefe[3]).

(13) As per 30 June 2010 HRE had a balance sheet total of approximately EUR 385 billion. For the first half of the financial year 2010 HRE reported losses of EUR 0.7 billion. For the financial year 2009 HRE reported losses of EUR 2.2 billion, compared to losses of EUR 5.5 billion for the financial year 2008.

(14) HRE is currently in a restructuring process.

(15) In the information notified by Germany on 2 September 2010, Germany submits that the current rating (Fitch long term rating) of pbb Deutsche Pfandbriefbank is A-.

2.2. Brief description of the updated restructuring plan

(16) On 1 April 2009 Germany notified a restructuring plan for HRE, which the bank updated in May 2010 and which HRE already started to implement.

(17) The core objective of the restructuring is to reduce the dependency of HRE on short-term refinancing. To this end, HRE intends to concentrate on covered bonds-eligible business[4] with period-congruent refinancing. That business will be funded through Pfandbriefe and be accompanied to a smaller extent by unsecured lending and money markets.

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[2] In June 2009, the Hypo Real Estate Bank AG (HREB) was merged with DEPFA Deutsche Pfandbriefbank AG to form "pbb Deutsche Pfandbriefbank".

[3] Pfandbriefe are a type of covered bonds. The Pfandbrief has two kinds of securitisation. In addition to a liability taken over by the bank itself it is collateralised by specific assets such as property mortgages or public sector loans as laid down in the German Pfandbrief Act ("*Pfandbriefgesetz*").

[4] In the field of Real Estate Finance and Public Sector Finance.

(18) The scope of business activities of HRE is going to be reduced. HRE plans to concentrate on two main business fields: Real Estate Finance and Public Sector Finance. Several business locations shall be closed.

(19) In order to limit distortions of competition Germany submits in its updated restructuring plan the following measures:

- Downsizing of HRE:
  The updated restructuring plan states that at the end of 2010 pbb Deutsche Pfandbriefbank will have a balance sheet total of EUR [110 – 120] billion at maximum. This amount is approximately [71 – 74]% below the balance sheet total of HRE Group at the end of 2008. At the end of 2008, HRE Group had a balance sheet total of approximately EUR 420 billion. That ratio calculation, however, ignores both internal financing and DEPFA Bank plc.'s so called "value portfolio" of about EUR [65 – 75] billion, and compares the formal consolidated group balance sheet to that of its "core bank". According to HRE, pbb Deutsche Pfandbriefbank is the strategic core bank of HRE, which will carry out Real Estate Finance and Public Sector Finance activities. That "value portfolio", although consolidated into the HRE Group, does not belong to the pbb Deutsche Pfandbriefbank, which is designated as "core bank". It contains a number of assets (outside the scope of public finance and commercial real estate) that cannot be transferred into the winding-up institution for legal, administrative or tax reasons. Yet this value portfolio, representing [15 – 18]% of the bank's balance sheet, is designed for a wind-up, even though it will stay on the balance sheet.
- Growth rate of pbb Deutsche Pfandbriefbank:
  The updated restructuring plan states that the balance sheet total over the restructuring period increases by [0 – 10] % per year on average.
- Time line for the re-privatisation:
  Germany intends to re-privatise the bank which is seen as an important element of the restructuring process. In this respect Germany assures that pbb Deutsche Pfandbriefbank shall be privatised as soon as possible, provided the conditions are "economically acceptable", but at the latest by 31 December […]. If a re-privatisation has not taken place by 31 December […], the bank shall be offered until 30 June […] at "no minimum price". If that approach is also unsuccessful, a divestiture trustee will then be appointed, mandated to carry out the re-privatisation.

(20) In order to manage the balance sheet total decrease from approximately EUR 420 billion (end 2008) to EUR [110 – 120] billion in 2010, Germany transfers assets amounting to up to EUR 210 billion from HRE to a winding-up institution and plans to wind up DEPFA Bank plc. In 2009 the balance sheet size of HRE has already decreased. The main effect, however, on HRE's size in terms of balance sheet total is the transfer of assets to the winding-up institution.

2.3. The measures to be temporarily found compatible with the internal market

2.3.1 SoFFin guarantee of EUR 20 billion (liquidity guarantee)

(21) Germany submits that HRE needs an additional EUR 20 billion liquidity guarantee because of adverse developments on the capital and interest rates futures markets. Those adverse developments will continue to affect HRE considerably until the majority of assets have been transferred to the winding-up institution. The EUR 20 billion liquidity guarantee will be used for bonds (Inhaberschuldverschreibungen) issued by pbb Deutsche Pfandbriefbank. Those bonds will mature on 31 December 2010 at the latest.

(22) Germany submits that the validity period of the guarantees has to be three months after drawing the guarantee in order to be eligible for central bank credit operations.

(23) The guarantee of EUR 20 billion will therefore have a duration of three months and will expire on 31 December 2010 at the latest.

(24) Germany explains that HRE currently still has a very restricted access to unsecured refinancing. HRE receives new liquidity on the market almost exclusively by providing sufficient collateral. Moreover, if the value of assets which HRE pledged to business partners decreases – as it happened due to market developments in August 2010 – HRE has to provide further collateral to its business partners. As HRE has already pledged nearly all of its pledgeable assets, it has to use parts of its liquidity reserve, or has to dissolve closed transactions. Negative market developments hence have led to liquidity outflows at HRE.

(25) According to information submitted by Germany, there exists an acute risk that there will be a liquidity shortage for the HRE Group. before 30 September 2010, i.e. before the date for which the transfer of assets to the winding-up institution FMS Wertmanagement (FMS) is scheduled.

(26) Germany submits that HRE has demonstrated that there are no alternative refinancing possibilities in order to close the liquidity gap. Refinancing through the ECB and e.g through KfW is only possible by providing collateral through HRE Group or third parties. However, currently there is no such collateral available at pbb Deutsche Pfandbriefbank or DEPFA Bank plc., and third parties will not provide collateral in the short-term either.

(27) In short, the SoFFin guarantee of EUR 20 billion is necessary for the following purposes:

i. EUR [6 – 13] billion liquidity shortage as per 30 September 2010 in the risk scenario (forecast as of 31 August 2010);

ii. EUR [3 – 7] billion buffer for maintaining the business operations;

iii. EUR [3 – 7] billion as a further buffer for carrying out preparation measures in view of the transfer of assets to the winding-up institution

(28) Furthermore, HRE also intends, if necessary, to use part of the EUR 20 billion guarantee frame at the end of September 2010 in relation to the transfer of assets to the FMS for unexpected liquidity needs caused by the asset transaction on 30 September 2010.

(29) HRE will pay a guarantee premium to SoFFin. The guarantee premium for the EUR 20 billion guarantee will amount to 0.8% (0.5 % plus mark-up of 0.3 % because of the rating;

see paragraph 15) per annum. For that part of the guarantee not used, a commitment fee of 0.1% per annum shall be paid.

2.3.2. SoFFin guarantee of up to EUR 20 billion (settlement guarantee)

(30) The second guarantee, i.e. a guarantee of up to EUR 20 billion (settlement guarantee), is sought because of the settlement procedures in connection with the transfer of assets to the winding-up institution. That guarantee will also be used for bonds issued by pbb Deutsche Pfandbriefbank. These bonds will mature on 31 December 2010 at the latest.

(31) The guarantee of up to EUR 20 billion will also be used for central bank credit operations and therefore have a minimum duration of three months, and expire on 31 December 2010 at the latest. The settlement guarantees, however, can only be drawn from 27 September until 30 September 2010.

(32) Germany submits that on substance the guarantee is restricted to the liquidity needs that stem from the execution of the asset transfer, and that quantity-wise the drawing amount of the settlement guarantee will be limited to the actual needs of HRE, taking the availability of other liquidity guarantees into account.

(33) If the guarantees are not used for the asset transfer they will be redeemed immediately.

(34) Germany submits that an adequate liquidity buffer is necessary, considering that the impaired asset transfer is a cross-border transaction of considerable size and complexity and considering that a many parties from various jurisdictions are involved. Germany also submits that if portfolios, securities, or collaterals cannot be transferred as planned, a liquidity need for a short period of a few days only could occur.

(35) Germany submits that in order to absorb the transfer and settlement risks, an adequate liquidity buffer must be available. This buffer will amount to EUR 20 billion, i.e., approximately 10% of the transaction volume. The settlement of foreign exchange-related positions, restrictions on unsecured funding or technical obstructions and a lack of capacities, in particular with regard to the required co-operation of counterparties, may occur and hinder planned transactions.

(36) HRE will pay a guarantee premium to SoFFin. The guarantee premium for the SoFFin guarantee of up to EUR 20 billion (settlement guarantee) will amount to 0.8 % (0.5 % plus mark-up of 0.3 % because of the rating; see paragraph 15) per annum. For that part of the guarantee not used, a commitment fee of 0.1% per annum shall be paid.

(37) **2.3.3. Impaired asset measure (winding-up institution)**

(38) On 21 January 2010 HRE applied to the Finanzmarktstabilisierungsanstalt (FMSA) for the formation of a winding-up institution in order to subsequently transfer assets of up to EUR 210 billion to this institution.

(39) Based upon paragraph 8a of the Finanzmarktstabilisierungsfondsgesetz (FMStFG), a winding-up institution (Abwicklungsanstalt) was incorporated on 8 July 2010 as a public

institution under the name FMS Wertmanagement. The FMS is an organizationally and economically autonomous entity registered in Munich which is not a banking institution as defined by the German banking law, the Kreditwesengesetz (KWG). The FMS is nevertheless authorised to carry out all banking activities necessary to wind-up its assets on a for-profit basis. The proceeds generated by FMS' assets shall cover all of FMS' operating expenses.

(40) FMS will carry out the winding-up of assets according to a wind-up plan that comprises inter alia a time-line for the wind-up of all assets, a cash income and outgo plan, and a statement of sources and application of funds. That plan also comprises statements regarding the net worth position, the financial position and the earnings position. FMS will report to FMSA on the implementation of the wind-up plan on a monthly basis.

(41) The German financial market stabilization fund SoFFin, managed by the FMSA, is obliged to compensate for all losses that FMS may incur.

(42) Germany has notified to the Commission the details of HRE's portfolio of assets that will be taken over by FMS on 30 September 2010. The portfolio comprises assets of up to EUR 210 billion. Those assets consist mainly of bonds from HRE's public sector financing activities, loans from its commercial real estate activities and cash collateral. However, they also comprise a sub-portfolio of derivatives that includes both related micro- and macro- hedges as well as exotic options and structured credit derivatives.

(43) Germany submits that according to the current planning stage, subject to the final decisions of the German Government and HRE, it is planned that HRE will transfer a balance sheet volume of up to EUR 195 billion to the winding-up institution. In view of potential market value changes of the derivatives to be transferred, the German Government on a precautionary basis notified on 10 September 2010 the transfer of balance sheet volume of up to EUR 210 billion into the winding-up institution.

(44) The transfer will take place in form of four different specific transfer procedures, i.e. either by way of a split-off, a true sale, a sub-participation, or a financial guarantee.

(45) Germany submits that after 30 September 2010 there could for certain assets be "upgrades" of the specific transfer procedures initially chosen, e.g. an upgrade from a financial guarantee to a sub-participation, in order to achieve the goals of balance sheet relief and risk weighted assets relief at the level of HRE, and to entirely transfer the legal and economic property rights and risks related to these positions to the winding-up institution.

(46) Germany claims that it is planned that the spin-off of assets takes place as of 30 September 2010 and that it is planned that the winding-up institution starts its operative business as of 1 October 2010. Germany also submits that a postponement of the planned filling of the winding-up institution to a later date would threaten the whole concept of HRE´s restructuring in a uncontrollable way. Such a postponement could therefore jeopardise financial stability, in particular because the HRE Group still is, according to a letter dated 6 September 2010 of Deutsche Bundesbank, of systemic relevance for the European banking system due to its size and its international linkages. In that letter Deutsche Bundesbank also underlines that a threat to the restoration of HRE could have a knock-on effect and also

endanger other relevant market participants, and hence exacerbate the international financial crisis.

(47) In particular, Germany has submitted that the whole concept of HRE's restructuring might be threatened, if the filling of the winding-down institute would be delayed, due to:

- The risk of non-compliance with regulatory requirements, in particular a capital shortage due to the failure to achieve the expected reduction of risk weighted assets;
- Liquidity risks, in particular the fragile liquidity situation of the HRE, that would continue without asset transfer;
- Domestic legal reasons, in particular as an implementation of a winding-up institution after 31 December 2010 is no longer possible under the German bad bank law (Finanzmarktstabilisierungsfondsgesetz; FMStFG);
- Accounting regulations, in particular the fact that a transfer presupposes audited balance sheets for both the remaining core bank and the winding-up institution. The current audit process, which takes approximately 6 to 8 weeks, is aligned with the scheduled transfer date;
- Technical reasons, in particular the volume and the complexity of the transfer;
- The impact on other projects, in particular the effect that scarce human resources in the IT department would be involved in the transfer for longer than initially planned, thus slowing down the overhaul of HRE's fragmented IT structure and the implementation of the core bank's new business strategy;
- The risk of reputational damage which – as capital markets expect the transfer to take place at the end of September 2010 – could potentially result in a retreat of counterparty lines and hence adversely affect HRE's capacity to obtain funding; and
- The risk of higher refinancing costs, as rating agencies could downgrade HRE as a consequence of a postponement of the transfer.

3. POSITION OF GERMANY

(48) The German authorities claim that the SoFFin guarantees are State aid to remedy a serious disturbance in the economy of a Member State. The German authorities claim that further negative market developments could lead to serious liquidity problems of for the HRE Group.

(49) As regards the SoFFin guarantees Germany claims that it notified the guarantees for precautionary reasons. Germany submits that the provision of SoFFin guarantees is carried out on the basis of the FMStFG, which has already been approved by the Commission as State aid scheme. Therefore an additional individual notification is, in the view of Germany, not necessary.

(50) As regards the impaired asset measure (winding-up institution) Germany doubts that it involves any element of State aid. Should the Commission deem that to be case, Germany claims that use of the winding-up institution does not constitute rescue aid within the

meaning of Article 107(3)(c) TFEU and of the Rescue and Restructuring Guidelines[5]. Rather, the measure, if being considered aid, is aid to remedy a serious disturbance in a Member State according to Article 107(3)(b) TFEU and according to the Communications from the Commission on the application of State aid rules to measures taken in relation to financial institutions in the context of the current financial crisis[6].

(51) Germany submits that on 6 September 2010, BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht), the German supervisor, reiterated that – in view of HRE´s worsened liquidity situation – HRE´s application for further SoFFin guarantees is justified. By letter of 6 September 2010, Deutsche Bundesbank underlines that HRE Group is, because of its size and its international linkages, of systemic relevance for the European banking system. Huge parts of its issued covered bonds are held by other banks, insurance companies, and other institutional investors. The supervisory authority, BaFin, in a letter of 14 October 2009 already pointed out that a collapse of HRE Group would have considerable negative effects on the national and international financial markets.

4. ASSESSMENT

4.1. Existence of State aid under Article 107(1) TFEU

(52) In the opening Decision[7] the Commission came to the preliminary conclusion that all measures granted until 7 May 2009 constitute State aid within the meaning of Article 107(1) TFEU.

(53) In line with the conclusion with regard to the guarantees covered in the opening Decision and the preliminary conclusion in the extension Decision[8], the Commission considers that the SoFFin guarantees of up to EUR 40 billion in favour of HRE confer an advantage to HRE, as HRE would not have received them on the market in the current circumstances. It is evident that those guarantees are financed from State resources. It is also clear that they are offered to one bank only and are hence selective. As HRE is active in the banking sector which is characterised by competition across the Member States, these measures distort competition and affect inter-State trade. For these reasons the guarantees constitute State aid, an assessment which the German authorities do not dispute.

(54) The Commission has already stated in its Decision of 13 November 2009 extending the formal investigation procedure in case C 15/2009[9] concerning HRE, that the transfer of assets to a winding-up institution might entail additional aid, considering that according to

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5 Community guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 244, 1.10.2004, p. 2.

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

7 Decision C(2009) 5888 final of 24 July 2009. That Decision withdrew and replaced Decision C(2009) 3712 final of 7 May 2009.

8 Decision C(2009) 8967 final of 13 November 2009.

9 Commission Decision of 13 November 2009 in case C 15/2009 – *HRE,* C 13 of 20.01.2010, p 64, point 56.

point 39 of the Commission's Impaired Asset Communication[10] ("IAC") an impaired asset measure, irrespective of its form, constitutes State aid in so far as the transfer value exceeds the market value of the total portfolio.

4.2. Compatibility of the aid

4.2.1. Application of Article 107(3)(b) TFEU

(55) Article 107(3)(b) TFEU enables the Commission to find aid compatible with the internal market if it remedies a serious disturbance in the economy of a Member State. As the breakdown of a systematically relevant bank can directly affect the financial markets and indirectly the entire economy of a Member State, the Commission currently bases its assessment of State aid measures in the banking sector on this provision in light of the on-going fragile situation on the financial markets.

(56) The Commission has no grounds to doubt Germany's qualification of HRE as a bank of systemic relevance.

(57) The German central bank Deutsche Bundesbank points out in a letter dated 6 September 2010 that a threat to the restoration of HRE could have a knock-on effect and also endanger other relevant market participants, and hence exacerbate the international financial crisis. The Commission will therefore assess the State aid measures for HRE under Article 107(3)(b) TFEU.[11]

4.2.2. Compatibility of the SoFFin guarantees

(58) According to the Banking Communication[12] any aid or aid scheme must comply with general criteria for compatibility under Article 107(3) TFEU, viewed in the light of the general objectives of the Treaty. In particular, aid must be appropriate, necessary and proportional. The Banking Communication contains general conditions for support measures in the financial crisis including, inter alia, for guarantees.

(59) Based on the Banking Communication, the Commission has authorised a German scheme for rescue guarantees to financial institutions (N 625/2008, N 330/2009, N 665/2009, N 222/2010) which contains more detailed conditions for State guarantees. However, point 16 of the Restructuring Communication[13] requires an individual notification of guarantees in all cases where a restructuring plan has already been presented. Any such further aid is to be taken into account in the Commission's final restructuring Decision. HRE is at presently restructuring on the basis of a restructuring plan. Therefore, the aid is not covered by the

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10 Communication from the Commission on the treatment of impaired assets in the Community banking sector, OJ C 72, 26.3.2009, p. 1.

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

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

13 Commission Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, OJ C 195, 19.8.2009

approved German bank support scheme but needs to be notified, assessed and approved individually by the Commission.

(60) Regarding the liquidity guarantee, first, from the information provided by Germany, it is evident that HRE continues to face serious difficulties in covering its refinancing needs without continued State support. Therefore State guarantees on its funding operations are an appropriate means and necessary to ensure that it can maintain its operations.

(61) In fact BaFin confirms that the HRE Group urgently needs the liquidity guarantee due to recent adverse developments on the capital and interest rates futures markets. Without an improvement of HRE's liquidity situation BaFin might be forced to take supervisory measures.

(62) Second, the liquidity guarantee amounting to EUR 20 billion is proportionate as it is limited in amount and time. The guarantee of EUR 20 billion will expire on 31 December 2010 at the latest.

(63) Third, the guarantee is adequately remunerated. HRE will pay a guarantee premium to SoFFin. The guarantee premium for the EUR 20 billion guarantee will amount to 0.8 % per annum. The Commission notes that this remuneration is in line with the Recommendations of 20 October 2008 of the Governing Council of the European Central Bank on government guarantees for bank debt, with the German rescue scheme[14], and with the DG Competition staff working document of 30 April 2010[15]. For the part of the guarantee not used, a commitment fee of 0.1% will be paid.

(64) As regards the settlement guarantee, the German authorities submitted that the settlement guarantee is necessary for the settlement procedures in the context of transferring HRE's portfolio of assets to FMS. That reason for settlement guarantees on that scale has also been confirmed in a letter of Deutsche Bundesbank dated 15 September 2010.

(65) The Commission accepts, in line with the statement of Deutsche Bundesbank, that the complexity of the transactions involved in the transfer and the resulting uncertainties require liquidity reserves. The SoFFin guarantee of up to EUR 20 billion (settlement guarantee) is thus necessary to prevent threats to the transfer of the assets, which if not accompanied by sufficient buffers, might be jeopardised. The fact that HRE may draw the settlement guarantee only during a very limited period, i.e. only from 27 September until 30 September 2010, limits the possibility that the guarantees could be used for other purposes than those related to the transfer. The settlement guarantee will expire on 31 December 2010 at latest. The settlement guarantee is also limited in amount since the drawing amount of the settlement guarantee will be limited to the actual needs of HRE, taking the availability of other liquidity guarantees into account.

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14 See cases N 625/2008, N 330/2009, N 665/2009, N 222/2010

15 DG Competition staff working document "The application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010", 30 April 2010

(66) Finally, the guarantee is also adequately remunerated. HRE will pay a guarantee premium to SoFFin. The guarantee premium for the EUR 20 billion guarantee will amount to 0.8 % per annum. The Commission notes that this remuneration is in line with the Recommendations of 20 October 2008 of the Governing Council of the European Central Bank on government guarantees for bank debt, with the German rescue scheme[16], and with the DG Competition staff working document of 30 April 2010[17]. For the part of the guarantee not used, a commitment fee of 0.1% will be paid.

(67) The Commission will assess and take into account those new SoFFin guarantees of up to EUR 40 billion in its assessment of HRE´s restructuring plan, in particular as regards burden-sharing measures and measures to limit distortions of competition. The renewed need for State-guaranteed liquidity also casts further doubts on HRE's capability to restore its long-term viability.

(68) However, on the basis of the considerations above, the Commission comes to the conclusion that the guarantees are appropriate, necessary and proportional, and can be considered compatible with the internal market on the basis of Article 107(3)(b) TFEU on a temporary basis. However, the Commission will take both the guarantees and their conditions into account in the assessment of the restructuring aid.

4.2.3. Temporary compatibility of the impaired asset measure (winding-up institution)

(69) The transfer of HRE's portfolio of assets to FMS constitutes an impaired asset relief which must be assessed under the IAC. The IAC provides guidance on the treatment under Article 107(3)(b) TFEU of asset relief measures by Member States, including in particular winding-up institutions as indicated in Annex II to the IAC. The compliance of the measure with the provisions of the IAC is assessed below.

- Eligibility of assets

(70) As regards the eligibility of the assets, the IAC indicates in section 5.4 that asset relief requires a clear identification of impaired assets and that certain limits apply in relation to eligibility. It notes that assets which have triggered the financial crisis and are subject to severe downward value adjustments appear to account for the bulk of uncertainty and scepticism concerning the viability of banks. In this respect, US mortgage-backed securities and associated hedges and derivatives are mentioned. The IAC also notes, however, that an overly narrow relief measure would not be advisable and refers to a proportionate approach permitting the extension of eligibility to well-defined categories of other assets as well.

(71) The wind-up portfolio consists of bonds, loans and, to a smaller extent, derivatives. Although not all of those assets have become illiquid or were subject to severe downward value adjustments, they have been adversely affected by the financial crisis.

(72) While in principle it would be questionable whether a spin-off of such assets at a transfer price above the market value is compatible with State aid rules, the IAC recognises in point

16 See cases N 625/2008, N 330/2009, N 665/2009, N 222/2010

17 DG Competition staff working document "The application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010", 30 April 2010.

34 the necessity of a pragmatic and flexible approach to the selection of asset types for impaired assets measures.[18] The Commission notes that the range of asset classes affected by the financial crisis became broader due to spill-over effects. Asset relief for such assets can help to achieve the objectives of the IAC, i.e. to increase transparency and to contribute to financial stability, even if those assets are not in the classes that initially triggered the financial crisis. Therefore, the Commission has in previous cases accepted asset relief measures for those assets, provided adequately thorough restructuring and remedies to avoid undue distortions of competition are being put in place.[19]

- Transparency and disclosure

(73) As regards transparency and disclosure, section 5.1 of the IAC requires full ex ante transparency and disclosure of impairments on the assets which are covered by relief measures, based on adequate valuation, certified by recognised independent experts and validated by the competent supervisory authority. That valuation must be provided to the Commission in line with point 37 of the IAC.

(74) In that respect, the Commission notes that Germany has presented a valuation on the portfolio that is certified by independent experts. That valuation, however, does not cover the derivatives portfolio and has so far not yet been validated by the competent supervisory authority. Furthermore the initial information provided by Germany to the Commission turned out to be incomplete and not up-to date.

(75) Consequently, the Commission notes that the IAC's criteria regarding transparency and disclosure are not yet met.

(76) However, the Commission notes that Germany committed to submit to the Commission all required information that is still outstanding.

- Management of assets

(77) As regards management of assets, section 5.6 of the IAC requires a clear functional and organisational separation between the beneficiary bank and its shielded assets, notably as to their management, staff and clientele. In this respect, the Commission notes that the established winding-up institution ensures a clear functional and organisational separation, and is thus sufficient to achieve compliance.

- Valuation

(78) Section 5.5 of the IAC explains that a correct and consistent approach to valuation is of key importance to prevent undue distortions of competition and to ensure the consistency of valuation methodologies.

(79) Germany has so far presented a valuation on the portfolio which does, however, not cover the derivatives portfolio. The Commission, supported by external experts, is currently

[18] Commission Decision of 22 October 2009 in case C 29/2009 – *HSH Nordbank*, point 40. C 281 of 21.11.2009, p. 42.

[19] Commission Decision of 22 October 2009 in case C 29/2009, *HSH Nordbank*, C 281 of 21.11.2009, p. 42, point 40, and Commission Decision of 22 December 2009 in case C 40/2009, *WestLB*, C 66 of 17.03.2010, p.22, point 54. To some extent also Commission Decision of 15 December 2009 in case C 17/2009 – *LBBW*, L 188 of 21.07.2010, p. 11, point 49.

carrying out a validation of the valuation, including an assessment of the value of the derivatives portfolio.

- Burden-sharing

(80) As regards ex ante burden-sharing, section 5.2 of the IAC points out that banks ought to bear the losses associated with the impaired assets to the maximum extent. Pursuant to paragraph 40 of the IAC that outcome is usually achieved by a transfer at the real economic value, in combination with a corresponding write down of the book value. Accordingly, the beneficiary bank must disclose incurred and expected losses of the portfolio, and should limit the transfer price to the real economic value. The same economic effect is obtained if the beneficiary bank, by its own means, capitalises the winding-up institute with sufficient equity, thereby enabling the winding-up institute to absorb future losses.

(81) Because no details regarding the capitalisation have been revealed and in the absence of a final valuation, it remains unclear whether the equity provided to FMS is sufficient to cover the write down or first loss as is required under the IAC.

(82) Moreover, the Commission notes that SoFFin has granted an unlimited guarantee to cover all losses incurred by FMS.

(83) The Commission consequently has doubts that the measures provides for adequate burden-sharing in line with the IAC and reserves a final judgement on compatibility until the real economic value of the transferred assets has been established.

- Remuneration

(84) Point 21 of the IAC notes that a correct remuneration is another element of the burden-sharing requirement, which at the same time prevents undue distortions of competition. The Commission must ensure, as noted in Annex IV to that Communication, that any pricing of the asset relief must include a remuneration for the State that adequately takes account of the risks of future losses exceeding those projected in the determination of the real economic value. In line with the Commission's practice[20] remuneration for impaired assets measures needs to be based on the capital relief effect resulting from the transfer or guaranteeing of assets.

(85) The notification does not indicate that HRE will remunerate the asset relief measure.

(86) The argument that Germany as the sole owner of HRE is interchangeable with the recipient of the remuneration is irrelevant in this context. From a competition point of view the renunciation of a remuneration would still be an advantage provided to the bank. If a bank is not in a position to adequately remunerate the aid received, the resulting distortion of competition must be compensated for by additional remedies such as further downsizing.

(87) As so far no adequate remuneration has been determined, the Commission has doubts regarding the remuneration.

(88) In sum, the Commission at this stage is unable to conclude on the transparency of the measure or to finalise the valuation and consequently it cannot conclude on remuneration and burden-sharing. On the other hand, the Commission considers that the measure

[20] Cf. Commission Decision of 15 December 2008 in case C 17/2008 LBBW, Commission Decision of 18 November 2009 in case C 10/2009 ING.

complies with the other criteria for compatibility under the IAC, namely the eligibility of assets and asset management arrangements.

(89) The Commission has established that it will authorise emergency measures temporarily if they are needed for reasons of financial stability[21], where it is not ready to take a definite Decision because there are doubts on compatibility of the measures as restructuring aid. By letter of 6 September 2010, Deutsche Bundesbank underlines that HRE Group is, because of its size and its international linkages, of systemic relevance for the European banking system. In that letter, Deutsche Bundesbank also underlines that a threat to the restoration of HRE could have a knock-on effect and also endanger other relevant market participants, and hence exacerbate the international financial crisis.

(90) Given the threat to financial stability in the absence of the winding-up institution, the Commission considers the asset relief to be temporarily compatible with the internal market as emergency support under Article 107(3)(b)TFEU until a final Decision has been taken. That conclusion is in line with previous Commission Decisions, where the investigation procedure was concluded after a preliminary authorisation.[22] Therefore, the Commission has at this stage temporarily no objections to the transfer as such of the assets to the winding-up institution.

4.2.4. Assessment of the restructuring aid

(91) The Commission takes note of the update of 7 May 2010 of HRE´s restructuring plan when compared to the initial restructuring plan dated 1 April 2009. However, the Commission continues to doubt that the restructuring aid is compatible for the following reasons:

(92) First, the Commission continues to doubt at this stage that the transformation of HRE's business model with its focus on two legs, i.e. public sector finance and real estate finance, will be capable of restoring the long-term viability of the bank. The Commission doubts that the bank can achieve sufficient margins with its future business activities, in particular those in the public finance sector which is characterised by low margins and which can therefore only be profitable if a bank has access to cheap refinancing. In the medium-term, the credit rating that HRE will be able to achieve and that directly affects its refinancing costs will be key for its future business prospects. It should also be noted that HRE is depending on wholesale funding (it does not have franchise funding), making it vulnerable to disturbances in the market. The bank's overall profitability is furthermore a result of both the margins stemming from existing assets and those stemming from new business. Since the margins achieved in the past were on average not sufficient, existing assets are a burden on the bank's profitability[23], and its business planning is dependant on the improved margins that the bank aims to achieve with its future business.

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[21] Commission Decision of 13 November 2008 in case C 15/2008, *Hypo RealEstate*, not yet published, and Commission Decision of 31 March 2009 in case C10/2009 *ING*, OJ C 158, 11.07.2009, p. 13.

[22] The Commission has taken similar Decisions. For instance in case C 9/09 point 77, *Dexia,* C 10/2008 *ING*, C 77/2009 *LBBW* and C 40/2009 *WestLB*.

[23] The majority of existing assets will be transferred to the winding-up institution; that measure enables the bank to get rid of underperforming assets and to increase the average profitability of remaining assets.

(93) Given the potential magnitude of the aid stemming from the guarantees, capital injections and the asset relief measure, and given the continuing doubts as regards viability, the Commission, at this stage, can not exclude that […] might be the only alternative to make all the aid compliant with Article 107(3)(b) TFEU.

(94) The asset valuation also revealed a weakness of HRE's [...].

(95) Moreover, and as already indicated above, the fact that HRE suddenly needs new liquidity guarantees of up to EUR 40 billion, casts further doubts on whether HRE has the capacity to manage its business properly.

(96) Second, the depth of the restructuring also hinges on the questions of appropriate remuneration for the impaired asset measure, which still needs to be determined. If HRE will not be able to pay an appropriate remuneration, the magnitude of the restructuring needs to cater for such a lack of remuneration. All these elements still need to be established in order to properly determine the framework for the assessment of the distortions of competition. That assessment also needs to consider the newly requested SoFFin guarantees of up to EUR 40 billion.

(97) In view of the doubts on the viability of the bank based on the current restructuring plan, the Commission will consider further options for HRE/pbb Deutsche Pfandbriefbank, including: a break-up into smaller entities, and/or an […] scenario.

4.2.5. Extension of the scope of the procedure regarding the restructuring aid

(98) In light of the doubts regarding compatibility of the asset relief measure with the IAC, and the failures of the current revised restructuring plan to demonstrate that the bank will be able to restore viability and that proper burden-sharing and mitigation of distortions of competition is ensured, the Commission further extends the scope of the formal investigation procedure pursuant to Article 108(2) TFEU. The Commission notes positively Germany´s commitment to submit to the Commission until 1 November 2010at latest all information for the assessment of the restructuring aid.

(99) In addition, the need of additional guarantees by SoFFin, i.e. a liquidity guarantee of EUR 20 billion and a settlement guarantee of up to EUR 20 billion will be taken into account in the assessment of the restructuring aid.

5. CONCLUSION

The Commission has decided to temporarily find compatible with the internal market the SoFFin guarantee of EUR 20 billion (liquidity guarantee) in favour of HRE until the Commission has taken a final Decision on the restructuring aid.

The Commission has decided to temporarily find compatible with the internal market the SoFFin guarantee of up to EUR 20 billion (settlement guarantee) in favour of HRE until the Commission has taken a final Decision on the restructuring aid.

The Commission will take both the guarantees and their conditions into account in its assessment of the restructuring aid.

Based on a commitment of Germany to deliver to the Commission by 1 November 2010at the latest all necessary and required information, the Commission has decided to temporarily find compatible with the internal market the impaired asset measure (winding-up institution) in favour of HRE until the Commission has taken a final Decision on the restructuring aid. The Commission will review the conditions of the impaired asset measure in its final Decision on the restructuring aid.

In the light of the foregoing considerations, the Commission has decided to extend the scope of the proceedings laid down in Article 108(2) TFEU with respect to transparency, valuation, burden sharing, and remuneration of the impaired asset measure (winding-up institution) and their impact on the assessment of the restructuring aid as regards viability, burden-sharing and distortions of competition. In the light of the foregoing considerations, the Commission has decided to also extend the scope of the proceedings laid down in Article 108(2) TFEU, in particular as regards the assessment of the restructuring aid, with respect to the additional liquidity guarantee of EUR 20 billion by SoFFin and with respect to the additional settlement guarantee by SoFFin of up to EUR 20 billion.

The Commission notes that Germany exceptionally accepts that this Decision to be adopted in the English language.

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

If this letter contains confidential information which should not be disclosed to third parties, 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 the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site:
http://ec.europa.eu/community_law/state_aids/state_aids_texts_de.htm

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

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State Aid Greffe
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Yours faithfully,
For the Commission

Joaquín ALMUNIA
Vice-President of the Commission