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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** **WORKING LANGUAGE** **This document is made available for information purposes only.**

Subject: **State aid C 29/2009 (ex N 503/2009) – Germany**
HSH Nordbank

Sir,

The Commission wishes to inform Germany that, having examined the information supplied by your authorities on the measure referred to above, it has decided to initiate the procedure laid down in Article 88(2) of the EC Treaty since the Commission has doubts as to the compatibility of the measures with the common market.

1. PROCEDURE

(1) On 30 April 2009 Germany notified to the Commission measures in form of a risk shield of € 10 billion and a capital injection of € 3 billion.

(2) On 29 May 2009 the Commission authorised in case N 264/2009 the measures as rescue State aid to HSH Nordbank AG ("HSH Nordbank" or "HSH") on the basis of Article 87(3)(b) EC for a period of six months[1].

(3) On 1 September 2009 Germany notified a restructuring plan to the Commission.

[1] Commission Decision of 29 May 2009 in case N 264/2009 *HSH Nordbank AG,* OJ C 179 of 1.8.2009, p. 1, http://ec.europa.eu/community_law/state_aids/comp-2009/n264-09.pdf .

Seiner Exzellenz Herrn Frank-Walter STEINMEIER
Bundesminister des Auswärtigen
Werderscher Markt 1
D - 10117 Berlin

2. DESCRIPTION

2.1. The beneficiaries

HSH Nordbank

(4) HSH is the fifth biggest German Landesbank with head offices in Hamburg and Kiel. It is a private joint stock company, established on 2 June 2003 as the result of the merger between Hamburgische Landesbank and Landesbank Schleswig-Holstein. In October 2006, nine trusts advised by J.C. Flowers & Co. LLC ("Flowers") acquired [20-30]%[*] of HSH shares, which had been owned by WestLB, with a view to an IPO of the bank in 2008.

(5) On 31 December 2008 HSH had a balance sheet of € 208 billion, risk-weighted-assets ("RWA") of € 112 billion and 4,300 employees.

(6) After the implementation of the rescue measures approved by the Commission on 29 May 2009 the ownership structure of the bank can be described as follows: the City State of Hamburg (Freie- und Hansestadt Hamburg) 10,89%, the State of Schleswig-Holstein (Land Schleswig-Holstein) 10,42%, Anstalt des öffentlichen Rechts ("the Anstalt"), which is a public-law institution established and controlled by Hamburg and Schleswig-Holstein, 64,18%, the savings banks Sparkassen- und Giroverband für Schleswig-Holstein 4,73%, the Schleswig-Holsteinische Sparkassen-Vermögensverwaltungs- und Beteiligungs GmbH & Co. KG 0,58% and nine trusts advised by Flowers 9,19%[2].

(7) HSH is a commercial bank, its core region is Northern Germany and its main focus is on private banking and merchant banking. The merchant banking activities are focused on corporate banking, shipping, transportation, real estate and renewable energy projects. HSH is the world's biggest provider of ship finance and […] provider of financial services in the transportation sector. The bank was present in major financial centres around the world (21 foreign locations in Europe, Asia and America) as of December 2008.

(8) HSH is one of the German public banks which until 18 July 2005 had profited from the unlimited State guarantees "Anstaltslast" and "Gewährträgerhaftung". Those guarantees have been abolished pursuant to decisions of the Commission[3]. According to those decisions all liabilities arising in the transitional period from 2001 to 2005 with maturity until 2015 are still covered by the guarantees. The part of HSH's liabilities which are still guaranteed by the Länder Hamburg and Schleswig-Holstein amounted as of 31 December 2008 to € [50-80] billion (€ [50-80] billion on 31 December 2009).

(9) On 6 May 2009 Standard&Poor's ("S&P") downgraded HSH credit rating by two notches from (A) to (BBB+) with a negative outlook.

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[*] Confidential information

[2] Before the implementation of the rescue measures the respective shares were as follows: the City State of Hamburg 30.41%, the State of Schleswig-Holstein 29.10%, the savings banks Sparkassen- und Giroverband für Schleswig-Holstein 13.20%, the Schleswig-Holsteinische Sparkassen-Vermögensverwaltungs- und Beteiligungs GmbH & Co. KG, Kiel 1.62% and nine trusts advised by Flowers LLC 25.67%.

[3] Anstaltslast conferred rights to the financial institutions vis-à-vis its owners, whereas Gewährträgerhaftung provided for rights of the creditors of the financial institutions vis-à-vis the owners. See the respective decisions in case E 10/2000, OJ C 146, 19.6.2002, p. 6 and OJ C 150, 22.6.2002, p.7.

The savings banks and the nine trusts advised by Flowers

(10) The Commission is of the preliminary opinion that the owners of HSH Nordbank who did not participate in the rescue measures, namely the Sparkassen- und Giroverband für Schleswig-Holstein, the Schleswig-Holsteinische Sparkassen-Vermögensverwaltungs- und Beteiligungs GmbH & Co. KG, Kiel ("the savings banks") and nine trusts advised by Flowers are also indirect beneficiaries of the € 3 billion recapitalisation measure granted to the bank. Following the capital injection the shareholdings of the two savings banks and the nine trusts advised by Flowers were diluted from 13.20%, 1.62% and 25.67% to 4,73%, 0,58% and 9,19% respectively. As explained in the assessment of this decision the Commission has doubts regarding the valuation of the bank and consequently about the price of the newly issued shares which the Commission regards as being too high. Because of that the Commission does not exclude that the savings banks and the nine trusts advised by Flowers disproportionately benefited from the capital injection by keeping excessively high shareholdings in the bank.

2.2. The events leading up to granting of the rescue measures

(11) The financial crisis led already in 2007 to a € [1-2] billion impairment loss in HSH's structured credit portfolio (CIP). The contagion effect of the real economy adversely affected the traditional loan portfolioand had a severe impact on the quality of the bank's claims related to its shipping, transportation, real estate and renewable energy project financing. These developments lead to an increase of the risk provisions to € [1-2] billion on the loan portfolio in 2008 in addition to the difficulties experienced with the CIP. The bankruptcy of Lehman Brothers further intensified the refinancing difficulties of HSH.

(12) On 29 April 2009 the German Banking Regulator (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) informed HSH Nordbank that given its current prudential situation BaFin […].

2.3. The financial measures in favour of HSH Nordbank

(13) In order […] to strengthen its core capital the City State of Hamburg and the State of Schleswig-Holstein (the "Länder") granted the following measures to HSH Nordbank:

1. Capital injection of € 3 billion;
2. Second-loss risk shield of € 10 billion on a large part of the balance sheet.

Recapitalisation by € 3 billion

(14) The Länder injected € 3 billion of capital into HSH Nordbank (€ 1.5 billion each). The recapitalisation took place in the form of ordinary shares with voting rights (Core Tier 1 capital). This amount was needed in order to fill the reserves which were released in the 2008 account statement.

(15) The capital increase was carried out by the Anstalt. The Anstalt obtained the financial means needed for the cash capital increase by issuing bonds on the capital markets. The Anstalt's liabilities which result from the bond issues are guaranteed by the Länder as partial debtors and to equal extent by means of guarantees to the bond holders. The Anstalt's bonds serve only the financing of the notified measures to support HSH. The Anstalt operates exclusively as a vehicle for the Länder and will not pursue any other purpose besides the capitalisation and provision of the second-loss risk shield.

(16) The price of the new shares was based on a valuation of HSH established by […] which arrived at a value in a range between € [1.5-3.5] billion and € [2-4] billion (€ [18-28] per share). The average value of HSH based on the valuation amounts to € [1-3] billion (€ [19-27] per share). The valuation was established before the rating downgrade of HSH. The impact of the downgrading on the value of HSH was not taken into account in the valuation, but was considered during the pricing discussion. It was based on the assumption that an upgrade to the previous (A) rating will be achieved in 2013.

(17) The objective of HSH and the Länder was to achieve a yearly 10% remuneration for the € 3 billion newly injected capital (€ 300 million per year). Given that the business plan of HSH did not project sufficient profits for the period 2009-2012 to pay a 10% dividend on all ordinary shares, the issue price of the new ordinary shares was reduced by a discounted 10% dividend payment for the period 2009-2012. The present value of the 10% dividend payment for the period 2009-2012 amounts to € [500-700] million (€ [3-6] per share). The price per share paid by the Länder was therefore fixed at € 19 and they acquired 157.894 new ordinary shares.

(18) After the capital increase the shareholding of the Länder increased from 59.51% to 85.49%. The shareholdings of the savings banks of Schleswig-Holstein and Hamburg and the nine trusts advised by Flowers were diluted to 5.31% and 9.19% respectively.

The risk shield of € 10 billion

(19) Under the risk shield the Länder shelter HSH Nordbank from losses stemming from total assets of about € [150-200] billion (based on exposure at default) as of a cut-off date in March 2009. A first-loss-tranche of € [2-4] billion is to be covered by HSH. The second-loss-tranche of up to € 10 billion is to be covered by the Länder (50% each). Losses beyond € [12-14] billion are covered by HSH. According to the submitted information the first-loss-tranche of € [2-4] billion covers all expected losses of the € [150-200] billion portfolio. The guarantee fee is fixed at [3.5-4.5] % of the total amount of the guarantee (€ 10 billion). The probability that the second-loss-tranche of € 10 billion will be drawn down at all (meaning a drawing of a single €) is estimated by Germany below [20-60] %.

(20) Of the € [150-200] billion of assets included in the risk shield, impaired assets such as assets-backed securities ("ABS") represent less than [2-8] % (€ [5-10] billion) of the overall shielded portfolio. The majority of the assets consist of […] loans, the core activity of the bank (€ [100-150] billion – [60-80] %). Other assets included in the portfolio are fixed income securities (€ [15-30] billion – [10-20] %), specific German financial products as secured tradable loans (Schuldscheindarlehen: € [10-20] billion – [5-10] %) and guarantees on payments (€ [4-10] billion – [2-5] %). Each element of this portfolio is denominated in various currencies including USD, EUR and GBP. The core bank is expected to be free of risk shield protection in [2013-2014].

(21) A valuation of the ABS portfolio has been conducted by external experts ([…] und […]).

The German Guarantee Scheme

(22) In addition to the measures by the Länder, on 6 November 2008 the bank applied for and was granted by the German Financial Markets Stabilisation Fund (Sonderfonds

Finanzmarktstabilisierung, SoFFin) […] liquidity assistance in the form of guarantees covering the issuance of new debt up to an amount of € 30 billion in the framework of the German guarantee scheme[4] approved by the Commission. As of 1 October 2009, drawings under the guarantee scheme totalling € 17 billion had been approved by SoFFin covering the issuance of bonds by HSH.

2.4. The restructuring plan

(23) HSH Nordbank has submitted an in-depth restructuring plan. The plan describes the measures the bank intends to apply […] to restore its long-term viability until [2013-2015]. HSH's restructuring plan foresees an overall [45-65] % reduction of the balance sheet, which is to be primarily achieved through the transfer of about [40-60] % of its total assets (as of 2008) into an internal winding-down bank *(Abbaubank)* and a concentration on core activities and core regions.

(24) In the Core Bank there will remain € [85-120] billion of assets ([35-60] % of € 208 billion per December 2008). The bank will focus on regional financial activities and selective international businesses with regional connections. The activities of HSH will be organized in three pillars:

- The regional activities consisting of private and corporate banking, the cooperation with the savings banks and commercial real estate financing;
- The "international sector specialist" encompassing project financing in shipping, transport and renewable energy with a focus on Northern Europe;
- Capital market activities only as a financial solutions provider (driven by clients' needs only) and a refinancing source for the regional and international sector business.

(25) About € [90-125] billion of assets will be transferred into the winding-down bank to be established. The assets to be transferred into the winding-down bank pertain to risky and loss-making activities or non-strategic activities (conventional energy projects, international leveraged buy out, renewable energy projects in the US, real estate financing, corporate finance in Scandinavia and Asia, part of shipping financing, parts of infrastructure, rail and logistics as well as container projects, international commodity finance, leasing, non–client-related capital market business) and are not necessarily impaired. The winding-down bank will not engage in any new business […].

(26) The restructuring plan foresees the divesture of […] and the 40% holding in the […]. The run-off of non-strategic activities will result in the closure of […] out of 21 international branches. The braches or representation offices in Helsinki, Stockholm, Oslo, Riga, Tallinn, Warsaw, San Francisco and Hanoi) have been already closed. The branches or representations in […] are going to be closed by 2012. After the restructuring period HSH Nordbank shall keep […] branches or representations in […]. However, the branches in […] will be downsized and the branches in […] transformed into representative offices.

[4] Commission Decision of 27 October 2008 in case N512/2008 *German Bank Rescue Scheme*, OJ C 293, 15.11.2008, p. 2 amended by Commission decision of 12 December 2008 in case N625/2008 *German Bank Rescue Scheme*, prolonged by Commission decision of 22 June 2009 in case N 330/2009, OJ C 160, 14.7.2009, p. 4.

(27) The restructuring plan foresees a negative operating result for 2009 and 2010 and a […] return to profitability thereafter.

(28) HSH Nordbank considers the run-off of non-strategic business activities (especially Energy US, real estate financing in New York and Western Europe, part of shipping financing), the divesture of […] and […] and closing of […] international braches or representation offices as compensatory measures for potential distortion of competition. Furthermore HSH Nordbank committed[5] not to advertise that the bank received State aid and offered to provide further behavioural commitments to mitigate potential distortions of competition.

3. POSITION OF GERMANY

(29) Germany argues that the exemption in Article 87(3)(b) of the EC Treaty applies to the measures. Germany also argues that the Impaired Assets Communication ("IAC")[6] does not apply *ratione temporis* to the risk shield, since the measure was designed at the end of 2008 and pre-notified prior to publication of the IAC. As a subsidiary argument, should the IAC be applicable, Germany claims that the risk shield in question would be overall in line with the IAC as regard the conditions pertaining to asset eligibility, asset valuation and pricing.

4. ASSESSMENT

4.1 Existence of aid

(30) As laid down in Article 87(1) EC, 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.

(31) The Commission recalls that it has already established in the rescue aid decision that the risk shield and the capital injection in favour of HSH Nordbank constitute State aid[7].

(32) The Commission is also of the preliminary opinion that a part of the State aid granted to HSH Nordbank in form of € 3 billion capital injection was passed to the savings banks and nine trusts advised by Flowers in form of disproportionately high remaining shareholdings of those bank owners.

4.2 Compatibility of the aid measures under Article 87(3)(b) EC

4.2.1 Application of Article 87(3)(b) EC

(33) 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 has acknowledged in its approval of the German Rescue package[8] that there is a threat of serious disturbance in the German economy and that

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5 Restructuring plan, final version of 3 September, page 172, point 7.2.

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

7 See footnote 1.

8 Commission Decision of 27 October 2008 in case N512/2008 *German Bank rescue scheme*, OJ C 293, 15.11.2008, p. 2 amended by Commission decision of 12 December 2008 in case N625/2008 *German Bank*

State support of banks is suitable to remedy this disturbance. Article 87(3)(b) EC can therefore be applied.

(34) As regards the case at stake, the Commission recalls that already in its decision temporarily approving the rescue aid for HSH Nordbank it assessed the applicability of Article 87(3)(b) EC and considered that given the present circumstances in the financial market the aid could be found compatible on the basis of Article 87(3)(b) EC, provided that Germany would submit a credible and substantiated restructuring plan for the bank. Germany has now submitted a restructuring plan for HSH Nordbank which the Commission will have to assess under Article 87(3)(b) EC.

4.2.2 Application of the Impaired Asset Communication

(35) In the Impaired Asset Communication ("IAC")[9] the Commission has provided guidance on the treatment of asset relief measures by Member States under Article 87(3)(b) EC. Impaired assets correspond to categories of assets on which banks are likely to incur losses. The Commissions notes that the IAC covers any kind of support measures targeting impaired assets and subsequently providing effective asset relief to the recipient institution. It defines asset relief as any measure whereby a bank is dispensed from the need for severe downward value adjustments of certain asset classes.

(36) The Commission points out that the risk shield is indeed intended to protect HSH Nordbank against the risk of future […] The risk shield, […] thus effectively releases the bank from regulatory capital requirements. Therefore, the risk shield constitutes an asset relief measure and falls within the scope of the IAC.

(37) As regards the *ratione temporis* objection of Germany, the Commission recalls that it has to apply law and guidelines in force at the time of the adoption of the decision, irrespective of the time at which the aid measures were designed or notified[10]. The Commission accordingly has applied in the context of the current financial crisis the IAC to measures adopted prior to its publication[11]. The Commission considers that the IAC applies *ratione temporis* to the risk shield, since the risk shield was notified after the publication of the IAC.

4.2.3 Quantification of aid element

(38) Based on a preliminary assessment, the aid amount involved in the recapitalisation and the risk shield can be estimated at € [5-13] billion, broken down as follows:

- The Commission assumes at this stage that the aid amount in a recapitalisation measure is likely to be up to 100 % and thus equal to the nominal amount of the capital injection.

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rescue scheme, prolonged by Commission decision of 22 June 2009 in case N 330/2009, OJ C 160, 14.7.2009, p. 4.

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

10 See Case C 334/07 P *Commission v Freistaat Sachsen*, judgment of 11 December 2008, not yet reported.

11 See Commission decision in case C 9/2009/1960 *Aides en faveur de Dexia en forme de garantie sur les obligations et sur certains actifs, liquidity assistance et augmentation de capital.*

- The aid amount in the risk shield has to be defined according to the Impaired Assets Communication[12]. The aid amount results from the difference between the transfer price and the market value of the shielded assets, capped at the notional amount of the guarantee. In the case at stake the transfer price is likely to be € [140-190] billion and corresponds to total nominal value of the shielded assets (€ [140-190] billion) minus the first loss of € [2-5] billion. It is difficult to assess the market value of the portfolio, which consists mainly of loans to corporate customers. The Commission notes that using in a preliminary analysis external pricing sources where available (for externally rated bonds), and extrapolating these to the entire portfolio, assuming a constant coverage ratio of expected losses[13], the Commission obtained an upper bound estimate for the portfolio of [80-100] % of its nominal value (€ [140-190] billion). Taking into account any volatility or risk premium for the current environment, further analysis is likely to reveal a lower market value. Therefore the Commission's preliminary assessment concludes that the market value of the portfolio is below € [150-200] billion. Thus the aid element involved in the risk shield is likely to be € [2-10] billion.
- When defining the aid element account should be taken of State aid received by the bank in whatever form[14], which means in the case at stake that the guarantee granted to HSH Nordbank under the German scheme has also to be considered.

4.2.4 Compatibility of the risk shield

Eligibility of assets

(39) As regards eligibility of the shielded assets, the IAC provides in its section 5.4 that asset relief measures require a clear identification of impaired assets[15] and that certain limits apply in relation to eligibility to ensure compatibility.

(40) The Commission has doubts regarding the compatibility of the portfolio with the eligibility criteria set out by the IAC since only a small fraction of the shielded portfolio falls directly into the definition of impaired assets in the IAC (structured credit products represent less than [4-7] % of the total). The bulk of the portfolio is made of standard credit, the main activity of the bank (€ [100-150] billion – [60-80] %), particularly ship and airplane financing, standard fixed income products with € [15-30] billion ([10-20] %), secured loans (Schuldscheindarlehen; € [10-20] billion ([5-10] %) and letters of credit (€ [4-10] Billion, [1-5] %). Each element of this portfolio is denominated in various currencies including USD, EUR and GBP. Whilst the IAC recognises the necessity of a pragmatic and flexible approach to the selection of asset types for impaired assets measures, the Commission questions the "impaired" nature of the loan assets included in the portfolio, in particular in light of the size of the portfolio as a proportion of total assets. The shielded portfolio is exceptional in size as it represents more than [50-80] % of the bank's total assets.

[12] Point 39 of the IAC emphasises that the current market value may be quite different from the book value and for some assets the market value might be non-existent in the absence of a market and thus virtually zero.

[13] The *Coverage Ratio* of a credit spread is the ratio of the actuarial spread of expected losses to the quoted CDS spread. It is assumed to be relatively constant across credit grades.

[14] Point 4 of 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 of 18.9.2009, p.1.

[15] To be dispatched in baskets reflecting the extent of existing impairment in line with Annex III to the IAC.

(41) In this context, the Commission also recalls paragraph 36 of the IAC, which sets out the general principle that the depth of restructuring is directly related to the width of the eligibility criteria for asset relief measures.

Transparency and disclosure

(42) As regards transparency and disclosure, the Commission notes that section 5.1 of the IAC requires full *ex ante* transparency and disclosure by eligible banks of impairments on the assets which will be covered by the relief measures, based on adequate valuation certified by recognised independent experts and validated by the relevant supervisory authority.

(43) In that respect, the Commission notes that valuation reports, while produced by independent experts cover only a residual fraction of the shielded portfolio, namely a major part of the structured credit securities. According to point 37 of the IAC HSH Nordbank has to provide a valuation of the whole portfolio carried out by recognised independent experts. Moreover, […], Germany has not provided so far a validation of the valuation process and outcome by BaFin. The Commission consequently questions the compatibility of the measures with the IAC regarding transparency and disclosure.

Management of assets

(44) As regards management of assets, the Commission notes that 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. The Commission states in that respect that this should allow the bank to focus on the restoration of viability and to prevent possible conflicts of interest.

(45) With regard to this point, the Commission notes that no evidence of a clear functional and organisational separation has been provided so far, since all shielded assets would remain on HSH's balance sheet under direct management and supervision of the bank. The Commission consequently has doubts about the compatibility of the measures with the IAC regarding management of assets.

Valuation

(46) Section 5.5 of the IAC provides 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. Therefore, the valuation of impaired assets should be closely co-ordinated *ex ante* by the Commission. For that purpose, the Commission has called on the technical assistance provided by experts from the European Central Bank and has retained as well its own external advisors.

(47) Assets should be valued on the basis of their current market value and their real economic value on the basis of underlying cash flows. The transfer value for asset insurance measures should be based on their real economic value to ensure that the aid amount is kept to a minimum and thus that aid is compatible. Uniform hair-cuts have to be considered to approximate the real economic value of assets that are so complex that a reliable forecast of developments in the foreseeable future would appear practically unfeasible. Since only the valuation of the structured credit portfolio was done by independent experts and the Commission has not sufficient information for the assessment

of the real economic value of the whole portfolio, the Commission has at the current stage doubts regarding the compatibility of the measure.

(48) In addition, as regards the independent valuation of the structured credit part of the portfolio, the Commission questions at this stage some of the assumptions retained by the bank and pertaining to the choice of the rate used to discount cash flows and the treatment of correlation between assets included in the portfolio. The Commission consequently has doubts about the compatibility of the measures with the IAC regarding valuation.

Burden-sharing

(49) As regards *ex post* burden-sharing, section 5.2 of the IAC provides that the bank should be requested to contribute to the loss or risk coverage by the means of claw-back clauses or a first loss piece of at least 10 % and a clause of residual loss sharing of any additional losses of at least 10 %.

(50) In this respect, the Commission points out that the first loss piece at € [2-5] billion only corresponds to [1-5] % of the shielded portfolio. The Commission consequently has doubts about the compatibility of the measures with the IAC regarding burden-sharing.

Remuneration

(51) As regards remuneration, point 21 of the IAC provides that correct remuneration is another element of burden-sharing requirement. It shall ensure, as noted in Annex IV, that any pricing of asset relief must include 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.

(52) The balance sheet guarantee granted by the Länder is remunerated by the bank by a fee amounting to [3-6] % of its nominal value. In this respect, the Commission points out that Germany offers two independent arguments to justify the guarantee fee pricing.

(53) The first one is by calculation of the implied Risk Weighted Asset relief that the guarantee infers. Germany submitted that the implied Risk Weighted Asset relief of the risk shield amounts to € [15-60] billion. With the bank reasoning that a [8-11] % target capital ratio is necessary for long-term viability, the measure has an effect equivalent to a direct capital injection of € [1-6] billion. The bank reasons that a 10% capital return minus a risk-free rate would be an appropriate remuneration for such an equivalent capital injection. As risk-free rate, HSH proposes the 30-year German Government Bond rate of 3.533% at the time, resulting in a fee of [4-7] % on € [1-6] billion[16], or [2-5] % in relation to the nominal amount of the guarantee (€ 10 billion)[17]. As a result, Germany argues that a [3-6] % fee should suffice to be in line with the IAC. The Commission questions in this

[16] See Annex IV of the IAC: The necessary target return could be "inspired" by the remuneration that would have been required for recapitalisation measures to the extent of the capital effect proposed asset relief.

[17] [4-7] % of € [5-8] billion equals € [300-400] million, or [3-4] % of € 10 billion.

argumentation the use of the 30-year German Government Bond as the risk-free rate, which does not seem appropriate to be used in the pricing of a 5-year guarantee[18].

(54) The second, more direct pricing methodology claims that a second loss tranche, with attachment points at € [3-5] billion ([1-3] % of the exposure at loss, EAD) and € [12-14] billion ([5-10] % of the EAD) will have an implied (BBB) rating. […], acting as an advisor to HSH, claimed that in some of the structured Collateralised Loan Obligation (CLO) transactions in the market at the end of 2008, general attachment points of [10-25] % could potentially result in a (BBB) rating. […] then uses average implied CDS spreads over historical (pre-crisis) periods to obtain an average CDS spread of about [3-6] %. As an additional point, […] argued that, as the shielded portfolio comprises the large majority of HSH's current assets, the portfolio rating should correspond to HSH's rating.

(55) The Commission has doubts in regard to the second argument. First of all, as the portfolio has not been studied thoroughly, it is hard to fathom why some structured transactions from the end of 2008 would have portfolios that have similar characteristics to the HSH portfolio. There is also no correspondence between the attachment points of [10-25] % of the structured CLO transactions under consideration and the [1-4] % - [6-10] % attachment points of the guarantee. Finally, HSH's rating is dependent on an analysis of its complete balance sheet, not just its assets. There is no necessary direct relationship between the rating of the bank's asset portfolio and its independent credit rating.

(56) The Commission consequently has doubts about the compatibility of the measures with the IAC regarding pricing

4.1.5 The restructuring plan

Return to viability

(57) In the present case, the Commission considers that an in-depth restructuring will be required, because a […] valuation of the shielded assets according to the principles set out in the IAC […] without State intervention. The need for in-depth restructuring is also triggered because HSH received about € [3-13] billion of State aid in form of a capital contribution and asset relief measure, which is about [2-10] % of its RWA and exceeds 2 % of its total risk weighted assets, the threshold stipulated in point 55 of the IAC.

(58) As the Commission has indicated in its Restructuring Communication[19] the restructuring plan must restore the viability of the company within a reasonable time span. In that regard, the Commission notes positively that HSH Nordbank intends to concentrate on its core competences and to abandon or significantly reduce non-core and more risky activities.

(59) However, the Commission has doubts that HSH Nordbank will be able to restore its long-term viability. On the funding side, the Commission notes that although HSH acts as central institution for savings banks it does not have access to retail deposits. HSH thus continues to rely […] on wholesale funding. In [2012-2015] more than € [60-100] billion

[18] The 5-years German Government Bond benchmark rate at the valuation date was around 2.31%, which in this calculation would lead to an implied guarantee premium of [2-6] % on € 10 Bio.

[19] Commission communication on the return to viability and the assessment of the restructuring measures in the financial sector in the current crisis under the State aid rules, OJ C 195, 19.8.2009, p. 1.

will have to be refinanced on the wholesale market. The Commission has thus doubts whether the current funding strategy will be sustainable on a stand-alone […].

(60) According to the submitted restructuring plan HSH Nordbank plans to strengthen its position in corporate and private banking in Northern Germany. Assumed growth rates in this segment are […] above growth rates of the corresponding underlying markets. The Commission notes that the financial crisis has led in some business segments to increased competitive pressure because other banks are entering the market[20]. If the bank wants to increase its market share in corporate banking, where it has already about […] % share in its region, it has to compete for new customers with other banks that are also refocusing their business models on traditional banking activities. However, competition will be based on price, margins will be low and the growth expected according to the restructuring plan seems to be doubtful. Therefore, the underlying assumption of increasing margins in this segment is questionable, in particular in view of the expected competition.

(61) The second pillar of HSH's restructuring plan is built on financing of business activities such as shipping and transport which are volatile in nature. […] HSH expects decreasing competition in these fields. However, the prospects for growth and return on investments in these fields are rather poor, so that HSH's expansion in these markets, in which it already has proportionally high market shares, seems questionable.

(62) The third pillar, the capital market activities, has been strongly developed by the bank in the recent years. […] To compensate it the bank engaged in non-customer related capital market activities, such as proprietary trading or arbitrage activities, […]. Activities such as proprietary trading or arbitrage, which contributed to the crisis, should in the future be limited to the minimum. They are to a limited extent required in order to offer a full range of products to wholesale clients or to support refinancing for the international sector business. […]

(63) The underlying business plan is based on […] growth rates in volatile markets and activities which have been the reason for the losses in the past. […] focused on cyclical business areas and its reliance on wholesale based funding. The assumption that an upgrade to the previous (A) rating will be achieved in [2011-2014] might therefore not be realistic either. […]

(64) Furthermore the question of strategic consistency arises. […] In light of its […] vulnerability in credit and funding markets, the Commission has doubts whether HSH's business model will be viable in the long-term […].

Own contribution

(65) Regarding the own contribution, the Commission notes that the restructuring plan foresees no far-reaching proposals. The bank makes some contribution by way of divestiture although the scope remains vague.

(66) The Commission has doubts whether there was proper burden-sharing in the capital injection. The Commission notes that the recapitalisation of € 3 billion took place in the form of ordinary shares with voting rights (Core Tier 1 capital). The price of the new

[20] […], Report on HSH's Restructuring Plan of May 2008, requested by SoFFin.

shares in the total amount of € 3 billion was based on the valuation of the bank by […], which arrived at a value in a range between € [1.5-3.5] billion and € [2-4] billion (€ [18-28] per share). The average value of HSH based on the valuation amounts to € [1.5-4] billion (€ [18-28] per share). Since the business plan of HSH did not project sufficient profits for the period 2009-2012 to pay a 10% dividend on all ordinary shares, the issue price of the new ordinary shares was reduced by a discounted 10% dividend payment for the period 2009-2012 (€ [3-6] per share). The price per share paid by the Länder was therefore fixed at € 19.

(67) After the preliminary assessment of the capital injection the Commission is of the opinion that the price of the new shares is […] too high. The Commission is also of the view that the valuation of HSH Nordbank provided by […] is based on a business plan which is too optimistic and does not take into account […] factors. […][21] itself subsequently invalidated the result of its own report by indicating that the business plan seems to be too optimistic, that the forthcoming State aid procedure before the Commission might have serious impact on the bank and that the downgrading of HSH's rating from (A) to (BBB+) by S&P was not taken into account in the valuation.

(68) The downgrade of HSH […] reflected S&P's view that the bank remains under significant financial stress. It also considered HSH's strategic challenges as a large commercial bank, which focuses on cyclical niches and relies […] on wholesale-market funding for its sizable balance sheet. It also took into account ongoing dislocations in HSH's key markets, in particular, ship finance and commercial real estate, and its significant restructuring needs.

(69) Consequently, taking into account of the downgrade of HSH Nordbank would have had a […] impact on the valuation and lead to […] lower value of the bank. Finally […] outlook for the bank was rather negative because of the critical developments in sectors relevant for HSH's business model and funding difficulties on the capital market.

(70) […]

(71) Finally the Commission ascertains that […] discounts - taking into account the size of the new capital contribution, the difficult market environment and the fact that HSH is a non-listed bank - have not been made. In comparable capital increases the discounts made were in a range of 30 % to 60%.

(72) In view of the above, the Commission is of the view that the value of the bank before the capital increase and the balance sheet guarantee was […] or […]. Thus, the price paid by the two Länder for the new shares (€ 19) was much too high. Consequently the Commission is of the preliminary opinion that the owners not participating in the rescue aid measures, namely nine trusts advised by Flowers and the savings banks, benefited from those measures disproportionately by not being completely diluted and still owning 9.19% and 4.73% of HSH Nordbank.

(73) Therefore, should HSH Nordbank not propose genuine measures for burden-sharing of the savings banks and the nine trusts advised by Flowers the Commission might have to

[21] […], Report Indikative Unternehmensbewertubng der HSH Nordbank AG of 31 March 2009, update from 15 May 2009, p. 151.

ask for recovery of the probably unlawful aid from the nine trusts advised by Flowers and the savings banks.

(74) In addition, no clear proposals as regards the stakeholders have been put forward. Already in the rescue aid decision Germany has made a commitment that HSHS will not pay out coupons on its hybrid capital instruments given that the bank had recorded huge losses. The Commission expects such burden-sharing to continue as long as the bank has discretion to decide whether it will pay coupons on hybrid instrument or not. Moreover, the Commission is of the view that loss participation of these instruments […].

(75) On this basis the Commission has doubts that the aid is limited to the minimum and that the burden-sharing to the restructuring would be sufficient.

4.1.6 Avoidance of undue distortions of competition

(76) According to point 30 of the Restructuring Communication the nature and form of measures limiting the distortion of competition depends on the amount of the aid and the conditions and circumstances under which it was granted as well as on the characteristics of the market or markets on which the beneficiary bank will operate. No significant measures mitigating the distortive effect of the aid have been proposed. In particular as regards the winding-down bank, HSH Nordbank is still reviewing alternatives and looking for an alternative solution […].

(77) The bank considers the run-off of non-strategic business activities (especially Energy US, real estate financing in New York and Western Europe) and the consequent reduction of its balance sheet, the divesture of […] and […] and closure of […] international branches or representation offices and significant rescaling of branches in […] as measures aiming at the avoidance of potential distortion of competition.

(78) The Commission appreciates that HSH Nordbank will significantly reduce its balance sheet and its risk-weighted assets, but does not consider above described efforts as sufficient because a considerable part of this reduction in activities would, as in other banking cases, in any event be necessary for the restoration of viability. Therefore the Commission doubts that these measures are genuine measures for mitigating competitive distortions.

(79) In addition, as regards the sale of subsidiaries such as […] and […] the Commission has only been provided with target dates to sell them but with no firm commitments that they will be sold at the end of [2012-2015]. Therefore, Commission's uncertainty as to the timing of the implementation of these measures sheds doubts as to their effectiveness to mitigate distortions of competition.

(80) Moreover, the Commission appreciates the commitment not to advertise with the fact that the bank received State aid. However, this is insufficient to mitigate the distortion of competition and the Commission would expect further measures of a behavioural or structural nature, especially in Northern Germany, such as a commitment that the capital effects of relief will be used for providing credit to real economy and not for financing of a growth strategy (in particular for acquisitions), a commitment for no price leadership in the market or a commitment for restrictions on dividend policy or caps on executive remuneration.

4.2 Prolongation of the risk shield

(81) Given that Germany submitted a restructuring plan to the Commission, in line with the principles of the Rescue and Restructuring aid Guidelines and with Article 87(3)(b) EC, the rescue aid measures are therefore extended until the Commission has taken a final decision on the restructuring plan.

4.3 Conclusion

(82) On the basis of the above the Commission comes to the preliminary conclusion that the above measures of Germany benefitting HSH constitute State aid. The Commission considers this aid as rescue aid, but has doubts that such aid can be found compatible with the common market pursuant to Article 87(3) EC.

5. DECISION

In the light of the foregoing considerations, the Commission has decided to initiate the procedure laid down in Article 88(2) of the EC Treaty to verify the conditions of the Impaired Assets Communication regarding the definition of the eligible assets, valuation (including the valuation methodology), remuneration and asset management of the measure and prolongs the preliminary authorisation of the impaired asset measure provided for six months until it has reached a final decision on the measure. Furthermore the Commission will verify the conditions of the recapitalisation measure, the burden-sharing and the necessary measures to limit distortions of competition.

Should the Commission come to the conclusion that unlawful State aid was granted to bank owners not participating in the rescue measures, namely Sparkassen- und Giroverband für Schleswig-Holstein, the Schleswig-Holsteinische Sparkassen-Vermögensverwaltungs- und Beteiligungs GmbH & Co. KG and nine trusts advised by J.C. Flowers & Co. LLC, and that the final restructuring plan would not contain adequate burden-sharing measures which compensate for the that unlawful aid, the unlawful aid will be recovered from the savings banks and the nine trusts advised by Flowers.

The Commission requires Germany to provide in addition to all documents already received, information and data needed for the assessment of the compatibility of the aid and in particular:

– A valuation of the shielded portfolio by external experts;

– A detailed timetable for the implementation of the different measures; final deadline for implementation of the restructuring plan in its entirety.

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

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

The Commission informs Germany that it will inform interested parties by publishing this letter and a meaningful summary of it in the Official Journal of the European Communities. It will also inform interested parties in the EFTA countries which are signatories to the EEA

Agreement, by publishing a notice in the EEA Supplement to the Official Journal of the European Communities, and will inform the EFTA Surveillance Authority by sending a copy of this letter. All such interested parties will be invited to submit their comments within two weeks of the date of such publication.

If this letter contains confidential information which should not be published, please inform the Commission within ten 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. Your request specifying the relevant information 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