COMMISSION

COMMISSION DECISION

of 26 July 1995

giving conditional approval to the aid granted by France to the bank Crédit Lyonnais

(Only the French text is authentic)

(Text with EEA relevance)

(95/547/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular Articles 92 and 93 thereof,

Having regard to the Agreement on the European Economic Area, and in particular Articles 61 and 62 thereof,

Having, in accordance with the abovementioned Articles, given interested parties formal notice to submit their comments [1],

Whereas :

1. INTRODUCTION

By letter dated 2 May 1995 [SG/95/D/5500], the Commission informed the French authorities of its decision to initiate the procedure provided for in Article 93 (2) of the EC Treaty in respect of State aid granted to the publicly owned bank Crédit Lyonnais (hereinafter referred to as 'CL').

At the end of 1993 CL was the leading European banking group in terms of total assets (nearly FF 2 000 billion), employing over 71 000 people. Its business included commercial, investment and merchant banking, third-party fund management, insurance and other activities allied to banking. CL operated in France and abroad, with some 900 branches in Europe outside France and 800 in the rest of the world.

On 31 December 1993 the majority shareholder in CL was the French State, which held 55 % of the capital and 76 % of the voting rights. The other ordinary shareholders were Thomson-CSF (a subsidiary of the publicly owned Thomson group, with just under 20 % of the voting rights) and Caisse des Dépôts et Consignations (a publicly owned credit institution, with 4 % of the voting rights). The rest of the capital (22 %) was accounted for by preference shares quoted on the stock exchange.

After almost five years of rapid growth, CL recorded losses in 1992 (FF 1,8 billion) and 1993 (FF 6,9 billion). These were very heavy losses in proportion to CL's own funds, and its solvency ratio — the ratio of own funds to risk-adjusted assets — would have fallen below the 8 % legal minimum if the French authorities, acting at the request of the authority responsible for supervising the French banking system (the Commission Bancaire), had not taken financial support measures in 1994, essentially consisting of a capital increase and the underwriting by the State of certain non-performing assets. At the beginning of 1995 it became clear that CL would be recording further losses which would threaten its solvency; the French Government put together a new rescue package, involving the setting-up of another specific hived-off vehicle to take over FF 135 billion of assets, including CL's non-performing or poorly performing assets. The setting-up of this vehicle limited the accounting loss for 1994 to FF 12,1 billion.

The crisis affecting CL seems to be linked to a large extent to the bank's aggressive lending and investment policy in the 1980s and at the beginning of the 1990s, without there being sufficiently strict monitoring of exposure. Between 1988 and 1993 total assets almost doubled, while the value of CL's industrial portfolio increased almost five-fold to FF 50 billion. CL's assets on the property market exceeded FF 100 billion, placing the bank among the leading group of French credit institu-

[1] OJ No C 121, 17. 5. 1995, p. 4.

tions lending to property developers, with a higher proportion of business than was reflected in its position on the market. Furthermore, in an attempt to expand its activities in Europe and the rest of the world further, CL acquired a number of foreign banks at very high prices (for example, Chase Banque de Commerce in Belgium, Banco Comercial Español and Banca Jover in Spain, Credito Bergamasco and Banca Lombarda in Italy, BfG in Germany and Slavenburg Bank in the Netherlands).

On the liabilities side of the balance sheet, CL pursued, against a background of growing competition, a debt policy entailing high financing costs. A deterioration in the quality of its assets then caused the bank's rating to fall and added to its funding costs on the markets. At the same time, the rise in overheads continued to exceed the growth in total assets. In order to sustain CL's development, the French Government provided the bank, directly or indirectly, with considerable resources (more than FF 17 billion), particularly through transfers of public company securities and through cross-shareholdings (Rhône-Poulenc, Usinor-Sacilor, Aérospatiale, Altus). While this increased the bank's own funds for accounting purposes, it undermined the group's results owing to the low return on these holdings and the consolidation of the losses incurred by some of these enterprises.

The slowdown in economic activity, which caused property and stock market prices to fall and borrowers' situations to worsen, further accentuated the bank's problems. The interest margin narrowed appreciably, while long-term holdings in the industrial sector showed low or negative returns.

Following an initial examination of the case, the Commission had decided that the measures taken to support CL contained appreciable State aid components which could not be disclosed at that stage and which, on the basis of the information available at that time, were compatible with the common market.

2. GENERAL DESCRIPTION OF THE AID MEASURES

The measures taken by the French Government to support CL comprise a capital increase of FF 4,9 billion and the underwriting by the State of the risks and costs associated with assets transferred to a separate ring-fenced vehicle in what has been termed a 'hive-off' *(opération de défaisance)*. Under the first rescue plan, which was put into effect in 1994, the State underwrote only FF 18,4 billion of the FF 42 billion of assets transferred. In 1995, with the transfer of further assets, the State has underwritten the entire net value of all the assets transferred in 1994 and 1995 (almost FF 135 billion) and the interest on the loan of FF 145 billion granted by CL to a public company named SPBI to finance the hived-off vehicle.

The capital increase was subscribed in July 1994 by the three main shareholders, namely the State (acting through SPBI, a partnership controlled by the State and Thomson SIEG, a subsidiary of Thomson CSF), Thomson CSF and the Caisse des Dépôts et Consignations, in proportion to their holdings in CL's capital. Following this operation, the French Government's direct and indirect holding in CL rose from 78 % to 80,7 %.

Equity warrants were distributed to the shareholders in return for their investment. Each warrant entitles the holder to subscribe for a new share at a price of FF 774 per share within five years. The price is equal to the net asset value per share estimated on the basis of the 1993 accounts.

In the 1994 hive-off, almost FF 42 billion of non-performing property loans for which insufficient provision had been made, out of a total of more than FF 100 billion in property loans outstanding, were transferred to a CL subsidiary company set up for the purpose, called OIG. This company bought the loans at their net book value, paying with the money provided by a participating loan from SPBI. This participating loan was in turn financed by means of a loan from CL to SPBI. The three publicly owned shareholders of CL undertook to cover any losses on the realization of the assets, up to a ceiling of FF 14,4 billion, and part of the burden of refinancing the loan from CL to SPBI in the first two years, amounting to FF 2 billion a year. The State underwrote the assets transferred, an operation which was entered in the accounts for 1993, and CL was able to reduce the level of provisions and write-downs for non-performing assets and so to continue in business. In effect, the State had enabled CL to acquire a secure asset in place of doubtful assets which needed substantial provisions.

In 1995, in an operation to be entered in the 1994 accounts, a new hive-off vehicle has been set up : this is Consortium de Réalisations (CDR), a wholly-owned subsidiary of CL. Under the plan supplied by the French authorities, this subsidiary is to buy CL assets amounting to almost FF 190 billion, notably those held by OIG, including FF 55 billion in liabilities. The assets concerned consist of property assets essentially grouped in OIG, banking subsidiaries (SBT, SDBO and Colbert), financial backing for the film industry, and industrial holdings ; all of these are to be sold off or liquidated. The plan is that

80 % of the assets will be sold in five years and, if market conditions permit, at least 50 % will have been sold in three years. The healthy parts of the banking subsidiaries transferred to CDR will either be sold off to third parties or returned to CL by 31 December 1995, so that at the end of the 1995 financial year no active banking organization will any longer be involved in CDR.

To enable it to buy CL's assets, CDR is to receive a participating loan of FF 135 billion from SPBI. SPBI is to obtain financing from CL in the form of a non-participating loan of not more than FF 145 billion. It will then be in a position to grant the participating loan of FF 135 billion to CDR and to buy zero-coupon bonds for approximately FF 10 billion. These bonds will enable SPBI to show a return of about FF 35 billion by the end of 2014, and this is intended to enable it to absorb whatever losses CDR has made by then.

CL's loan to SPBI and SPBI's loan to CDR both reach maturity on 31 December 2014. CL's loan is to be repaid in instalments as and when assets are sold, the amount repayable each time being the amount thus realized. The annual rate of interest is to be 7 % in 1995, and 85 % of the money market rate in 1996 and thereafter. The participating loan given by SPBI to CDR is to be partially repaid at the end of each financial year: SPBI is to be repaid an amount equal to assets disposed of during the year and, if there are any losses on disposals, it will abandon claims on CDR to an amount equal to the losses shown by CDR.

As a result of the participating loan mechanism, therefore, CDR's losses will be borne by SPBI, that is to say by the State, up to the ceiling of FF 135 billion. Were CDR's losses to exceed that amount, they would be borne by CL, CDR's sole shareholder. CL consequently has a State guarantee in respect of the repayment of its loan to SPBI, which means that CDR's accounts do not have to be consolidated with those of the CL group for either prudential or accounting purposes. The mechanism thus enables CL to reduce the provisions and write-downs it has to make and to comply with the solvency ratio.

In return, SPBI will have a claim on CL under a 'better fortunes' clause. It is to receive a contribution of 34 % of CL's consolidated net profit (before account is taken of that contribution and the annual allocation to the fund for general banking risks and before imposition of French corporation tax), plus 26 % of that fraction of the profit exceeding 4 % of the group's consolidated capital (i.e. approximately FF 1 billion). The French authorities have also told the Commission that the State may deposit its CL shares with SPBI for a fixed term, in which case dividends and any proceeds on the projected privatization of CL would accrue to SPBI.

Under the contract of agreed objectives between the State and CL, CL is entitled to buy back certain industrial and commercial holdings at market value, up to an amount not exceeding 10 % of the present value of its portfolio of holdings, that is to say about FF 5 billion. In addition, any healthy parts of the banking subsidiaries transferred to CDR which are not sold to third parties will have to be bought back by CL before 31 December 1995, with the remainder being wound up.

According to the agreement, CL will provide CDR with assistance under the terms of a service contract which includes a profit-sharing clause in respect of certain assets, the details of which are to be settled later by agreement between the parties. However, the French authorities have since verbally confirmed that this clause is to be eliminated.

3. APPLICATION OF THE STATE AID RULES TO BANKS

3.1. Applicability of the State aid rules to banks and assessment of the existence of State aid

In examining State measures to support banks, it must first be borne in mind that the Treaty contains no specific rules governing State aid for credit institutions. The Commission is aware, however, of the special nature of the banking sector and of the great sensitivity of financial markets, even where difficulties are limited to one or other institution; this has to be borne in mind in applying the State aid rules.

In Directive 89/647/EEC [1] on a solvency ratio for credit institutions, the Council of the European Communities stated that 'in a common banking market, institutions are required to enter into competition with one another and [...] the adoption of common solvency standards in the form of a minimum ratio will prevent distortions of competition and strengthen the Community banking system'.

[1] OJ No L 386, 30. 12. 1989, p. 14.

In the same Directive, the Council also took the view that 'the development of common standards for own funds in relation to assets and off-balance-sheet items exposed to credit risk is [. . .] an essential aspect of the harmonization necessary for the achievement of the mutual recognition of supervision techniques and thus the completion of the internal banking market'.

These points are based on recognition of the fact that a minimum solvency ratio level constitutes, at one and the same time, a criterion of equal competitive conditions and one of the criteria for a bank's viability. However, State measures which have the effect of giving financial support to banks in difficulty to enable them to satisfy Community prudential standards may also contain State aid components. The Commission must therefore establish whether the State aid rules in the Treaty are being complied with in order to prevent any incompatible distortion of competition.

In a competitive environment, credit institutions are free to choose, subject to prudential requirements and the control of their supervisory authorities, the investment policy and the risk/yield combination of their asset portfolios which they consider to be most appropriate. A daring and aggressive policy may yield higher expected returns but it also entails a higher level of risk if it is not adequately controlled. The identification, control and limitation of these risks, which vary in nature and are frequently interconnected, constitute one of the basis aspects of the banker's trade. Where major risks lead to actual losses, these may reduce the bank's profits and affect the amount of own funds and the solvency ratio. A reduction in risk activities or an increase in capital may become necessary to restore the minimum required level of own funds and the ratio (8 %). Faced with such a situation, the bank's shareholders may provide additional resources if they believe they will see an adequate return on their investment. They will normally call for restructuring measures to be taken to reduce the level of risk.

Given that the alternative to a bank's winding-up is frequently a more costly operation overall than for an industrial enterprise owing to the — by definition — higher ratio of third-party funds to own funds and to the often greater responsibility of majority shareholders towards depositors, and given that the confidence of depositors must be preserved, the banking supervisory authorities impose constant and very strict controls on the management of banks and on shareholders in order to prevent the negative effects of a petition for bankruptcy.

They carry out inspections and may require corrective measures to be taken if they consider them to be necessary. Where prudential rules are infringed, they have a number of means of restoring normal banking activity conditions, ranging from warnings to the withdrawal of a credit institution's licence. They may also ask shareholders to provide support for the bank's recovery, particularly if its bankruptcy may have an undesirable negative impact on depositor confidence and perhaps on financial markets. This impact may be very great and even be out of proportion to the difficulties faced by the individual bank in question.

If the bank cannot be recapitalized by its shareholders or purchased by another institution, various solutions are possible : filing for bankruptcy, application of a mechanism for a controlled liquidation or sale by lots, or collective intervention by a number of other banks with the aim of preventing the possible undesirable negative effects mentioned above. If, without being under any obligation to do so, the private sector also invests substantial sums in a rescue operation, it may be concluded that no State aid is involved.

According to the scale of the possible crisis affecting the financial system, the supervisory authorities may act. In the case of publicly-owned banks, the State may also be called on to intervene as a shareholder.

If the State is providing all or most of the financial support, even at the request of the supervisory authorities, the Commission has to evaluate any State aid component in the measures taken by the State. Here, the Commission generally applies the test of the private market-economy investor as set out in its communication on public undertakings [1]. That communication states that there is an aid component in a transaction if it would not have been acceptable to a private investor operating under normal market conditions.

Turning to the question of public holdings in company capital, the Commission made clear its view in a 1984 communication [2] that such a transaction would not be acceptable to a private investor, and that the presence of aid could therefore be presumed, where the financial position of the company is such that a normal return (in dividends or capital gains) cannot be expected within a reasonable time from the capital invested or where the risks

[1] Commission communication to the Member States on the application of Articles 92 and 93 of the EC Treaty and of Article 5 of Commission Directive 80/723/EEC to public undertakings in the manufacturing sector (OJ No C 307, 13. 11. 1993).

[2] *Bulletin of the European Communities*, No 9, 1984.

involved in such a transaction are too high or extend over too long a period.

In the same way, the Commission takes the view that there is a presumption of State aid in a State guarantee if the guarantee is necessary to the survival of the company — in other words, if the aid component is equal to the amount guaranteed — and if it lasts for an exceptional length of time or entails a very high level of risk.

To enable the Commission to establish whether the private market-economy investor test is satisfied, it must be shown that the State in its capacity as shareholder is indeed acting as a private investor would. A coherent and detailed restructuring plan must be presented which shows that it can reasonably be supposed that there will be a normal return on the State's investment in the whole operation which would be acceptable to a private investor in a market economy. Otherwise, there is a State aid component.

Article 10 (3) of the abovementioned Directive 89/647/EEC on the solvency ratio also stipulates that 'if the ratio falls below 8 % the competent authorities shall ensure that the credit institution in question takes appropriate measures to restore the ratio to the agreed minimum as quickly as possible'. This provision calls for three points to be made. First, an obligation is imposed on the supervisory authorities to ensure that appropriate measures are taken to restore the bank's solvency. Clearly, to be appropriate such measures must not only restore the ratio from an accounting viewpoint but must also entail more substantial action designed to ensure that the bank is effectively restructured and is restored to permanent health so that the same problems are not encountered in the future.

Secondly, it must be pointed out that the supervision obligation is justified, as is emphasized in the preamble to the Directive, by the need to prevent any crisis of confidence and to maintain fair competition. Continual strict supervision is very important because it may entail corrective measures designed to restrict banks' exposures and prevent a crisis and its possible disastrous consequences, and so limit the amount of resources needed for any rescue operation. Monitoring by the supervisory authorities therefore helps to minimize any aid required for recovery.

Since the Directive's aim is to safeguard not only the stability of the system but also equal competitive conditions, the supervisory role which the Directive assigns to the supervisory authorities through monitoring of the solvency ratio has to be carried out within the framework of the rules governing competition, and in particular those relating to State aid, in order to ensure fair competition. The supervisory authorities must therefore ensure that credit institutions do not incur too many risks which may affect the solvency ratio and which are underpinned by explicit or implicit State support because the institutions in question are publicly owned or are 'too big to fail'. An automatic injection of capital to meet the solvency ratio requirement or any other equivalent measure by the State would have the effect of endorsing the failing institution's unfair competitive practice prior to the crisis.

Finally, it should be pointed out that this provision of the Directive does not impose restoration of the ratio at any price and by any means. It is clear, however, that failure to comply with solvency standards entails withdrawal of the credit institution's authorization and, consequently, its winding-up or bankruptcy. According to point (d) of Article 8 (1) of Council Directive 77/780/EEC [1], insufficiency of own funds constitutes a ground for the competent supervisory authorities to withdraw a credit institution's authorization [2].

Even where national rules provide for compulsory recapitalization of a bank in difficulty, such recapitalization would constitute aid if it were not granted under normal conditions that were acceptable to a private investor in terms of return. In comparing the actions of the State and those of a market-economy investor, the evaluation of the amount of aid must be based on a comparison between the cost of the operation and its correctly discounted value [3].

Even if State intervention is judged to be necessary for reasons which go beyond the problems of the aided institution, that does not remove the obligation to check that the solution involving least distortion has been chosen; where major distortion is inevitable, a substantial *quid pro quo* must be required which benefits other sector operators and offsets the negative effects and the limitation of the possibilities for more radical but sometimes unavoidable solutions that apply in the industrial sector, which is less sensitive to difficulties encountered by an individual enterprise.

[1] OJ No L 322, 17. 12. 1977, p. 30.
[2] It is also possible in principle for the supervisory authorities to waive the 8 % ratio requirement temporarily provided that the required level is quickly restored.
[3] Commission communication to the Member States published in OJ No C 307, 13. 11. 1993, in particular point 37.

In conclusion, the State aid rules must also be applied to banks in order to determine whether there is an aid component in a State measure taken in support of a bank in difficulty, the distortions which such support creates and the conditions the State must meet to ensure that the aid is in line with the common interest.

3.2. Assessment of the compatibility of State aid for one or more banks

If it determines that the measures under consideration do constitute State aid falling within the scope of Article 92 (1) of the Treaty, the Commission has then to establish whether that aid is compatible with the common market.

Where circumstances outside the control of the banks cause a crisis of confidence in the system, the State may need to give its support to all credit institutions in order to avoid the negative impact of such a systemic crisis. In the case of a true systemic crisis, therefore, the derogation provided for in point (b) of Article 92 (3) may be invoked in order 'to remedy a serious disturbance in the economy of a Member State'. For aid to be compatible with the common market, it must be granted in a neutral fashion from the viewpoint of the competition of the State concerned; it must cover the whole of the banking system and must be confined to what is strictly necessary.

While difficulties encountered by one or a number of banks do not necessarily lead to a crisis of confidence throughout the system, the failure of a single bank of some size, though due to internal management errors, may place a number of other credit institutions which are financially linked to it in difficulty, thereby causing a more general crisis. State support may be necessary but that should not mean unconditional support for the failing institution, and the support should not be provided without serious action being taken on the definitive restructuring and on the individual limitation of the competitive distortion caused by the aid.

In assessing whether or not aid granted to large banks is compatible with the common market, the Commission checks that the aid does not adversely affect trading conditions to an extent contrary to the common interest, in accordance with point (a) or (c) of Article 92 (3). It must therefore verify that a coherent and realistic recovery plan has been duly notified. As regards the recovery plan, it bears in mind that in certain situations special measures may be needed to prevent the undesirable repercussions which the failure of a large bank could have on financial markets. The need to ensure that measures are in line with the common interest may require the impossibility of an institution becoming bankrupt to be offset by major restrictions on its competitive strength.

In its guidelines of 27 July 1994 on State aid for rescuing and restructuring firms in difficulty [1], the Commission stated that, in order not to undermine the common interest and therefore to be declared compatible with the common market, State aid had to comply with the following four principles:

(a) the aid must restore the viability of the firm within a reasonable timescale;

(b) the aid must be in proportion to the restructuring costs and benefits and must not exceed what is strictly necessary;

(c) in order to limit distortions of competition for competitors, aid measures must have the least distorting effect on competition possible and the firm must make a significant financial contribution to the restructuring costs;

(d) measures must be taken to compensate competitors as far as possible for the adverse effects of aid.

The Commission takes the view that these four general principles can be applied to banks provided that account is taken of any undesirable negative effects of applying them on the financial system and on public confidence in the banking sector and of the need to comply with Community rules in the banking sphere.

Where the State is the main shareholder of the bank in crisis, its role as shareholder must be separated from its role as the supervisory authority required to safeguard confidence in the banking system. This latter task may lead the State to take measures in support of the bank that are additional to what is really necessary to restore the bank's viability. The Commission can therefore take a more favourable view of support measures adopted by independent supervisory authorities, especially in the case of publicly owned banks, if they guarantee the neutrality of State intervention and equal competitive conditions.

4. THE FRENCH AUTHORITIES' REPLIES TO THE REQUESTS FOR INFORMATION MADE BY THE COMMISSION IN ITS DECISION TO INITIATE THE PROCEDURE

In its decision to initiate the procedure provided for in Article 93 (2) of the Treaty, the Commission expressed its opinion on the general outline of the recovery plan. It accepted that an attempt was being made to tackle the

[1] OJ No C 368, 23. 12. 1994, p. 12.

bank's fundamental problem, that a major effort was being demanded of CL and that account was being taken of the legitimate interests of competitors by curbing CL's expansion and reducing its activities in certain areas. It noted that further recapitalization had been avoided, that unproductive assets had been hived-off from the bank and were to be sold and that CL was to refocus on its core business. In assessing the compatibility of the aid, the Commission also confirmed that it would give special weight to the effort demanded of CL, and particularly to the slimming-down of the balance sheet, to the principle of a 'better fortunes' clause which has the effect of moderating future expansion by CL, and to the far-reaching rationalization of its banking activities, including further large reductions in staffing and geographical spread.

Nevertheless, the Commission believed that there were important points which needed clarification. Without further information, the Commission could not conclude that the plan was compatible with the common market. It also reaffirmed the general principles governing State aid to firms in difficulty, namely that aid be confined to the strict minimum so that the main recovery effort was made by the firm itself, that there should be a *quid pro quo* sufficient to offset the distorting effect which aid on this scale would have on competition, and that a restructuring plan enabling the firm to return to viability within a reasonable time should be fully implemented.

The Commission particularly asked for further information regarding :

(a) the detailed lists of the assets transferred, referred to in the agreement concluded between the State and CL, and the assessments carried out by the consultant banks and by the Commission Bancaire ;

(b) the restructuring plan, broken down by activity and geographically, showing CL's return to viability ;

(c) the separation between CDR and CL, and the arrangements regarding CL's stake in the monitoring of CDR's management ;

(d) the arrangements for the repurchase by CL of the hived-off assets ;

(e) the possible carry-over of tax losses ;

(f) the total State cover for all of SPBI's liabilities ;

(g) the cost of restructuring the hived-off assets in order to sell them ;

(h) the conditions for privatizing CL, particularly regarding the future of the constraints imposed on CL following such privatization ;

(i) the possible condition regarding the withdrawal of SPBI's minority shareholders ;

(j) the sale of FF 100 billion of assets outside the CDR/SPBI mechanism ;

(k) any other sale on the periphery or in the field of CL's core activities ;

(l) OIG's activities in 1994, including, for example, its financial dealings.

It is necessary next to set out the information provided by the French authorities. That information was supplied in writing (letters of 26 and 28 April, 23 June and 6 July, registered on 27 April (A/33402), 3 May 1995 (A/33499), 26 June (A/34961) and 7 July (A/35317) respectively) or verbally during discussions between representatives of the Commission, the French Government and CL (held on 28 April, 17 May, 20 and 27 June, and 5 July 1995).

4. (a) The aim of point (a) was first to carry out a check on the hived-off assets and their transfer prices. The Commission also needed further information to enable it to estimate the aid content of the rescue measures more precisely. The support effectively provided by the State has to be quantified in order to determine what can be expected of the recipient in return and to ensure that the aid is limited to what is strictly necessary.

As regards the accounting check, CL has reported the transfer of FF 190 billion of assets, to which FF 55 billion of liabilities are linked. An examination of the documents sent shows that the net amount of hived-off assets (securities plus claims) is some FF 130 billion. To this amount must be added the transfer of FF 16 billion of quantifiable guarantees and a number of other, non-quantifiable guarantees : these consist in particular of potential risks likely to arise from liability guarantees provided for third companies by CL or its subsidiaries, from disputes and from commitments contracted by legal persons controlled by CDR. The table below shows the purchase values of the assets, broken down by broad categories, as communicated by CL :

Table 1

Transfer values of hived-off assets risks

(in billion FF)

	Securities	Claims	Total assets	Quantifiable guarantees
CLBN and film industry	2,3	18,7	21	2,4
Other financial assets (1)	14,4	48,9	63,3	11,1
Other non-financial assets (2)	34,8	11,1	45,9	2,8
Total assets	51,5	78,7	130,2	16,3

(1) [. . .]
(2) [. . .] (*)

The transfer prices of the assets are set as follows :

— claims, fixed-interest securities and shares in non-consolidated companies : book value at 31 December 1994 net of provisions (except for claims on the MGM group which are being transferred at their gross value),

— shares in consolidated companies : prices are set such that they do not cause any variation in the consolidated own funds of the CL group as at 31 December 1993.

Given that, under the agreement between the State and CL, the transfers will take place with retroactive effect from 1 January 1994, the yield and costs arising from the hived-off assets over the period between 1 January 1994 and the date of transfer had to be transferred to CDR. In accordance with this principle, the transfer prices of the securities have been increased by an amount of interest calculated at a rate of 4,845 % (85 % of the money market rate for 1994, i.e. 5,7 %). In the case of claims, the principle has been applied on a standard basis : CL is waiving the right to reimbursement of financing costs and is retaining interest yield where that has been entered in the accounts.

4. (b) In its decision to initiate the procedure, the Commission requested that it be provided with CL's recovery plan to enable it to assess the compatibility of the aid, and in particular the capital increase. The Commission requested more detailed financial information on CL's various economic and geographical sectors of activity in order to establish that the aid did not exceed what was strictly necessary and that CL could return to viability without further support from the State in the future. This information is essential if the Commission is to determine whether or not CL's reference scenario for the next five years is realistic and, in particular, if there is a prospect of reducing CL's operating ratio (that is to say the ratio of overheads plus depreciation to net receipts from banking) in four years from its current level of 81 % to a level below that of its main competitors (i.e. around 70 %), thereby producing a corresponding improvement in CL's results.

The French authorities have transmitted the business plan drawn up by CL. With a view to restoring CL's capacity to generate profits, the business plan analyses the main problems responsible for the bank's difficulties, namely excessive and poorly controlled growth, runaway overheads and insufficient control over exposure. Following this analysis, the plan divides into three main areas :

(a) a process of refocusing on priority activities, with a freeze on significant external expansion. CL will continue its commercial banking activities in France (with a further segmentation of its customer base, the development of new distribution channels and measures to maximize the performance of its branch network) and to provide banking facilities for the large companies and major investors of the world. It will also reduce the global geographical spread of its activities : retail banking activities outside Europe and ancillary banking activities outside Europe will be sold off. CL plans in particular to sell all its Latin American subsidiaries in 1995. Other sales will take place in its international network. CL will also sell or close those retail banking activities in Europe which have no prospect of producing a satisfactory return. In this context, CL has already closed all its retail banking establishments in the United Kingdom this year. The figures set out in the business plan include the sale of CLBN in 1995 and the sale of other foreign subsidiaries in subsequent

(*) Throughout the text, blanks between square brackets indicate business secrets which have been omitted.

years following their restructuring. All other things being equal, this refocusing operation will lead to an estimated reduction in CL's balance sheet of some FF 100 billion over a four-year period, leaving aside the transfer of assets to the hived-off structure.

(b) Improved productivity, as reflected in the reduction in the operating ratio (overheads plus depreciation/net receipts from banking) from more than 80 % to 70 % in four years. The measures taken in this regard fall under two main headings, the first of which covers action on per capita wage costs and the reduction in staffing. At the end of the first phase of the plan in 1994, 1 500 jobs had been eliminated in France. The aim is to reduce jobs by some 2 400 in 1995. The final phase of the plan — covering the period from 31 March 1996 to 31 March 1997 — should bring a comparable improvement in productivity. It was on that basis that the provisions were made for restructuring in 1994. In Europe the aim is to cut the workforce from [...] in June 1994 to [...] in December 1995. The number of people employed in commercial banking outside Europe (currently 11 600) will be reduced [...] as a result of the strategic refocusing operation. To this first type of measures must be added the reduction in other costs, especially at administrative level.

(c) Monitoring and control of risks — an objective which CL expects to achieve mainly through reorganization of its commitment function, measurement of the cost of risk and improved recovery, in addition to the beneficial effect of the hived-off risk vehicle.

The table below shows the CL group's main accounting aggregates after restructuring for 1994-99, as presented by CL.

Table 2

Estimated changes in the CL group's accounting aggregates (1)

(in billion FF)

	1994	1995	1996	1997	1998	1999 ... 2014
Net receipts from banking	[...]	[...]	[...]	[...]	[...]	[...]
Gross operating result	[...]	[...]	[...]	[...]	[...]	[...]
Participating clause	—	(0,3)	(0,5)	(1,1)	(1,9)	(2,3) (6,0)
Net result before tax	[...]	[...]	[...]	[...]	[...]	[...]
Tax	[...]	[...]	[...]	[...]	[...]	[...]
Net result, of which	(11,1)	1,8	2,3	2,9	3,6	3,9 13,6
— the group's share	(12,1)	0,7	0,9	1,3	1,9	2,3 4,2

(1) The results after 1999 are based on the assumption of a growth in pre-tax profits of 4 % a year and the reinvestment of the previous year's net profit at the money-market rate used for drawing up the business plan, i.e. 4.67 %.

The forecasts for the basic activities and the figures available in the business plan for 1995-96 are an aggregate of the forecasts transmitted by operational managements and a number of specifically targeted measures relating mainly to net receipts from banking and overheads as broadly defined, the results of which were then allocated to the basic entities.

For the years 1997, 1998 and 1999, the forecast was made not by reference to the most basic unit level but in a more general manner for each of the group's main activities.

CL's business plan is based on the following hypotheses:

— that short-term interest rates will remain low throughout the period in question in Europe (in France 4,78 % in 1995 and 4,67 % thereafter) but will rise in the United States (from 6,06 % to 6,45 %),

— that long-term interest rates will remain stable,

— that the US Dollar's position will improve compared with 1994 and the DM/FF parity will remain stable,

— that the economic environment will reflect the expected improvement in economic trends in Europe, thereby permitting a reduction in the amount allocated to provisions up to 1997.

The results were presented by CL with the following comments:

— net receipts from banking will be down in 1995 [...] and in 1996 as a result of the change in the 7 % return on the CL loan to SPBI to 85 % of the money-market rate (i.e. 4 % according to the interest-rate hypothesis adopted for the modelling exercise). In subsequent years, the positive impact of SPBI's reimbursements to CL as hived-off assets are sold will be offset by the sale of certain European subsidiaries and by restructuring effects,

— overheads and depreciation will diminish throughout the life of the plan. The restructuring measurers will have their automatic impact linked to the reduction in the workforce,

— the operating ratio will show a constant improvement, falling from [...] in 1994 to [...] in 1996 and, finally, to [...] in 1999,

— the trend in net allocations to provisions is based on the assumption that the catching-up process will be completed in [...], the high point of the banking cycle,

— the other elements include the life assurance contribution [...] and the exceptional capital gains and losses realized on sales.

Table 3 shows the trend of CL's profitability ratio according to the business plan (group results before deduction of participating clause in relation to capital).

Table 3

Return on capital of Crédit Lyonnais

(in billion FF)

	1994	1995	1996	1997	1998	1999
Results (1) (a)	(12,1)	1	1,4	2,4	3,8	4,6
Group capital (2) (b)	31,4	31,8	32,7	34,0	35,9	37,1
Profitability ratio (a/b) not significant	n.a.	3,1 %	4,3 %	7,0 %	10,6 %	12,4 %

(1) Group results prior to deduction of participating clause.

(2) Group capital, including fund for general banking risks, after participating clause and distribution (dividends will be paid as from 1999).

4. (c) When it initiated the procedure, the Commission requested a clearer separation between the hived-off structure (CDR) and CL in order to ensure independent control of the management and sale or liquidation of the transferred assets. The Commission felt that, even though savings could have been made in the management of certain areas (notably banking and property) by the CL teams, there was a clear risk of conflicts of interest arising. These possible conflicts of interest must be eliminated through a clear separation between CDR and CL and through greater direct influence by the State. The same concern has been expressed by the interested parties.

In the course of the procedure, the French authorities provided the Commission with the final version of the articles of the agreement between the State and CL concerning the management of CDR, and that version indicates that the initial draft has been amended. According to those amendments, the appointment of CDR's managing agents, which company law entrusts to the shareholder CL, will be submitted to the State for approval. An advisory monitoring committee is also to be set up which will consist of three members appointed by SPBI under the direct control of the Minister for Economic Affairs, two members appointed by CL and five experts appointed by the Minister for Economic Affairs. According to the agreement, the appointment of the members nominated by CL is subject to the Minister's approval.

The advisory committee has very extensive powers. It will have to express a view on all major decisions committing CDR or its subsidiaries and concerning, for example, sales of assets, additional financing operations or disputes which exceed thresholds laid

down in the agreement and which may subsequently be amended by the committee's rules of procedure. Although, legally speaking, these opinions are merely advisory, they have the effect, if negative, of ruling out financial responsibility on the part of SPBI. In practice, the advisory committee will have the power to reject such operations.

In completing its tasks, the committee will be able to carry out audits of assets or transactions effected. In particular, selling instructions will, unless expressly approved by the committee, be entrusted to third-party banks to ensure an independent evaluation. This safeguard will also apply to the management of assets, which, if necessary, will be entrusted to another establishment.

As regards the profit-sharing clause designed to encourage CL to manage the hived-off structure well, the French authorities have made it known informally that the article of the agreement relating to that clause will not be implemented.

4. (d) With regard to the possible repurchase by CL of certain hived-off assets, Annex 12 to the agreement requires any selling instructions to be entrusted to third-party banks and CL will have to request the express and prior agreement of SPBI before acquiring an asset. Particularly in the case of a planned sale to a third party other than the CDR group, a purchase by CL must be carried out on terms, especially regarding price, that at least match those proposed by the third party other than the CDR group. In the event of a spontaneous sale at any time as part of the management of the assets, SPBI will be able to require CL to compete with third parties. In this case and in the case of the sale of the hived-off banks, the price of acquisition by CL will, if SPBI so requests, be set jointly by two commercial banks, appointed by CL and SPBI respectively as competent experts.

4. (e) The Commission had also taken the view that the possibility open to CL to carry over tax losses was a problem which had to be dealt with according to the principles laid down in the rules governing restructuring aid. The complainants also called for this possibility to be eliminated.

At the end of 1994 the tax group made up of CL and 71 of its subsidiaries had a loss carry-over of the order of FF 29 billion, the result mainly of the activities of the parent company in metropolitan France. According to CL's forecasts, the group's result for tax purposes should be slightly positive and should thus consume part of the tax loss which can be carried over for five years only, except for that part of the loss arising from the depreciation of property assets (i.e. FF 4,8 billion), which can be carried over indefinitely.

[. . .]

The French authorities have also confirmed that, in the event of a privatization of CL together with the probable transfer of the 'better fortunes' clause, the possibility of carrying over losses can in any case be reviewed in such a way as to make any such carry-over impossible.

4. (f) The Commission had stated that it could not declare total State cover which might undergo major variations to be compatible with the common market. Whilst it is aware that the precise cost of the underwriting to the State is very difficult to determine now, given the volatility of the value of the assets, the Commission must obtain an estimate of the final cost of the operation to the State, even within a range between two extreme values, in order to be able to assess compliance with the State aid rules, particularly as regards the limitation of the aid to what is strictly necessary and the compensating arrangements. In the event of the approved cost overshooting, the Commission will re-examine the case.

Furthermore, it should be pointed out that, as SPBI is a partnership with two partners — the State and Thomson SIEG — and Thomson SIEG's liability is limited to FF 1 000 according to SPBI's articles, the State remains solely responsible for SPBI's net liabilities. Although this liability is unlimited, the amount of SPBI's net liabilities can be estimated as the difference between CL's loan to SPBI (FF 145 billion) and SPBI's receipts, notably those from the zero-coupon bonds, the 'better fortunes' clause, the participating loan to CDR and the counter-guarantee provided by CDC and Thomson CSF against part of OIG's losses.

The French authorities have confirmed that the State's underwriting (through SPBI) of CDR's risks and costs is limited to the amount of SPBI's participating loan to CDR, i.e. FF 135 billion, and that a lower limit could not be set without jeopardizing the approval of the deconsolidation of the hived-off structure from CL's accounts by the auditors and the supervisory authorities.

4. (g) The aim of the hiving-off mechanism is to enable CL to avoid entering substantial provisions in the accounts, estimated with the auditors' technical assistance, to be FF 60 billion. This amount includes FF [...] billion of quantifiable risks estimated on the basis of the 30 June 1994 accounts (including the FF [...] billion of quantifiable guarantees referred to at point 4 (a)), FF [...] billion of carrying costs for the 1994 financial year and FF [...] billion of provisions for the first half of 1994 against exceptional situations. According to the information supplied by the French authorities, the gross carrying cost for 1995 can be estimated at some FF 4 billion. No estimate can be made for the following years.

4. (h) Given the length of the period in which the financial mechanism for supporting CL is to be applied (20 years), the Commission had requested clarification concerning CL's future privatization, and, in particular, concerning any amendments to the plan's conditions in such an eventuality, especially as regards the 'better fortunes' clause and the cover provided by the State.

The French authorities have indicated that privatization of CL remains their objective but that neither the date nor the conditions governing such privatization can be set given the uncertainty over the time needed for restructuring the bank. However, an initial examination will be carried out in five years' time to check whether or not CL can be privatized. Before then, there will have been a detailed stocktaking on 31 December 1997 of the implementation of the recovery plan in order to review, where appropriate, its parameters. CL's privatization will be conditional upon the State, via SPBI, securing a position of financial balance from the unravelling of the financial arrangements. With this in mind, the French authorities have confirmed that the French Government has no intention of abandoning, without adequate compensation at the time of privatization, the clause entitling SPBI to a share of CL's profits. Consultant banks will then assess whether the compensation is adequate.

In the course of the discussions between the Commission's representatives and the French authorities, the latter reaffirmed their intention to privatize CL, in principle within five years if the business plan is observed and the bank is restored to viability.

The French authorities have also confirmed that the proceeds of privatization will contribute to the final balancing of SPBI. With that in mind, the Government's holding in CL may be transferred to SPBI.

4. (i) The Commission had requested more detailed information on the involvement of the minority shareholders (in particular, Thomson and CDC) in CL's recovery plan, and in particular on the possible condition regarding the withdrawal of those shareholders from SPBI.

The French authorities have emphasized that Thomson CSF and CDC remain guarantors of OIG's losses if they exceed FF 12,3 billion, subject to a ceiling of FF 1,77 billion for Thomson CSF and then, if necessary, to one of FF 300 million for CDC. The call date for this commitment has been put back to 31 December 2012.

As regards SPBI, the French authorities have pointed out that it is a partnership with two partners : the State and Thomson SIEG, a subsidiary of Thomson CSF. According to SPBI's articles, Thomson SIEG's liability is limited to the amount of its participation in SPBI, namely FF 1 000. No provision is made for the withdrawal of Thomson SIEG.

4. (j) The French authorities had announced that CL would reduce the size of its balance sheet by at least FF 100 billion as soon as possible, leaving aside the effects of creating CDR. They have confirmed this reduction, specifying that it may take place through disinvestment (whether of a banking or non-banking nature), disposals of claims, securitization and sales of securities.

The authorities have stated, in particular, that the entire banking network in Latin America has been put up for sale, selling instructions have been issued or plans for such sales have been drawn up for other international components of the group, the Banca Lombarda in Italy has been sold, and CLBN (Netherlands) and a specialist French subsidiary have been put up for sale. The sales undertaken account for more than FF 120 billion of assets in CL's consolidated balance sheet, excluding securitization (almost FF 14 billion).

4. (k) The business plan provides for CL's operations to be refocused on the two core activities of commercial banking in France and providing banking facilities for large enterprises and major investors of the world. CL has stated that retail banking activities outside Europe and ancillary banking activities outside Europe are to be sold off. The French authorities have not provided details of any additional sales.

4. (I) The French authorities have provided the Commission with a provisional report on OIG's activities and accounts. The 1994 results are not very significant since the start-up has been very slow. Assets totalling FF 2 billion have been sold, while the cost of carrying the assets in the portfolio has corresponded to FF 2,5 billion of new funds. That amount increased to FF 3,3 billion in March 1995 owing to the continuing very weak situation of the property market.

5. COMMENTS RECEIVED IN THE COURSE OF THE PROCEDURE

5.1. Reactions of interested third parties

Banque Nationale de Paris (hereinafter referred to as 'BNP') and Société Générale, two French banks of comparable size to CL, have transmitted their comments on this case to the Commission. As the two sets of comments received are very similar, their arguments are set out below as a single presentation.

The association of employee and former employee shareholders of the CL group has expressed its concern to the Commission regarding CL's future, particularly with regard to the reduction in its size. It has also pointed out that the aggressive and daring policy pursued by CL during the second half of the 1980s was explicitly supported by the French Government.

The Office of the United Kingdom's Permanent Representative to the European Union and the British Bankers' Association have also sent two letters expressing their agreement with the Commission's approach to the application of State aid rules to banks, whilst at the same time stressing the need to preserve economic operators' confidence in the reliability of the banking system. As regards CL, they argue that the Commission should ensure that the aid is limited to what is strictly necessary and that CL should provide a substantial *quid pro quo* in the form of asset sales and a size reduction.

The Office of the Danish Permanent Representative to the European Union also sent a letter expressing its approval of the approach adopted by the Commission. However, the Danish comments arrived after the expiry of the reply deadline set in the Commission's notice published in the *Official Journal of the European Communities* and they are therefore simply reported for information purposes. The Danish authorities have also stressed that in certain cases urgent and immediate measures need to be taken to prevent the danger that the filing for bankruptcy by one or more major banks leads to a systemic crisis.

The arguments put forward by the French banks are summed up below:

I. the rescue plan does not provide a clear indication of the strategic objective sought. Without a clear and significant reduction in the geographical spread and range of CL's activities, the State support is likely simply to reconstruct the identical bank;

II. the capital committed does not yield a normal return. The plan comprises an amount of State aid, net of CL's contributions, of between FF 50 billion and FF 62 billion (value as at 1 January 1995). This amount is obtained by adding together the discounted values of the capital increase (FF 5,3 billion) and the hiving-off operation (between FF 54 billion and FF 66 billion) and deducting the discounted return from the zero-coupon bonds (FF 7,8 billion) and the 'better fortunes' clause (FF 1 billion). The discounting rate used (7,81 %) has been obtained from the French authority's estimates of the value of the zero coupon. The estimate of the cost of the hiving-off operation has been based on the assumption that the entire portfolio of transferred assets will be sold within five years and that a carrying cost of between 5 % and 6 % will have to be borne each year;

III. the plan will create serious competitive distortions which are not offset by any significant restructuring effort by CL. According to the complainants, the highly aggressive policy pursued by CL during the period from 1987 to 1993, and particularly its acquisition of banking and industrial holdings at very high prices, had already largely been financed by the State (through the transfer of almost FF 20 billion of capital, whereas self-financing accounted for less than FF 6 billion). Furthermore, through its disproportionate activity, CL has been a major factor in the worsening property crisis in France. Before the hiving-off operation, CL accounts for almost a third of total lending to property developers (FF 105 billion out of FF 324 billion), more than twice the total commitments of BNP and Société Générale, institutions of similar size to CL. In view of this, the conditions governing the plan's implementation impose few constraints, and CL's slimming-down exercise is purely a possibility given that the rationalization measures taken in France by CL are of the same type and scale as those of its competitors (e.g. in 1994 the workforce employed by CL in metropolitan France fell by 2 % over the same area of activity, compared with a reduction in BNP's workforce in metropolitan France of 2,3 %) (1);

IV. the following corrective measures should therefore be envisaged:

(1) BNP reports that in the period from 1992, 1993 and 1994 French public banks, faced with losses of some FF 40 billion, received public fund injections of FF 25 billion and guarantees for hiving-off operations amounting to more than FF 180 billion.

1. the management of CDR should be independent in order to prevent any possible conflict of interest (the capital, the managing bodies and the staff should be totally independent of CL);

2. Altus, SDBO and Colbert should remain part of the CL group (which should itself bear the costs connected with the liquidation of those banks);

3. there should be a ceiling on the State guarantee;

4. the State operating subsidy provided for CL, which stems from the substitution in CL's accounts of the hived-off non-profitable assets by the SPBI loan, should be greatly reduced;

5. the carrying-over of tax losses should be cancelled;

6. the 'better fortunes' clause must be locked in for the period initially planned (20 years), whether CL is privatized or not;

7. CL should sell substantial parts of its operations, both within and outside Europe;

8. CL's commitments should be clearly specified and identified and should be irrevocable; furthermore, an annual public report should provide details of the application of the plan.

Most of the comments made by the two French banks, which had already been taken into account by the Commission when the procedure was initiated — either in the assessment of the aid content or in the request for information — are discussed in greater detail in the assessment of the aid content of the operation and in the examination of its compatibility.

However, the Commission takes the view that some of the complainants' arguments cannot be accepted, particularly those referred to at points 2 and 4. Point 3 is not pertinent to the problem of the Commission's assessment of the aid content of this guarantee.

The complainants' call for Altus, SDBO and Colbert not to be transferred to the hived-off vehicle would not seem to be acceptable, for two reasons. First, if those subsidiaries were to remain part of the consolidated CL group, the group would need an additional capital increase of at least FF 9 billion to meet the auditors' demands regarding provisions. Secondly, if those subsidiaries have not been sold or liquidated by the end of 1995, all of them will be taken over by CL. The repurchase price will be set by two independent commercial banks.

With regard to the reduction in the operating subsidy, and in particular the argument that the cost of carrying the hived-off assets has to be added to the amount of losses estimated by the auditors, the Commission regards this argument as incorrect since it means that the aid would be counted twice since, according to the French authorities, this amount of losses includes any asset-carrying cost.

5.2. The French authorities' response to the reactions of third parties

The arguments put forward by third parties have been discussed with the French authorities at the regular meetings held between them and the Commission's representatives. Their comments are included in the Commission's assessment of the operation and the examination of its compatibility (points 6 and 7).

6. ASSESSMENT

6.1. Confirmation of the aid content of the financial support for CL

Since CL is a State-controlled bank, the Commission will apply the market economy investor principle in order to determine whether there is a State aid element in the financial assistance being given to the bank.

The reorganization measures taken in 1994 and continued in 1995 can be regarded as a single restructuring process which the aid granted in 1994 and 1995 is intended to support.

6.1.1. *Capital injection*

On the basis of the documents supplied, the Commission takes the view that the capital increase in May 1994 was unlikely at the time to ensure future viability. The capital increase must be regarded as having been essential for the bank's survival, since its solvency ratio had fallen below the 8 % minimum. However, the operation was not part of a [...] recovery plan for the bank.

In addition, the price of the increase seems to have been based on an overestimate of the bank's value. The French authorities have pointed out that the estimate had been certified by [...]. But there are several factors which suggest that a private investor would not have accepted that estimate as a basis for investing in CL.

Before subscribing fresh capital, a private investor would have called for a thorough study of CL's assets and accounts and for a detailed recovery plan ; but [. . .], which was not asked to review CL's main assets, made its assessment on the basis of information supplied by CL, most of it a matter of public record, and was not put in a position to verify that information fully. Moreover, the value of the net assets was estimated on the basis of the 1993 accounts, which did not appear to reflect their real values, especially in the case of the industrial portfolio and the banking assets. A private investor would also have taken the view that some assets, particularly in the industrial portfolio, whose yield was lower than the cost of financing them, would be a burden on the bank's future profits. A further reduction in the value of the net assets could therefore have been deemed necessary.

Consequently, instead of being able to count on a reasonable return on its May 1994 investment without having to provide additional financing, the State has had to consider fresh financial support for CL.

In addition, Directive 89/647/EEC requires supervisory authorities to ensure that a bank whose solvency ratio falls below 8 % takes the necessary steps to restore the proper level as rapidly as possible, by recapitalizing or by reducing its liabilities, failing which it must cease activities. But such recapitalization and liabilities-reducing exercises may constitute State aid if they do not take place on normal market terms. Thus, the solvency ratio is a constraint which was imposed because it was felt that there was a minimum level of solvency below which a bank could not function soundly. The requirement is thus one of the tests of a bank's viability and, at the same time, ensures that banks compete with one another on an equal footing.

Accordingly, the conclusion must be that a market economy investor would not have agreed, as the French Government did in May 1994, to inject capital into CL at a price of FF 774 per share without a [. . .] study of the bank's accounts and without a [. . .] restructuring plan showing that CL would return to viability within a reasonable period. On the basis of the available information, therefore, the capital increase of FF 4,9 billion must be regarded as constituting State aid.

6.1.2. *State guarantee as part of the first hive-off operation*

Moving on to the State's underwriting of FF 18,4 billion as part of the 1994 hive-off, it must be concluded that there is a State aid component here too. In opening the proceeding, the Commission had taken the view, accepted by the French Government, that such cover was necessary to the survival of CL since otherwise the provisions needed would have exhausted the bank's reserves and rendered it insolvent. Without such cover, or some other operation on the same scale, CL would have had to go into liquidation.

In addition, there is no fixed risk premium on the guarantee, although there is a 'better fortunes' clause. Even so, given the overestimate of the non-performing assets and the fact that there was no certainty that there would be a return to better fortunes, that clause had no practical value. The overestimate meant that the provisions being underwritten were insufficient, as [. . .] stated in its report on CL, so that the guarantee would very likely have been taken up. Because the cover was necessary to the survival of CL and no return was expected, the aid component in the guarantee is practically equal to the cover extended.

In addition, it should be noted that this operation took place some three years after the change in the economic situation in this sector. During that period, CL had made [. . .] no provisions against the assets acquired, which nonetheless continued to increase, while a number of experts estimated that provisions should have been made against a [. . .] proportion of the property loans.

The Commission had also rejected the argument put forward by the French Government that such cover did not constitute State aid because it had been provided by shareholders at the request of the Commission Bancaire and formed part of a hiving-off mechanism which has also been used by other French banks. Indeed, there are other special features which distinguish CL's case from that of other French banks which have adopted similar hiving-off mechanisms. First, CL made no significant losses on the nominal value of the assets transferred to OIG, because the State had underwritten the risks of the new vehicle by virtue of the transfer of the assets at their net book value, and the provisions made by CL were almost negligible in relation to the nominal value of the assets.

It would also seem, from the information received, that, among such hiving-off mechanisms, CL's special vehicle OIG is the only one whose risks are underwritten by the

State. That cover enabled CL to keep those liabilities in its books in 1994 without needing to make additional provisions or reconstitute its own funds, as required by the rules on the solvency of credit institutions. The other French banks do not seem to have been given the same advantage : they had to set up special companies outside the scope of their consolidated accounts and the risks were covered through their own financial holding companies and not by their ultimate shareholders.

The payment of FF 4 billion to CL for servicing the loan made to the special vehicle seems peculiar to the mechanism in CL's case. Payment of this carrying cost clearly has to be considered State aid additional to the aid constituted by the cover itself.

It must be concluded, therefore, that there is substantial State aid in the hiving-off mechanism, and particularly in the State's underwriting of the risks attaching to the assets transferred and of the loan-servicing costs.

6.1.3. *Second hive-off operation*

In 1995, under the second rescue plan, the hiving-off mechanism was adapted in order to allow for further potential losses that would have exceeded CL's original own funds. The French authorities have stated that the arrangement envisaged was carried out at the request of the Commission Bancaire and is the only one which would satisfy the many constraints imposed on a recovery plan : the protection of depositors, compliance with the provisions of banking, commercial and stock-exchange law, minimization of the cost of the plan to the taxpayer, avoidance of any distortion of competition ; and the protection of the property of the State and of the minority shareholders.

They have also stated that the cost to the State of any alternative solution would be far higher, that complete State cover for the assets transferred is necessary if they are to be removed from CL's consolidated accounts and those accounts certified, and that the 'better fortunes' clause, together with the proceeds of asset sales, the zero-coupon bonds and the privatization of the bank, will meet the cost of the State cover provided, including the interest payable on the CL loan to SPBI.

The Commission, though, takes the view that the hiving-off mechanism, and in particular the cover of the risks and costs of the mechanism extended by the State, constitutes State aid. That it is State aid can be deduced from the fact that it is necessary to CL's survival, that its duration is unusually long, that the degree of risk is very high, and that no adequate return for the cover can be expected since it is subject to wide variations which CL is unable to meet.

On the basis of the available information, the Commission takes the view that there is no reason to believe that the total foreseeable cost of this mechanism to the French State is any lower than the cost to the State as a shareholder in the event of a supervised liquidation or any other solution involving sale or restructuring, bearing in mind the possible constraints imposed by national or Community rules governing the various possible scenarios. Those rules may mean that the costs of a liquidation are higher in the banking sector than in industry.

In addition, there are grounds for concluding that the cost to the State would have been much lower if it had acted earlier. If the State had intervened to restrict CL's excessive growth, it would also have limited the risks to which CL was exposed, buoyed up by the substantial support provided by its shareholder, and hence reduced the final cost of rescuing CL.

It should be recalled here that CL's aggressive policy, which was not properly supervised, and the poor quality of its assets, had already prompted Moody's credit rating agency to reduce the bank's credit rating in 1991 to two points below the maximum. However, the credit rating still remained above the actual quality of CL's portfolio, since it received preferential treatment in the form of the guarantee provided by the State, which was the bank's principal shareholder.

Moreover, a number of elements had already alerted the French authorities at the start of 1992 : the reversal in the economy, with its clear effects on CL's assets in the property and industrial sectors ; the fragile position of CLBN, in particular because of its involvement with CL in the MGM affair ; the consequences of stakes in loss-making publicly-owned companies such as Usinor-Sacilor ; and the poor operations revealed by the Commission Bancaire's initial enquiries into a number of subsidiaries in the group, such as Altus.

Despite this, CL continued its [...] expansionist policy. The balance-sheet total rose from FF 1 600 billion (end of 1991) to almost FF 2 000 billion (end of 1993), an

increase of 25 % in two years ; half of this was accounted for by the takeover of BfG in Germany in December 1992. At the same time, CL strengthened its presence in America, Asia and Africa ; the industrial and commercial portfolio, which was almost FF 38 billion at the end of 1991, was to reach some FF 50 billion by the end of 1993 (+30 %). It is clear, therefore, that closer supervision of CL's expansion would have limited the recovery costs. Accordingly, the rescue plan is late.

It should be noted that the French authorities have not presented an alternative solution in the form of supervised liquidation or sale in blocks, or an assessment of the costs. If such a solution had been adopted, and even if its costs had been close to those of the rescue plan selected, it is clear that this solution would have had a significantly less distortive effect on competition. Thus, applying the principle of proportionality, this solution should have been chosen.

[...]

Although the reasons which prompted the French authorities to opt for a rescue plan accompanied by substantial State financial support are understandable, that does not mean that the significant adverse effects of such a solution on competition may be ignored. Such effects require a substantial *quid pro quo.*

Lastly, it must be seen as very probable that the cost to the State of the rescue operation would have been lower if a detailed and comprehensive analysis, including an appropriate rescue plan, had been prepared when the State first took action, or even before.

To sum up, the Commission takes the view that, on the basis of the information available, the capital increase, the different aspects of the CDR/SPBI mechanism and the State's underwriting of the assets transferred include substantial elements of State aid.

6.2. Assessment of the business plan

CL's business plan seems to tackle the bank's fundamental problems and enable CL to return to viability. However, a number of points need clarification.

First, given that the rescue package for CL enables it to restore its solvency ratio to 8,3 % while keeping to a minimum the amount paid by the State at present, it is reasonable to conclude that the aid is not significantly higher than the strict minimum which is currently necessary. Nonetheless, a substantial *quid pro quo* is also needed to ensure that CL is not reconstituted as before, that it bears a significant proportion of the restructuring costs and that it provides appropriate compensation to competitors to offset the distortion of competition caused by the aid.

According to the information provided by the French authorities concerning future movements in CL's own funds, the restructuring plan allows CL to become viable again with an adequate solvency ratio. With a rate of increase in the group's own funds (18 % in five years) above the rate of growth of the weighted assets (4,6 %), the solvency ratio will improve.

It is relatively easy to estimate the movement in the solvency ratio and its value at the end of the restructuring period on the basis of CL's estimates of the growth of its weighted assets and of the group's own funds, and making the particularly prudent assumption that residual own funds (minority interests and supplementary own funds) will remain constant at 1994 levels (almost FF 50 billion). This exercise shows that the solvency ratio will remain above the statutory minimum during the entire recovery period (table 4).

Table 4

Analysis of CL's solvency ratio

(in billion FF)

	1994	1995	1996	1997	1998	1999
Weighted assets (b)	974	970	1 006	1 019	1 019	1 019
Total own funds (1) (a), of which :	81,0	81,4	82,3	83,6	85,5	86,6
— original, of which :	[...]	[...]	[...]	[...]	[...]	[...]
— group share (2)	[...]	[...]	[...]	[...]	[...]	[...]
— supplementary	[...]	[...]	[...]	[...]	[...]	[...]
Solvency ratio (a/b)	8,3 %	8,4 %	8,2 %	8,2 %	8,4 %	8,5 %

(1) Total own funds are the sum of the group's share of own funds, as estimated by CL, and supplementary own funds, estimated by the Commission as constant at 1994 levels, i.e. FF 50 billion.

(2) Including the fund for general banking risks.

However, the assumptions made in the business plan seem to be somewhat optimistic. The business plan assumes that nominal and real interest rates will fall in 1995 to a low level (4,78 %) and remain stable thereafter (4,67 %). But the expected fall in interest rates has so far been rather limited. Current short-term interest rates are around 7,2 %, or 2,4 percentage points higher. In a situation where inflation remains low (1), this means high interest rates in real terms. Past experience of bank recoveries and studies carried out by the Commission Bancaire show that it is much more difficult for a bank to recover when real interest rates are high.

In particular, the studies presented by the Commission Bancaire in its annual reports reveal that, in general, there is a positive relationship between real interest rates and the minimum return that banks must obtain on average from their credit operations to reward their borrowed resources and cover the cost of intermediation (break-even point for banks).

Monetary tightening reduces demand for credit and increases competition between credit institutions, the effect of which is to reduce banking margins. In addition, the flat interest-rate curve in France (short-term rates are at almost the same level as long-term rates) penalizes market activities and increases the carrying cost of immovable assets. Lastly, the cost of funds for the weaker credit institutions increases since they have a lower credit rating, in particular for long-term borrowing (2).

Thus, the assumption that CL can catch up with, and even overtake, its competitors by the end of 1999 in terms of its operating ratio seems optimistic. That would mean CL increasing its market share. However, it seems more realistic to suppose that the efforts made during this period by its competitors to improve their productivity will prevent CL from overtaking them. Catching-up is possible when there is wastage and inefficiencies that can be eliminated, but doing better than the competition would mean assuming that CL can introduce new management systems that are more efficient and more profitable than those of its competitors and with which they are not familiar. This objective therefore seems ambitious.

In addition, the planned improvement in costs must not be overestimated. In particular, any reduction in personnel costs in France is limited by the current system of redundancies, which makes it difficult to replace older staff with younger staff who are better prepared for the introduction, spread and intensive use of computerized systems. Although redundancy programmes have been drawn up with the agreement of the trade unions to encourage voluntary redundancies of excess staff, it would seem difficult to take further steps to keep and attract more valuable staff and to improve their productivity.

Alongside [...] is the fact that [...] covering 2000-2014 [...]. The business plan forecasts annual growth of 4 % for profits after tax; with annual inflation of some 2 %, that means an automatic annual real rate of growth of 2 % for net profits, *ceteris paribus*. It is clear that this arithmetical approach is not realistic. If there is only marginal growth in the banking sector, such an assumption implies growth in CL's market share. That is unacceptable.

For all the above reasons, it therefore seems more appropriate to assume that actual profits will be stable after CL's recovery. The rate of return on own funds assumed for 1999 (12,4 %) confirms CL's return to viability, whilst the automatic increases in the following years would seem overly optimistic.

Accordingly, a more prudent estimate should be made of CL's ability to stage a recovery. Naturally, this means that the forecast revenue for the State (income from the 'better fortunes' clause, and income accruing to the State as a shareholder in the form of dividends and transfers to retained profits) must be revised downwards by a sensitivity analysis based on the assumption of a nominal rate of growth of 2 % for profit after tax for the period 2000-2014.

6.3. Quantification of the amount of State aid

It is very difficult to quantify the cost to the State of rescuing CL because it is not easy to assess the aid content of the hive-off mechanism. It is not possible to give an accurate figure for the aid content of the State guarantee of the assets transferred to the hive-off vehicle because of the difficulties in quantifying the risk attaching to the assets. Producing a meaningful estimate of the aid content of the guarantee would require detailed valuations of all the hived-off assets. Such valuations can be carried out only by professional auditors. Accordingly, the Commission wished to examine the findings of the different assessments made by a number of experts, in particular the Commission Bancaire, CL's new auditors, and the advising banks.

(1) Inflation in France is currently 1,6 %.
(2) CL's long-term credit rating remains very low: BBB+ with the American rating agency Standard and Poor's, and A3 with Moody's.

An indicative estimate of the aid content of the State guarantee can be made by first looking at the amount of own funds that CL would have needed to satisfy the solvency ratio if the risk had not been underwritten by the State. The Commission made such an estimate when it opened the proceeding. The main purpose of the State cover of the total net value of the hived-off assets is to enable CL to remove the hived-off vehicle from its consolidated accounts, thus avoiding the need to make provisions (either to write assets down to their book value or to meet carrying costs) and to increase its own funds under the rules on the solvency of credit institutions, which would have had a substantial impact on the State budget.

Using information provided by the French authorities, this method has produced a more accurate estimate of the gross amount of the operation. The amount includes FF 4,9 billion of capital increase, FF 60 billion in provisions (1), and some FF 4 billion relating to the mechanical effect on the own funds requirements associated with deconsolidation, making a total of almost FF 69 billion.

However, as the French authorities have stressed, the aim of the mechanism is to avoid CL having to record these losses now and to defer them for several years, hence enabling them to be offset by the different elements of the mechanism. The French authorities state that the deficit arising on the waiver of claims on CDR will be offset by a 'better fortunes' clause involving levies in favour of SPBI, any capital gains on assets transferred recorded at their net value in SPBI's accounts and the proceeds from the sale of CL shares by SPBI when CL is privatized. The amount outstanding at the end of the operation in 2014 will be met out of the proceeds of the zero-coupon loan, up to a maximum of FF 35 billion.

To examine the validity of this argument, the expected return on the operation for the State as a shareholder must be compared with the costs that the State has to bear. Of course, all the nominal amounts of actual costs and expected income from the mechanism in the relatively near future, in particular the final losses and income from the 'better fortunes' clause, from the dividends and from the zero-coupon loan, must be compared correctly. That means that any future value must be discounted in the appropriate manner.

(1) See below for detail.

The reason for the Commission having to use this approach is first the French authorities' argument that the operation has a zero net final cost to the State, and secondly the estimate, submitted in the course of the proceeding by competing banks, of FF 50-62 billion for the net present value of the aid.

In addition, this method of assessing State aid was defined by the Commission in its 1993 communication (2), in which it confirmed that, in order to assess State aid, the behaviour of the State had to be compared to that of a private investor. In particular, it stated that, 'a market economy investor would normally provide equity finance if the present value (future cash flows discounted at the company's cost of capital or in-house discount rate) of expected future cash flows from the intended project (accruing to the investor by way of dividend payments and/or capital gains and adjusted for risk) exceed the new outlay.' The Commission also stated: 'This aid element consists in the cost of the investment less the value of the investment, appropriately discounted'.

In evaluating the capital injections and the expected income in the form of dividends and/or capital gains, the discount rate must be the rate that the capital markets would have used in order to assess the return on their contribution.

According to estimates made by a number of experts, including CL, the appropriate rate of return for capital invested in a bank is of the order of 12 %. The same estimate may be arrived at by looking at the average rate of return over the last four years of a sample of major international banks (3). Thus, the target rate of return on own funds set by CL is of the same order of magnitude; the expected rate in 1999, after recovery, is 12,4 %. Accordingly, the Commission takes the view that a rate of 12 % may be regarded as appropriate for calculating the present value of future income for the State.

Three elements must be taken into account in arriving at an assessment of the net cost to the State of the operation. First, it should be noted that since SPBI is a partnership owned by the State, it enjoys a full guarantee by its share-

(2) OJ No C 307, 13. 11. 1993, in particular points 35 and 37.
(3) The sample comprises 20 banks; two French, three Swiss, three German, two Dutch, four British, five American and one Japanese, and hence involves 80 observations (Source : IBCA).

holder. The aid component of the operation includes not only the losses on the participating loan in CDR but also the costs of financing SPBI.

Secondly, in the case at issue the method must be based on the fact that CL's value without the rescue plan would have been zero because its losses would have exhausted CL's own funds. Accordingly, the gross amount of the aid must include the zero-coupon loan, the income from the 'better fortunes' clause (the 'levy') and the share of profits accruing to the State as a direct and indirect shareholder (Thomson and CDC), in the form of dividends and transfers to retained profits.

Lastly, it should be noted that the actual net financial contributions made by CL to the CDR/SPBI mechanism under the 'better fortunes' clause must be reduced by the tax revenue foregone by the State in order to enable CL to contribute to the costs of the operation. Since the clause is a levy on profits before French taxation, the State will forfeit the taxes normally due to it as the collector of taxes.

Accordingly, the aid comprises the following elements:

(i) the capital injection;

(ii) the waiver of the claim on CDR under the participating loan of FF 135 billion granted by SPBI and guaranteed by the State, after taking into account any income, the asset-carrying costs and the costs of restructuring the assets;

(iii) the net cost of carrying other hived-off assets, i.e. the difference between the cost to SPBI of the loan granted by CL and the income for SPBI from the participating loan granted to CDR.

The following costs should also be included:

(iv) the discounted future income from the zero-coupon bond;

(v) the discounted future income from the 'better fortunes' clause and the share of profits expected to accrue to the State directly and indirectly (Thomson and CDC), reduced by the tax revenue foregone by the State because of the clause.

The capital injection of FF 4,9 billion was completed in July 1994; the present value of the injection is FF 5,2 billion.

With regard to item (ii), it should be noted that the maximum loss incurred by SPBI on CDR cannot exceed the amount of the participating loan, unless SPBI makes further loans to CDR [1]. A number of elements should, in principle, be taken into account to estimate this loss: the current unrealized losses on these assets, their carrying cost or cost of disposal, sales proceeds, the probability of the guarantees being taken up, and market trends. Such an estimate is particularly difficult because of the nature of the assets and the volatility of market conditions.

To simplify matters, the hived-off assets can be separated into two groups, the first composed of assets that are unprofitable or not very profitable and on which it is reasonable to assume that all the provisions to be made were concentrated, the second comprising more profitable assets. With regard to the first group, the French authorities had initially stated that the foreseeable loss was equal to the estimates of the need for provisions made with the assistance of the auditors, i.e. about FF 50 billion. After looking at the findings of the various analyses carried out by the French authorities with the cooperation of the auditors, the Commission Bancaire and the advising banks, the Commission concluded that to this amount had to be added CL's provisions for the first quarter of 1994 and the carrying costs for the 1994 financial year, which were also transferred to CDR; in total these amount to approximately FF 9,8 billion.

The cost of financing the more profitable assets (iii) should be added to this amount; the carrying cost of these assets is borne by SPBI, which is financed by CL. The interest rate on the loan granted by CL is 7 % for 1995 and thereafter 85 % of the money-market rate. Assuming that all the assets are sold within five years at a steady rate [2], and if the money-market rate is a constant 4,7 % (the rate used by CL to prepare the business plan), this cost may be estimated at some FF 11 billion (present value).

[1] The French authorities have stated that the additional credit line of up to FF 10 billion was envisaged only as a precautionary measure and could not be established before 1 January 1998. On that date, the partial repayments already made by SPBI mean that the total amount used should, in any event, remain below the initial amount of FF 135 billion.

[2] In fact, the plan is to sell 80 % of the assets within five years. However, the difference for the purposes of the calculation below is only marginal.

Table 5

Cost to SPBI of the loan from CL to finance the hived-off assets (1)

(in billion FF)

	1995	1996	1997	1998	1999	Total
Amount of assets to be financed	[...]	[...]	[...]	[...]	[...]	[...]
Nominal cost of loan	[...]	[...]	[...]	[...]	[...]	[...]
Present value of nominal cost	[...]	[...]	[...]	[...]	[...]	[...]

(1) The rate used for the present value calculation is the rate used to calculate CL's contribution through the zero coupon (7,8 %). It is assumed that all the assets will be sold within five years at a steady rate.

The income from the most profitable assets should be deducted from this amount. The French authorities estimate the nominal value of this income at some FF 5,2 billion, or FF 4,1 billion in present value. Accordingly, the net carrying cost of the other hived-off assets may be estimated at approximately FF 7 billion.

These total costs to the State (some FF 72 billion) must be deducted from the income accruing to the State from the zero coupon (iv), from the 'better fortunes' clause and the income accruing to the State as a shareholder in the form of dividends and transfers to retained profits (v).

The zero coupon of FF 10 billion (iv) should produce proceeds of FF 35 billion in twenty years, implying a rate of interest of 7,8 %. Thus, the present value of those proceeds, discounted at the same rate, is some FF 8 billion (value at 1 January 1995).

Of course, in order to estimate the extent of CL's contribution to the financing of the mechanism, all the revenue expected for the State on the basis of the recovery plan should be taken into account, i.e. all types of profits, whether in the form of a levy for the hiving-off vehicle under the 'better fortunes' clause or whether available after tax for the State as a shareholder, which are paid as dividends or taken to reserves (v). It should be noted that by also deducting from the cost of the operation the present value of future normal dividends (paid out or retained) that the State will receive directly or indirectly (Thomson and CDC), account is taken of the value of any privatization or, in the absence of privatization, of the present value of CL after restructuring, using the net present value of future cash flows.

Through the 'better fortunes' clause, the State as a shareholder must be regarded as losing the dividends to which it would normally be entitled as a direct and indirect shareholder in CL (with 71 % of the share capital (1)) and as the tax collector. That is why CL's net contribution to the costs of the hiving-off mechanism is limited. Without the clause, the State would have received some 35 % of the profits in the form of taxation and 71 % of the amount available to shareholders (81 % of the profits), whereas, with the clause, it immediately receives some 47 % of the profits (2) and, in total, 90 % of the profits. At the same time, however, it loses some of the French taxes (approximately one sixth of the amount receivable under the clause) that it would otherwise have received. The surplus for the State arising from the clause is therefore 9 % of the profits, i.e. some FF 3 billion over twenty years (present value).

It is therefore clear that what the State gains on the one hand from the clause it loses on the other in taxation and normal dividends, except for that portion of the levy under the clause that the State raises [...]. However, the clause is an obligation producing a restraining effect on CL, all the more so since the levy under the clause is made before provisions for the fund for general banking risks.

Under the business plan, the present value of the levy under the 'better fortunes' clause and the present value of profits accruing to the State as a shareholder are estimated at FF 18 billion and FF 12 billion respectively.

However, the Commission takes the view that the business plan is based on somewhat optimistic assumptions (see point 6.2). The money-market rate is currently much higher than the rate used in the estimates in the business plan for 1995. Analysis of previous cases of bank recoveries and studies of banks' break-even points suggest that the recovery of a bank is often more difficult against a background of low inflation and high real interest rates than vice-versa. In addition, it would seem unlikely that CL will be able to reduce its overheads so quickly (18 %

(1) Since Groupe Thomson is controlled by the State, which holds some 50 % of the shares.

(2) Average rate adjusted to forecast profits in the business plan of percentages of 34 % and 60 %.

in four years), although this reduction is necessary if CL is to catch up its competitors. Lastly, it should also be noted that the model in the business plan from 2000-2014 is based on an assumption of automatic growth of profits after tax of 4 % per annum, which does not seem either realistic [. . .].

For all these reasons, therefore, it seems more logical to assume that actual profits will stabilize after CL's recovery. The rate of return on own funds assumed for 1999 (12,4 %) confirms CL's return to viability, whilst the automatic increase assumed in subsequent years seems too optimistic. This means that the income from the 'better fortunes' clause and the revenue accruing to the State as a shareholder in terms of dividends or retained profits must be revised downwards. A sensitivity analysis based on the assumption of nominal growth of profits after taxation of 2 % gives an estimate for these two components of FF 15 billion and FF 10 billion respectively.

However, this estimate cannot be regarded as definitive because the State loses part of its normal tax take because of the clause. Account must be taken of this effect when calculating the cost of the State intervention since the intervention is justified by the possibility of benefiting from a return to better fortunes. Even though this tax concession is applicable to private and public investors alike, it applies only to firms in difficulty. In principle, therefore, such a concession constitutes State aid.

As mentioned above, the levy under the clause is applied before French taxes. Given that CL's tax losses have been deferred for five years and that almost half CL's revenue is generated abroad, the shortfall of taxation can be estimated at 17,5 % of the present value of income from the clause from 2000 to 2014, or FF 2 billion. This amount must be deducted from the present value of the clause. Accordingly, a more accurate estimate of the value of the 'better fortunes' clause is FF 13 billion.

Table 6

Gross income from the CL recovery operation accruing to the State for the period 1995-2014 (1)

(in billion FF)

	'Better fortunes' clause	State share of profits
Optimistic assumption in business plan		
Nominal value	67	38
Present value	18	12
Moderate assumption used		
Nominal value	51	33
Present value	15	10
Moderate assumption corrected for tax effects		
Present value	13	10

(1) An internal rate of return of 12 % was used to calculate the present value of future profits.

To sum up, the estimates of the different components of the operation to rescue CL are set out below:

(i) capital injection with a present value of FF 5,2 billion;

(ii) waiver of claim by SPBI on CDR under the participating loan; maximum amount FF 135 billion and estimated at FF 60 billion, after taking account of the income and carrying costs and restructuring costs of unprofitable assets and assets with low profitability;

(iii) the net carrying cost of other hived-off assets, FF 7 billion, i.e. the difference between the cost to SPBI of the loan granted by CL (FF 11 billion) and the income for SPBI from the participating loan granted to CDR (FF 4 billion).

The following costs of the mechanism should be taken into account:

(iv) present value of future income from the zero-coupon bond, some FF 8 billion;

(v) total value of future income received by the State under the 'better fortunes' clause and in its capacity

as a shareholder, corrected by the sensitivity analysis: estimated at FF 23 billion.

The balance of some FF 41 billion is the present-value estimate of the net cost of the mechanism to the State, and on which the Commission has based its examination of whether the aid is compatible with the common market. However, given the high degree of uncertainty concerning certain aspects of the plan, in particular with regard to CDR's losses and SPBI's future income, a margin of error of ± 10 % on the above costs (FF 36 billion excluding the capital injection) must be assumed. Accordingly, the estimate of the maximum net cost of the State intervention is FF 45 billion.

6.4. Other elements of assessment

The Commission notes the statement by the French authorities that it will be possible to consider privatizing CL only once the bank has recovered. Under the business plan presented by the French authorities, CL returns to viability in 1999. The Commission takes the view that the business plan is sufficiently realistic and achievable, at least until 2000. Accordingly, it also takes the view that privatization could take place after 1999.

On the basis of the information received from the French authorities, the Commission considers that the question of the role of Thomson SIEG and of CDC in the operation to support CL is not relevant to the questions that the Commission has to examine.

6.5. Distortion of trade between Member States

The liberalization of financial services and the integration of financial markets are making intra-Community trade more and more sensitive to distortions of competition.

Aid to an international bank such as CL, which provides loans and other forms of financing to firms that are in competition with one another on international markets and offers financial services in competition with other European credit institutions, while at the same time expanding its activities abroad through a network of branches outside France, is clearly liable to have a distorting effect on intra-Community trade. In particular, the aid in question enables CL to save and restructure a number of foreign subsidiaries, in particular in the Netherlands, Spain, Portugal and Germany, which are in competition with other Community financial institutions.

It should be noted that half of CL's assets are currently located outside France, a substantial part of which are within the Community, that the purpose of the aid to CL is, in large part, to cover sizeable losses outside France but within the Community, and that the aid in question will enable CL to remain on the market elsewhere in the Community.

It must consequently be held that the increase in capital and the State's underwriting of risks are caught by Article 92 (1) of the Treaty because they are liable to constitute State aid and to distort trade within the common market.

7. COMPATIBILITY OF THE AID

7.1. General

After evaluating the presence of State aid in the financial support measures for CL, it must now be examined whether the aid is compatible with the common market under Article 92 (2) and (3) of the Treaty.

It must be borne in mind, first of all, that this is not aid with a social character granted to individual consumers, nor aid to facilitate the development of certain regions of France.

Half of CL's assets, and therefore probably the same proportion of its activities, are located outside France. Its activities in France are spread throughout the country but are concentrated in medium-sized and large urban areas.

Nor is the aid designed to remedy a serious disturbance in the economy, since it is intended to remedy the difficulties of a single recipient, CL, rather than those of all enterprises in the sector. Furthermore, the Commission considers that CL's problems do not stem from a systemic banking crisis in France, although CL is not the only French bank in difficulty; some other banks, including public banks, are also facing difficulties. The causes of CL's losses are specific to it and appear to be connected to a large extent with the aggressive lending and investment policy the bank pursued in the second half of the 1980s, without there being sufficiently strict monitoring of risks and evaluation of assets acquired. However, although the Commission is aware of the special sensitivity of financial markets and of the possible undesirable negative consequences that the bankruptcy of a bank such as CL might have, the aid granted cannot be considered either to be of common European interest.

Consequently, only the derogation provided for in point (c) of Article 92 (3) can be considered.

As mentioned above, the compatibility of such measures with the common market has to be assessed in accordance with the special rules on aid for rescuing and restructuring firms in difficulty, with account also being taken of the effect of State intervention on the financial system in the Member State concerned. In the particular case of banking, the Commission takes the view that rescuing and restructuring aid may be compatible as long as the four conditions set out above (point 3.2) are met.

The Commission has to establish, in particular, whether the distorting effect of the State aid on competition is offset by anything solid compensation in the restructuring plan. Such a *quid pro quo* is necessary if the aid is not to be declared contrary to the common interest.

Given the colossal amount of aid involved, which is also intended to cover the losses incurred from assets acquired by CL during its period of aggressive expansion in the 1980s, CL's contribution must be both substantial and accompanied by a reduction in its commercial presence; at the same time, the need to restore and maintain CL's viability has to be met. This contribution must contain a real and substantial *quid pro quo* for the further reason that the bankruptcy solution is ruled out since it would have an undesirable and disproportionate negative impact on other credit institutions and on the financial markets. That solution would probably have been adopted in the case of any non-banking private enterprise recording such colossal losses. The competitive distortion created by the aid is therefore very marked and must be matched by a corresponding *quid pro quo*. It should be pointed out that the deficit will not be made up, even after 20 years, by the projected profits.

7.2. Questions arising from the Commission's assessment and conditions governing acceptance of the aid

7.2.1. *Separation between CL and CDR*

In the light of the amendments made by the French authorities to the mechanism for controlling CDR, as described above, the Commission considers that the danger of a conflict of interests arising will be eliminated if the committees and the team leaders are independent of CL. The teams themselves should be financially answerable to CDR. It is also necessary to ensure that the committees responsible for managing the hived-off assets are independent of CL.

As regards the profit-sharing clause introduced to encourage CL to manage the hived-off vehicle well, the Commission considers that, once a clear separation between CL and CDR has been achieved, this clause will no longer be necessary and will therefore have to be eliminated, as the French authorities have already informally accepted.

7.2.2. *Repurchase of the hived-off assets*

With regard to the possibility of CL repurchasing certain hived-off assets, the Commission considers that the amendments to the rules on the management of CDR have not solved this problem.

The Commission considers that, in permitting CL to repurchase all or part of the transferred holdings at market prices after having transferred them to CDR at their book value just because it could no longer finance them — on the grounds that it could then still maintain its favourable commercial relationships with the enterprises in question — CL would benefit from the aid twice, an outcome which cannot be defended for competition reasons.

The Commission takes the view, however, that, if CL considers it appropriate to repurchase certain assets, that possibility should not confer an undue advantage on CL. In its opinion, therefore, CL should be able to repurchase hived-off assets, to the limited extent indicated in the contract of appeal objectives, only at the price at which the assets were transferred to CDR or at the market price if that is higher than the price at which the assets were transferred to CDR.

7.2.3. *Carry-over of tax losses*

The Commission applies the principles underlying the rules on restructuring aid to the carry-over of losses for tax purposes. Those rules stipulate that any loss offset by aid cannot be carried over for tax purposes. The 1994 losses, which correspond to the capital increase of FF 4,9 billion, cannot therefore be carried over for tax purposes.

With regard to residual tax losses, the Commission is asking the French authorities to rule out the possibility of a carry-over of tax losses for CL at the time of privatization if the 'better fortunes' clause is transferred.

7.2.4. *Reduction of FF 100 billion of assets and sales in the banking network*

In order to restrict the amount of aid to what is strictly necessary and to provide an adequate *quid pro quo* without undermining CL's future viability, a significant contribution is necessary in terms of a reduction in CL's size. While it is aware of the need for confidentiality in this regard, the Commission must ensure that this reduction in CL's size is actually achieved.

The business plan provides for CL's activities to be refocused on two core areas, namely commercial banking in France and banking services for large companies and major investors of the world. CL has stated that its retail banking activities outside Europe and its ancillary banking activities outside Europe will be sold off, together with certain unprofitable retail banking subsidiaries in Europe (see point 4 (j)). The Commission notes that the following sales or liquidations have already been carried out or are to be carried out between now and 1998 :

(a) certain French subsidiaries specializing [...] (1995);

(b) CLBN (Netherlands), CLBS (Sweden), Banca Lombarda (Italy) and all the retail banking establishments in the United Kingdom (1995);

(c) other European subsidiaries;

(d) all the Latin American subsidiaries (1995);

(e) other subsidiaries in the international network outside Europe.

The sales undertaken in 1995 account for more than FF 120 billion of assets in CL's consolidated balance sheet. The French authorities have also stated that CL is planning almost FF 14 billion of securitization. However, the Commission considers that securitization is not a valid *quid pro quo* for the aid since it means that CL simply transfers the risk involved in the assets in question, while maintaining commercial links with its clients.

The Commission is not convinced that the abovementioned sales will reduce the size of CL's balance sheet to such an extent — leaving aside the simple restructuring effect — to constitute a sufficient *quid pro quo*. The sales envisaged in the business plan involve those less profitable activities which CL would have had to sell in any case, even if it had received no aid.

Given the colossal amount of aid involved and the distorting effects on competition, the Commission considers that CL should make a significant effort by making an adequate contribution to the restructuring costs and by compensating its competitors for those distortions. It should be pointed out in this connection that a number of CL's banking subsidiaries and branches abroad were acquired as a result of the aggressive policy which has been pursued by CL in recent years — only possible with State support — and which could not have been pursued by any other European bank for lack of resources. The sales envisaged in the business plan can clearly not be regarded as constituting appropriate compensation for the aid in question.

The sale of non-profitable or poorly performing subsidiaries must therefore be accompanied by the sale of profitable subsidiaries or branches, which will enable CL to finance its restructuring as far as possible through its own resources. As some subsidiaries need to be restructured before they can be sold, the sales can in principle be extended over a three-year period starting from the date of this Decision.

The French authorities have informed the Commission that, in accordance with the commitments given by the French Government [...], CL will be required to reduce its commercial capacity by cutting its business activities abroad, including the European banking network, by at least 35 % by the end of 1998.

If this objective cannot be achieved by the deadline set without major losses being incurred and without the shareholder in question having to provide further financial support, in particular to ensure that the Community solvency ratio is observed, the Commission will re-examine the possibility of perhaps extending this deadline.

CL will not be able to use the proceeds from the sale to purchase other banking networks or activities but must use them to finance the restructuring of other activities, for example [...]. CL can derive special benefit from the proceeds of selling the subsidiaries by using them to restructure loss-making subsidiaries; the return on such restructuring — in the form of the elimination of substantial losses — is especially high.

7.2.5. Privatization and transfer of the 'better fortunes' clause

In the course of the discussions between the Commission's representatives and the French authorities, the latter reaffirmed their intention to privatize CL, explaining that the privatization process would be launched once the bank's economic and financial situation had been corrected. If the business plan is observed, CL's economic and financial situation will be restored, and the bank will again become viable, within five years.

The Commission takes a favourable view of the French authority's wish to privatize CL because this will help the recovery plan to succeed and will reduce the competitive distortions. Privatization will have the effect of limiting the life of the mechanism (20 years) and therefore the uncertainty over the risks and net costs of the mechanism. It will therefore reduce the scale of the aid; such a reduction will be guaranteed if the proceeds of privatization are paid to SPBI. At the same time, privatization will limit the distorting effect of the aid which would otherwise be spread over 20 years.

Given that any amendment of the plan's clauses, particularly at the time of CL's privatization, could have the effect of altering the final cost to the State, any such amendment will have to be notified to the Commission before it is carried out in order to enable the Commission to check that those amendments are compatible with the common market. The Commission will have to be notified if privatization is delayed for more than five years. Furthermore, the transfer of the participating 'better fortunes' clause against payment will have to be carried out at the market price, which will be independently assessed.

The Commission takes the view that, even if, for the State as shareholder, the sale of CL with or without these clauses does not in principle make any difference in economic terms (apart from the effect on the minority private shareholders), given that the transfer of the clause against payment will have the effect of increasing the selling price by an amount equal to its discounted value, the consequences for competitors may be different.

A sale to the public which is coupled with an announcement that the clause is to be cancelled should normally lead to a corresponding increase in the shares to be sold by the State which fully reflects the market value of that clause.

7.3. Monitoring and supervision of the implementation of CL's recovery plan

The Commission considers that the proper implementation of the plan should be supervised, particularly as regards the slimming-down of the balance sheet, the refocusing on core activities, the rationalization of those activities and CL's contribution to the hived-off vehicle in the form of a levy or dividends. In accordance with the rules on restructuring aid, the Commission takes the view that such aid should normally be necessary only once.

The French authorities will therefore have to submit the following documents to the Commission every six months:

(a) a detailed report on the application of the plan, together with the reports submitted to Parliament;

(b) the balance sheets, profit and loss accounts, and reports of the directors of the companies involved in the hiving-off operation, namely OIG, CDR, SPBI and CL;

(c) a list of the hived-off assets that have been liquidated or sold, with details of selling prices, the names of purchasers, and the names of the banks to which selling instructions have been given;

(d) a detailed list of abandonments of CDR claims to be set against the participating loan granted by SPBI;

(e) a detailed list of the banking assets sold by CL outside the hived-off mechanism, together with an evaluation, based on objective and verifiable criteria, of the reduction in its commercial operations abroad;

(f) detailed figures for CL's contributions to the hived-off structure in the form of a levy or dividends.

Any intention to amend the plan as communicated to and approved by the Commission, particularly at the time of privatization, will have to be notified to the Commission before it is carried out.

8. CONCLUSIONS

In conclusion, the capital increase carried out in 1994, the State's underwriting of the risks and costs of the transferred assets, as amended in 1995, and the other elements of the hiving-off mechanism contain appreciable State aid components within the meaning of Article 92 (1) of the Treaty. The estimate of the discounted net cost to the State arising from the scheme is FF 5,2 billion for the capital increase and FF 36 billion for the underwriting. Given the uncertainty regarding certain aspects of the plan, a margin of variation of approximately 10 % needs to be incorporated into the value of the State intervention, leaving aside the capital increase. The maximum estimate of the discounted net cost is therefore FF 45 billion.

These measures have been carefully examined in the light of point (c) of Article 92 (3) of the Treaty to establish whether they can be regarded as being compatible with the common market. In view of the arguments set out above, the aid granted to CL would seem to meet the conditions laid down in the guidelines on aid for rescuing and restructuring firms in difficulty. Consequently, and subject to compliance with a number of conditions, some of which constitute an essential *quid pro quo* for the substantial aid if the common interest is to be met, the aid can be exempted from the ban laid down in Article 92 (1) of the EC Treaty and Article 61 (1) of the EEA Agreement since it is compatible with the common market according to the provisions of point (c) of Article 92 (3) of the EC Treaty and point (c) of Article 61 (3) of the EEA Agreement,

HAS ADOPTED THIS DECISION:

Article 1

The aid contained in the recovery plan for Crédit Lyonnais in the form of a capital increase of FF 4,9 billion, the underwriting of the risks and costs associated with the assets transferred to the hiving-off structure (up to a maximum of FF 135 billion) and tax concessions inherent in the 'better fortunes' clause, the total net cost of which

to the State, taking into account the revenue accruing to the State, is estimated at a maximum of FF 45 billion, is hereby declared to be compatible with the common market and with the EEA Agreement under point (c) of Article 92 (3) of the EC Treaty and point (c) of Article 61 (3) of the EEA Agreement.

Article 2

The aid referred to in Article 1 is authorized subject to France meeting the following conditions and commitments :

(a) it must ensure that all the recovery measures and all the arrangements provided for under the scheme described in Article 1 are implemented ;

(b) it must not amend the conditions laid down in the recovery plan, except with the Commission's prior agreement. At all events, the 'better fortunes' clause may be transferred no earlier than at the time of the privatization of Crédit Lyonnais, and only at the market price ; that price will be verified by independent assessments ;

(c) it must ensure, given the size of the estimated overall cost of the scheme to the State of FF 45 billion, that the commercial capacity of Crédit Lyonnais is reduced by means of a cut of at least 35 % in its commercial operations abroad, including its European banking network, by the end of 1998 in accordance with the commitments given by France [...]. If that objective cannot be achieved by the deadline set without causing substantial losses that require the shareholder in question to provide further financial assistance in order in particular to ensure compliance with the Community solvency ratio, the Commission undertakes to examine the possibility of extending that deadline. If the costs of the scheme, estimated at FF 45 billion, are exceeded, it will be necessary to re-examine the scale of the reduction in the commercial operations of Crédit Lyonnais as accepted by [...] ;

(d) it must prevent Crédit Lyonnais from benefiting from a carry-over of tax losses in respect of the 1994 tax loss covered by the capital increase of FF 4,9 billion ;

(e) it must prevent Crédit Lyonnais from repurchasing hived-off industrial and commercial assets, except at the price at which the assets were transferred to CDR or at the market price if that is higher than the price at which the assets were transferred to CDR, and at all events subject to an overall limit of FF 5 billion ;

(f) it must prevent Crédit Lyonnais from sharing in any of the proceeds of sales from CDR ;

(g) it must achieve a separation between CDR and Crédit Lyonnais as regards their managers, their administration and the system of monitoring and supervising the management of the hived-off assets ;

(h) it must ensure that the committees responsible for managing the hived-off assets are independent of Crédit Lyonnais ;

(i) it must eliminate any possibility of a carry-over of residual tax losses for years prior to 1995 for Crédit Lyonnais if, at the time of privatization, the 'better fortunes' clause is transferred ;

(j) it must ensure that Crédit Lyonnais uses the proceeds of sales to restructure non-performing assets and activities ;

(k) it must ensure that Crédit Lyonnais pays to SPBI the levy sums in accordance with the 'better fortunes' clause ;

(l) it must pay to SPBI the proceeds of privatizing Crédit Lyonnais, particularly those deriving from the sale of the shares currently held by SPBI, and ask Parliament to endorse payment to SPBI of the proceeds of privatizing the remaining shares.

Article 3

The Commission has taken account of the French authorities' statement that their firm objective is to privatize Crédit Lyonnais and that the anticipated recovery should enable it to be ready for privatization within five years. Any deferment of privatization beyond five years will have to be notified to the Commission.

Article 4

The French authorities must cooperate fully in monitoring compliance with this Decision and must submit the following documents to the Commission every six months as from 1 March 1995 :

(a) a detailed report on the application of the plan, together with the reports presented to Parliament ;

(b) the balance sheets, profit and loss accounts, and reports of the directors of the companies involved in the hiving-off operation, namely OIG, CDR, SPBI and Crédit Lyonnais ;

(c) a list of the hived-off assets that are liquidated or sold, with details of selling prices, the names of purchasers, and the names of the banks to which the selling instructions have been given ;

(d) a detailed list of abandonments of CDR claims to be set against the participating loan granted by SPBI ;

(e) a detailed list of the banking assets sold by Crédit Lyonnais outside the hived-off vehicle, with an evaluation, based on objective and verifiable criteria, of the reduction in its commercial operations abroad ;

(f) detailed figures for Crédit Lyonnais's contributions to the hived-off vehicle in the form of a levy or dividends.

The Commission may ask for these documents and the implementation of the plan to be assessed by means of special audits.

Article 5

This Decision is addressed to the French Republic.

Done at Brussels, 26 July 1995.

For the Commission

Karel VAN MIERT

Member of the Commission